692

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

AUGUST 10, 11, 12, 13, and 14, 1942

Volume 2

Printed for the use of the Committee on Finance

UNITED STATES
GOVERNMENT PRINTING OFFICE
76093 WASHINGTON : 1942

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CONTENTS

Statement of— Page

Adair, Herbert J., Philadelphia, Pa., executive vice president, Art-Loom Corporation ... 2111
Alexander, William C., representing Stephano Bros., Philadelphia, Pa ... 1917
Alvord, Ellsworth C., Washington, D. C., chairman, committee on Federal finance, Chamber of Commerce of the United States ... 1762
Arisman, George M., comptroller, Armstrong Cork Co., Lancaster, Pa ... 2108
Arkwright, Preston, Atlanta, Ga., president, Georgia Power Co ... 1839
Baar, Arnold R., Chicago, Ill., representing Associated State Chambers of Commerce ... 1944
Bird, Frank W., Butte, Mont., president of the Montana Power Co ... 1859
Botwinick, Benjamin, chairman, board of directors, Metropolitan Package Store Association, Inc., New York, N. Y ... 1562
Bowen, E. R., executive secretary of Cooperative League of the United States of America ... 1586
Bowman, H. E., treasurer, Boeing Aircraft Co., Seattle, Wash ... 1963
Bozell, Harold V., New York, N. Y., president, General Telephone Corporation ... 1643
Brach, Henry, representing Appel & Brach, tax consultants, New York, N. Y ... 1496
Brenchman, Fred, Washington representative, the National Grange ... 1691
Broadgate, W. C., Phoenix, Ariz., director, Arizona State Department of Mineral Resources ... 1381
Burnett, George H., treasurer, Joseph Burnett Co., Boston, Mass ... 2124
Byerly, F. B., New York, N. Y., acting chairman, committee on Federal taxation, New York State Society of Certified Public Accountants ... 2136
Caldwell, Harry B., Greensboro, N. C., master, North Carolina State Grange ... 1938
Caldwell, W. L., Birmingham, Ala., president, Alabama Rock Asphalt Co ... 1417
Callahan, Donald, Wallace, Idaho, vice president, American Mining Congress, also representing Idaho Mining Association ... 1389
Campbell, Rolla D., Huntington, W. Va., representing coal-producing members of the American Mining Congress ... 1399
Capehart, Homer E., president, Packard Manufacturing Co., Indianapolis, Ind ... 2224
Chapelle, C. C., Chicago, Ill., representing American Farm Bureau Federation ... 2047
Chapman, A. B., New York, N. Y., on behalf of Controllers Institute of America ... 2077
Compton, Wilson, Washington, D. C., representing the Lumber and Timber Products War Committee ... 1696
Connolly, John L., St. Paul, Minn., secretary and general counsel, Minnesota Mining & Manufacturing Co ... 2172
Cooper, Harry P., Indianapolis, Ind., secretary, National Association of Mutual Insurance Companies ... 1974
Cooper, Walter A. M., White Plains, N. Y., chairman, committee on Federal taxation, American Institute of Accountants ... 1596
Cowdin, J. Cheever, New York, N. Y., representing the National Association of Manufacturers ... 2057
Cox, Millard, Louisville, Ky., representing the Distilled Spirits Institute ... 1547

Statement of—Continued. Page
Cranch, Raymond G., Washington, D. C., economist, representing the American Federation of Labor 1709
Dana, Charles, Toledo, Ohio, representing Spicer Manufacturing Corporation 1990
Davis, Ralph E., Pittsburgh, Pa., representing the natural gas section of the American Gas Association 1371
Dawson, A. F., Cincinnati, Ohio, representing Cincinnati Gas & Electric Co 1887
Denson, W. A., Birmingham, Ala 2157
Despain, Donald, industrial relations counsel of Chicago, Ill 1951
Driesen, Daniel, representing American Communications Association, Congress of Industrial Organizations 2254
Easley, George A., New York, N. Y 2123
Ekern, Herman L., Chicago, Ill., representing the National Association of Mutual Insurance Companies 2025
Erickson, Edwin R., Buffalo, N. Y., pension underwriter 2134
Fell, Harold B., Ardmore, Okla., representing the production division of the petroleum industry 1323
Fisher, Irving, New Haven, Conn., professor emeritus of economics, Yale University 2163
Foreman, H. E., Washington, D. C., managing director, Associated General Contractors of America, Inc 2128
Forstall, James J., representing Mickelberrys Food Products Co., Milwaukee, Wis 2228
Freeman, Hovey T., Providence, R. I., chairman, legal committee, Associated Factory Mutual Fire Insurance Companies 2014
Garcia, Alvero M., New York, N. Y., president, Cigar Manufacturers Association of America 1427
Garrison, J. D., of Lord, Day & Lord, New York, N. Y., in behalf of Cornell-Dubilier Electric Corporation 2141
Glass, I. R., New York, N. Y., representing Tanners Council of America 1573
Goodner, George E. H., Washington, D. C., representing rock asphalt producers 1409
Gore, Hon. Thomas P., Oklahoma City, Okla., representing Mid-Continent Oil & Gas Association and Independent Petroleum Association of America 1311
Greenfield, Samuel C., representing the Teachers Union of New York City 1531
Gretz, Harry C., assistant comptroller, American Telephone & Telegraph Co., New York, N. Y 1685
Gross, Harry F., Des Moines, Iowa, representing Iowa Mutual Tornado Insurance Association 2018
Gruhn, A. V., general manager, American Mutual Alliance, Chicago, Ill 2001
Harrington, John, associate counsel, Illinois Manufacturers' Association 1919
Harris, Samuel K., Lansing, Mich 1581
Helman, N. G., Madison, Wis., general counsel, Credit Union National Association 1694
Hess, Beecher, Washington, D. C., representing Peoples Committee to Defend Life Insurance and Savings 1971
Hodes, James, New York, N. Y 1621
Holbrook, George, Wellsville, N. Y., president, New York State Oil Producers Association 1362
Hopkins, Albert L., Chicago, Ill., committee on Federal finance of the Chamber of Commerce of the United States 1751
Hurst, O. E., Lexington, Ky., chairman, legislative committee, Kentucky Mutual and Cooperative Fire Insurance Association 2018
Ingebretsen, James C., Washington representative, Los Angeles Chamber of Commerce 2252
Jacobs, Floyd E., Kansas City, Mo., counsel for American Reciprocal Insurance Association 1485
Javits, Benjamin, New York, N. Y., representing Investors Fairplay League 2117

Statement of—Continued. Page
Johnson, Arthur L., Washington, D. C., national executive and legislative secretary, General Welfare Federation of America 2247
Jones, Rowland, Jr., Washington, D. C., representing the National Association of Retail Druggists 1675
Kellogg, C. W., New York, N. Y., president, Edison Electric Institute 1873
Kelly, Ralph, executive vice president, Baldwin Locomotive Works 1985
Kent, Arthur H., San Francisco, Calif., chairman, Conference of Taxpayers on Foreign War Losses 2093
Kilgore, Hon. Harley M., a Senator from the State of West Virginia 1358
Kingsbury, F. B., New Haven, Conn., representing the American Tube Bending Co., Inc 1594
Klein, Joseph J., certified public accountant, New York, N. Y 1507
Kline, Clayton E., Topeka, Kans., representing the Kansas Power & Light Co 1862
Langley, William C., Westbury, N. Y 1629
Lanier, J. C., Greenville, N. C 1930
Laylin, Clarence D., Columbus, Ohio, general counsel and tax adviser of the Ohio Chamber of Commerce 1656
Lee, Hon. Josh, a Senator from the State of Oklahoma 1356
Lewis, Charles W., of Townsend & Lewis, New York, N. Y., counsel for Huyler's 2206
Lucas, Hon. Scott W., a Senator from the State of Illinois 1803
Matthisen, A. F., representing the Self-Locking Carton Co., Chicago, Ill 1682
May, William H., commissioner of agriculture of Kentucky, Frankfort, Ky 1901
McCarran, Hon. Pat, a Senator from the State of Nevada 1923
McCarter, Thomas N., Newark, N. J., representing Public Service Corporation of New Jersey 1851
McCobb, Edward C., representing Grand Rapids Store Equipment Co., Grand Rapids, Mich 2111
McFarland, Elden, Washington, D. C., representing the firm of Murphy, Lanier & Quinn 2232
McWain, L. J., treasurer, Universal Paper Products Co., Chicago, Ill 1982
Mohr, Arthur, attorney, Associated Operators of Los Angeles County, Inc., Los Angeles, Calif 2256
Moylan, Frank J., Omaha, Nebr., representing Nebraska Power Co 1895
Murphy, Ray, New York, N. Y., representing the Association of Casualty and Surety Executives 2050
Mylander, Charles H., vice president, Huntington National Bank, Columbus, Ohio 1995
Neely, Hon. Matthew M., Governor of the State of West Virginia 1359
Nelson, Dr. Wilbur A., Administrator, Mining Branch, War Production Board 1928
Nemzek, Theodore C., New York, N. Y., representing Aspinook Corporation 2137
Oehler, I. C., attorney, St. Paul, Minn 1988
Osgood, Roy C., Chicago, Ill., committee on Federal finance, Chamber of Commerce of the United States 1717
Parker, Lovell H., tax associate, Guy & Brookes, Washington, D. C 1463
Paul, A. Harding, Washington, D. C 2237
Pepper, Hon. Claude, a Senator from the State of Florida 1451
Ringer, Walter M., president, Foley Manufacturing Co., Minneapolis, Minn 1566
Robertson, H. M., Louisville, Ky., representing the Brown & Williamson Tobacco Co 1907
Robins, James, Merion, Pa., president, American Pulley Co 1576
Robinson, Samuel, executive director, Associated Operators of Los Angeles County, Inc., Los Angeles, Calif 2256
Schultz, Raymond H., Chicago, Ill 2213
Shorb, Paul E., Washington, D. C., committee on Federal finance of the Chamber of Commerce of the United States 1731
Snyder, Daniel W., Jefferson City, Mo., president, Missouri Power & Light Co 1616

Statement of—Continued. Page
Spitzer, A. Lewis, New York, N. Y. 1678
Stiles, James F., Jr., vice president and treasurer, Abbott Laboratories, North Chicago, Ill. 1423
Stokes, Edward L., Philadelphia, Pa. 1978
Straus, Harry H., president, Ecusta Paper Corporation, Pisgah Forest, N. C. 2178
Strong, Homer, Rochester, N. Y. 1918
Sullivan, Benjamin H., Washington, D. C., attorney at law 2105
Sutherland, William A., of Sutherland, Tuttle & Brennan, Atlanta, Ga. 1419
Swann, A. K., Evansville, Ind., in behalf of independent oil operators of Illinois, Indiana, and Kentucky 1368
Thomas, Hon. Elmer, a Senator from the State of Oklahoma 1358, 1405
Townsend, Dr. Francis E., founder, Townsend Old-Age Pension Clubs 1541
Weaver, H. R., New York, N. Y., in behalf of International Paper Co. 2119
Weil, James M., secretary-treasurer, Michaels, Stern & Co., Inc., Rochester, N. Y. 1493
Wood, George A., Brooklyn, N. Y., representing Brooklyn Trust Co. 2106
Briefs, letters, memoranda, resolutions, etc.:
Aeronautical Chamber of Commerce of America, Inc., letter on authorization of plant construction, etc. 1829
Allied Mills Corporation, Chicago, Ill., statement in regard to fiscal-year provisions of H. R. 7378 1803
Alvord, Ellsworth C., Washington, D. C., supplement to statement on technical provisions of Federal tax laws—amendments urged 1795
American Institute of Accountants, statement on technical recommendations dealing with H. R. 7378 1606
American Reciprocal Insurance Association, statement on reciprocal insurance business 1488
Anderson, C. Vivian, chairman, Peoples Committee to Defend Life Insurance and Savings, Cincinnati, Ohio, statement on deduction of life insurance premium payments from income tax 1972
Arkansas individuals and concerns voicing opposition to increase in tax on gasoline and lubricating oil, list 2317
Associated State Chambers of Commerce, Federal tax program and recommendations adopted by conference August 5, 1942 1946
Bailey, Bob, Lieutenant Governor of Arkansas, Little Rock, Ark., letter opposing tax on gasoline 2316
Barkley, Hon. Alben W., a Senator from the State of Kentucky, statistics on tobacco prices to farmers 1942
Biddle, Hon. Francis, Attorney General:
Letter to Chairman Doughton on changing name of Board of Tax Appeals 2299
Letter to Senator George on changing name of Board of Tax Appeals 2297
Letter to Secretary Morgenthau on changing name of Board of Tax Appeals 2298
Blake, Octave, New York, N. Y., president, Cornell-Dubilier Electric Corporation, brief proposing extension of time for payment of income and excess-profits taxes 2142
Bliss, D. S., Deputy Commissioner, Bureau of Internal Revenue, Treasury Department, letter concerning documentary stamp taxes on issue and transfer of matured and paid-up shares of cooperative banks 1800
Brewster & Steiwer, attorneys, Washington, D. C., memorandum proposing amendment permitting additional time for credit against Federal unemployment taxes 1706
Brown, Ray C., Tampa, Fla., attorney and representative for Cigar Manufacturers Association of Tampa, letter with reference to tax on cigars 1460
Bucher, G. H., president, Westinghouse Electric & Manufacturing Co., Pittsburgh, Pa., letter on pension trusts 1821
Bureau of Internal Revenue, Regulations 103—Income tax 1353

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Bushfield, Harlan J., Pierre, S. Dak., Governor of the State of South Dakota, letter opposing proposed increase in tax on gasoline and lubricating oil 2324
Byrd, Hon. Harry F., a Senator from the State of Virginia, memorandum on smoking tobacco Federal excise tax 1969
Calamia, Eric, president, Retail Tobacco Dealers of America, Inc., brief protesting the proposed taxes on cigars 1441
Caraway, Hon. Hattie, a Senator from the State of Arkansas, statement on effect of the proposed gasoline tax increase upon the precarious financial position of Arkansas 2286
Cavanaugh, Leo R., district manager, Automobile Legal Association, and others from the State of Rhode Island, letters opposing additional tax on gasoline and lubricating oil 2323
Chamber of Commerce of the United States, statement by Ellsworth C. Alvord on the revenue bill of 1942, H. R. 7378 1785
Chindgren, H. H., president, Oregon Fairs Association, letter on pari-mutuel betting 2198
Cigar Makers International Union of America, memorandum in the matter of proposed increase in cigar excise taxes 1461
Cigar Manufacturers Association of America, memorandum on proposed increase in excise taxes on cigars 1428
Cigar tobacco growers and dealers, petitions and resolutions opposing tax on cigars 1437
Cilento, Sol, secretary-treasurer, Distillery, Rectifying, and Wine Workers' International Union of America (American Federation of Labor), statement opposing proposed increased tax on distilled spirits 1554
Civil Aeronautics Administration, letter by Mr. Phillips Moore, on use of natural rock asphalt 1409
Cobb, Zach Lamar, Los Angeles, Calif., attorney on behalf of Community Property Committees of Idaho, Nevada, and New Mexico, memorandum in behalf of community taxpayers 2260
Colborn, I. L., Cassopolis, Mich., secretary, Michigan Beverage Retailers Association, memorandum proposing a consumers tax 1556
Comer, Donald, chairman of the board, Avondale Mills, Sylacauga, Ala., letter urging tax on income 1992
Commerce Photo-Print Corporation, New York, N. Y., letter objecting to increase in rate of tax on photographic paper 1818
Connally, Hon. Tom, a Senator from the State of Texas, memorandum in behalf of community taxpayers 2260
Controllers Institute of America, recommendations of, relative to revenue bill of 1942 2081
Deuel, J. J., Berkeley, Calif., director, law and utilities department, California Farm Bureau Federation, letter opposing tax on freight and express charges 2342
Distillery, Rectifying, and Wine Workers' International Union of America (American Federation of Labor), statement opposing proposed increased tax on distilled spirits 1554
Donworth, George, Seattle, Wash., attorney for Taxpayers' Committee in the State of Washington, memorandum in behalf of community taxpayers 2260
Dow, Hiram, Roswell, N. Mex., letter on percentage depletion allowance 1355
Drefs, Arthur G., vice president, McQuay-Norris Manufacturing Co., St. Louis, Mo., brief on general provisions of revenue bill of 1942 2285
Dresser, Robert B., of Edwards & Angell, Providence, R. I., brief in regard to capital gains tax 2280
Duff, W. H., Chicago, Ill., statement in connection with public utility taxation 2351
Dunbar, Charles E., Jr., New Orleans, La., attorney for Louisiana Community Property Taxpayers' Committee, memorandum in behalf of community taxpayers 2260
Eberstadt, F., chairman, Army and Navy Munitions Board, letter recommending depletion allowance for lumber industry 2279

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Edison Electric Institute, New York, N. Y., letter supplying information on number of electric utility security holders 1886
Ehrman, Sidney M., chairman, State-wide tax committee, California State Chamber of Commerce, statement on revenue bill of 1942 2269
Elliott, Hon. A. J., a Representative in Congress from the State of California, letter noting objections to tax on transportation charges 2342
Everett, Frederic E., Concord, N. H., commissioner, Highway Department of the State of New Hampshire, letter opposing proposed increase in tax on gasoline 2323
Flore, Edward T., New York, N. Y., general president, Hotel and Restaurant Employees International Alliance and Bartenders International League of America (American Federation of Labor), statement opposing proposed increased tax on distilled spirits 1555
Fontenot, Rufus W., Baton Rouge, La., collector, Department of Revenue of the State of Louisiana, letter opposing proposal to increase tax on gasoline and lubricating oil 2319
Ford, Sam C., Governor of Montana, and others, telegrams opposing increase in tax on gasoline and lubricating oil 2320
Fowler, Edgar F., executive vice president, American Association of Personal Finance Companies, memorandum re amendment to section 501 (b) of the Internal Revenue Code 2340
Freiberg, L. A., brief on behalf of the National Hairdressers & Cosmetologists Association, Inc., in the matter of proposed amendments to section 2402 (b) of the Internal Revenue Code 2143
General Depletion Committee for the Petroleum Industry, letter naming witnesses and giving a list of members of the committee 1309
General Welfare Federation of America, proposal for gross profit or "value added" tax 2250
Gibbons, George C., executive vice president, Texas Mid-Continent Oil & Gas Association, statement on subject of the depletion allowance 1376
Gresham, T. D., Washington, D. C., letter on surtax on "undistributed profits" 2343
Guffey, Hon. Joseph F., a Senator from the State of Pennsylvania, list of persons and organizations in favor of 27½-percent depletion allowance 1943
Gurney, Hon. Chan, a Senator from the State of South Dakota, letter transmitting statement of Kenneth Kellar 1819
Harnischfeger Corporation, Milwaukee, Wis., statement on tax problems of heavy-machinery manufacturers 2241
Harper Ford C., general manager, Chamber of Commerce of the State of Oklahoma, memorandum with respect to H. R. 7378 1830
Harrison, James S., Milwaukee, Wis., letter urging tax on reclaimed lubricating oil 2329
Hatch, James P., New York, N. Y., attorney for Paul J. Christoph Co., statement on foreign corporation tax 1978
Hendrickson, Roy F., Administrator, Agricultural Marketing Administration, United States Department of Agriculture, letter opposing 5-percent tax on transportation charges 2341
Hotel and Restaurant Employees International Alliance and Bartenders International League of America (American Federation of Labor), statement opposing proposed increased tax on distilled spirits 1555
Hull, Hon. Cordell, Secretary of State:
Letter opposing increase in tax on cigars 1462
Letters in connection with the proposed tax on imported bitters 1811
Hurley, Frank C., Birmingham, Ala., vice chairman, Alabama Highway Users Conference, letter opposing increase in tax on gasoline 2316
Hushing, W. C., chairman, national legislative committee, American Federation of Labor, brief on taxation of radio broadcasting 2154
Illinois Chamber of Commerce:
Resolution in re life-insurance premiums 1950
Resolution urging recognition of inventory reserves in computation of taxable income 1951

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Illinois Manufacturers' Association, suggestions and recommendations of the Federal tax committee of the association in connection with H. R. 7378 1920
Ingebretson, James C., Los Angeles, Calif., attorney and Washington representative, Los Angeles Chamber of Commerce, memorandum in behalf of community taxpayers 2260
Interstate Oil Compact Commission, resolution on percentage depletion allowance and right to charge to expense intangible development costs 1355
Jackson, J. P., Dallas, Tex., statement on estate- and gift-tax laws 2263
James, Richard T., Indianapolis, Ind., auditor of the State of Indiana, letter opposing increase in tax on gasoline 2319
Johnson, Hon. Hiram W., a Senator from the State of California, letter 2152
Jones, Roy B., Wichita Falls, Tex., president, Panhandle Refining Co., letter urging tax on reclaimed lubricating oil 2327
Jouett, John H., president, Aeronautical Chamber of Commerce of America, Inc., Washington, D. C., letter on amortization of plant constructions, etc 1829
Joyce, William B., New York, N. Y., letter on taxation of stock insurance companies 2016
Kansas Independent Oil Producers, resolution on percentage depletion allowance 1361
Kellar, Kenneth C., Lead, S. Dak., statement on percentage depletion for mines 1819
Keller, Joseph E., Washington, D. C., on behalf of National Petroleum Association, Pennsylvania Grade Crude Oil Association, Western Petroleum Refiners Association, and American Petroleum Industries Committee, statement opposing increase in tax on lubricating oil 2308
Kendig, C. M., president, American Jeweled Watch Manufacturers' Association of the United States 2201
Kennedy, G. Donald, president, American Association of State Highway Officials, brief in opposition to increase in Federal excise tax on gasoline 2289
Kern, Paul J., New York, N. Y., statement for committee on national taxation, National Lawyers Guild 2200
Keyser, Caldwell R., Milwaukee, Wis., credit manager, Cudahy Bros. Co., a four-point tax plan 1822
Klepinger, Robert F., Washington, D. C., letter opposing proposed change in name of Board of Tax Appeals 2300
Kolodny, Joseph, executive secretary, National Association of Tobacco Distributors, memorandum on proposed increases in cigar taxes 1442
La Follette, Hon. Robert M., a Senator from the State of Wisconsin, statement of a shipbuilding company 2191
Law, John, general counsel, National Alcoholic Beverage Control Association, Chicago, Ill., brief opposing proposed increase of tax on distilled spirits 1559
Law Notes, article opposing proposed change in name of Board of Tax Appeals 2301
Locke, Herbert E., Augusta, Maine, statement that income from involuntary conversions should have same status as income from voluntary sale or exchange, not subjected to excess-profits tax or declared value excess-profits tax 1564
Los Angeles Chamber of Commerce, recommendations with respect to H. R. 7378 2253
Lourie, Harry L., Washington, D. C., executive vice president, National Association of Alcoholic Beverage Importers, Inc., letter opposing proposed increase of tax on distilled spirits 1560
Lucas, Hon. Scott W., a Senator from the State of Illinois, list of firms and individuals opposing fiscal-year provisions of H. R. 7378 1804
Luhrsen, J. G., Washington, D. C., executive secretary-treasurer, Railway Labor Executives' Association, letter on revenue revision of 1942 1579
Maguire, Walter N., Stamford, Conn., memorandum on renegotiation of war contracts 2193

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Massachusetts Co-Operative Banks, statement on Federal documentary stamp tax ... 1808
McClure, John E., Philadelphia, Pa., counsel for the Reading Co., brief on deductions for bad debts ... 1585
McCurry, John J., legislative representative, International Brotherhood of Electrical Workers, American Federation of Labor, statement on radio broadcasting tax ... 2277
McKellar, Hon. Kenneth, a Senator from the State of Tennessee, letter opposing increased tax on gasoline and lubricating oil ... 2327
Michigan Oil and Gas Association, statement on percentage depletion allowance ... 1379
Miles, C. O., of C. W. McNear & Co., Chicago, Ill., statement submitting proposed amendment to section 23 of the Internal Revenue Code (relating to deductions from gross income) ... 2337
Miles, F. L., Charleston, W. Va., executive secretary, West Virginia Farm Bureau, telegram opposing proposed increase in tax on gasoline ... 2328
Miller, Martin H., Washington, D. C., national legislative representative, Brotherhood of Railroad Trainmen, statement on the 1942 Revenue Act ... 2153
Montague, Joseph G., Fort Worth, Tex., general counsel, Texas and Southwestern Cattle Raisers' Association, memorandum in behalf of community taxpayers ... 2260
Montana State officials opposed to increase in tax on gasoline, list ... 2320
Montana State Oil Conservation Board, telegram re percentage depletion allowance ... 1378
Munson, G. Kibby, Washington, D. C., attorney, brief on behalf of Virginia Blue Ridge Railway, in re deductions for bad debts ... 2145
Murdock, J. Edgar, Chairman, United States Board of Tax Appeals, letter on changing name of Board of Tax Appeals ... 2304
Ogg, J. S., comptroller, Lipe-Rollway Corporation, Syracuse, N. Y., letter and statement on tax liability ... 1827
Ohio Chamber of Commerce, statement urging freezing of social security taxes at present rate ... 1663
Oil Weekly, March 2, 1942, article entitled "O. P. A. Says 19,300 Wells Will Meet 1942 Requirements" ... 1345
Oklahoma State Chamber of Commerce, memorandum with respect to House bill 7378 ... 1830
Nash, Al, legislative representative, United Automobile, Aircraft & Agricultural Implement Workers of America, Congress of Industrial Organizations, Aircraft Local 365, statement on the 1942 revenue bill ... 2348
National Alcoholic Beverage Control Association, brief opposing proposed increase of tax on distilled spirits ... 1559
National Association of Alcoholic Beverage Importers, Inc., letter opposing proposed increase in tax on distilled spirits ... 1560
National Association of Manufacturers:
Memorandum on pension trusts, stock bonus, and profit-sharing plans—analysis of provisions of H. R. 7378, with suggested revisions ... 1835
War financing recommendations ... 2068
National Association of Retail Druggists, statement on the 1942 revenue bill ... 1676
National Catholic Welfare Conference, letter opposing tax on religious and charitable organizations ... 1806
National Retail Liquor Package Stores Association, memorandum opposing proposed tax on liquor ... 1553
Northern Illinois Retailers Association, resolution opposing proposal to increase tax on gasoline ... 2319
Page, Frank C., New York, N. Y., vice president, International Telephone & Telegraph Corporation, letter and statement on special tax regime for corporations developing inter-American business ... 2273
Palin, Willard P., arguments against the taxing of the reclaiming of used oil ... 2296

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Pennsylvania Manufacturing Co., Jenkintown, Pa., brief by Early Lyman Gilbert on renegotiation of contracts 2357
Petroleum Industry War Council, report of committee to study ways and means of increasing crude oil reserves and preventing the premature abandonment of small wells 1334
Pink, Louis H., memorandum filed with House Ways and Means Committee in 1936 hearings on the undistributed surplus tax 2049
Polk, James K., of Whitman, Ransom, Coulson & Goetz, New York, N. Y., memorandum on taxation of mutual insurance companies other than life 2329
Provis, B. M., Chicago, Ill., president, Gasoline Retailers' Association of Metropolitan Chicago, statement opposing increase in tax on gasoline 2318
Public Roads Administration, letter by Mr. Thomas H. MacDonald, on use of natural rock asphalt 1409
Railway Labor Executives' Association, letter on revenue revision of 1942 1579
Ralls, Robert Blount, New York, N. Y., statement on effect upon invested capital of deficit corporations after reorganization 2350
Reading Co., Philadelphia, Pa., brief on deductions for bad debts 1585
Ready, Right Rev. Msgr. Michael J., general secretary, National Catholic Welfare Conference, letter opposing tax on religious and charitable organizations 1806
Reed, W. T., of Larus & Bro. Co., Richmond, Va., telegram recommending adoption of cigarette tax differential 1971
Regan, Joseph, president, National Retail Liquor Package Stores Association, memorandum opposing proposed increased tax on liquor 1553
Rhode Island individuals and organizations opposed to proposed increase in Federal tax on gasoline 2324
Roberts, David, Jr., president, Brilliant Coal Co., Birmingham, Ala., statement on excess-profits tax 2360
Robertson, Jeff A., Topeka, Kans., chairman, State Corporation Commission of Kansas, telegram urging retention of depletion allowance 1973
Rudick, Harry J., New York, N. Y., memorandum by committee on taxation, Association of the Bar of the City of New York, with respect to H. R. 7378 2345
Sandblast, L. B., Portland, Oreg., letter on "head tax" 2197
Smart, J. D., president, New Hampshire Fire Insurance Co., Manchester, N. H., letter on taxation of insurance companies other than life 2046
Smith, J. Emil, editor, Illinois State Journal, Springfield, Ill., letter opposing withholding tax proposed in H. R. 7378 1805
Social Democratic Federation of New York, memorandum in regard to the tax program 1810
Sonneborn, Rudolf G., New York, N. Y., telegram favoring tax on reclaimed lubricating oil 2323
Sours, Hal G., director of highways for Ohio, statement opposing increase in gasoline tax 2023
South Dakota State Highway Commission, letter opposing proposed increase in Federal tax on gasoline 2326
Spaeth, G. Howard, Commissioner of Taxation of the State of Minnesota, letter on deductions for medical expenses 1678
Squires, J. Duane, New London, N. H., statement on annuity bonds 2212
Standard Pressed Steel Co., Jenkintown, Pa., brief by Early Lyman Gilbert on renegotiation of contracts 2354
Summers, Turner A., president, Kentucky Automobile Dealers Association, Louisville, Ky., letter opposing increase in tax on gasoline 2317
Sutton, Louis V., president, Caroline Power & Light Co., Raleigh, N. C., memorandum on taxation of electric utilities 2307
Thatcher, George B., Reno, Nev., telegram on necessity for tax relief for miners of strategic minerals 1928
Tobey, Hon. Charles W., a Senator from the State of New Hampshire, statement on the Treasury's proposal to increase gasoline and lubricating oil levies and the effect upon New Hampshire 2321

Briefs, letters, memoranda, resolutions, etc.—Continued. Page
Tyrrell, Richard H., Milwaukee, Wis., representing Chain Belt Co., and Grede Foundries, Inc., statement concerning technical amendments proposed for the revenue bill of 1942 ... 2358
Vallier, L. C., treasurer, Buffalo Foundry & Machine Co., Buffalo, N. Y., memorandum on post-war refund ... 1492
Van Horn, R. E., *international president, Cigar Makers International Union of America*, memorandum in the matter of proposed increase in cigar excise taxes ... 1461
Vernon, Weston, Jr., New York, N. Y., letter in behalf of committee on taxation, New York State Bar Association ... 2345
Walker, L. M., Washington, D. C., president, National Rural Letter Carriers' Association, letter opposing increase in tax on gasoline and lubricating oil ... 2156
Ways and Means Committee, House of Representatives, *excerpt from* Report 2333 ... 2016
Wear, Wilbert, Washington, D. C., chairman, committee on economic security, National Association of Manufacturers, letter and memorandum with respect to pension trusts ... 1835
Webster, Monroe, vice president, Commerce Photo-Print Corporation, New York, N. Y., letter objecting to increase in rate of tax on photographic paper ... 1818
Westinghouse Electric & *Manufacturing* Co., Pittsburgh, Pa., letter on pension trusts ... 1821
Whiting, Justin R., president, the Commonwealth & Southern Corporation, statement with respect to proposals for corporate taxation in 1942 ... 1813
Willis, C. G., Los Angeles, Calif., telegram urging retention of percentage depletion allowance and option of expensing intangible drilling costs ... 2152
Wine Institute of California and other States, letter opposing increase in tax on wines ... 2271
Wisconsin Power & Light Co., statement ... 2293
Wiseman, John, on behalf of American Window Glass Co., Pittsburgh, Pa., and others, in re section 129 of H. R. 7378, relating to fiscal-year taxpayers ... 2147
Witt, Eli, president, Havatampa Cigar Co., Tampa, Fla., brief opposing tax on cigars ... 1455
Appendix ... 2291
Index ... 2363

REVENUE ACT OF 1942

MONDAY, AUGUST 10, 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.

The committee expected to have a short executive session, but since quite a number of the Senators are not here promptly this morning, we will hold an executive session just before the noon hour, say at 11:45.

I make that statement so that some of the Treasury officials remaining here on that one matter will be at liberty to be at ease until about 11:45.

We will be glad to have you stay anyway.

We have here this morning quite a number of witnesses on percentage depletion. Mr. Reporter, you will please insert this letter addressed to the chairman and giving the list of all of the associations and organizations that are represented in the General Depletion Committee for the Petroleum Industry into the record.

(The letter from the General Depletion Committee for the Petroleum Industry, referred to by the chairman, is as follows:)

GENERAL DEPLETION COMMITTEE
FOR THE PETROLEUM INDUSTRY,
Washington, D. C., August 10, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR MR. CHAIRMAN: Following the announcement by representatives of the Treasury Department that they proposed to suggest to Congress drastic changes in the depletion law affecting petroleum and other mineral industries, a meeting was called throughout the petroleum territory for the purpose of planning a proper presentation of testimony setting forth the views of the petroleum industry in regard to this proposal.

The production division of the petroleum industry operates throughout a number of States. It was our conclusion that it would be impracticable for separate individual representatives of the companies affected to come from all these States and appear here before your committee. In order to facilitate this it was determined to create a general depletion committee composed of representatives from various associations organized from the production branch of this industry. This committee was created with J. C. Hunter and Russell B. Brown as cochairmen, and Tom Payne as secretary, and the title for this temporary organization was the General Depletion Committee for the Petroleum Industry.

In order to further facilitate the hearings, this General Depletion Committee has selected a few witnesses to present the case for all those participating in the organization of this General Depletion Committee. We have previously submitted to you the names of the witnesses selected, as follows:

Hon. Thos. P. Gore, Oklahoma City, Okla.
Col. H. B. Fell, Ardmore, Okla.
J. E. Moorhead, Oil City, Pa.
Ralph E. Davis, Pittsburgh, Pa.

On yesterday Mr. J. E. Moorhead, after a serious illness of only a few hours, died, and we ask permission to substitute for him the name of George Holbrook, of Wellsville, N. Y., who will present the paper prepared by Mr. Moorhead.

In addition to the witnesses appearing in person, we will desire to submit certain statements by certain individuals and associations which may, if permitted, be filed in the record. For your information the associations represented in the General Depletion Committee, and the names of their representative on this committee, are as follows:

Name	Association	Address
James E. Allison	Natural Gasoline Association of America.	Box 1569, Tulsa, Okla.
G. D. Almen	Osage Oil & Gas Lessees Association	Care of Winona Oil Co., Kennedy Bldg, Tulsa, Okla.
D. T. Andrus	Bradford District Pennsylvania Oil Producers Association.	Fulton Bldg., Bradford, Pa.
Paul R. Bishop	Kansas Independent Oil and Gas Association.	520 Fourth National Bank, Wichita, Kans.
Frank J. Blaise	Illinois-Indiana Petroleum Association.	35 East Wacker Drive, Chicago, Ill.
Burdette Blue	Mid-Continent Oil & Gas Association (Kansas-Oklahoma Division).	425 National Bank of Tulsa, Tulsa, Okla.
Russell B. Brown and H. B. Fell	Independent Petroleum Association of America.	Tulsa, Okla.
W. J. Brundred	Central Pennsylvania Oil Producers Association.	Care of Brundred Oil Corporation, Oil City, Pa.
F. A. Calvert	Oil and Gas Association of Michigan	Saginaw, Mich.
Arthur M. Campbell and B. A. Hardey.	Mid-Continent Oil & Gas Association (Louisiana-Arkansas Division).	Slattery Bldg., Shreveport, La.
H. L. Carnahan	Louisiana Petroleum Association	Hibernia Bldg., New Orleans, La.
Warren S. Churchill	American Association of Oilwell Drilling Contractors.	407 Philtower Bldg., Tulsa, Okla.
C. W. Coughlin	California Oil and Gas Association	Care of Richfield Oil Corporation, Richfield Bldg., Los Angeles, Calif.
Ralph E. Davis	American Gas Association (Natural-Gas Section).	1710 Union Bank Bldg., Pittsburgh, Pa.
Fayette B. Dow	The Pennsylvania Grade Crude Oil ducers Association.	930 Munsey Bldg., Washington, D. C.
Jos. E. Keller	National Petroleum Association	930 Munsey Bldg., Washington, D.C.
Philip N. Faine	Ohio Pennsylvania Grade Oil Producers Association. National Stripper Well Association.	New Straitsville, Ohio.
Richard Fenton	California Stripper Well Association	Subway Terminal Bldg., Los Angeles, Calif.
George C. Gibbons	Mid-Continent Oil & Gas Association (Texas division).	P. O. Box 1617, Dallas, Tex.
George Holbrook	New York State Oil Producers Association.	Care of Bradley Producing Corporation, Wellsville, N. Y.
J. C. Hunter and Clarel B. Mapes.	Mid-Continent Oil & Gas Association.	308 Tulsa Bldg., Tulsa, Okla.
A. Jarvis	Tri-State Petroleum Association for Defense Coordination.	Evansville, Ind.
C. A. Johnson	Independent Refiners Association of California.	458 South Spring St., Los Angeles, Calif.
W. A. Locker	Independent Gas Producers Association of Ohio.	P. O. Box 148, Wooster, Ohio.
Baird H. Markham	American Petroleum Institute	50 West 50th St., New York City.
George McGrath	Panhandle Producers and Royalty Owners Association.	Care of McIlroy Oil Co., Amarillo Bldg., Amarillo, Tex.
D. G. Powell and Howard Whitehill.	Oklahoma Stripper Well Association	711 World Bldg., Tulsa, Okla.
Walter M. Priddy	East Texas Oil Association	Care of Sabine Royalty Corporation, Peoples Bank Bldg., Tyler, Tex.
Keith F. Quail	Independent Oil Men of New Mexico.	221 Ward Bldg., Artesia, N. Mex.
D. T. Ring	Ohio Gas and Oil Men's Association	805 Atlas Bldg., Columbus, Ohio.
Edwin Robinson	West Virginia Oil and Natural Gas Association.	512 Jacobs Bldg., Fairmont, W. Va.
J. D. Sandefer, Jr	West-Central Texas Oil and Gas Association.	Breckenridge, Tex.
H. L. Sawyers	New Mexico Oil and Gas Association	Roswell, N. Mex.
Carl H. Schwyn	Lima Crude Oil Improvement Association.	Cygnet, Ohio.

Name	Association	Address
Fred Sohmann	North Texas Oil and Gas Association.	1108 City National Bank Bldg., Wichita Falls, Tex.
C. C. Spicer	San Joaquin Valley Oil Producers Association.	Rrepublic Petroleum Co., 811 West 7th St., Los Angeles, Calif.
George W. Strawn	Southern Oklahoma Oil and Gas Association.	Admore, Okla.
E. J. Sullivan	Rocky Mountain Oil and Gas Association.	Box 906, Casper, Wyo.
Earl D. Wallace	Kentucky Oil and Gas Association	205 Walton Bldg., Lexington, Ky.
C. P. Watson and W. H. Geis.	Oil Producers Agency of California	1035 Subway Terminal Bldg., Los Angeles, Calif.
H. E. Zoller	Western Petroleum Refiners Association.	Care of Derby Oil Co., Wichita, Kans.

Very truly yours,

J. C. Hunter,
Russell B. Brown,
Cochairmen.

The Chairman. Senator Gore is the first witness listed. Senator Gore, will you please come around?

STATEMENT OF HON. THOMAS P. GORE, OKLAHOMA CITY, OKLA., REPRESENTING MID-CONTINENT OIL & GAS ASSOCIATION AND INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

The Chairman. All right, Senator Gore; we will be very glad to hear from you.

Mr. Gore. Mr. Chairman, my name is Thomas P. Gore. My home is Oklahoma City, Okla., and my office address is 525 Union Trust Building, here in Washington. At present, I am engaged in the practice of law, for reasons too delicate to mention.

I appear, Mr. Chairman, at the joint request of the Mid-Continent Oil & Gas Association and the Independent Petroleum Association of America.

These associations represent the industry at this hearing.

I shall confine my remarks to one issue, and that issue is this; the present law provides that in the case of mines, oil and gas wells and timber there shall be a reasonable allowance for depletion and for depreciation of improvements.

The present percentage depletion, as related to oil and to gas wells, is 27½ percent on the gross income from the property, in no case to exceed 50 percent of the net income. That is the present law. The oil industry urges this committee to retain that law as it is and to preserve the present policy, which has worked with such marked success.

The Treasury Department urges this committee to repeal that law and to substitute for percentage depletion, what is known as cost depletion. The oil industry asks you to retain the present law. The Treasury asks you to repeal the present law and revolutionize the present system.

That is the issue which is here joined. The oil industry regards the present law, in the present circumstances, as essential to its success if not to its survival, and the industry regards its survival as essential to the effective production of petroleum and its products and the industry regards petroleum and its products as essential to our mode of life, as organized at present.

The industry and the Treasury agree upon one point, that petroleum is indispensable. The oil industry does not wish to dispense with the indispensable.

In the past, the race has gone through what is known as the Stone Age, the Bronze Age, the Iron Age, and it is hardly too much to say that this is the Oil Age, because oil is indispensable to our industry and social life as constituted at this time. Our civilization is geared to gasoline. Petroleum and its products are indispensable to our civilian life to the arts of peace, and indispensable to the arts of war. Petroleum is indispensable to the prosecution of war. You cannot wage mechanized war without it; you cannot win mechanized war without it. It is an old military proverb that God Almighty is on the side that has the heaviest artillery. Napoleon said that God is on the side that has the last reserves. That might be paraphrased to say that the God of battle is on the side that has the largest oil reserves, and I have no doubt that the Germans and the Japanese fear the triumph of those who have the largest oil reserves.

Japan has been pouring out blood and treasure without stint to conquer the oil fields of the Far East. She has captured the oil fields of Burma and the Indies; she has paid the blood price. Germany is waging war to conquer the oil fields of the Near East. She is now making a desperate effort to capture the oil fields of the Caucasus. She is not haggling about the price of what she needs to win; Hitler is not haggling about the price of the indispensable.

I have here a copy of Collier's magazine, an article by Secretary Ickes. It indicates the location of the oil fields of the world and indicates the desperate struggle now waging to control those oil reserves.

Mr. Chairman, we are in a fortunate position with reference to these oil reserves. Nature has favored our land and it is not necessary for us to make the struggle that our enemies are making in order to conquer the oil fields of the world.

What is proposed? What is the point in this controversy? The Treasury Department says that if you appeal the present law and abolish the percentage depletion, it would save, insofar as the oil and gas wells are concerned, $80,000,000 a year.

Think of it! $80,000,000 a year! Enough to run this war for a little more than one-half a day; enough to run this war for about 13 hours and 13 minutes, I will say.

Now it is proposed to abolish the system in order to obtain $80,000,000. It is proposed to abolish a system which has secured to us a current supply in excess of current demands and reasonable reserves for the future.

Now, Mr. Chairman, I speak for those who are producing petroleum, all those who have their time, talent, money, and labor devoted to that industry. But I speak not for the producer alone, I speak for the consumer of oil, for without the producer the consumer would go unprovided for.

I speak for the 30,000.000 that own automobiles, whether rationed or not; I speak for all those who use petroleum, either on the farm or in the factory, as a source of power without which their present industry could not continue as it has in the past.

Now, then, I cannot say, while I speak for the producer and consumer in a way, it does not lie in my mouth, as I say, that I speak for the Army, the Navy, and the Air Corps. I cannot say that I speak for our embattled forces wherever the four winds blow. I cannot say that I speak for those who go down to the sea in ships, or for those who outstrip the eagle in its flight. I cannot say that I speak for those who are today defending our far-flung battlements, and who are fighting our battles out upon the rim of the world.

Mr. Chairman, this committee speaks for them. That is your duty. They are your charge. The Constitution of the United States has committed their interest to Congress and not to the Department of the Treasury. Congress alone, Congress and Congress alone, is vested with the power to provide for the common defense, the power to declare war, the power to raise and support armies, the power to provide and maintain navies, the power to lay and collect taxes, to pay the debts and provide for the common defense and general welfare of the United States.

Congress and Congress alone is charged with the duty of raising revenue to provide for the common defense, and for the general welfare, and I believe that the cause which I now present to you is essentially alike to the common defense and to the general welfare.

The oil industry asks you to maintain the present status. Now, when the Treasury Department asks you to change the existing status and to supersede a system that has worked with signal success, the burden of proof devolves upon them to convince you that the change is not only desirable, but that the change is necessary. In order to meet that task and to bear that burden you would assume that the Treasury Department would undertake to demonstrate that the present system has not succeeded, that the present system has failed, that it has not provided an adequate supply of oil for current needs and has not provided a reasonable reserve for the future before they ask you to change a system which was designed to bring about those results, and which has brought about those results.

The Treasury Department undertakes no such task as that. On the other hand, the only complaint, as I can make it out, is that the present system has worked too well. It has worked so well that it has ceased to be necessary. It has worked so well in the past that it is not needed for the future.

That would remind one of the captain of a ship who would undertake to change the rudder of his vessel in the midst of a storm, to change the keel of his ship in the midst of a storm, not because the keel was not strong or sound and safe, but because the keel was better than was necessary, and it was a waste to use a better keel than necessity demanded. Now, that is the argument of the Department of the Treasury, and they ask you to change this system which has provided us with an ample supply for the present and reasonable reserves for the future.

For what? The Secretary of the Treasury says for $200,000,000 under these proposed rates. As I said, $200,000,000 would run the war for about 1 day and 9 hours, and for that, for the mere dust in the balances, they undertake and they ask you to abandon a system which has provided security for the present and will provide security for the future.

There is one statement in Secretary Ickes' article, one sentence which I call to your attention. He says the future of the world depends upon the control of petroleum reserves, and he says America needs oil statesmanship today.

America needs oil statesmanship today. Upon that we will all agree. I believe that America has oil statesmanship today. I know America had oil statesmanship in the past, and I believe America has oil statesmanship this day as well as then.

I need not tell this committee that from time to time Congress has been subjected to more or less criticism in days gone by, and I need not tell this committee that in my view, much of that criticism was undeserved, most of that criticism was undeserved. Congress has been subjected to much criticism that was undeserved, and it has not always received the credit to which it was entitled, and I come now to a concrete case, at least judged by the lights of the Treasury, and I shall undertake to show that the policy of this Congress and this Government, with reference to oil reserves and oil production, as a measure deliberately adopted to accomplish a given end, no measure in all the history of Congress has better answered the hopes of those who enacted it.

Mr. Chairman, it happens that, as a member of this committee, I offered the amendment to the Revenue Act in 1918 which laid the foundation of our present depletion policy. I claim no special credit for that. The credit was shared by the committee and by the Congress. It happens that I know the reason why that amendment and that measure was adopted; I know what it was designed to accomplish; and I know how well it has answered the hopes of those who passed it.

What was the situation then? That amendment was offered as a war measure. We were then in the toils of World War No. 1. That war was, in part, mechanized, but nothing in comparison with the present.

Petroleum was indispensable to our success, and our production was running 60,000 barrels a day behind our consumption. The supply was 60,000 barrels a day less than the demands of war. The price of crude oil was $2.19 and our oil reserves were sufficient for about 14 years in the future. That was the condition which we confronted then, and it was a condition and not a theory which confronted us. We needed more oil then and in the future and in order to insure the future, the amendment which I proposed was adopted, an amendment basing depletion upon the discovery value. That measure has been in operation now about a quarter of a century, and changed, in the meantime, to percentage depletion, as I shall show.

What is the situation today, Mr. Chairman? Our daily production is now three times as large as it was in 1918. Our daily potential production is in excess of our daily demands. The excess of current production to current needs is substantial. Today we are producing 4,000,000 barrels of oil per day. Today the average price of crude oil is $1.13 instead of $2.29 and today our reserves are three times as large as they were when that measure was adopted. Then less than

7,000,000,000 and now more than 19,000,000,000 barrels in our known reserves. What that measure was designed to accomplish has been accomplished. Congress adopted that measure as a means to an end, and that end has been achieved.

What I say the Senator from Rhode Island—if he is present—is he present?

The CHAIRMAN. Yes.

Mr. GORE. The Senator from Rhode Island can bear witness to what I say. He is the only member of this committee today who was a member of that committee then. His fingerprints are on that legislation. He shares the credit of its enactment. Mr. Chairman, I am the only other man now living who was a member of that committee then. The rest have all gone their way, but their wisdom was sufficient unto their day. More than that, their wisdom and their foresight was sufficient unto this day. That legislation stands now as a monument to their memory and to their statesmanship.

May I not say in passing that it was 25 years ago—and may I not say in passing that a quarter of a century hence, when others shall sit in these places and someone shall stand where I now stand commenting upon your labors as I comment upon theirs, I hope it may be said of you, as I say of them, that your statesmanship was sufficient unto your day and your generation.

But the Secretary of the Treasury says that it certainly cannot be contended that this depletion allowance contributed to exploration or discovery. He says there are grave doubts as to whether it made any substantial contribution to the discovery of oil. In other words, Daniel comes to judgment and says all this might have happened anyway, that Congress had no foresight and deserves no credit.

Mr. Chairman, it would never be possible for Congress to earn any credit for any measure if, after its measure has achieved the intended results, and some Daniel, as I say, comes to judgment and says, "The thing would have occurred anyway."

Of course, nobody can tell what would have happened if what did happen had not happened.

The Secretary's argument reminds me of the complacent father who was telling his little 7-year-old girl that if he had never met and married her mother she would never have been born. The little girl casually said, "That would not make any difference, mother could have married somebody else anyway."

That is what the Secretary's argument comes to.

Gentlemen, we are not forced to rely upon arguments of this sort. I think we have two concrete cases which demonstrate the efficacy of this legislation. Gentlemen, when that measure was passed in the act of 1918 the annual production of oil in Pennsylvania was 7,000,000 barrels. Soon after that the curve of production began to rise, and today Pennsylvania is producing 20,000,000 barrels of oil a year.

When that measure passed western New York was producing 600,000 barrels of oil a year, and today western New York is producing 4,000,000 a year. I know these quantities seem small, and they are, in a way, but these oils are extremely valuable on account of their large lubricating content.

Your yield from that oil is 20 to 22 percent, while western oils yield only 4 or 5 percent. Now there is one concrete proof.

I think another can be found in this circumstance: The act of 1918 established depletion on the discovery basis. The act of 1926 substituted percentage depletion for discovery and depletion, insofar as oil and gas wells were concerned, but Congress did not make the shift to metals, minerals, copper, iron, and the like until the act of 1932, and then instead of placing upon minerals a percentage depletion of 27½ percent it limited depletion to 15 percent.

What has been the result? I will not say we are in desperate straits, but we are in urgent need of copper and in all other metals essential to our war effort. If the depletion allowance for copper had been as high as 27½ percent I doubt not it would have stimulated the discovery of other mines and increased the copper production.

Congress applied the proper principle, but did not make a sufficient allowance.

What is the situation with reference to copper today? The Government is paying the copper companies 12 cents a pound for their respective fixed quotas, and the Government is paying the copper companies a premium of 6 cents a pound for every pound of copper which they produced over and above their appointed quota, and yet, in the midst of this war, the Department of the Treasury asks you to abandon the percentage allowance, not only with reference to copper and the other metals, but with reference to petroleum itself.

Mr. Chairman, sometimes it is possible to profit by the experience of others. What does Canada do in this respect? Canada has granted a percentage depletion allowance of 30 percent. It is now 33 percent, to be exact. The basis is different but the principle, the motive, the object, are the same. Indeed, Canada has gone one step further, and in the case of dividends declared by companies entitled to the depletion allowance, Canada grants allowances of 10 percent to the stockholder who enjoys the dividend as a payment in the way of return of capital.

We have sent missions to Canada to study her price regulations and other measures, and there she has set an example which we may well observe, because it was our good fortune to set the example in the first instance.

Now these are long-time policies, Mr. Chairman. The amendment adopted during the World War did not accomplish this result at once. The price of oil continued to advance until it reached $3.50 a barrel. Then came the crash of 1920 and 1921, and speculative businesses, like the oil business, must necessarily be—were the worst and the first sufferers in the depression.

The price of gasoline advanced for a time.

I have here an extract from a report made by a subcommittee of the Senate Committee on Manufacturers, the chairman of which was then the former Senator La Follette.

This policy, as I say, on account of the depression and for other causes, being a long-range policy, had not gotten into full swing and operation, and in this report the La Follette committee said that if the present tendency continues, in 10 years the United States will be importing one-half of its petroleum from foreign countries. One-half! Today our imports are negligible.

The report went further and said that if large oil companies were permitted to manipulate the situation, the people of the United States must be prepared to pay as much as a dollar a gallon for gasoline.

A dollar a gallon! Now that was an investigation made in 1922, after the depression when the price of gasoline had gone up. That situation has been changed and our current supply exceeds our current demand and our known reserves are ample for the immediate future.

There is one remark here I wish to address your attention to. Senator La Follette said, "A few oil concerns were permitted to manipulate the oil business and oil prices." Some people imagine that four or five large integrated oil concerns dominate the oil business and dictate oil prices. There are several large integrated concerns which exercise an influence in proportion to their size and their activity. It cannot be otherwise, but, Mr. Chairman, the oil business today is a competitive business. I have here the statistics from the Bureau of Internal Revenue for the year 1939.

For that year there were 5,206 concerns engaged in the production, or in the effort to produce oil and gas—5,206 concerns engaged in the industry. Of those 1,656 showed a net return, a net income, whereas 2,982 showed no net income but it shows how sanguine the business is. Those figures do not quite check, as the Bureau said, on account of certain inactive concerns. The business is not monopolized.

Mr. Chairman, I wish to take time out for a moment and tell the committee what this is all about. I do it rather for the record than for the members of the committee, because what I shall say shall be elementary.

Now the law provides for reasonable allowances for depletion and for depreciation of improvements in respect to oil, gas, and mines. Now what do those terms mean? They are confusing to the layman. I will begin by pointing out the distinction between the two. Depreciation relates to those things which are made by human hands, to things which are manufactured and which wear out by use, and which can be replaced when worn out. The law wisely allows a depreciation for ordinary wear and tear, so when a business concern wears out its tools and machinery it has a fund with which to make purchases and replace them and proceed with its business.

Now depletion does not relate to things made with human hands. Depletion relates to natural resources, to resources which are exhausted, which are removed from the ground and which can never be replaced. When once removed, they are removed forever.

But, Mr. Chairman, the owner of an oil or gas well, or mine, when he removes his commodity from the ground, he has diminished his capital. Every ton of coal and every barrel of oil removed from the ground diminishes the owner's capital to that extent. The day comes when his reserves are entirely exhausted and when, if he is to continue in business, he must go out and by exploration and operation, discover new sources of oil, gas, or copper.

Now the Government has wisely provided for a depletion in such cases in order to replace the capital as it is removed from the ground so that when one mine or one well is exhausted the owner can, and perhaps in the meantime has, by exploration and otherwise made provision to acquire other oil territory, other mines, and to proceed with his business.

That is not any more important to the people engaged in the business than it is to the general public whom they serve, and who must be served with these indispensable commodities. It is a wise public policy.

Now there are different kinds of depletion. On the basis of cost, on the basis of discovery value, or fair market value, and on a percentage basis. We have tried them all.

Now to illustrate the cost basis, I can take a simple example. It is not quite parallel, but it illustrates the point.

Take a shoe merchant in this town who buys and sells 100,000 pairs of shoes a year. He pays $5 a pair on the average and sells them for $8. At the end of the year he has sold shoes costing him $500,000 for which he has received $800,000. That must be said to be his gross income, but his gross profits were $300,000. From that you subtract his expenses and arrive at his net income, and upon that you levy a tax. No one would levy a tax on the $500,000 which was merely replacing the capital with which he bought the shoes.

Congress had no disposition to do that and Congress has no power to do that. Even a direct tax on land must be made in accordance with the rule of apportionment.

We tried the cost depletion, in a way, in the act of 1916. Oil companies were allowed to deplete on the basis of cost, in a way. If in that venturesome business a man paid $1,000 for a lease and bought in oil property worth $100,000, he was allowed to deplete on the basis of $100,000.

But this thing happened, which I set up as a red light warning against rushing through an open drawbridge. The act of 1917 came along and levied a graduated excess-profits tax.

There were five brackets, I believe, and the highest bracket, over 33 percent profit on invested capital, the tax was 60 percent. The concern was allowed to deplete on the basis of $1,000.

Those little concerns, wildcat concerns, had very little invested capital, and when they had to pay 60 percent on all their profits over 33⅓ percent it practically prostrated many, many oil companies then engaged in the business and indispensable to its continuance.

The act of 1918 remedied that defect.

Mr. Chairman, wise taxation, scientific and just taxation, takes into account the character of the business to be taxed, the character and characteristics of the subject to be taxed. It would be as unsound to tax things that are unalike as if they were alike, as it would be to tax things that are alike, as if they were unalike.

The oil business is the most capricious, the most uncertain. The oil business is little more than an organized risk. It is an organized hazard. Every well that is drilled involves a risk.

Now that must be taken into account when you come to tax the oil industry, and that explains the action and wisdom of the action on the part of Congress.

There is only one way that this business can be carried on, and that is by wildcatters, the explorers getting out in advance, exploring new territory and bringing in new fields, taking a chance, running a risk, and sooner or later bringing in a discovery well.

Mr. Chairman, in the United States last year there were 3,113 wildcat wells drilled. That was in new territory. Of that number 486 produced oil. There were 2,700 dry holes, all of which cost perhaps $20,000 or more apiece, and some a quarter of a million.

Now you cannot run this as if it were a conservative business like the shoe factory or the shoe merchant. You have got to take that fact into account.

And, Mr. Chairman, those 486 wells had to pay out their own cost before they ever paid a dollar of net profit to the owner and they had to share a part of the losses on those 2,700 dry holes. You cannot insure today against a dry hole, Mr. Chairman.

The oil business, drilling dry holes which are indispensable, must charge the expense of the dry holes against the wells that produce. I will give you two classic illustrations. Governor Marland of my State went to Oklahoma in the early days and obtained 20 leases from the State on school lands, contracted to drill a test well on each tract, drilled 19 dry holes on the first 19 tracts at a cost of a half million dollars. The twentieth well produced. There was no depletion allowance and the $500,000 was a total loss. With the depletion allowance, when he discovered the final well, he would have received some compensation for the risk he had taken and for the losses he had sustained. Grant Stebbins, another promoter, drilled 27 holes before he brought in a producing well. Now, of all the wells drilled, one-fourth are dry, one-fourth never pay out, or only pay out, and the other one-half must pay the expenses not only of their own discovery and drilling, but in the long run, must bear the expense of the other half that were drilled and never paid out.

That is what this depletion allowance is all about. That is the character of the oil business. That is the only way it can be maintained. The producing wells must pay for the bad wells, and Congress, in its wisdom, has made some provision to cover that contingency.

Now it is like this: Take a tobacco farm down here in Virginia that has been producing tobacco for 300 years; we will say it is a 100-acre farm that had been take care of. It produces as much tobacco today as it did 300 years ago. The owner has his capital invested in the farm. He is content with a reasonable annual return on that investment. That farm will produce as much tobacco 100 years from now as it does today, and the owner will be content with a reasonable return on his invested capital.

Let us assume that an oil well was brought in in Virginia, and let us assume that it was on the adjoining tract, and it came in a fair producer.

Now, the owner of that well—judged by certain standards worked out in Oklahoma, it would be a free-flowing well—the owner during the first year of that well's life, would get 63 percent of all the oil it would ever produce.

The second year he would get 20 percent of the total output, the third year 12 percent, and the remaining 5 percent would be spread over the remaining years of its existence.

In 20 or 25 years that oil well would be a memory or a tradition.

Now, then, no owner of an oil well ever gets $1 of net profit until the entire expense of the well has been returned to him. Not $1. The well, I say, must pay for its own birth, and it must pay the funeral expenses of those that were brought in dead.

That is the experience of this business, and it cannot be run any other way.

One object of this legislation is to maintain the birth-rate, to insure that a sufficient number of new wells are brought in from time to time, discovery, and other wells. On the other hand, one of the main objects is to preserve and prolong the life of these wells. Every well, no matter how deep, becomes a stripper well, that is, a well that produces from, say, 3 or 4 barrels a day down to 3 or 4 gallons a day.

Some of the stripper wells in Pennsylvania, which have such a high lubricating oil content, are operated although the yield is only 3 or 4 gallons a day.

Mr. Chairman, we have in this country today 400,000 oil wells. You will be surprised when I tell you the average production of those wells is less than 10 barrels a day apiece. Three hundred thousand of those wells are either marginal or stripper wells. That is, the return upon the oil, the value of the oil only exceeds the expense of operation in a very, very slight measure. When it costs more to lift the oil out of the well than the oil will bring, the well is abandoned.

This percentage depletion makes it possible to keep the little wells alive. You say, "Well, what of it? They only bring in a few gallons, or a few barrels a day."

Mr. Chairman, that is true, but those 300,000 marginal or stripper wells produce a million barrels of oil a day. They produce one-fourth of our entire output. Shall we abandon them and lose that daily production?

Mr. Chairman, that is not the worst of it. When you abandon those wells, as a rule, you abandon those fields where they have been drilled, and those 300,000 wells represent one-third of our entire oil reserves. Of all our 19,000,000,000 of reserves, one-third would be largely lost if you closed down those stripper wells, and when you shut down those wells, they go to water and all the king's horses and all the king's men can never restore one drop of oil to production.

That is what you face when you abandon this policy.

The CHAIRMAN. Senator Gore, you have had practically an hour and we have a large number of witnesses on this one question.

Mr. GORE. Yes, sir. I will make one more point, Mr. Chairman, and that is in regard to the taxation of the oil business. I appreciate the necessity for taxes, and the oil business is not shrinking from its burden. It is willing to bear its share of taxes, increased taxes, willing to bear the 45 percent on its earnings or income. It is willing to bear 90 percent on excess profits, if that be the pleasure of the Congress, but Mr. Chairman, the oil business rates as the third largest business in this country. It owns one-twentieth of our national wealth; it enjoys one-thirty-third of our national income; and the oil business pays one-tenth of all our taxes levied by the National Government, the State, and local Governments combined. Including school districts, there are 175,000 taxing units in the United States and the oil industry and its products pay one-tenth of all the taxes paid, or $1,800,000,000 a year.

Gasoline alone pays $1,300,000,000 a year.

The total value of all the crude oil produced in this country each year is $1,585,000,000 and the industry and its products pay $1,800,000,000 of taxes.

Of course the added value by processing enables them to bear the burden.

Now just one further word: The Secretary estimates that $200,000,000 will be saved to the Treasury by abolishing the depletion allowance and other allowances. I think, Mr. Chairman, that the Secretary has viewed too small an arc in the circle of events. He has mistaken the part for the whole.

Now taking $200,000,000, one-third of that would be $66,000,000, but the part chargeable to percentage depletion would be about two-thirds of that. Now when he says he can take that money and drill as many wells, 3,100 wells in a year, he overlooks the expense of exploring and determining the location, which costs thousands and thousands of dollars, sometimes on a single location. He overlooks the expense of exploring perhaps twice as many locations which were never drilled out, and he overlooks the fact that while 3,100 wildcat wells were drilled, nearly all of which were dry, more than 4,000 wells were drilled on proven or semi-proven territory, edge wells which turned out to be dry and unproductive.

With this allowance, he will have to drill all the wells, wildcat wells and other wells, in order to maintain this industry at its present production.

Now, Mr. Chairman, you can repeal this law and say we will save $200,000,000 to the Treasury, or you can allow it to stand and can assure a reasonable supply of oil for the present and future. You can have either one or the other. You can have the $200,000,000 or you can have an assured supply of oil. Take you choice. You cannot have both.

I do not speak for my sponsors, I speak for myself alone when I say that if you gentlemen feel certain that you can abandon this present policy and substitute cost depletion in its stead and at the same time you can have the same assurance of a sufficient supply of oil for the present and for the future; then I say strike it out, but unless you feel certain of that, don't cut the pound of flesh nearest the heart.

Don't bet the success of the future against $200,000,000.

I thank you.

Senator BARKLEY. Mr. Chairman, I would like to ask Senator Gore a question, which he can comment on in a sentence or two.

The complaint which has been made by the Treasury in regard to this depletion allowance affects largely oil and gas?

Mr. GORE. Yes.

Senator BARKLEY. Not the minerals?

Mr. GORE. Not so much.

Senator BARKLEY. The minerals are about 15 percent as compared to 27½ percent for the oil and gas wells. What is your view as to the merits of the difference between the depletion allowances in oil and gas and in minerals?

Mr. GORE. My judgment is—and I do not speak as an expert, of course—I think that this committee ought to increase the percentage depletion on copper in this legislation, notwithstanding the arrangements the Government has made to pay a premium to the copper concerns of 6 cents a pound. I think it would stimulate production.

I think it is essential in either case, and this depletion allowance as to mines covers all these rare minerals, that we are searching the earth to discover.

Mr. Chairman, I would like to reserve the right to submit a supplemental statement in further answer to Senator Barkley's question, giving an historic background to the schedule of percentage allowances. These percentages were not fixed ad capitandum. They were the result of several investigations, both official and unofficial. One of the investigations indicated that the discovery depletion allowance on behalf of metals in a period of 5 years amounted to a little more than 17 percent of the smelter return, which was the gross selling price of the ore. But when Congress substituted percentage depletion, in the case of mines, it fixed the percentage at 15, which time has proved was too little. Fortunately the percentage allowance on behalf of oil and gas was neither too little nor too late.

(The supplemental statement referred to is as follows:)

SUPPLEMENTAL STATEMENT OF HON. THOMAS P. GORE, OKLAHOMA CITY, OKLA.

The official investigations referred to led to the conclusion that an allowance for depletion of 27½ percent of gross income from an oil or gas property, if limited to 50 percent of the net income from property, would accomplish an equitable result. In a study made by the Bureau of Internal Revenue while the Revenue Act of 1926 was under consideration, covering the tax returns of 50 representative producers of oil, it was found that under the depletion provisions of the Revenue Acts of 1918 and 1921, which were based upon discovery value, the depletion allowances to these representative producers for the 5-year period 1918 to 1923 amounted to 46.83 percent of their gross income. When percentage depletion was considered and adopted by Congress in 1926, it was with the full acquiescence of the Treasury Department and the only question for decision was the one of rate. In view of the aforementioned study, as well as other studies made by governmental agencies and also by the oil industry itself, the Senate fixed a rate of 30 percent of gross income. In conference with the House, the rate was fixed at 27½ percent of gross income with the following explanation (see amendment No. 6 on pp. 31–32 of the conference committee report—H. Rept. No. 356, 69th Cong., 1st sess.):

'The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration the Senate amendment provides that in the case of oil and gas wells the allowance for depletion shall be 30 percent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess fo 50 percent of the net income of the taxpayer from the property is retained.

"The House recedes with an amendment providing that the depletion deduction based upon gross income in the case of an oil and gas well shall be 27½ percent of that income instead of 30 percent, * * *"

Subsequent to the enactment of the Revenue Act of 1926, the Division of Investigation of the Joint Committee on Internal Revenue Taxation made a comparative study with regard to the results arising under percentage depletion and under discovery value depletion. Since the provisions of the 1926 Revenue Act were retroactive to the year 1925, this was the last opportunity to make such a study and, accordingly, a comprehensive report covering the year 1925 was prepared for the joint committee. Therein, it was brought out conclusively that the 27½-percent rate was entirely equitable. The report concluded that—

"When the average price of oil in the United States is at $1.65 per barrel, as it was during 1925, the effect of the provisions of the Revenue Act of 1926 are such as to slightly reduce the depletion allowed the oil industry. This reduction, however, falls entirely on the lessors as the depletion allowed the lessees is practically what it would have been under the 1924 act.

"As to future years, if the price of oil goes above $1.65 per barrel the depletion will be greater under the 1926 act; if it goes below $1.65, it will be less under the 1926 act."

The percentage depletion provisions as applied to the mining industry were not adopted by Congress until 1932. Until that time, this industry had continued to receive allowances for depletion based upon discovery value, however, the administration of same had progressively become more and more difficult and costly. It was due to these great administrative difficulties that the committees of Congress in 1932 eliminated the discovery depletion allowance in favor of a percentage of income provision.

The percentage rate was determined by studying the average of the depletion allowed under the discovery value method, taking the weighted average over a 5-year period; and it was found that in the case of metal mines this amounted to slightly in excess of 17 percent of the smelter return, which was the gross selling price of the ore.

The rate of 15 percent, which was acceptable to the metal-mining industry, was agreed upon by the Congress more or less as a compromise, and was considered conservative in view of the fact that it was considerably less than the average rate that was allowed over the prior years.

Now I wish to point out that in the case of both the oil and gas industry and the mining industry the rates or percentages of income, by which the depletion allowances were measured, were arrived at by means of extensive studies conducted by the Bureau of Internal Revenue and the staff of the Joint Committee on Internal Revenue Taxation. Also, these rates were fully supported by studies made by the industries themselves. Furthermore, and in each instance, the rates finally fixed by Congress were considerably less than the percentage which the depletion allowance under the prior system bore to the taxpayers gross income.

The CHAIRMAN. Thank you very much, Senator.

Mr. GORE. I am sorry to have transgressed on your time.

The CHAIRMAN. Colonel Fell.

STATEMENT OF HAROLD B. FELL, ARDMORE, OKLA., REPRESENTING THE PRODUCTION DIVISION OF THE PETROLEUM INDUSTRY

Mr. FELL. Mr. Chairman and members of the committee, my name is Harold B. Fell, of Ardmore, Okla. I am an engineer by profession, and have been an independent oil producer for 22 years. My appearance here is as a witness on behalf of the production division of the petroleum industry, representing 41 associations with members engaged in the production of petroleum throughout the United States.

Representatives of the Treasury have recommended the elimination of the deduction for percentage depletion and also the elimination of the option to expense intangible development costs They made the same recommendations before the Ways and Means Committee of the House and, as you know, it was reported that the committee, after extended hearings, rejected the Treasury recommendations by a vote of 21 to 4. We, of the natural-resource industries, are convinced that the provisions in question are proper and should be continued without change or modification.

Regarding the development of the congressional policy of encouraging the search for and maintenance of adequate petroleum reserves, it is unnecessary for me to add materially to what Senator Gore has already said.

There was an actual shortage of petroleum at the time of the last World War. Unquestionably Congress and the country as a whole were definitely concerned over that shortage of supply and reserves.

As a result, Congress adopted a policy, the purpose of which was to encourage the development and maintenance of an adequate oil supply. We contend that the congressional policy of encouraging the finding and development of adequate petroleum reserves found expression in the Federal income-tax laws through provisions which would encourage oil producers to search for new sources of supply and at the same time would provide at least a part of the funds to risk in that search. It was to this end that the Revenue Act of 1918 provided for discovery depletion, and it was for this reason that Congress has concurred in the continuation of Treasury regulations, adopted in 1917, which permitted the oil operator to elect to deduct the intangible costs of drilling and developing oil properties from current annual income.

The changes made in the original discovery provisions and the adoption of percentage depletion for oil in 1926, and for mines in 1932, represented only changes in form for the purpose of administrative simplification without any change in the basic concept and certainly without any change in the method of carrying out the congressional policy. The policy of encouraging the discovery and maintenance of petroleum reserves through the medium of the income-tax laws and regulations was obviously more than a mere theory of taxation. Although the use of the tax law as a vehicle for carrying out that policy may have represented an experiment in statesmanship in the first instance, the continued use of that vehicle for 25 years indicates that both Congress and the country as a whole were satisfied with the method adopted and the results obtained.

The Treasury has frequently challenged the percentage depletion provisions and they have been thoroughly reviewed at previous sessions of Congress. The administrative officers have in effect requested Congress to forget the lessons learned in the last World War and to discontinue the tax provisions which encouraged the operator to search for new reserves. Throughout this period Congress refused to abandon its long-range policy.

The quantity of petroleum needed in the first World War was very small when compared with requirements of the present war. The demands for petroleum resulting from this war may be such as to call for supplies far in excess of those presently available. The very existence of the 19 to 20 billion barrels of known oil reserve is proof of the wisdom of Congress in adhering without deviation to its policy of encouraging the discovery and maintenance of our petroleum reserve. This reserve is one of the few strong weapons with which this country entered the present war.

The wisdom of the congressional policy is further demonstrated by the practical advantages which have resulted from the use of tax incentives in carrying out that policy. You know that prospecting and drilling for oil involve an enormous hazard. The venture money necessary to carry on the search must be substantial in amount and available in cash. It will not be available unless left in the business or put into the business as the result of effective incentives. The tax provisions under consideration have operated to encourage producers to rerisk their earnings in exploration and development and to induce investors to put new risk money into such enterprises. The oil industry has been built around these provisions which have operated so successfully for the past 25 years. They have encouraged the development of a free and competitive industry and the search for new oil reserves which has resulted in this country having larger known oil reserves than any other country.

The Treasury is now apparently of the opinion that our existing reserve is adequate. The Treasury's optimism is not shared by others who are fully informed concerning the existing facts and trends in the oil industry. See, for example, the speech of Robert E. Allen, Assistant Deputy Petroleum Coordinator, in Fort Worth, Tex., on October 16, 1941, where he said:

> With respect to the status of the known crude-oil reserves of the United States, the attached chart demonstrates the fact rather strikingly that, contrary to popular belief, an overabundant known underground crude oil reserve does not exist in the United States at this time. It shows clearly that the American petroleum industry must continue exploration and discovery activities with even greater intensity than in the past, in order to locate new supplies of oil, if the oil withdrawn from the known fields for current uses is to be offset and if a continuous and adequate supply of petroleum for national defense is to be maintained.

Already the oil reserves of our Allies in the East Indies and Burma have been lost to the enemy. The oil reserves of the United Nations in the Caucasus and in Iran and Iraq are now seriously threatened and may be seized and used by the Axis Powers. The importance of oil in the present war is pointed out in an article by Secretary Ickes appearing in the August 15, 1942, issue of Collier's. Our supply is not inexhaustible. Every potential barrel of our production including that from stripper and marginal wells must be kept available. We must assure ourselves and our Allies of adequate reserves for a long war. If we are to meet such requirements, we must make every effort to continue the production from present wells and to explore for and develop new reserves.

Every year the numerical odds against the discovery of new reserves increase and the amount required to be risked in each exploratory venture becomes greater. The record discloses that for the 3-year period, 1934–36, it required 280 dry holes for each new major pool discovered (meaning, by major pool, one which will produce 20,000,000 barrels or more.) However, for the more recent 3-year period, 1938–40, it required 700 dry holes for each major pool discovered. Furthermore, there has been a decided decline in the recoverable reserves per pool since 1934. The average oil reserve per pool discovered in 1934 was 19,400,000 barrels, whereas the average per pool discovered in 1941 was only 1,200,000 barrels. If this downward trend continues or grows worse, then the amount of risk money required will increase proportionately.

Obviously, unless there is enough incentive, in the way of a possible margin after taxes in the event of success, the risk money required for exploration and development will seek a safer place to work.

The difficulty in obtaining risk money cannot be overemphasized. The money for wildcatting cannot be obtained by bank borrowings on the security of wildcat ventures, or from sale of stock. Most of it must come from the industry itself. The Petroleum Industry War Council, in a recent official report to the Petroleum Coordinator, expressly emphasized this characteristic problem of the oil industry in the following statement:

The industry relies upon the over-all difference between cash income and cash outgo to provide the funds for exploration. Exploration is a controllable expense. In a broad sense that amount remaining after meeting all other expenses is allocated to exploration With constantly increasing tax levies such remainder correspondingly decreases. Tax assessments are in fact direct charges against funds otherwise available for exploration. (See exhibit A for full text of report.)

In the same report the Petroleum Industry War Council, which was appointed by the Petroleum Coordinator, and which made its investigation at his request, stated clearly that the maintenance of production from stripper and marginal wells is one of the objectives for which the retention of the statutory percentage depletion allowance is essential. Another reason for encouraging the maintenance of stripper and marginal wells is the fact that they are distributed geographically over widely separated parts of the United States, and thus form important local reserve supplies, available in the event of emergencies. Many stripper-well areas lie relatively near the eastern seaboard and are now of great strategic importance.

These findings of the Petroleum Industry War Council's committee are fully supported by the more detailed and amplified statement which, as reported by the Oil Weekly on March 2, 1942, was prepared for the War Production Board by the Office of the Petroleum Coordinator. The statement indicated the desirable level of known reserves would exceed the existing quantity by 30 percent or more. It was stated that the "estimate of required drilling in the United States in 1942" included 4,000 exploratory wells, this being "nearly 29 percent greater than the 3,113 wildcat wells drilled in 1941, which was an all-time high." After analyzing the demands for essential uses, and making allowance for curtailment of nonessential uses, the Petroleum Coordinator's Office, as reported, concluded that, "because of the none too satisfactory level of known underground reserves, exploratory activity, particularly, must be pressed with increasing intensity." (See exhibit B for full text of Oil Weekly article.)

The oil industry is constantly urged by Government officials charged with the responsibility of assuring this country of adequate reserves, to prosecute its exploratory efforts to the utmost. Typical of these appeals is the following excerpt from an article by D. R. Knowlton, Director of Production, Office of Petroleum Coordinator, appearing in the Oil Weekly of April 13, 1942:

We have about 20,000,000,000 barrels in reserve, but new reserves must be found to win this war. The situation is serious. Last year was a good wildcatting year, but new discoveries were disappointing. We need better tools to find oil. All companies are urged to continue basic research in the finding of oil.

Further evidence of the increased demand for petroleum and the need for increased exploratory effort is brought out in the Bureau of Mine's reports on oil production and stocks for the first 5 months, 1942. These reports show that the demand for the first 5 months of 1942 exceeded that of the same period of 1941 by approximately 42,500,000 barrels.

We submit that no legislative action should be taken which would retard exploratory drilling. Oil fields cannot be delivered "on demand." They can only be discovered by long scientific search and exploratory drilling over large areas. This is necessarily a continuous process. If prospecting is discouraged, the exploratory organizations now maintained would necessarily be reduced or abandoned. When it is discovered that additional oil reserves are immediately necessary, it may be impossible to meet the emergency. Organizations would have to be assembled and trained and large areas explored and drilled with the result that needed reserves would be discoverd too late.

Despite the congressional policy and despite the downward trend in discovery of oil reserves and the increase in consumption of our existing supply, the Treasury continues to recommend the elimination of the provisions for percentage depletion and intangible development costs.

Too much confusion has arisen from repeated attempts to shroud these decisions as highly complicated and technical mysteries and, without an understanding of their application to the business involved, to condemn them with labels imputing unfairness, special treatment, unwarranted loopholes, and the like. The charge that the petroleum industry enjoys any "special privilege" arises, no doubt, from a lack of complete knowledge of its operating conditions and from the misunderstanding resulting therefrom. There is certainly a real distinction between "special privilege" and the recognition of special conditions.

Among the special conditions which exist in the oil industry are the following:

EXPLORATION AND LEASING

Oil and gas are exhaustible natural resources. Only by drilling can the presence of the oil or gas be definitely determined. There are certain facts ascertainable in advance of drilling which tend to indicate presence of oil or gas. Some of these can easily be seen. Others can be observed only by trained technicians. The fields easiest to find through scientific methods available have already been discovered and the hunt for new fields becomes more difficult and costly as time goes on. Most producers do extensive exploratory work before a well is drilled.

The oil producer must acquire and pay annual rentals on a number of leases in both proven and unproven territory to have even a reasonable chance of a future supply of oil or gas. Notwithstanding preliminary exploration, most leases so acquired are unproductive. The cost of acquiring and holding these leases is one of the necessary costs of the oil producer. In no other business is the source of cost of future supply more indefinite.

EXPLORATORY DRILLING

The peculiar nature of the oil producer's business is further illustrated by the risks attending the drilling of exploratory wells. For example, only 486 out of 3,113 wildcat wells drilled in 1941, or 16 percent, were productive. Every well drilled presents the distinct possibility that it will not repay its cost. A dry hole is a liability. It must be plugged and abandoned, at an additional cost. The portion of all drilling costs such as labor, freight, fuel, water, and so forth, which cannot be salvaged, is exceedingly high. In cases of strictly wildcat wells, these costs are necessarily much greater than the average. Accordingly, the oil producer must spend large amounts in drilling with the knowledge that where a dry hole is drilled the investment will not be repaid. It would be well to note that out of the 29,916 wells drilled for oil or gas in 1941, 7,147, or 24 percent, were dry. Even if he gets production, there will be many instances where the full investment will never be recovered.

ADDITIONAL DRILLING

In most lines of business, after the building of a successful plant, the proprietor is not required to begin the immediate building of additional plants. The oil operator is not so fortunate. After he completes a commercially productive well on a lease he is usually required, by the covenants of the lease, to drill one or more additional wells because of—

First. The provisions of most oil and gas leases and the laws of many States require the lessee to proceed with the development of proven properties in a manner reasonably consistent with the best interests of the farmer and other royalty owners.

Second. The completion of a commercial well will usually result in the drilling of wells by ather operators on adjoining properties, which may cause the drainage of the oil to adjacent properties. Therefore, the operator to protect himself, the farmer, and other royalty owners must drill offset wells.

Third. Additional wells are necessary to outline the oil-producing pool and to make it possible to utilize most effectively the best conservation practices. Since one of the purposes of such wells is to define the limits of the pool, many of such wells will fail to produce sufficient oil to repay the cost.

MAINTAINING PRODUCTION

Finally, the peculiar nature of the oil producer's business is illustrated by the necessity for additional expenditures to continue production. Production results in the depletion, not only of the oil in the pool, but also of the natural forces which lift the oil. Therefore, every producer must eventually resort to mechanical or other aids to production, if he expects to extract the maximum recoverable oil from the pool. The use of these aids necessitates spending substantial amounts of money, which in many cases exceeds the original cost of developing the lease.

When the oil producer has to resort to these methods of maintaining production his property is approaching the marginal or stripper well classification. The stripper well operators necessarily resort to secondary recovery methods, which methods involve the drilling of additional wells, the erection of water treating and pumping plants or compressor plants for the introduction of water, gas, or air into the formation. Unless such methods can be used successfully, stripper well properties must be plugged and the underlying reserve lost.

All of these peculiar circumstances prove that the oil-producing business is extremely hazardous and that increasing amounts of money must be plowed back into every venture. The peculiar circumstances which attend the discovery and production of petroleum clearly disclose the fact that the typical producer is in fact a wildcatter, a producer, and a stripper operator. He does not advance from one phase to the other but maintains all three phases at the same time. The proceeds from his existing flush production is the source of his "plow back" funds which he uses to carry on his concurrent wildcatting and stripper well activities.

The Secretary of the Treasury suggested to your committee that it would have cost the Government about one-third as much to have paid the cost of drilling all the wildcat wells drilled in 1941 as the revenue which the elimination of the provisions in question would produce at the 1942 proposed rates. The inference was that the Government could have pocketed the difference. In making that suggestion the Secretary lost sight of the fact that the exploratory effort involves a great many costs other than those attending the actual drilling of a well. In addition to the cost of drilling the wildcat wells, the Secretary should have also included in his computation the cost of geological and geophysical work, including the costs attending core drilling, seismograph, torsion balance and gravity meter surveys; the cost of acquiring undeveloped leases including lease bonuses, title and legal expenses; annual delay rentals on undeveloped leases; the maintaining of land and scouting departments; the cost of drilling the 4,034 additional dry holes drilled in 1941 in the exploring and development of proven and semiproven areas; and the costs attending the exploration, drilling, and development of noncommercial producing wells.

The Secretary has also mentioned a case of a leading oil company as being the owner of a number of oil properties costing $3,000,000 and on which percentage depletion of $3,600,000 had been allowed at the time only one quarter of the oil had been recovered. It is assumed that the example was offered as supporting his charge of "special privilege" and as proof that depletion should be limited to the bare cost of each producing property. The answer to the Secretary's example is that the deduction, when limited to the cost of a particular property, offers no incentive to institute the search in the first instance, and provides no funds with which to continue the search. As early as 1918, Congress concluded that it was advisable to permit a deduction which could exceed the cost of a particular property in order that the funds so derived could be used in search for new sources of supply and to compensate for losses on dry holes and unprofitable properties, and the other unusual hazards and costs of the business. The elimination of the deductions would result in the abandonment of the congressional policy. If the congressional policy is not to be abandoned, it will be for the reason that Congress is still of the opinion that the continued exploration for new sources of petroleum is of greater importance to the Nation than is relatively insignificant revenue which would result from limiting the tax deduction on each producing property to its cost.

We have understood that the provisions under discussion were authorized to provide the incentive necessary to compensate for those hazards and inherent burdens and to give the venturer some insurance against being taxed on more than is truly net income. If any man would glibly say that the risks of the business of finding oil are not so unusual as to justify these provisions, let him examine the record of losses, failures and violent fluctuations of income and outgo in the business. Better still, let him consider whether he would risk his own capital in an exploration and development venture, and be content to reckon his current income as if every dollar of that capital were well and safely invested.

REGULATION PERTAINING TO INTANGIBLE DRILLING AND DEVELOPMENT EXPENSE

The Treasury's present regulation with respect to intangible drilling and development expense has been in effect for 25 years and was the direct outgrowth of the serious doubt in the mind of the average oil operator as to whether, when he had expended money for drilling a hole in the ground, he could soundly conclude that he would ever get his money back. The basic principle of the regulation is that the oil-producing taxpayer elects with respect to intangible drilling and development expenditures, either to deduct them from income in the year in which they are made or to capitalize them and apportion the deductions over the productive life of the property. It should be clearly understood that when the oil operator has once made his election, it is binding on him for all future years. The only ones who now have an option under this regulation would be those engaging in the oil-producing business for the first time.

This regulation is not an example of special favoritism or ill-considered action. On the contrary, it represents the careful decision of the Treasury Department's own engineering and accounting staff, after a thorough study of the facts peculiar to the business of producing oil and natural gas. Prominent among the facts which existed were:

(1) Every drilling for oil or gas represents an enormous risk, even if it results in a producing well. There is never complete assurance that the well will be productive nor, if productive, that production sufficient to pay the cost of operation will endure beyond the first year.

(2) It is often impractical to distinguish or to allocate expenditures as between development and operation.

(3) Accounting by petroleum producers, both individual and corporate, and both before and after the inception of the income-tax law, reflected these peculiar fact conditions.

Some operators charged off currently all expenditures for intangibles, such as labor, fuel, hauling, and expendable supplies; others capitalized all expenditures with respect to the property until it became commercially productive, and thereafter charged intangible expenditures to expenses; others capitalized all expenditures for intangibles and wrote them off over the life of the property.

None of these methods resulted in an unreasonable determination of the income. Accordingly, the Treasury Department, pursuant to the policy of determining income in accordance with reasonable, recognized accounting methods, consistently applied, reached the conclusion that there should be a choice of methods. Provision for such a choice was first made in a Treasury regulation in 1917.

Although the language of the regulation relative to the election was changed somewhat in subsequent regulations, such changes were nothing more nor less than the straightforward steps of a fully informed Treasury staff toward implanting in the income-tax law a choice of alternative methods which had been found to produce a reasonable determination of taxable income according to the circumstances. The full text of the provision now known as section 19.23 (m)-16 of Regulations 103 appears in an appendix to this statement. (See exhibit C.)

The statement of the Treasury Department before the House committee that the election to charge intangible development costs to expense was equivalent to a "double deduction" is not warranted by the facts or the original intent of the statutes or regulatory provisions. This expenditure is not allowed as a deduction from income but one time. The deduction of intangible development cost is not depletion. Unless the fact is kept in mind confusion over the effect of the election is likely to result.

I will try at this time to give you a brief explanation as to why the election does not result in a "double deduction" and at the same time how the provision operates to provide additional risk money.

The establishment of the option did not rest on the narrow ground of a technical definition of "capital items" or of expense. The regulation recognized the fact that, even if some of the exploration and drilling costs might technically be designated as capital expenditures, nevertheless a reasonable rate of extinguishment of such capital items would, in many cases, write them off wholly, or nearly so, in the first year. Thus there is no real issue here on the question of whether, according to accounting terminology, a capital item may be treated as expense.

Capitalization ordinarily serves only to postpone deduction. Ultimately the capitalized amount should find its way into those deductions which reduce net income. It should be evident that the effect of the Treasury recommendations for the elimination of the deduction is one which would, under ordinary conditions, result in only a temporary increase in tax revenue. The Treasury evidently anticipates, however, that the deductions for amortizing intangible drilling and development expenditures, when capitalized, will continue to be designated "depletion." That designation is not appropriate. The expenditures, when capitalized, should be returnable through depreciation. If they were, the issue would be merely one of immediate versus deferred deduction from gross income. Contrasted with the foregoing is the circumstance that the right to deduct these charges, when incurred, has actually operated to provide the oil operator with some of the risk money necessary to carry out the congressional policy of encouraging the exploration for and development of our Nation's petroleum resources. If, because of earlier recovery, funds were made available which would not otherwise have been available, it was in furtherance of the intent of Congress that those funds be used to carry out its policy.

After due and careful consideration of all of these facts and explanations, we submit that neither the authorized treatment of intangible development costs nor the percentage depletion allowance can be termed "special privileges." We have shown your committee that both provisions were incorporated in the tax law and the Treasury regulations in recognition of the unusual conditions which exist in the producing branch of the petroleum industry and in the furtherance of a definite and wise national policy.

For 25 years both Congress and the taxpayers have accepted the Treasury's regulations which recognize the oil industry's right to expense intangible drilling and development costs, and both Congress and the courts have repeatedly found that the oil producer is entitled to an allowance for depletion. For 16 years, after numerous surveys of this question, Congress has retained the percentage method of calculating this deduction and has adhered to the present rate of percentage. We commend the present Congress for adhering to the historic position of prior Congresses on these questions.

At the time the Treasury Department recommended the elimination of these deductions by the Ways and Means Committee of the House, it also made some alternative suggestions. The oil industry resisted the alternative suggestions on the ground that they were administratively unworkable and that any change would destroy or reduce the existing incentives. Fully detailed information was presented to the House committee and after careful consideration of the entire problem that committee rejected both the recommendation for complete elimination of the deductions and also the alternative suggestions. The Secretary made no reference to them in his appearance before your committee. However, we of the oil industry desire to register our opposition to any change or modification of the existing provisions with respect to percentage depletion and intangible development costs and in support of our position we refer you to the record of the Ways and Means Committee hearings. We submit that the oil industry has been erected on the foundation of these provisions which carry out the policy of Congress and that any change or modification would operate to destroy or retard the exploratory effort and the operation of marginal and stripper properties.

The results of continuing these provisions unchanged are that the petroleum industry has supplied the country with adequate reserves of petroleum, that it has supplied the consuming public with a constantly improved product at a decreased cost. The benefits have accrued to the public. An analysis of the industry's earnings over the past 15-year period shows that the 24 leading oil companies have had an average earning of 5.37 percent on their capital employed, and at the same time 400 industrial companies had an average earning of 7.57 percent on their total capital employed. (The above figures from the testimony of Mr. John D. Gill before the Temporary National Economic Committee with additions for the years 1940 and 1941.)

The Secretary evidently assuming our reserves to be adequate, recommends that these incentives for exploration be eliminated, and he states that the elimination will produce $200,000,000 of additional revenue at the proposed rates. This we assume is his maximum figure. If the Secretary is right in his analysis of our position from the standpoint of petroleum reserves and present trends, and if the Office of the Petroleum Coordinator for War, the Petroleum Industry War Council, the Interstate Oil Compact Commission (see exhibit D attached), the National Conference of Petroleum Regulatory Authorities (see exhibit E attached) and in fact, the entire oil industry is wrong—we will gain $200,000,000 of additional revenue which at the present rate of expenditure would run the Government less than 1½ days. If the Secretary by any chance is wrong, the loss to this Nation cannot be measured in terms of money. If our supply of oil is inadequate, it will at least prolong the war—at a cost not measured in dollars but in the lives of our fighting forces. If our supply of oil is inadequate, we might even lose the war, and it is impossible to calculate what that eventually would cost.

All of the facts to which we have called your attention establish the following propositions:

(1) It has long been the policy of Congress to encourage the exploration and development of petroleum reserves by providing in the tax law reasonable incentives for exploration and assurances of some relief from the unusual hazards of the business.

(2) The wisdom of such a policy has been demonstrated by the accomplishments in the finding of new reserves and by the development of new methods for the recovery of oil from the existing reserves during the past 25 years.

(3) The present known reserves, although great, are not sufficient for the safety of the Nation and its allies.

(4) The continuation in the tax law of the existing incentives and assurances is more important than ever, not only to encourage exploration and development, but to maintain the production from thousands of wells that might otherwise be abandoned.

(5) Percentage depletion, and the right to deduct intangible drilling and development costs in the year in which they are incurred, have proven to be a practical and reasonable means of providing such incentives and assurances.

(6) The suggested substitute methods are impractical and if adopted, would destroy the incentive now existing.

(7) The revenue to be gained through abandonment of the established provisions is far too small to compensate for any threat to our petroleum supremacy, particularly during the greatest war in history.

CONCLUSION

On final analysis the question raised by the Treasury's recommendations is not merely a matter of taxation, or even fiscal policy. The real question is whether Congress believes it wise to change its long established policy of encouraging the development and maintenance of the Nation's petroleum resources at a level adequate to meet any emergency requirements. Considering the magnitude of the over-all budget, the additional revenue resulting from the proposed changes is indeed insignificant when weighed against the dangers of declining national petroleum reserves.

Where does the national interest lie—in the maintenance of an adequate petroleum supply or in a comparatively small increment to its tax receipts? For I can assure you gentlemen, in this case, we cannot have both. Adoption of the Treasury's recommendations would certainly be followed by such a drastic decline in exploratory work, that the effect on reserves would be felt within a short period. This is not a matter of opinion. Application of the laws of simple arithmetic gives the inescapable answer. One of the greatest assets of this Nation is its proven petroleum resources.

We are deeply sympathetic with the plight of the Secretary of the Treasury in the necessity of searching for new funds to finance the war. We do not blame him for scrutinizing with the utmost care every possible source of increased revenue. The petroleum industry is willing to pay its fair and equitable share of any increased taxes that it may be necessary to levy. However, it seems unthinkable, in the greatest crisis that has ever confronted our Nation, when our very existence is at stake, that a tried and proven continuous policy that has resulted in making available in our Nation the largest petroleum reserves in the world would be abandoned in favor of the unknown. Such action would result in a situation that might lose the war. We, therefore, express our complete confidence that this Congress will not make any change in the percentage depletion allowances in the income-tax law, nor in our present right to expense intangible development costs.

(Mr. Fell submitted the following exhibits:)

EXHIBIT A

REPORT OF THE COMMITTEE APPOINTED BY THE PETROLEUM INDUSTRY WAR COUNCIL TO STUDY WAYS AND MEANS OF INCREASING CRUDE OIL RESERVES AND PREVENTING THE PREMATURE ABANDONMENT OF SMALL WELLS

Approved by the Petroleum Industry War Council February 4, 1942

The information submitted herein has been assembled and is presented pursuant to the following resolution of the Petroleum Industry Council for National Defense (now the Petroleum Industry War Council) dated January 7, 1942:

"Whereas, the Petroleum Coordinator has requested information regarding the abandonment of small wells and the method of increasing the oil reserves, therefore, be it

"*Resolved*, That the chairman appoint a committee of nine members to study ways and means of increasing the reserves of oil and prevent the premature abandonment of smaller wells."

INTRODUCTORY

The magnitude of the war effort forced upon the United States by hostile action of an aggressor nation allied with other nations in an attempt to subjugate the world to their debased ideology, is so vast it commands the fullest utilization of all essential raw materials.

It has been stated that in the First World War the United States and its allies "floated to victory on a sea of oil." Today the need for oil for victory is even more necessary. This is not only true because of the world wide nature of the active battle fronts where greater forces than ever before in the history of the world are locked in mortal combat on land, at sea, and in the air, but because the armament, not only of our own forces but all forces of the United Nations, is now so largely mechanized that without oil our armies would be impotent before the onslaught of our enemies. The coordination of the activities of all individuals and operating units of the petroleum industry into a unified effective whole with the purpose of providing our armed forces with an abundance of every petroleum need necessary to the victorious conclusion of the struggle, is not only desirable, but essential.

Fortunately, our country faces the present gigantic need of oil for armament and for the defense economy well provided with proved petroleum reserves and daily productive capacity.

While the total crude oil reserves of the country are estimated to be the highest ever recorded, the declining rate of discovery of new oil over the past few years, if continued, will make it increasingly difficult to retain them at the levels necessary to supply without waste of reservoir energy, the large withdrawals required therefrom by the war effort, the duration of which may prove to be much longer than can now be anticipated.

PRESENT RESERVES OF CRUDE OIL

The most recent figures available on the crude oil reserves of the United States, as this report is written, are those contained in the last survey of the American Petroleum Institute's Committee on Petroleum Reserves, which estimated that on January 1, 1941, crude oil reserves totaled 19,024,515,000 barrels.

While figures as of January 1, 1942, are not yet available, it appears nevertheless to be the general consensus of opinion that new discoveries, and revisions and additions to old fields during last year were somewhat greater than the amount of oil produced, and that the net result of finding and producing oil during 1941 was a slight continuation of the upward trend of proved reserves which began in 1935, after a short period of decline in the amount of oil known to be available and recoverable by present means of extraction.

The estimated crude oil reserves as of January 1, 1941, namely, 19,024,515,000 barrels, can only be recovered if production rates are restricted to make the maximum use of the natural reservoir energy in the fields constituting this reserve. Violations of the laws of conservation would result in substantial reduction of the estimated oil which may be recovered. If prudent practices are followed withdrawals from presently known reserves will follow a pattern of gradual decline toward marginal well productivity and continue at that rate over a period of 30 years or even longer as evidenced in the eastern fields of the United States. And even if unrestricted production were permitted these reserves cannot be made to yield all their production over the period of years indicated by the ratio of current withdrawals to total reserves. Recognizing these facts the petroleum industry has considered as a desirable objective the establishment of a level of reserves which would allow the production of current requirements at the optimum rate of production commensurate with the preservation of reservoir energy.

TREND OF OVER-ALL ADDITIONS TO RESERVES

The individual yearly additions due to new discoveries, and revisions and extensions to old fields, which in 1932 registered the lowest annual total since 1900, showed continuous and gratifying additions through 1937. Since then these annual additions, even including the expansion in fields previously discovered, have become successively smaller, and whereas by the end of 1937 the total estimated crude oil reserves had increased considerably above the 1932 level—the falling off in annual additions since 1938 has resulted in a decelerated rate of increase in total reserves since that time.

The declining rate of additions to total reserves is rapidly approaching the amount currently being withdrawn as production, and unless this downward trend is reversed, the total of new discoveries, and revisions and additions to old fields can be expected to fall below annual crude oil requirements as may clearly be seen in accompanying graph A.

With possible increased demand for petroleum due to the war effort, such a trend is undesirable. Much time and effort has been spent by the industry and others in an effort to build crude oil reserves and potentialities to produce to such an extent that the optimum rate of production of crude petroleum may at least equal, if not exceed, the total crude oil requirements of the country. Prolonged decline in reserves would make more difficult the application of accepted good practice in the production of our crude oil requirements.

It must be kept in mind in contemplating the above trend and conditions that the figures of new additions to reserves referred to there, include not only the oil found as a result of the discovery of new fields and producing areas, but also the additions to and revisions in the older fields, which have come about as a result of revisions of earlier estimates of recoverable oil, additional drilling, and exploratory work.

TREND OF DISCOVERY OF NEW FIELDS

Were we to consider only the new oil found as a result of the discovery of new producing fields, and exclude revisions and extensions of older fields, such data would indicate that a downward trend in the rate of discoveries set in as far back as 1937. Since about 1938 the amount of oil found through these discoveries has been less than the amount of crude extracted from the ground even though the rate of exploratory work, as measured by the number of dry holes drilled, has increased throughout the entire period since that time. The curves on the accompanying graph B allow a comparison between discovery rates and production rates since 1920.

The number of dry holes drilled each year is an index of the amount of exploratory work undertaken. Studies[1] of the number of dry holes drilled in relation to major fields discovered divulge some very interesting trends and the conclusion is clear, as shown on the accompanying graph C, that an increasing

[1] Wallace E. Pratt, Mining and Metallurgy, vol. 22, No. 415, p. 349.

total number of wells must be drilled in order to discover the same amount of oil as formerly and this because of the increasing number of unsuccessful wells, thus adding to the already high cost of finding and producing oil.

A major field is defined as one whose ultimate production will exceed 20,000,000 barrels, currently equal to about 5 days' crude-oil production for the United States as a whole. Such fields have accounted for more than 80 percent of all the oil discovered in the entire country.

For instance the record shows the following number of dry holes drilled for each major field discovered in each of the periods indicated: 1934–36, 280; 1935–37, 290; 1936–38, 320; 1937–39, 410; 1938–40, 700. In other words, the chance of finding a major field during the 1938–40 period had become 2½ times as difficult or 2½ times less likely than during the 1934–36 period. . . .

EXPLORATORY ACTIVITY, DISCOVERIES, AND PRICE RELATIONSHIPS

The apparent increasing difficulties being experienced in finding new fields may suggest that the industry has entered a phase which will demonstrate that the various geophysical methods, so successfully employed during recent years, are becoming less effective in finding oil. Consequently new means of discovery are needed and perhaps a greater resort to random drilling until such time, at least, as new methods now being advanced and studied shall have been proved effective.

Following is a table indicating the methods used in discovering major fields through 1939, by decades:

Number of United States major oil fields [1] discovered, by method of discovery [2]

Period	Geology				Geophysics	Deeper drilling	Surface indications	Random drilling	Total
	Surface geology	Subsurface geology	Core drilling	Total geology					
1870–79	1.0			1.0					1
1880–89									
1890–99	1.5			1.5			2.0	1.5	5
1900–1909	5.7			5.7			4.8	6.5	17
1910–19	29.7			29.7		1.0	7.4	6.9	45
1920–29	55.0	18.7	6.6	80.3	4.0	6.1	11.6	15.0	117
1930–39	23.0	20.5	1.2	44.7	61.2	0.1	2.3	6.7	124
80-year total	115.9	39.2	7.8	162.9	65.2	16.2	28.1	36.6	309

[1] Major oil fields defined as all those having more than 20,000,000 barrels ultimate recovery. These fields account for 80 percent of all oil found in the United States.

[2] Practical figures used where more than 1 method of discovery contributed to discovery of a field.

Authority: Wallace E. Pratt and L. G. Weeks, in Finding and Producing Oil.

That the price of crude oil does affect the rate of exploratory activity is clearly illustrated in graph D which shows the trend of price of crude oil and the magnitude of the finding effort as indicated by the number of dry holes drilled. For instance, the weighted average price of crude oil in the United States for the 3-year period of 1924–26 was $1.90. During that period there were about 20,100 dry holes drilled. Immediately following this period the price of crude oil turned downward, a trend which continued to such an extent that the weighted average price per barrel during the 3-year period of 1931–33 was 70 cents. The number of dry holes drilled during this period also declined continuously after the momentum developed by the previous upward trend of price had been dissipated. The effect of the lowering price level was reflected slowly at first, in that the rate of increase in the number of dry holes was still upward for a short period, but at a decelerating rate until the curve of such drilling finally started downward and accelerated as the price curve continued downward also.

The trends just referred to reached the fullest extent of the potentialities involved during the 1931–33 period, when the average price of crude oil for the country as a whole was 70 cents a barrel, the lowest level for more than 25 years. The number of dry holes drilled also established the lowest level of many years during the 1941–33 period, when 10,600 were drilled, about 50 percent of the 1924–26 rate when oil was $1.90 per barrel.

The trend of price then turned upward and continued to rise at an accelerated pace over several years but then slowly eased off in its upward movement until a downward trend again set in during 1937. This downward trend continued into 1940.

The number of dry holes drilled followed an almost identical course with the upward price trend which began late in 1931. This was upward quite rapidly at first, but gradually slowing up, not as quickly, however, as the price trend, since the full upward momentum of exploratory work, brought about by the previous greatly accelerated upward movement of price, had not yet entirely spent itself. With the momentum dissipated, the number of dry holes drilled slowed up considerably until the curve had almost become flat, the rate of increase being considerably reduced by the relatively lower prices which existed during the 1938–40 period. In connection with these relationships it is again interesting to note that as the price of crude oil showed renewed upward tendency in the 1939–41 period the number of dry holes drilled during the same period again reacted upward.

After establishing a new record low during 1932 the increased rate of new oil found, for several years followed the increased trend of drilling activity created by the upward trend of price which existed at that time. This upward trend of ned discoveries continued through 1934–36 period and reached its high in 1937. This was coincident with the trend of price and drilling activity, but from 1937 through 1940 new discoveries were downward at an accelerated rate, which occurred in spite of the fact that during the entire period exploratory work still continued upward, although tending to reverse itself as the price of crude oil flattened and declined toward the end of the period. More recently, as was indicated earlier, the price slumped off, as did drilling, and this further accelerated the downward course of new discoveries; however, there were doubtless other things involved in this situation such as the unattractive allowables granted to new fields and the general tax situation, bringing about conditions not commensurate with the risk involved.

In 1941 the price increased slightly as did the number of dry holes drilled, but as stated earlier, the new discoveries during last year no doubt continued to decline. Further reference to graph D will show these trends and relationships.

ABANDONMENT OF SMALLER WELLS

Involved, of course, in this situation as to trends of reserves and other developments are a large number of small producers frequently referred to as "marginal" or "stripper" wells. Such wells might be defined as any well producing at a cost which closely approximates the revenue from the sale of oil from such well. Obviously the output of the well cannot of itself be the determining factor as to classification, it being an undeniable fact that many wells of rather small production, even as little as a fraction of a barrel per day, often are profitable producers, whereas many of larger production are not. It would seem that whether or not a well falls in the stripper class is more definitely related to whether or not it is an economic or uneconomic operation, than it is to size. It is generally recognized in the industry that recent increases in producing costs in the way of material, labor, taxes, etc., have forced many wells into the so-called stripper group.

The abandonment of uneconomic wells is a continuing process in the operation of the petroleum industry and the rate at which these abandonments occur fluctuates with the rise and fall of conditions surrounding their operation. Factors that influence the abandoning of wells are the return received for the oil produced and the condition of the reclaimed materials market and whether or not the price of recoverage equipment as used material, or as junk, exceeds the value of the well as an operating unit, all in relation to the capabilities of the well as a producer or as an economically justifiable operation.

Placing restrictions against an operator abandoning a well which he no longer deems an economic operation would not prevent the operator from discontinuing to pump his well but it would have the effect of prohibiting him from salvaging the material in order to use it elsewhere. Although only limited quantities of salvage material are suitable for new and deeper wells, this would to a degree defeat the purpose intended in that the material would then be frozen in the ground with no oil being produced through the use thereof. Such restriction would be artificial and would operate against normal economic forces and conceivably would withhold from oil field supply markets materials which might possibly have been used in the finding elsewhere of considerable additional new oil reserves.

There are at the present time about 400,000 producing wells in the United States and for the past 3 years new oil wells completed have averaged 20,400 per year. Abandonment of old wells has averaged 10,100 during the past 10 years. This is an estimated figure based upon the number of producing oil wells in operation at the beginning and end of each year, with consideration given to the number completed during the year.

While there are a large number of wells falling into the marginal or stripper classification, the margin of profit of these wells varies considerably and it is only the wells which have reached the break-even point under existing conditions which are affected by changing crude or junk prices.

Information on the number of abandonments over the past few years was recently obtained from States in which about 70 percent of all of the oil wells in the country are located. No information is available for the State of Pennsylvania which has 21 percent of all wells. Based upon the 70-percent sample, the details of which are shown in table I, it is estimated that the trend of abandonments over the country as a whole during the past 5 years has been as follows: 1937, 8,200; 1938, 8,400; 1939, 10,000; 1940, 9,300; 1941, 10,700.

The trend of these abandonments by months in the States for which 1941 information is available is set out in table II. Annual totals for these States for 1939 and 1940 are also shown, monthly information for these years not being available to the committee as this report was written.

Study of the information contained in the tabulation next set out, and that in the table of abandonments for 1939, 1940, and 1941, indicated earlier by States, will show that many are in the States of small production and doubtless the average for the abandoned wells was less than the average production of all the wells in these States.

While information indicating the daily average crude-oil production involved in the abandonments enumerated is not definitely available, it would appear to be the logical conclusion from the foregoing that no very great amount of daily production was involved, perhaps not much more than one-half of 1 percent of total production and perhaps a lesser amount.

This low rate of production of abandoned wells would seem also to apply to most discarded wells in the central west and in a large part of the mid continent. In California and in parts of the Gulf coast as well as in the Rocky Mountain district a somewhat different situation may exist due to the heavier type of oil produced in many of the fields in these districts, and information is available to the committee which indicates that a worth-while number of wells in California, overlying a considerable reserve of heavy oil, have had to be shut down due to the inability of the owners thereof to continue to operate them on a paying basis.

Figures showing the number of wells producing in each State at the end of 1941 and the daily average crude-oil production per well per day appear in table III.

The committee was unable to determine the amount of reserves generally involved in the question of abandonments. However the over-all figure was not thought to be large, and perhaps not greater in relation to total reserves of the country than is the production involved in relation to total production of crude oil.

SUMMARY

The committee's study of the data presented suggests the following conclusions:

1. That additions to the Nation's known oil reserves have shown a declining trend for the past 3 or 4 years.

2. That new reserves are needed in order to meet indicated consumptive demand without waste.

3. That there is an indicated trend of increased abandonment of small wells.

4. That an increased number of wells must be drilled in order to discover the same amount of oil as formerly.

5. That premiums granted discovery wells in the form of increased allowables are an incentive to exploration.

6. That adequate prices of crude oil, which give consideration to over-all costs, are essential to exploration incentive and to extend the economic life of small wells.

7. That retention of present statutory percentage depletion allowance is essential to the above objectives.

War conditions may temporarily restrict civilian use of petroleum and its products, but to offset this defense demands are rapidly increasing and it is possible that the petroleum resources of our Allies may be lost to them through enemy action making it necessary for the United States to supply any resulting deficiency. Regardless of immediate demand oil has become one of the most critical materials in modern civilization. Long-term trends of consumption are strongly upward and it becomes vital that this country not only maintain but increase its known reserves of crude petroleum.

For all fields which have not been substantially depleted there is an approximate optimum rate of production, which, if exceeded, results in waste of natural energy and loss of ultimate recovery. It is essential, therefore, that reserves be maintained at that amount at least which will permit production sufficient to meet consumptive demand without violation of recognized laws of conservation. The data presented in the earlier section of this report indicates that the reserves of the country may soon be inadequate to supply current requirements without waste.

Since the introduction and refinement of geophysics no great advance has been made in the art of oil prospecting. The record shows an ever-increasing amount of nonproductive drilling required for each important discovery. Less positive evidence in advance of drilling is clearly apparent. The conclusion seems inescapable that greater sums must be expended for exploration if we are to increase or even maintain the Nation's reserves.

The industry is qualified and prepared to increase its exploratory effort, dependent on two primary factors—first, the incentive to venture, and, second, the availability of venture money. It will be seen that these two factors are closely related.

Satisfactory prices for crude oil adequate to cover all operating and discovery costs and taxes are essential to maintain finding effort. Potentially advancing prices greatly accentuate the motive force behind such effort. The discovery rate under prices and other conditions existing during the past few years has declined. Accordingly, it is reasonable to conclude that higher prices for crude oil would speed up finding effort and discovery rates and would tend to build up reserves.

The industry relies upon the over-all difference between cash income and cash outgo to provide the funds for exploration. Exploration is a controllable expense. In a broad sense that amount remaining after meeting all other expenses is allocated to exploration. With constantly increasing tax levies such remainder correspondingly decreases. Tax assessments are, in fact, direct charges against funds otherwise available for exploration.

The present percentage depletion allowance embodied in the tax laws is a modification of the original discovery depletion allowance, adopted 24 years ago as an incentive to stimulate discovery and development of the petroleum resources of the country. The oil industry of today stands as a tribute to the wisdom of the Congress and its tax-making bodies in that it has been ever ready to meet the rapidly increasing demands of the Nation, and with lower prices for its products over that period. It can be demonstrated that the establishment and application of the principle of depletion allowance in determining income tax has been one of the most effective motivating forces in establishing the present levels of crude oil reserves.

In view of the present emergency, and in consideration of the downward trend of new discoveries against increasing demand, suggestions of the Treasury Department that percentage depletion be reduced are shortsighted and show a complete lack of appreciation of the imperative need to maintain the incentive to find new oil, which results from this provision. An increase in this allowance would be wiser over-all governmental planning.

Similar conclusions can be reached with respect to the problem of extending the life of marginal wells. Incentive provided by increased prices or anticipation of higher prices serves to encourage the operator to continue wells even after their economic limit has been reached. Statutory percentage depletion allowance also serves to retard abandonment of these small wells.

Respectfully submitted.

O. D. DONNELL, *Chairman.*
FRANK BUTTRAM,
J. F. DRAKE,
WALTER S. HALLANAN,
WM. F. HUMPHREY,
JOHN M. LOVEJOY,
CHAS. P. MCGAHA,
LAWRENCE VANDER LECK,
H. C. WIESS,
Committee.

TABLE I.—*Oil-well abandonments*

[NOTE.—The States listed below are the only ones which replied to wire requesting this information]

State	1937	1938	1939	1940	1941
Arkansas	98	91	164	162	108
California	273	251	269	321	326
Colorado	22	10	23	16	10
Illinois	104	145	421	410	392
Kansas	574	493	640	549	609
Louisiana	559	573	807	690	746
Michigan	194	212	282	303	221
Mississippi					2
Montana	16	36	50	26	51
Ohio	1,234	1,105	983	831	1,053
Oklahoma	1,007	1,174	1,075	1,249	1,247
Texas	1,246	1,320	1,907	1,534	2,083
West Virginia	266	330	355	323	472
Wyoming	84	139	42	68	56
Totals	5,724	5,878	7,018	6,482	7,466
Estimated United States total based upon above State information	8,200	8,400	10,000	9,300	10,700

TABLE II.—*Oil well abandonments for years 1939 and 1940 and for year 1941 by months*

State	1939 total	1940 total	1941 total	1941 Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Arkansas	164	162	108	6	7	3	8	6	8	7	9	13	17	20	6
California	269	321	326	26	22	29	26	23	29	37	26	28	33	25	28
Colorado	23	16	10	1		4	1			2				1	1
Kansas	640	549	609	23	35	30	48	57	79	103	94	75	44	44	67
Louisiana	807	690	746	44	14	39	89	53	64	61	87	86	85	[1] 61	[1] 61
Mississippi			2			1		1							
Montana	50	26	50		3	2	2	4	12	3	4	6	5	4	5
Ohio	983	831	1,053	52	78	51	89	79	97	92	125	88	106	113	83
Oklahoma	1,075	1,249	1,247	102	65	44	154	90	123	139	138	109	132	76	95
Texas	1,907	1,534	2,083	157	147	107	175	207	141	148	138	113	258	164	238
Total	5,962	5,378	6,324	410	361	310	594	519	544	582	623	520	680	498	663

[1] Estimated.

Source: Requested by wire.

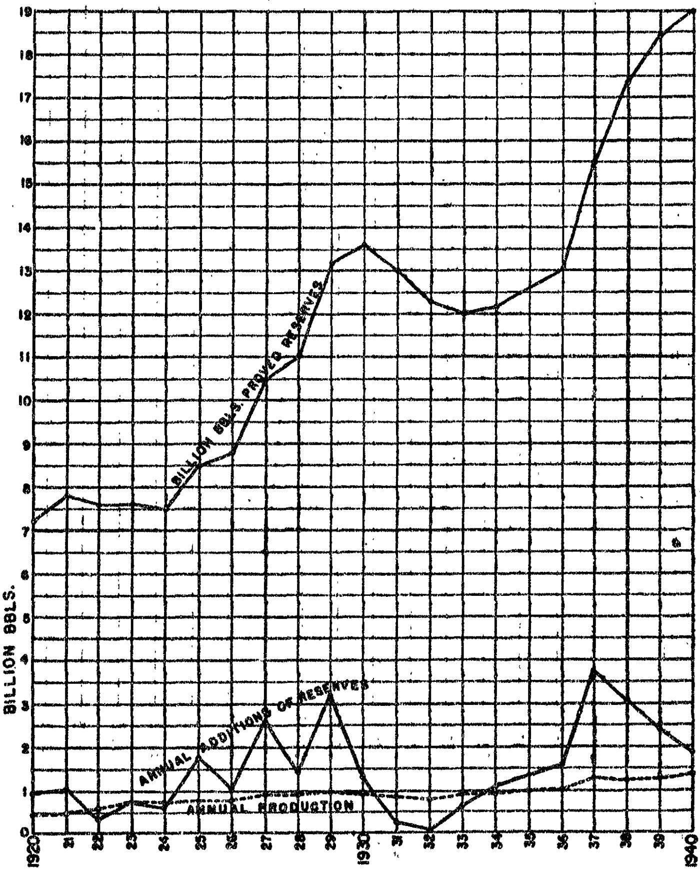
TABLE III.—*Producing oil wells in the United States by States and average production for 1941*

	Total producing oil wells end of 1941	Average production per well per day during 1941		Total producing oil wells end of 1941	Average production per well per day during 1941
Arkansas	2,942	24.5	New Mexico	3,637	30.8
California	16,944	39.1	New York	20,950	.7
Colorado	214	24.0	Ohio	24,000	.4
Illinois	23,434	18.5	Oklahoma	54,787	7.7
Indiana	1,862	10.4	Pennsylvania	82,250	.6
Kansas	21,784	10.4	Tennessee	81	1.0
Kentucky	14,300	.9	Texas	98,927	14.1
Louisiana	7,100	47.2	Utah	17	.6
Michigan	3,135	14.7	West Virginia	17,800	.5
Mississippi	335	193.5	Wyoming	3,530	33.4
Missouri	90	1.4			
Montana	1,918	11.1	United States total	400,061	9.7
Nebraska	74	90.0			

Data taken from The Oil Weekly Jan. 26 1942.

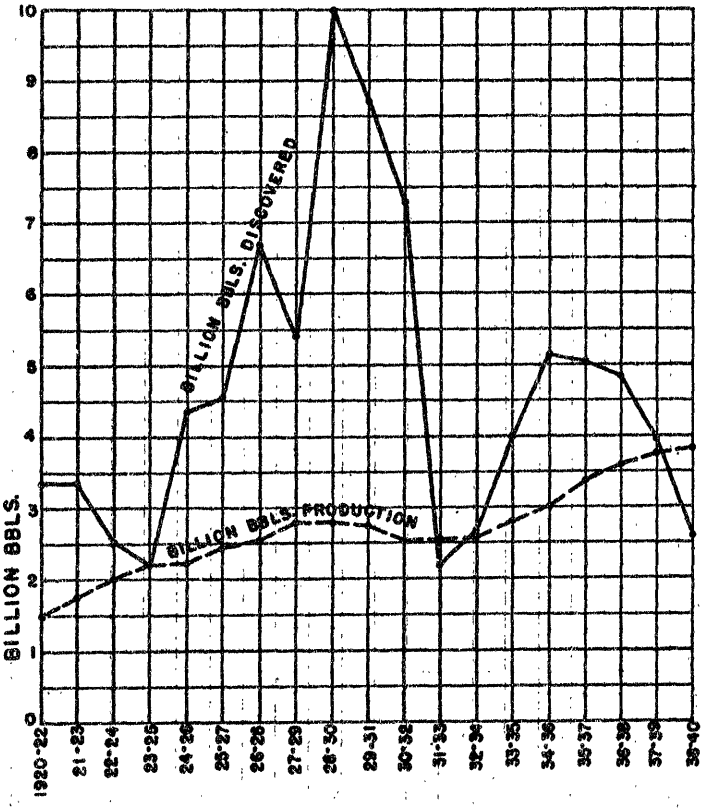
GRAPH A. ANNUAL ADDITIONS OF RESERVES, TOTAL PROVED RESERVES AND ANNUAL PRODUCTION

[Basic reserve data for years prior to 1935 taken from information developed by department of statistics, American Petroleum Institute. Data for 1935 and subsequent years is taken from information developed by American Petroleum Institute's committee on petroleum reserves. Production data are those of the Bureau of Mines.]



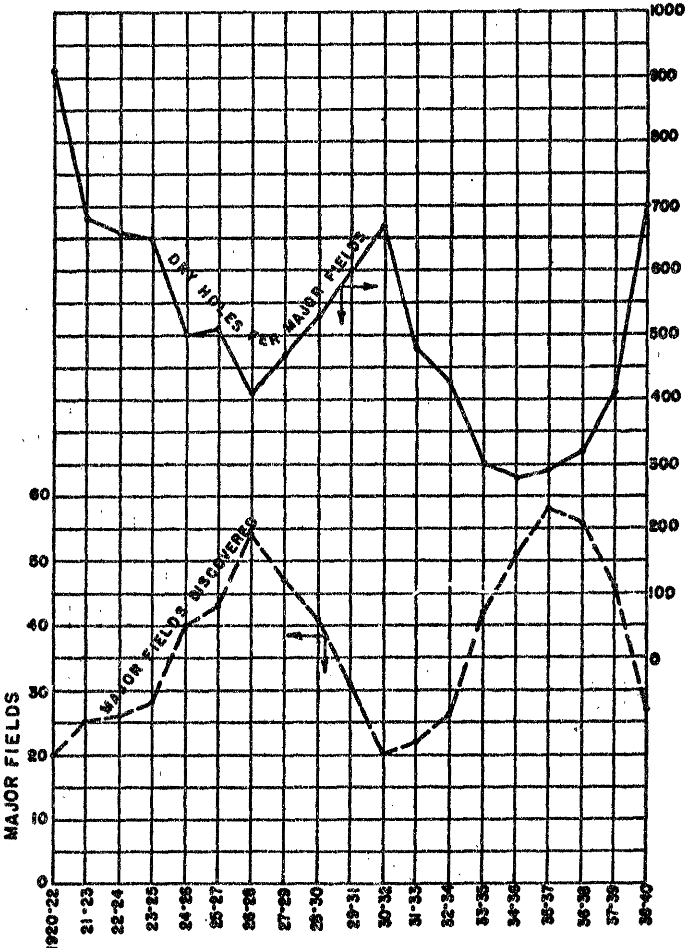
GRAPH B. VOLUME OF NEW DISCOVERIES AND PRODUCTION—OVERLAPPING 8-YEAR PERIODS, 1920–40, INCLUSIVE

[Discovery data taken from article entitled "Oil, Discovery Rate 8 Years Hence Depends on Price of Crude Now," by Wallace E. Pratt, published in July 1941 issue of Mining and Metallurgy. Production are those of the Bureau of Mines.]



GRAPH C. MAJOR FIELDS DISCOVERED AND DRY HOLES DRILLED PER MAJOR FIELD—OVERLAPPING 3-YEAR PERIODS, 1920–40, INCLUSIVE

[Basic data taken from article entitled "Oil Discovery Rate 3 Years Hence Developed on Price of Crude Now," by Wallace E. Pratt, published in July 1941 issue of Mining and Metallurgy.]



GRAPH D. DRY HOLES DRILLED, AVERAGE PRICE, NEW DISCOVERIES AND NEW DISCOVERIES PER DRY HOLE—OVERLAPPING 3-YEAR PERIODS, 1920–40, INCLUSIVE

[Basic data taken from article entitled "Oil Discovery Rate 3 Years Hence Depends on Price of Crude Now," by Wallace E. Pratt, published in July 1941 issue of Mining and Metallurgy.]

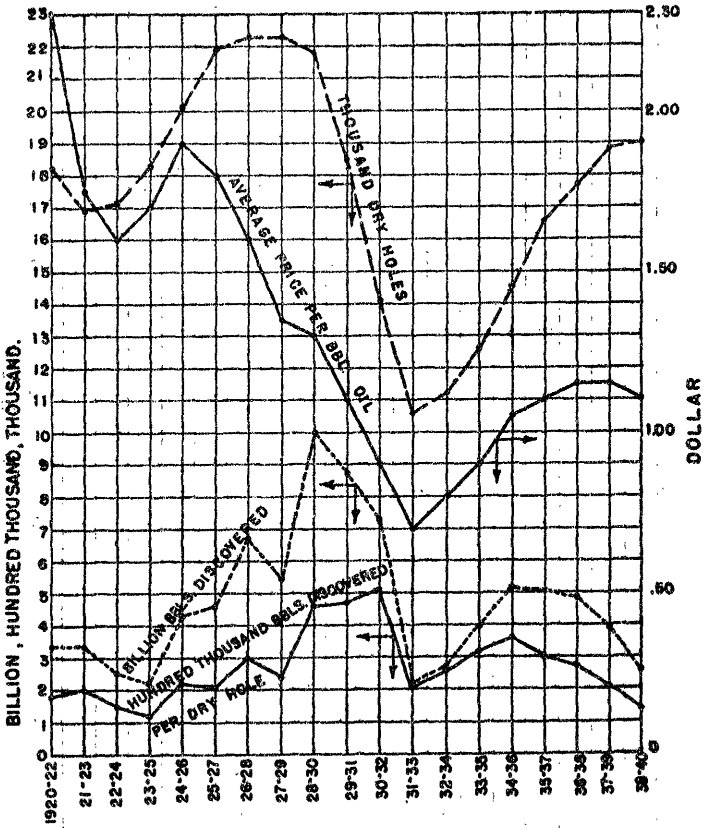


EXHIBIT B

[From the Oil Weekly, March 2, 1942]

OPC SAYS 19,300 WELLS WILL MEET '42 REQUIREMENTS

SURVEY OF INDUSTRY'S POSITION AND EQUIPMENT NEEDS PREPARED FOR WAR PRODUCTION BOARD AND PRESENTED TO THE COLE COMMITTEE IN WASHINGTON LAST WEEK, EMPHASIZES NECESSITY FOR CONTINUED DEVELOPMENT IN PRODUCTION BRANCH TO INSURE ADEQUATE SUPPLY OF PETROLEUM PRODUCTS FOR THE WAR PROGRAM

The growing shortages of critical materials resulting from the urgent requirements of the war program make it necessary for the War Production Board to review carefully the needs of all industries, with a view to limiting expenditures to the minimum consistent with essential operations. With respect to the petroleum industry, the question has been raised concerning the necessity of expending materials in the production branch for the drilling of wells, referring particularly to development drilling as opposed to exploratory drilling. This report presents an analysis of the situation which shows that it is essential to make available certain quantities of materials for development as well as exploratory drilling in order to provide an adequate sustained supply of petroleum for the war program.

Essential character of petroleum

The importance of petroleum to the war program and supporting essential industrial and civilian activity is quite widely and fully recognized Petroleum has often been appropriately termed the "lifeblood" of our Nation, and it truly is an absolute necessity to the war program and to our modern industrial operations. Without the products of petroleum, our air arm could not rise from the ground to engage in combat; modern armies could not be placed and maintained in the field; our naval units would be reduced to hulks of scrap metal; transportation facilities would be largely stalled for want of fuel, proper lubricants, or other products; our entire industrial system would likewise be practically paralyzed; and the whole range of human activity would automatically be drastically curtailed. It therefore follows that it is imperative, as a part of the war program, to insure an adequate and sustained supply of petroleum products to meet fully all likely or possible military and essential industrial and civilian requirements for such commodities.

Necessity for maintaining petroleum reserves

The first and principal requirement to insure an adequate and sustained supply of petroleum products for the war program and other essential needs is to develop and continuously maintain sufficient known and developed underground reserves of crude oil and natural gas to provide the productive capacity to meet all necessary demands for these raw materials. The other requirements of course involve providing adequate transportation, refining, and distribution facilities in order to gather the raw materials, manufacture the desired products, and deliver them to the points of need. However, the maintenance of adequate known developed reserves is the basic requirement, for crude oil and gas reserves constitute the foundation of the entire petroleum industry. Without a supply of the raw materials out of which petroleum products are made, the refining and other facilities comprising the industry would serve no useful purpose.

Productive capacity and required reserves

The maintenance of adequate petroleum productive capacity is dependent upon active exploratory operations to locate new fields and upon proper development of the new reserves as discovered. Such operations must proceed concurrently with production operations, for new fields cannot be discovered and developed overnight or at will. The process is at best complicated and time consuming.

The discovery and development program should be designed to locate and make available for production new reserves at a rate consistent with the total known developed reserve on hand at any time and with the rate of production and consumption of the known reserves at the same time. Such a program is necessary for two principal reasons. Firstly, the fluid and fugacious nature of oil and gas is such that they ordinarily are readily handled, refined, and transported rapidly and in large volumes; but these same properties make them relatively difficult and expensive to store above ground in large quantities in relation to demand.

Thus, oil and gas are produced for use on substantially a day-to-day basis, particularly so in the case of gas, and the above-ground stocks or inventories of oil are relatively small in terms of consumption or days' supply. Secondly, developed petroleum reserves and productive capacity are actually a "wasting asset," and each barrel of oil produced from a given developed reserve diminishes the size and the productive capacity of that particular reserve. Hence, in order to maintain productive capacity at the required level, the production or depletion of known developed reserves must be offset by new discoveries and development; and a backlog of known and developed underground reserves must be maintained at all times in an amount consistent with the current and likely future requirements for petroleum.

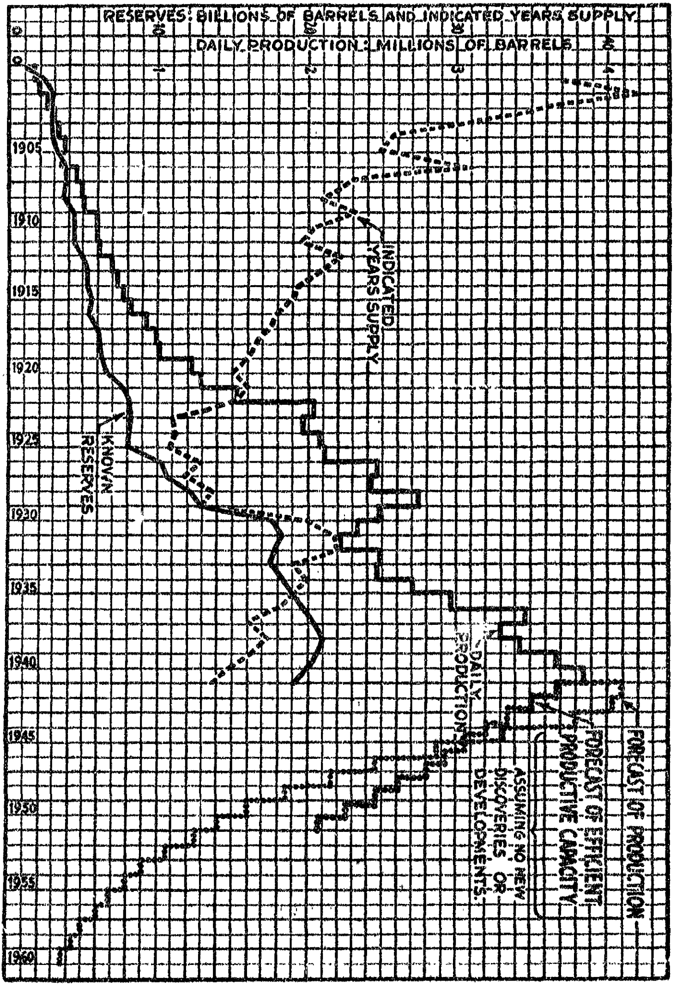
The history and experience of the industry indicates that the amount of known developed underground reserves on hand at all times should be maintained at the equivalent, in terms of the likely consumption, of an indicated supply for at least 15 years, and preferably 20 years, in order reasonably to insure an adequate sustained supply and to provide reasonably efficient operation and oil recovery. To one who is not fully informed of the physical conditions surrounding the production of petroleum, an "indicated years' supply" of 15 to 20 years may seem quite abundant, and it might be concluded that a moratorium on well drilling and petroleum operations could be declared for an indefinite period without serious consequences under such circumstances. Thus, for example, it might be thought that a known developed underground reserve of 15,000,000,000 barrels of oil would sustain a production rate of 1,000,000,000 barrels annually for 15 years without further discovery and development of new reserves during the period. That such reasoning is completely erroneous is commonly recognized throughout the industry and is revealed fully by the actual production histories of literally hundreds of oil fields. As indicated previously, the productive capacity of any specific reserve diminishes continuously as production and consequent depletion of the reserve proceeds. Experience shows that the natural physical limitations on the rate at which oil can be produced are such that most oil fields must be operated for a period of at least 25 years and usually longer in order to obtain all of the oil that is practicably recoverable.

Status of United States oil reserves

The question has been raised concerning the adequacy of the present known petroleum reserves of the United States to supply for an indefinite period the requirements of the war program and essential supporting activity. As a move to conserve critical materials, it has been suggested that well drilling, particularly that concerned with the development of fields, might be eliminated or drastically curtailed for a period of time. The consequences of such action may be quite definitely determined through an analysis of the present petroleum reserve situation. Resort to theory, trial, or speculation is unnecessary, as reasonably accurate deductions concerning the results of following such a course may be made simply on the basis of operating experience.

The Nation and the petroleum industry are fortunate in that the industry has, over past years, been able to supply all requirements for petroleum and at the same time to build up a substantial backlog of known underground reserves of crude oil. As of the first of the year 1942 there existed a known underground oil reserve of approximately 19,000,000,000 barrels which is the result of continued discovery and development operations extending over past years as far back as the year 1900 and before.

Referring to the attached chart, it is seen that the known underground reserves of crude oil in the United States have increased greatly over past years, despite a more than twenty-fold increase in rate of production since the year 1900. Reserves have been increased from a level of between two to four billion barrels in the decade 1900-10 to about 19,000,000,000 as of the first of the year 1942, while daily production has risen from just under 180,000 barrels per day in 1900 to 3,845,000 barrels per day for the year 1941. Production continues to mount rapidly as a result of the war program, and it is now just under 4,100,000 barrels daily which is equivalent to an annual production of close to 1½ billion barrels.



Reserves and Production of Crude Oil in the United States

Under the current demand for petroleum the current known underground reserve is equivalent to an "indicated years' supply" of about 13 years. While there exists sufficient productive capacity to satisfy the immediate demands likely to be made upon the industry without material effect upon producing efficiency, yet the current reserve in terms of current oil requirements is less than the minimum value of the proper level of reserves. Actually it would be desirable to have available a known developed underground reserve of around 25,000,000,000 barrels under the current rate of production as compared with the present actual 19,000,000,000 barrels.

The thought is prevalent among those who are not informed on the subject that the United States is possessed of a great abundance of petroleum and that, without qualification, the industry is prepared to meet indefinitely all requirements. It is unfortunate that the industry itself is partly responsible for this erroneous and harmful public impression.

The performance of the industry in the past indicates that it will likely be able to fill the demand for petroleum unless a too drastic limitation of operations, because of restrictions on materials, is imposed. However, it will be shown that unless materials required for necessary drilling operations are made available, the reserve position would soon become critical and the productive capacity would diminish rapidly far below anticipated essential requirements.

The attached chart demonstrates the fact rather strikingly that contrary to popular belief, an overabundant known underground crude oil reserve does not exist in the United States at this time. It shows clearly that the petroleum industry must be in a position to carry on exploration and discovery activities with even greater intensity than in the past and that reasonable development operations must also be conducted.

Plotted on the chart are: (*a*) the known underground reserves of crude oil as of the first of each year since 1900, (*b*) the average daily production by years since 1900, (*c*) the "indicated years' supply" of crude oil represented by the known underground reserves, which is obtained by dividing the known [1] underground reserves shown for the first of each year by the annual production of the preceding year, and (*d*) forecasts of production and efficient productive capacity assuming that new discovery and drilling operations were stopped as of January 1, 1942.

Forecast of productive capacity with no new development

The most significant features of the chart are the forecasts of the rapid reductions in productive capacity of presently known reserves which would occur under the assumption that new discovery and development operations were terminated as of January 1, 1942. These are indicated by the light dotted black and red lines on the chart projected from the beginning of the year 1942. As previously stated these forecasts are based simply opon actual operating history and experience.

The light dotted black line was forecast on the premise that drilling would cease entirely on January 1, 1942, and that production would be continued for as long a time as possible at the present national total production rate of about 4,100,000 barrels per day. It is seen that the current production rate could be maintained under such circumstances only through the present year and that the year 1943 would witness the beginning of a natual decline in production. By 1944 productive capacity would drop to 3,800,000 barrels per day, and it would fall very rapidly thereafter as shown.

The light dotted red line was forecast on the premise that production would be limited at all times to the estimated efficient production rate for each field and that all exploratory operations would cease but that drilling would proceed until all presently known reserves were fully developed. It is estimated that this would require approximately 11,400 wells. Under such conditions, production would have to be reduced to 3,700,000 barrels per day for 1942, and it would thereafter diminish at the rate of about 150,000 barrels per day annually. The two dotted curves bound the range of varied conditions within which it might be expected that the rate of crude oil production might logically be expected to fall. I is significant that even though production of crude should be artificially limited in the future to say 3,500,000 barrels per day, by restriction of the consumption

[1] It should be understood that the known underground reserves shown for any particular time represent the estimated recoverable oil then remaining in all of the oil fields discovered up to that time. Thus the reserve indicated for a specific date does not include the reserves of those fields subsequently discovered.

of petroleum products for reasons of rubber or automobile shortages, transportation difficulties, or other causes, such a production rate could not be maintained without continued drilling to discover and develop new supplies of oil for maintaining a proper backlog of developed reserves.

Another factor of considerable importance, bearing upon the question of maintaining oil production during the year 1942 under the assumption of cessation of drilling, is that some 43,000 wells now flowing naturally would soon necessarily have to produce at capacity in order to offset the decline in production of older wells. The result would be that such wells would soon cease natural flow and would then require installation of pumping or other artificial lifting equipment. This equipment involves the use of the highest quality steels as well as gears and engines, all of which are critical. With continued development and the maintenance of reserves at a proper level, the majority of the wells in question would continue to flow naturally indefinitely.

Diminishing trend of "indicated years' supply"

Referring to the historical features of the chart, it is to be noted that while the known underground reserves of crude oil have been greatly increased over past years, yet the increase in reserves has not kept pace with the phenomenal record of the rise in production. In other words, the expression of known reserves in terms of future supply has diminished substantially over the long term as a result of the tremendous increase in the demand for crude oil. This fact is revealed by the heavy black dashed line plotted on the chart and labelled "Indicated Years' Supply", which as indicated before, was obtained by dividing the known underground reserves on hand as of the first of each successive year by the annual production during the preceding year. It is seen that although only relatively small reserves of crude oil were known at the beginning of the century, yet they were large in terms of the annual production at that time and constituted an indicated supply for the demand at that time of from 30 to 40 years. As the demand for oil rapidly increased, the indicated years' supply trended downward sharply until the latter part of the decade 1920–30, even though discoveries of new reserves exceeded production and substantial additions to known reserves were made.

With the widespread application of approved scientific exploration technique and as the result of the discovery of several exceptionally large fields, known reserves gained rapidly following the year 1925 and outstripped the rising demand for oil, so that the indicated years' supply increased from a low of 11 years, as of the first of 1926, to 22 years for 1933. At that time, however, the trend reversed, and it has since been sharply downward, having reached a value of just under 14 years as of the first of 1942.

Necessity for continued discovery and development

The decidedly downward trend in the indicated years' supply of known underground crude oil reserves presents a rather unfavorable outlook when one reflects upon the necessity of insuring an adequate sustained supply of petroleum for the war program and supporting essential activities. The picture becomes more disturbing when the fact is realized that new discoveries of petroleum have failed to balance production during the past 3 years by a total of about 2,000,000,000 barrels, as may be seen by reference to the chart. Furthermore, the known reserves of natural gas have been seriously depleted in important sections of the country because of the lack of further discoveries. Demand for gas by strategic and essential businesses in highly industrialized areas is now seriously pressing the available supply.

The cause of this situation may be traced entirely to the simple cold fact that the discovery of prolific new fields, particularly in the case of oil, is becoming increasingly difficult, despite continuous improvement of prospecting technique, as drilling proceeds at greater depth and as the more favorable possible oil productive areas become more thoroughly combed and tested. This does not imply that there do not remain important unknown fields yet to be found. It is a fact, however, that oil is becoming harder to locate, as each new discovery made simply means one less for the future.

The increasing difficulty of discovering new petroleum reserves is attested by the fact that despite exploratory activity, less new reserves have been discovered. This is shown by the table below which presents the history of exploratory operations over the past several years.

It is to be noted that exploratory drilling has increased considerably in recent years. Although this greater activity resulted in the discovery of a larger number of new fields, yet the quantity of new reserves discovered has diminished because of the progressively poorer quality of the new fields found.

The position of known reserves in terms of the likely future requirements for petroleum should be improved. In the light of the earlier discussion concerning the dependence of productive capacity upon the maintenance of an adequate backlog of known developed underground reserves, it is obvious that the downward trend cannot long be permitted to persist if an adequate domestic supply is to be continued. Even at this time some of the important oil-producing areas are pressed to the limit of capacity to supply the local demand for oil. Many fields are being operated at excessive rates of production, which lessens oil recovery and further diminishes the known recoverable reserve and accelerates the decline in productive capacity. This condition, coupled with the inability to predict the duration of the present conflict, clearly indicates the necessity for intensified exploratory work. Although it may not be possible to provide sufficient materials to strengthen the known petroleum reserve position at this time, sufficient drilling must be done to discover and properly develop new reserves of oil and gas at a rate at least equal to that at which known or previously discovered reserves are produced and consumed.

History of exploratory operations—1934–41

Year	Total wildcat wells drilled	Successful wildcats	Number new pools discovered	Total new reserves discovered, barrels	New reserves discovered per pool, million barrels
1934			86	1,668,000,000	19.4
1935			104	1,901,000,000	18.3
1936			104	1,757,000,000	16.9
1937	2,224	222	148	1,898,000,000	12.8
1938	2,638	294	166	1,816,000,000	11.0
1939	2,689	224	170	766,000,000	4.5
1940	3,089	302	217	674,000,000	3.1
1941	3,113	486	340	400,000,000	1.2

In discussing the problem of maintaining adequate domestic reserves of petroleum, it has been suggested that future drilling programs should be directed or confined to discovering and developing the most prolific and strategic fields and the most desirable crudes, such as, for example, aviation-gasoline-yielding crudes and other desirable types depending upon requirements. While a limited degree of choice might possibly be exercised to advantage, it should be kept in mind that it has not been possible to discover sufficient new reserves to balance required withdrawals during recent years regardless of any consideration of the quality of the field or the type of crude. The fact of the matter is that all additions to all types of reserves would be welcome and desirable. Proper cognizance of variations in the quality of fields and crudes can be taken, with reference to the expenditure of scarce materials, by making suitable adjustments in the development programs.

The thought has also been expressed that greater reliance should be placed upon the petroleum reserves of other countries in the Western Hemisphere to supply the requirements of the United States. In considering this point it should be recognized that other petroleum-producing countries of this hemisphere do not possess any surplus of known developed reserves and that, from the standpoint of the expenditure of critical materials, it would require materials to discover and develop added reserves in South America just as it will in this country. Without considering the merit of other phases of this question, it will suffice to say that the United States should strive always to remain self-sufficient as far as petroleum reserves and available petroleum supply are concerned. Although under normal circumstances it might be wise to consider drawing more extensively on foreign reserves, a domestic supply fully adequate to meet all likely requirements must be maintained in this emergency. It would be folly to depend to any substantial extent upon importations of foreign crude because of the serious limitations of transportation facilities arising from the challenge to our sea lanes.

Future crude requirements

The current demand for domestic crude-oil production is close to 4,100,000 barrels per day, which amounts to nearly 1½ billion barrels per year. Because a large portion of the products from this volume of crude finds its way into civilian uses not directly related to the war program, it is not widely understood that much of the production is necessary to supply the constituents of the four petroleum products considered to be of greatest direct importance to the war program; namely, (a) aviation gasoline, (b) aviation lubricants, (c) toluene, and (d) synthetic rubber.

It has been estimated that nearly 2,600,000 barrels per day of crude will be needed to produce the requirements of these essential products for this year. With the completion of additional units in 1943 for the manufacture of the four critical petroleum products, the crude requirements will mount to almost 3,600,000 barrels per day, or over 1.3 billion barrels per year, which is equal to 88 percent of the current volume of production. This quantity of crude will be required irrespective of the demand for ordinary petroleum products, such as motor gasoline and fuel oil, which would in effect be produced as byproducts of the four critical military products. It therefore becomes apparent that any possible curtailment of civilian consumption of gasoline or fuel oil would have a relatively small effect upon crude-oil requirements.

There has been much loose talk of the possibilities of reducing crude-oil requirements by restricting so-called nonessential civilian consumption of motor fuel. While admitting that some nonessential uses of gasoline could be eliminated without serious consequences, yet there exists considerable doubt as to the extent to which civilian consumption of motor fuel could be limited without jeopardizing essential industrial activity. It is believed that essential needs for petroleum will actually increase beyond the current level of production. The controlling factor in the matter will be fuel oil, and, irrespective of the effects of the rubber or automobile shortages or of possible artificial curtailment on motor fuel consumption, the essential needs for fuel oil will likely require the maintenance of crude-oil production at or above the current level. The crux of the matter is simply that limitation of crude-oil production through restriction of gasoline consumption would seriously affect the supply of fuel oil, for, with the essential requirements of other products, fuel oil yields can be shifted only moderately, probably a maximum of 5 percent on the total volume. The supply of fuel oil is "tight" at this time, and any substantial restriction in use would soon raise other important problems concerning critical materials and would also seriously affect essential industrial operations.

Drilling and material requirements for 1942

Over the past 6 years exploratory and development drilling for oil and gas has totaled in excess of 25,000 to a high of approximately 32,000 wells annually. As pointed out before, discoveries of new reserves of oil in the past 3 years have not kept pace with production, and the reserve position in terms of the growing demand for petroleum has become progressively less secure over the past decade in spite of the large amount of drilling done.

With the urgent requirements of critical materials for direct military purposes and the consequent steadily growing shortages, it is fully recognized that the production branch of the petroleum industry must conduct its operations with greatly reduced expenditures of materials. This simply means that the industry is faced with the formidable task of discovering, developing, and producing more and more petroleum with less and less material. Because of the none too satisfactory level of known underground reserves, exploratory activity, particularly, must be pressed with increasing intensity.

Prior to the outbreak of war it had been hoped, because of the urgency of continuing the discovery and development of new petroleum reserves, that the production branch of the industry would be able to continue without serious reduction in the scale of drilling operations, despite the fact that general shortages of materials had already developed. Shortly before hostilities began, however, it became fully apparent that the industry could not hope to receive other than the bare minimum amount of materials required to permit a reasonable continuation of necessary operations. Accordingly, thought was given to the methods whereby the limited quantities of materials available could be placed to the most advantageous use. This culminated in the promulgation of Conservation Order M-68. The effect of this order is to make available a greater quantity of oil per pound of steel expended by broadening the spacing of wells and by eliminating over-development or unnecessary drilling in any particular field. Thus a greater quantity of underground reserves of petroleum can be made available for production with a minimum practicable use of materials.

While considerable savings of materials can and will be made in petroleum-production operations, it is essential to realize that materials necessary for the continued proper functioning of the production branch of the industry must be made available if an adequate sustained supply of petroleum is to be provided. Under the operation of Conservation Order M 8, it is estimated that the drilling of about 19,300 wells in the United States dur. the year 1942, properly divided between exploratory and development operations, should be sufficient to maintain fairly satisfactorily the required domestic productive capacity to enable the production of at least 1¼ billion barrels of oil during the year. The estimate of 19,300 wells for 1942 is 39 percent below the 31,733 wells drilled in 1941. The detail of the estimate of domestic drilling required in 1942 is as follows:

	Oil	Gas	Dry	Total
Exploratory wells	624	116	3,260	4,000
Development wells	11,164	1,829	2,294	15,287
Total	11,788	1,945	5,554	19,287

It is noted that the estimate of required drilling in the United States in 1942 is divided 4,000 wells to exploratory work and the remainder to development. The 4,000 wells set aside for exploratory operations is nearly 29 percent greater than the total of 3,113 wild-cat wells drilled in 1941, which was an all-time high. Because of its obvious importance, the Office of Petroleum Coordinator has emphasized and will continue to urge intensified exploratory activity. If the estimated total required number of wells are drilled, it may be expected that around 5,500 to 5,600 will be dry, something less than 2,000 will be gas wells, and the rest oil wells. The dry holes will require only a minor amount of material as compared with the estimated 13,733 successful oil and gas well completions. The reason for this is that little or no casing or other tubular goods are left in unsuccessful wells. The estimate of 13,733 oil and gas well completions for the year 1942 compares with 23,100 in 1942 and represents a 40-percent reduction. This means that the expenditure of materials in the production branch in 1942 will be at least 40 percent less than the quantity used in 1941. It can be stated with assurance that a minimum reduction of 40 percent will be automatically accomplished under the application of Conservation Order M-68.

An estimate of the various classes of material requirements for the production branch of the industry for the year 1942 has been made. The requirements are based upon the proposed drilling program and necessary auxiliary operations as piscussed above. The detail of the estimate is as follows:

Ferrous materials:	*Tons*
1. Cutting tools	985
2. Nickel bearing steel	36,800
3. Other alloy steels	59,900
4. Carbon steel	262,000
5. Steel castings	22,300
6. Steel scrap	30,800
7. Steel bars and shapes	154,000
8. Wire rope, etc	8,900
9. Steel plate	32,900
10. Steel sheet	61,100
11. Tubular goods	925,000
12. Drill pipe	33,400
13. Pig iron—iron castings	64,800
14. Iron scrap	58,900
15. Ferrous alloys	1,110
Total	1,752,895

Nonferrous materials:	Tons
16. Tungsten	179
17. Nickel	111
18. Copper	4,910
19. Zinc	5,840
20. Tin	780
21. Lead	780
22. Aluminum	1,150
23. Rubber	4,280
24. Synthetic rubber	1,275
25. Plastics	157
26. Chemicals	4,250
27. Cordage	1,810
Total	25,522

The foregoing estimate shows a required ferrous tonnage of approximately 1,750,000 and a nonferrous tonnage of 25,500. As indicated before, these quantities of materials are about 40 percent less than the expenditures of materials in the year 1941.

Recommendation

It is the belief of the Petroleum Coordinator's Office that the quantities of materials specified herein represent a reasonably accurate picture of the essential requirements of the production branch of the petroleum industry necessary to provide an adequate sustained supply of crude oil and natural gas to support the war program. Accordingly, the recommendation is hereby made that the War Production Board be urged to allocate to the production branch of the petroleum industry, for the year 1942, the specified amounts of materials, if at all possible and consistent with the urgency of the requirements for military and other war industry purposes.

EXHIBIT C

[*From Bureau of Internal Revenue, Regulation 103—Income tax*]

SEC. 19.23 (m)-16. *Charges to capital and to expense in the case of oil and gas wells.*—(a) Items chargeable to capital or to expense at taxpayer's option:

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells at the option of the taxpayer may be deducted from gross income for the year in which the taxpayer completes such a well or be charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) If deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or if capital expenditures have been charged to expense in lieu of depreciation

or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(b) Recovery of optional items, if capitalized:

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized insofar as they are not represented by physical property are returnable through depletion. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological wok, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, insofar as they are represented by physical property, are returnable through depreciation. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items for the purposes of determining the depletion and depreciation allowances.

(c) Nonoptional items distinguished:

(1) Capital items: The option with respect to intangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable though depeciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the options provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

(d) This section does not grant a new option or election. Any taxpayer who made an election or elections under article 223 of Regulations 69 or under article 243 of Regulations 74 or under article 236 of Regulations 77 or under article 23 (m)–16 of Regulations 86 or under article 23 (m)–16 of Regulations 94 (section 3.23 (m)–16, Title 26, Code of Federal Regulations), or under article 23 (m)–16 of Regulations 101 (sec. 9.23 (m)–16, Title 26, Code of Federal Regulations) is, by such election or elections, bound with respect to all optional expenditures whether made before January 1, 1939, or after December 31, 1938, in connection with oil and gas wells. Any taxpayer who has never made expenditures for drilling oil or gas wells prior to the first taxable year beginning after December 31, 1938, must make an election as to intangible drilling and development costs in general in the return for the first taxable year in which the taxpayer makes such expenditures and a taxpayer who has never made expenditures for a nonproductive well prior to the first taxable year beginning after December 31, 1938, must make an election as to the cost of such wells in the return for the first taxable year in which the taxpayer completes such a well. Any election so made is binding for all subsequent years. A taxpayer is considered to have made an election in accordance with the manner in which the respective types of optional items are treated (1) in his return for the first taxable year ending after December 31, 1924, in which optional expenditures of the respective types are or were made, or (2) in an amended return filed between June 18, 1927, and December 18, 1927, in accordance with Treasury Decision 4025. Any taxpayer who has made expenditures for optional drilling and development costs must attach to his return for the first taxable year beginning after December 31, 1938, and for each year thereafter a clear statement of his election under each of the options, together with a statement of the time at which, and the manner in which, such election was made.

EXHIBIT D

RESOLUTION ADOPTED BY THE INTERSTATE OIL COMPACT COMMISSION, AT ITS REGULAR QUARTERLY MEETING AT LITTLE ROCK, ARK., ON MARCH 28, 1942

The oil industry requires the protection afforded by existing tax laws which provide for percentage depletion and optional expensing of intangible drilling costs in order to guard against waste in the production of crude petroleum which waste would result primarily because of—

First. Producing from our known reserves at a rate so excessive as to prevent efficient recovery of the greatest possible amount of oil from these reserves; and,

Second. Abandoning producing wells and leaving recoverable oil in the producing horizons without first employing all known methods of primary or secondary recovery.

Encouragement to search for new reserves and to maintain production through marginal and stripper wells, or through secondary recovery methods, now exists in the provisions of our tax law allowing for a percentage depletion and the right to charge to expense intangible development costs as provided by the Treasury Department regulations.

The wisdom of the Congress of the United States in making provision for the present depletion, and of the Treasury Department in recognizing the right to charge to expense intangible development costs in income-tax returns, has been well justified. The conservation program of the petroleum industry and of the regulatory bodies of the oil-producing States would be greatly hampered and embarrassed by a change in these laws and regulations.

Therefore, the Interstate Oil Compact Commission states as a policy its approval of the present method of allowing percentage depletion and the optional right to charge to expense intangible development costs as provided by the present laws of the United States and Treasury Department regulations thereunder.

EXHIBIT E

HIRAM M. DOW

ROSWELL, NEW MEXICO

WASHINGTON, D. C., *April 15, 1942.*

Hon. WESLEY E. DISNEY,
House of Representatives, Washington, D. C.

DEAR CONGRESSMAN: Hon. Harold L. Ickes, Petroleum Coordinator for National Defense, acting under the authority vested in him by the President of the United States, has recently formed the National Conference of Petroleum Regulatory Authorities, and appointed to the membership thereof one representative from each regulatory agency of the several oil-producing States of the Nation, and one representative from the Interstate Oil Compact Commission.

The first meeting of this national conference was held in the office of the Petroleum Coordinator in the Interior Building, Washington, D. C., on April 14 and 14, 1942. There were present at the meeting representatives from 20 oil-producing States. As the member representing the Interstate Oil Compact Commission, I attended the meeting and was elected chairman of the conference.

During the course of the meeting several resolutions were adopted, among which was one concerning the present provisions of law allowing to oil producers a depletion deduction of 27½ percent and an option to charge as expense intangible drilling and development costs. The language used in the resolution is as follows:

"The present depletion allowance of 27½ percent must be retained. This, in reality, creates a defense fund, capital to find new oil to replace the oil being currently consumed. No change should be made in the law allowing the charge for intangible development costs."

Inasmuch as there is now pending before the Ways and Means Committee a proposal from the Treasury Department, that these provisions of law be eliminated or drastically changed, I respectfully call your attention to the resolution above quoted and request that this letter or a copy of the resolution be presented by you to the Ways and Means Committee, and if agreeable, have it inserted in the record of the hearing of the committee on this subject.

Very truly yours,

HIRAM M. DOW.

The CHAIRMAN. Senator Lee, you say you have a statement you wish to make?

Senator LEE. Yes.

The CHAIRMAN. All right, Senator Lee.

STATEMENT OF HON. JOSH LEE, A UNITED STATES SENATOR FROM THE STATE OF OKLAHOMA

Senator LEE. Mr. Chairman, Hitler in his drive for the Caucasus is trading blood for oil. Why is he paying such a price for these oil fields? Because he knows that if he can gain control of the oil from the Caucasus and from Persia that America will then be the nearest source of supply for oil.

Unfortunately Hitler is slowly but steadily gaining his battle for this rich prize. If he wins the Caucasus there is little doubt that he will then move toward Persia, the only oil supply in Europe and Asia then available to the armies of the Allies. This will mean that America must supply the oil for the entire fighting forces of the United Nations.

Therefore, we must not take any steps which will reduce the development of new supplies of oil. We must not discourage the exploratory efforts. On the contrary we should be thinking of means of encouraging the discovery of new oil fields.

During World War I the Congress faced a similar situation. Out of the necessity born of that situation came the present percentage depletion-allowance legislation. The Congress then recognized the wisdom of providing a 27½-percent depletion allowance for the oil industry, in writing the tax program.

I would like to emphasize the fact that this has been an important part of the present program and is deeply imbedded into the foundational structure of the petroleum industry.

Therefore, I sincerely trust that you will not take the risk of interfering with the progress of an industry on which we are so dependent today.

It is conceivable that our colleagues at the time of the original adoption of this program may have had some doubts as to its successful operation. That is true of any new program, but we are more fortunately situated in what we have 25 years of experience by which we may judge the fairness and the success of this program.

The record indicates that the oil industry as such continues to contribute its proper share to the revenues of our Government.

While the oil industry has not profited excessively as a result of this law, it has been encouraged by the wisdom of a governmental policy which encourages the search for new oil reserves.

The mere fact of a prolonged continuation of legislative policy is not in itself sufficient to justify its performance, nor even its indefinite continuation.

However, prolonged observation of such a policy as the 27½ percent depletion allowance naturally encourages oil men to believe that it will continue in the absence of justifiable grounds for a change of policy.

It is a fundamental rule of law that upon him who urges departure from long established custom there rests a heavy responsibility to show the need for a change of policy.

Secretary of Treasury Morgenthau and his tax adviser, Randolph Paul, have made the charge that the depletion allowance is a "special privilege" and a tax loophole which should be changed or eliminated. They have proposed this change but they have not sustained the burden of proof, in support of their proposal nor have they offered a satisfactory substitution for the measure they seek to eliminate.

The depletion allowance was inaugurated for the purpose of encouraging discovery and exploratory activities. Such activities, if successful, supply petroleum to keep the industry in operation and also to build up a reserve for known and unknown contingencies. How well it has succeeded is best seen in the position of America in the world of oil. Yet, despite these reserves, our present need is so huge and also so unpredictable that we can ill afford to allow any diminution in the extent of our reserves.

Yet, at the precise moment when the necessity of preserving the present extent of reserves is a paramount consideration, we find that last year more oil was consumed by three times than was discovered in new fields. With this alarming reversal of the trend of discovery, we are confronted with a proposal to withdraw the incentive which primarily caused the discovery operations to be undertaken and without which we should probably be empty-handed today.

Coordinator Ickes has asked that increased new discoveries be undertaken and that a 3-year downward trend of wildcat operations be reversed. This request cannot be complied with if the incentives are withdrawn, unless the Government itself goes into the business of discovering new oil reserves.

This, as you may well imagine, would not only be expensive but less satisfactory than the other method which is to allow sufficient incentives for private initiative in this field.

We have a time-tested method approved by successive Congresses under which expansion and industrial strength has been fostered, and we are now asked to surrender this proven method for the nebulous promises of Government compensation "where necessary."

The risk involved in making such a change at this crucial stage in world affairs is so great that no practical man should make such a proposal, and no impartial tribunal should approve it at this time.

I submit that with so much at stake, and dependent upon the continuous flow of petroleum, that any method of improvising should not replace a time-tested legislative policy under which unprecedented progress has been made in the creation of the world's largest supply of oil.

Mr. Chairman, the depletion allowance law has a twofold base. First, because of the difficulty of ascertaining what amount of oil has been found in a well that is discovered, it is recognized that every barrel of oil sold might be a part of the capital invested in that endeavor.

Second, it is also recognized that any of the efforts to find the oil, although very expensive, might prove fruitless.

Therefore, by allowing a depletion of 27½ percent Congress has established a fair and just formula for dealing with the oil industry.

Therefore, I strongly recommend that we continue this program which 25 years has shown to be a wise policy.

Now, Mr. Chairman, there is a second policy, known as the intangible development costs option, which was established in 1917.

This policy allows the petroleum companies at their option to expense certain intangible development costs.

In other words, the producer may elect whether or not the intangible expenses involved in the development should be capitalized or charged off as expense items.

This is not a continuing option. Once the election is made, it is binding through the life of that operator. Most of the small operators, commonly known as independents, charge off their intangible development expenses in making their income-tax returns.

While this option is of great assistance to the small operator, it is doubtful if the Treasury Department in the long run loses anything by the operation of this option because the Treasury Department receives revenue on an installment basis rather than receiving it all at one time.

To change this policy would eventually destroy the small companies and thus kill the goose that lays the golden egg.

Now, Mr. Chairman, please bear in mind that I am not recommending a change in our laws. I am resisting a change which might result in immediately increasing the revenues but which would undoubtedly result in decreasing the revenues over a long period of time.

Furthermore, to change either one of these policies as recommended by the Secretary of the Treasury would, first, destroy many small oil companies and increase the tendency toward monopoly in the oil industry.

Second, it would discourage exploratory effort at a time when we need to increase our available supply of oil.

Mr. Chairman, I thank you and the members of the committee.

The CHAIRMAN. Thank you, Senator.

Senator Thomas.

STATEMENT OF HON. ELMER THOMAS, A UNITED STATES SENATOR FROM THE STATE OF OKLAHOMA

Senator THOMAS. Mr. Chairman, I appear here for a group on another feature, respecting rock asphalt. Let me say I support the position taken by Senator Gore, Colonel Fell, and my colleague, Senator Lee. I will oppose, in the best way I can, any change in respect to the 27½ percent depletion.

The CHAIRMAN. Senator Kilgore.

STATEMENT OF HON. HARLEY M. KILGORE, A UNITED STATES SENATOR FROM THE STATE OF WEST VIRGINIA

Senator KILGORE. I want to join particularly in the statement made by the second speaker, Mr. Fell, in favor of the retention of any reasonable depletion exemption for minerals, and believe that the one now in operation is the proper one. It has been my experience that unless some provision is made for depletion, progress and prospecting cases. Our mineral States have always taken this into consideration and have found it a reasonable and workable solution, and it is my belief the Federal Government should follow this. If we do not allow some depletion exemption we are really taxing a capital sale. Our income tax then becomes instead a gross sales tax under prohibitive rates.

It is like a farmer buying an uncultivated field in the spring, planting a crop and then selling the field and crop in one sale. Under no law would he be refused exemption on the purchase price of the field, because that is a part of his capital. Yet, if we do not allow an exemption for depletion the capital reserves in the form of minerals—and I mean by that coal, oil, gas, metals of all types—we are taxing capital sales.

The CHAIRMAN. The Chair sees Governor Neely in the room. I very well recall it was Governor Neely's motion back in 1924 or 1926——

Governor NEELY. 1926.

The CHAIRMAN. When he objected to the committee depletion allowance and moved a depletion allowance of 35 percent. He was beaten on that by one vote in the Senate, as I recall; and then he moved 30 percent, which was carried, and in conference between the House and Senate the 27½ percent depletion for gas and oil was written into the law.

STATEMENT OF HON. MATTHEW M. NEELY, GOVERNOR OF THE STATE OF WEST VIRGINIA

Governor NEELY. Mr. Chairman, that is true. And may I not venture to hope that those of the committee who were Members of the Senate at that time will remember that during the progress of the debate on my amendment, Senator Smoot, chairman of the Committee on Finance, admitted that he did not believe that the 25-percent depletion allowance provided in the bill was sufficient; and that Senator Simmons, who was, at that time, the ranking minority member of the committee, also stated that he considered the 25-percent allowance inadequate. On a roll call vote, the Senate sustained my motion to increase the oil and gas depletion allowance to 30 percent.

Gentlemen of the committee, as stated by your able chairman, Senator George, the Senate and House conferees reduced that allowance to 27½ percent. That determination was promptly and duly made a part of the law of the land and such it has continued to be from 1926 until the present hour.

In natural resources, West Virginia is one of the richest States in the Union. She produces approximately a fourth of the Nation's entire output of bituminous coal. Her oil and gas industries are highly important. Her oil is identical with that known to the industry as Pennsylvania grade—the high quality of which is not surpassed by the oil of any other region on earth. This grade of crude yields from 4 to 11 times as much vital lubricating oil as the crudes of the various other producing sections of the United States.

As the Governor of West Virginia, it has appeared to me to be my duty to come before your honorable committee very briefly but most respectfully and earnestly to urge, to the limit of propriety, that the provisions for depletion allowances in favor of coal, oil, and gas now contained in the bill, which is before the committee, be retained without diminution.

Senator BARKLEY. And all other minerals?

Governor NEELY. Thank you, Senator Barkley. Manifestly all other minerals, metals, and deposits that are similar to coal, oil, and gas should enjoy the benefit of depletion allowances. My sole reason for appealing to the committee and through it to the Senate in this matter lies in my firm belief that every toiler and every proprietor of a coal, oil, gas, or other producing enterprise—the capital resource of which is necessarily annihilated in the process of utilization—should enjoy the benefit of equitable depletion allowances such as the pending bill very appropriately contains. In my opinion, justice not only to the explorers and exploiters of mineral, oil, and gas deposits, but also justice to all the employees of all the industries that are engaged in the transformation of our natural resources into the consumable necessaries of daily life demands that all the existing provisions for depletion allowances of the pending bill be translated into law.

The principle on which the depletion allowances is based is sound in logic, just in its operation to all the people, and, in this crisis, it is as vital as life to the most important enterprise on this side of the grave, namely the successful waging of the present frightful war to a speedy conclusions in behalf of righteousness, liberty, and civilization.

Gentlemen of the committee, for your courtesy in permitting me thus to express these views, I sincerely thank you again and again.

The CHAIRMAN. Thank you, Governor Neely.

Senator CONNALLY. May I ask you one question?

Governor NEELY. Certainly.

Senator CONNALLY. There is something that has not been touched on, and that is this: In your opinion, does the allowance of the depletion credit aid the little man relatively more than it does the big oil companies?

Governor NEELY. Yes; very much more.

Senator CONNALLY. The big companies have got their money in their reserves, and they can wildcat and charge it off and go ahead, but in the case of an independent wildcatter, with small capital and small opportunities, is not the depletion allowance almost necessary for him to be able to go out and, in a measure at least, compete with the big monster oil companies?

Governor NEELY. Senator Connally, certainly I concur in all that you have said and all that is implied in your question. The greatest of the oil-producing companies have what is known as settled production. Their hazards are relatively few and far between. But those who are known as wildcatters almost daily risk their financial lives in searching for new worlds of natural resources with which to serve and bless their country. Very few wildcatters ever become wealthy. Multitudes of them have become bankrupt. Many of them have died in the poorhouse.

I have known of only two so-called wildcatters who have become very rich. Colonel "Mike" Benedum, the world's greatest seeker and finder of fabulous quantities of oil in unexpected places, and Mr. Marland, the Oklahoma pioneer, are the only ones who, to my knowledge, have ever made and even partially retained great fortunes by means of the highly hazardous and equally expensive service of searching for nature's carefully concealed deposits of oil and gas. Colonel Benedum, an illustrious West Virginian by birth, is now making in his native State the most patriotic and costly experiment ever undertaken by the producers or hunters of crude oil. He is drilling wells to depths never dreamed of and to sands generally condemned as worthless until after the beginning of the present World War. I have learned, not from Colonel Benedum, but from others who are well informed on the subject that the Colonel's explorations now in progress in West Virginia will cost him at least a half a million dollars. And please bear in mind that Colonel Benedum is hunting for oil not for the purpose of adding to his own riches, but for the praiseworthy purpose of helping to win the war.

For this service, Colonel Benedum is entitled to the gratitude of not only all his fellow West Virginians, who immeasurably love him, but also to that of all the friends of liberty throughout the world.

Mr. Chairman and members of the committee, let me once more thank you for your kindness in most courteously listening to the observations which you have permitted me to make.

The CHAIRMAN. Governor, we thank you very much for your appearance.

Senator BARKLEY. I understand, Governor, that you expect to be back here shortly.

Governor NEELY. If the blessings of Divine Providence continue to descend upon me in the future as they have descended upon me in the past, and the incomparable people of West Virginia favor and support me as generously and loyally in November as they have supported and favored me during the 30 years that have just passed away, you may depend upon my returning to this, the greatest capital city in the world in 1943, and as a result of all which will once more be my happy privilege to say that where you and the other members of the committee are there I shall likewise be.

Senator CAPPER. Mr. Chairman, I have received a telegram from D. R. Lauck, president of the Kansas Independent Oil & Gas Association, Wichita, Kans., reaffirming a resolution passed by their association this spring and reprinted at my request in the Congressional Record of March 24. This page from the Record is attached for the committee's information.

Upon being advised that the Finance Committee would devote a part of today's meeting to hearings on this section of the pending measure, the Kansas Independent Oil Producers called a special meeting and adopted a resolution urging the retention of the present depletion allowance. I trust the committee can give favorable and sympathetic consideration to this appeal. I am wholeheartedly in accord with their stand because the resolution sets forth strong reasons why any reduction of the depletion allowance would work an unfair hardship to this important and vital industry.

(The resolution referred to is as follows:)

RESOLUTION PASSED BY INDEPENDENT OIL PRODUCERS OF KANSAS, AT MASS MEETING, WICHITA, KANS., JULY 29, 1942

The recommendation of the Treasury Department that the percentage depletion allowance be eliminated is to be considered by the Senate Finance Committee on August 4, 1942.

From 1918 to 1941, it has been commonly recognized that oil in place is capital and that this capital should be returned to the oil industry, free of tax. In order to return this capital free of tax, Congress determined in 1918 that the value of oil in place should be based either on cost, the fair market value as of March 1, 1913, or the fair market value within 30 days from the date oil was discovered. This method, however, of arriving at the amount of capital involved was difficult to administer and was expensive to the Government and to the oil industry.

To simplify the computation of allowable depletion, Congress in 1918 passed the percentage depletion method, which allowed 27½ percent of the gross income from the oil and gas produced by a property during each year, to be deducted from Federal income, but in no event was this to be more than 50 percent of the net income from the property. This depletion allowance passed by Congress in 1926 has been approved by Congress in each succeeding revenue act; and the fact that this method of computing depletion has stood for the past 16 years is evidence that it is fair, just, and equitable to both the taxpayer and to the Government. The further fact that most State income-tax departments have approved this method of depletion allowance argues in favor of its fairness.

The independent operator is justified in his request that this percentage depletion be continued, because of the risks he takes every time he drills a well. For the presence of oil cannot be determined without the expenditure of large sums of money. Even if oil is found, it cannot be measured. The amount of oil in place can only be estimated.

A manufacturer or merchant can replace their stocks by making new purchases. However, an oil operator cannot replace the oil he pumps out of his wells. He must drill more wells in order to discover new production. This results in his drilling many dry holes, and their cost is rightfully chargeable to the producing wells.

We believe that any reduction of the depletion allowance will result in the taxation of capital invested in the oil industry and will make it impossible to develop new reserves which are vital to our war effort; Therefore be it

Resolved by the independent producers of the State of Kansas at a mass meeting held at Wichita, Kans., this the 29th day of July 1942, That the provisions of the present law are fair and equitable; that they return no more to the industry than the capital consumed, and that its elimination or reduction would discourage an essential industry necessary to the welfare and defense of the Nation.

The CHAIRMAN. The committee will go into executive session at this time, and the open hearing will be resumed again at 1:30 today, on account of the unusual number of witnesses who are on the schedule.

(Whereupon, at the hour of 11:45 a. m., the committee retired into executive session, the open hearings to be resumed at 1:30 p. m., of the same day.)

AFTERNOON SESSION

(Whereupon, at 1:30 p. m., the committee met pursuant to recess.)

The CHAIRMAN. The committee will please come to order.

Now, the next witness listed here was Mr. Moorhead. I am advised that Mr. Moorhead passed away yesterday, and someone is appearing with a statement from Mr. Moorhead.

A VOICE. Mr. George Holbrook, Mr. Chairman, will present his statement.

The CHAIRMAN. The statement which Mr. Moorhead prepared. Mr. Holbrook, you may come around.

The other members of the committee will be in shortly.

STATEMENT OF GEORGE HOLBROOK, WELLSVILLE, N. Y., PRESIDENT, NEW YORK STATE OIL PRODUCERS ASSOCIATION

Mr. HOLBROOK. Mr. Chairman, thank you for the opportunity of presenting Mr. Moorhead's statement.

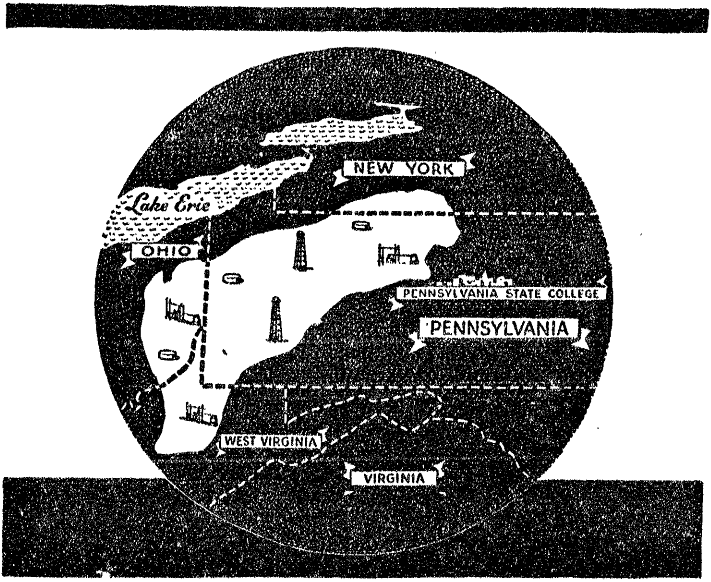
My name is George Holbrook. My home is in Wellsville, N. Y. I am president of the New York State Oil Producers Association, and I have been engaged in the oil producing business in the New York State fields for 12 years.

These fields are part of the Pennsylvania grade oil region which is shown on this map.

There are 133,420 wells in the four-State area and the daily output per well averages about half a barrel. In some counties the average is as low as a tenth of a barrel daily.

The 80,000 barrels produced daily from these small wells is only about 2 percent of the national crude production but that is sufficient to lubricate one-fourth of the cars in the United States in normal times. Today this production is looked to by our Government as the primary source of high-grade aviation oils required by the air fleets of the United States and the United Nations.

Most oil fields in this country are evaluated principally for their yield of gasoline. The region shown on this map [indicating] is important mainly because of the quality and the quantity of the lubricating content of its crude. Whereas other crudes usually yield 2 to 5



MAP OF PENNSYLVANIA GRADE CRUDE OIL REGION

percent lubricating oil, Pennsylvania grade crude uniformly yields 22 percent.

From the time of the initiation of the rearmament program 2 years ago, very great demands have been made on the supplies of Pennsylvania products for military and naval uses. New airplane motors are run in and tested exclusively on Pennsylvania oils. These oils are specified for many turbine, hydraulic, fire control, and propeller operations.

The wax byproduct is needed in constantly greater quantities in munitions factories. But above everything else there is a mounting demand for our aircraft oils for the bombers and fighters of the Allied fleets.

The pressing war need for the products of our fields is evidenced by the high priority ratings assigned to oil-well materials in this district, by the exemptions and exceptions provided by War Production Board well-spacing orders and by the urgent insistence of the Office of Petroleum Coordinator that the Pennsylvania grade refineries operate as nearly at maximum capacity as possible.

It is extremely fortunate that the fields which provide these important lubricants lie close to the Atlantic seaboard. The transport problem is simple and deliveries are prompt, whether intended for domestic or overseas destinations.

The supply of these oils hinges mainly on the ability of the producers to lift the crude from the ground. The current stocks of both crude and the primary refined products are at an all-time low. There is a margin of unused refining capacity. There is much drilling and development material immediately available. The location of the fields near the eastern seaboard adds strategic importance to the supply. There is a very manifest war need for more Pennsylvania grade lubricants than are now manufactured.

The recoverable reserves in this region are estimated to be only slightly less than 1,000,000,000 barrels—almost as much oil as has been produced in this area since the Drake discovery well was drilled in 1859.

In the interest of the war effort and the anxiety of our producers to make their maximum contribution to its prosecution, we must protest against the elimination of or change in the present depletion provisions in the tax law. We must protest also against what is of equal or even greater importance to us—the proposal to cancel the right to expense intangible drilling costs. These changes can have no other possible effect than to reduce the present lubricating oil output of our region at a time when the Nation's war needs require that it must be substantially increased. Moreover, such changes will necessarily reduce the supply of gasoline and fuel oil sorely needed on the east coast.

Unlike the newer western fields, the production of crude from the Pennsylvania region, where the American oil industry was born 83 years ago, does not depend upon new discoveries.

The boundaries of the productive sands have been well established. Most of the favorable acreage has been explored. Production comes almost entirely from known reserves of crude and can be made available only by the continued drilling of additional wells. Producers drill their properties annually much as a farmer seeds and plows his field.

There are no production quotas or allowables in this area; when drilling ceases the output declines. There are no valves that can be opened to increase the flow from flush operations.

Oil is produced in this region by two methods, both readily understood in principle. It is brought to the surface either by the simple action of pumps on the sands, or by the introduction of water, air, or gas under pressure into the sands to drive the oil out of its natural reservoir. This latter system is known as secondary recovery, and represents the successful effort to regain from areas once regarded as exhausted a substantial residue of highly valuable petroleum. This method requires the drilling of more than twice as many wells as the older methods, and here the proposal to eliminate the right to expensive intangible drilling costs becomes of particular significance to all secondary recovery operations, whether in these older eastern fields or in some of the stripper-well fields farther west, to which this method is gradually being extended.

Secondary recovery methods also require the addition of pressure plants to exert the necessary force against the stubborn sands, and much field and laboratory experimentation, the cost of which is offset only when the output per well is multiplied several times.

About two-thirds of the oil produced from this region comes from secondary recovery operations. Where water is the energizing medium the output would decline more than 50 percent in the following 3 years if no new wells should be drilled. The rate of decline for the old pumping wells varies from 6 to 10 percent annually, and this rate is accelerated by the abandonment of uneconomic wells.

It is important to remember that the continuation, much less the enhancement, of the available supply of this peculiarly valuable crude oil is dependent on a steady and systematic drilling program and upon the extension of secondary operations.

The proposed revisions in the income-tax law strike directly at the only funds which are available to the producer for the maintenance of these essential drilling operations. The practical effect of their enactment would be to wipe out the only source of capital by which the necessary output of oil can be maintained or increased. The money available to the producer from the provisions of the present law is not a profit taken out of the producer's business and expended by him as his own. It is plowed back into the property in the form of drilling expenditures. Only by its use in this manner can the properties continue to provide an annual income. It acts substantially as a revolving fund. If it is dried up by the proposed changes the wells, too, are dried up. The business no longer is a going concern, the Nation is robbed of its dependable supply of lubricants, and the vast reserves are lost. Such a procedure at a time when the country faces the probability of a prolonged war seems to us the very epitome of risky experimentation, if not the outright waste of an essential war material. One should never lose sight of the fact that this particular crude, with its unique properties, is not duplicated anywhere else in the world.

The greater part of the production of Pennsylvania grade crude is provided by thousands of very small operators, and the margin for profit on many properties is narrow. Indeed, the prospect of an increase in production for the future depends upon the drilling of thousands more small wells and an improvement in the efficiency of their operation. Any step which jeopardizes the contact between these wells of low production and the huge reserves of oil beneath them not only works the ruin of the operator and cancels out all hope of future production from his properties but it menaces the immediate supply for the air fleets of the United Nations.

Relatively few of our producers are well financed, but, under the application of these provisions, those who are would fare little better than their less prosperous neighbors. While such a producer can, and must, produce oil from the wells he has already drilled, so severe are the effects of the newly proposed changes that his funds hitherto available for new drilling would have to be used to meet his tax bill.

The part which the depletion allowance and the right to expense intangible drilling costs play in this area seems to be misunderstood by the Treasury. Practically all operators own some properties where secondary operations have not yet been introduced. These properties seldom show any profit—more often they show a loss—but the operations, nevertheless, must be continued to maintain contact with the reserves beneath.

It is true, of course, that only a small benefit is realized from the depletion allowance where the profit margin is slender. But the operator must have the benefits of depletion on his more profitable acreage in order to protect the very existence of the wells which later are to be stimulated by the injection of water, air, or gas.

The existence of the present provisions effectively conserves thousands of acres of property and millions of barrels of crude which are a valuable part of the national oil resource.

It is true that the benefits of the provisions now under attack do not apply equally to each producer. Neither does the bachelor taxpayer benefit equally with the family man from the public-school law. But the justice of the existing provisions are as applicable to our area as to any oil region in the United States.

The large productive years of the State of Pennsylvania, by natural flow and pumping, were in the 40-year period of 1871–1910. For the next 15 years, the continued pumping of the old wells yielded a fairly steady production. Stimulated by the wise provisions of the 1926 Revenue Act which served as an incentive to find new methods of recovery, water flooding was developed in the Bradford field, in northwestern Pennsylvania. The daily output immediately increased and thus, from sands once thought to be practically depleted, secondary methods have recovered oil in quantities comparable with the years of our flush pools. This is a record of great credit to Federal and State taxing authorities as well as to the Pennsylvania oil producers. The development of these methods has brought about reappraisal of the Nation's precious oil reserves.

Let me illustrate this fact. In 1918 the production in the State of Pennsylvania was approximately seven and one-half million barrels. Currently, it is at the rate of 20,000,000 plus. Similarly in 1918, the production in the Allegany field of New York State was less than 600,000 barrels, whereas current production is at the rate of more than 4,000,000 barrels. One of the contributing factors to this development has been the encouragement afforded by the existing depletion provisions in the tax statute and the right to expense intangible drilling and development costs.

Almost half of the total recovery to date from the areas now under water flood has come in the years since the enactment of the first depletion statute. Your attention is drawn to this chart.

As has been explained, the most productive acreage in the Pennsylvania grade region to a great degree already has been developed. Future production must come from more intensive work on progressively poorer properties. The financial hazards will be much greater. The practical effect of the Treasury recommendations, if adopted, will be to eliminate a large part of this remaining acreage from any possibility of development and to cut off the great underground reserves from any use during this war.

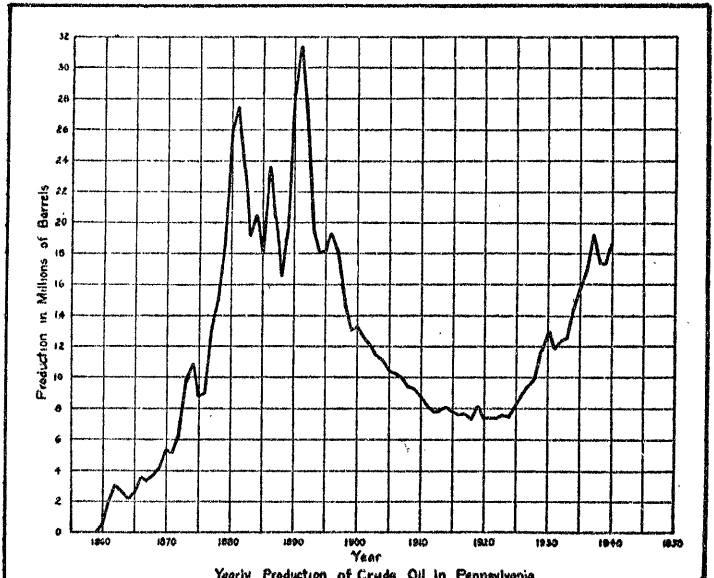
Any interruption to the production program in the Pennsylvania grade area will constitute an irretrievable loss. The oils essential to the armed services cannot be replaced from any other source. Reverting to the present tax structure later would represent a costly delay. The abandonment of wells and the interruption of current supply are all beyond compensation. The economic loss to our country in peacetime and the eventual and inevitable loss of taxable revenues to the Government, important as they are, are relatively insignificant as compared to the urgent and emergent necessity of keeping our mechanized fleets and armies supplied with an essential material available nowhere else.

The CHAIRMAN. Thank you, sir.

Senator Guffey, are there any questions you would like to ask?

Senator GUFFEY. I have no questions.

(The following chart was submitted for the record:)



Yearly Production of Crude Oil in Pennsylvania

The CHAIRMAN. Mr. Swann.

STATEMENT OF A. K. SWANN, EVANSVILLE, IND., IN BEHALF OF INDEPENDENT OIL OPERATORS OF ILLINOIS, INDIANA, AND KENTUCKY

Mr. SWANN. My name is A. K. Swann. I reside at Evansville, Ind., and I am speaking in behalf of the independent operators of that State and of the tri-State area consisting of Illinois, Indiana, and Kentucky.

I do not have a prepared statement to present, I do, however, wish to call attention of the committee to certain particular things which relate to that area which have a direct bearing on this particular subject—the matter of the depletion clause.

In the Illinois area, a large number of independent operators are operating drilling wells. They have drilled approximately 75 to 80 percent of the wildcat wells which have been drilled in the tri-State area.

Of course, it is a known fact that in the drilling of those wells, they have been aided by the purchase of acreage from their blocks by major oil companies, but, actually speaking, that is the percentage.

The independent oil industry will be more adversely affected by a change in this tax structure and by an elimination of the depletion clause than any other part of the industry for several reasons: In the first place, in the make-up of the tax structure, the purchaser of an oil property can, if he chooses, take as a basis for depletion, the cost price, notwithstanding the allowance of the 27½ percent. The major oil companies as a rule purchase a great many properties.

Independent operators seldom make purchases, or, if they make those purchases, the prices involved are very small, and usually they are made in advance of production.

As a consequence, it is our opinion that the Government will not realize, if the tax depletion allowance is removed from the tax structure, anywhere near the sum of money which they hope to realize for the reason that these large companies which make purchases of oil properties and pay large sums of money will still be able to take depletion on those properties notwithstanding the possible elimination of this depletion clause.

On the other hand, the independent operators are working on a small margin. As Senator Gore very properly said, most of the wildcatting, most of the discovering of new oil fields, is a result of the expenditure of the margin of income over the outgo in the operation of the oil business, and that is more particularly true of the oil industry represented on the independent side than any other.

The independent operators must have income from their proven locations in order that they may go out and prospect and bring in new discoveries.

Now, the whole oil industry has been established on the basis of an allowance of 27½ percent depletion clause. They have figured on it. They conduct their business on the basis of that allowance, and if that allowance be taken away from them in the tax structure, it will mean that it must be replaced by an increase in the price of oil because that particular margin has been taken into consideration in the operations in which they have engaged.

Now, our situation in Illinois is just a little different from any other part of the country. We do have, as some of the other States have, some stripper wells. In fact, there are 12,000 stripper wells in Indiana and Illinois today producing about 1.1 barrels per well per day. That brings in about $550 a year to the owner of the well per well. He has 27½ percent of that as an allowance which calculates about $150. The amount that he saves in taxes depends on his tax bracket, of course, ranging, let us say, from 25 percent to 50 percent bracket. Therefore, he has an allowance on his tax bill of something between $37.50 and $75 as a result of this allowance, and that represents in the case of the independent operator and, as far as that is concerned, any operator of a stripper well, probably all the profit he gets from that particular well during the year.

An elimination of that tax clause will mean that a great number of those stripper wells, and especially those which are producing less than a barrel per day, will be abandoned. That oil is necessary.

The Illinois area is nearer to the east coast than any other area in the United States, and the elimination of the tax depletion clause in the case of Illinois will have a more disheartening effect and a more injurious effect on the oil industry than it will in any other part of the country for several reasons.

In the first place, as a number of the members of this committee will recall from having been on the Commerce Committee, there has been the little matter of the effect of M-68, the Conservation Order on drilling in Illinois.

Illinois production has declined since the entry of that order from around 400,000 barrels per day to approximately 270,000 barrels. That has meant a serious decline in the income of Illinois producers and operators, and if the tax depletion allowance is taken from them, it will present another blow which I do not believe the independent oil industry in Illinois can possibly survive.

There are other States, I think, which are similarly situated. I think perhaps Michigan is in a similar position. I believe Mississippi is probably so situated. It simply means this: Senator Gore said this morning, correctly, that the oil industry is one in which there is large competition. That is true. But in view of the difference between the situation of the major oil company and the independent oil company and the independent individual operator, if this allowance is taken out of the tax structure, it will bring some injury of course to the major oil companies but nothing in comparison to what will happen to the independent industry.

The men who have notoriously in times past drilled 75 percent of the wildcats which have been drilled in the United States will be in a position where they can no longer do that wildcatting. They will not be in a position to go out and discover new oil pools, and it will aid in the destruction of the independent arm of the industry which is an extremely important arm. It will encourage monopoly; it will result in a great growth of big companies and a decline in little companies.

Now, that particular phase of the situation, of course, is a selfish matter which the independent operators think of first

Don't let us be misunderstood. We do not say that the great oil companies should be destroyed or that anything should be done to injure them. We merely say this: That a program should not be adopted which will destroy so important a phase of the industry as the independent industry.

We know this: That in the case of Michigan, for example, it was demonstrated by a sudden increase in the production of oil from that State that the reserves which had been credited to that State were found not to exist. A request was made, the production allowable in Michigan, I think, was increased 10,000 barrels per day over the allowance which had been made, and in a short time they were making only 8,000 barrels, and in a short time only 5,000 barrels, and it demonstrated that the reserves which they thought they had to contribute to the war industry were not there.

The point is this: One of the great fields of the Nation is the East Texas oil field. It is strictly controlled and operated on an allowable basis. It is accorded, in the Nation's petroleum reserves, a very large part of those reserves, and yet the probabilities are that if that field were given a very large increase in production today, they would discover that the reserves now thought to be present there are not there.

There is one thing which will be necessary to win this war and that is oil, and any step that is taken to discourage and not to encourage the drilling of additional wells will eventually come back, it will bring back with it misfortune; it will demonstrate in all probability that the United States has been kidding itself into believing that it has something which it has not.

Now, the oil industry cannot be developed in a day, in a month, or even in a year. It is not possible, either, for a Government official or for the oil men themselves, like the Hindu who charms his snake, to charm the oil and bring it out of the ground. You can't simply say, "We have got to have more oil," and commence to get it. It is a slow process of drilling, and everything which can be done ought to be done to encourage the drilling of additional wells, and the elimination of this tax depletion clause will result in the exact opposite in particular fields, and I am sure it will result the same way in most fields in the United States.

As the war goes in Europe today, it will not be very many days until the United States will be forced to supply all of the oil products which will be used by the United Nations.

The day will come, and it is not very far off, when a small percentage of the steel of the United States must be devoted to the drilling of oil wells, and if a further discouragement is now brought on the oil industry by the elimination of this tax depletion clause, when the time comes that we need the oil, it will be impossible to get enough production per day.

The United States is consuming 4,000,000 barrels of oil per day, and when the 165,000 airplane goal of the President is realized, another million barrels of oil per day will be needed. That oil can only be obtained, as I said before, by a concerted effort. It is declining rapidly. Every oil field declines when it is not developed. The decline is natural. The maintenance of oil production is the natural result of drilling, and oil production cannot be maintained in any other fashion than by the maintenance of drilling operations.

Now, the situation of Pennsylvania, the situation of New York, and of the other States is not different from Illinois except that in our particular area most of our production is coming from new wells, 10,000 new wells, and 12,000 old wells are today producing about 130,-000,000 barrels of oil per year, or were a few weeks ago.

Now, out of that 12,000 barrels per day is coming from the old wells and the rest of it, a total of some two hundred and fifty-odd-thousand barrels per day is coming from the new wells. That means that they are producing 30 barrels of oil per day. They form an important part of the oil business of the United States.

That State is the only State or, rather, that area of Illinois, Indiana, and Kentucky, is the only area which is in a position to furnish quickly to the eastern seaboard, where an oil famine now exists, a quantity of oil that is needed there.

The encouragement of further drilling in our State will mean a quicker relief to the eastern seaboard of the United States than from any other area, simply due to the fact that our State is the only one so situated that it can take the oil to the eastern seaboard with a minimum of transportation burden. Now, that is simply our own picture. That is repeated in practically all the States in the Union in some degree, but I think it is proper to say that the State or locality or States or localities which would suffer the worst from an elimination of this depletion clause would be the States which lie east of the Mississippi River, which are today in a position to deliver their oil to the places where it is needed, in the industrial region of the East, more quickly than any other State.

They have huge oil reserves in the State of Texas. There is no way in the world in which there can be a comparison made between the southwestern area and the area in the Illinois Basin.

In the Illinois Basin, the only thing we can contribute to the war effort is quick production, easily available to the East, and if we are permitted to continue, we will continue to do that, and we can transport it up the Ohio River and other places when other States cannot do that, and I assure you that outside of the major oil companies that the independent industry in the State of Illinois will suffer almost a death blow on the elimination of that tax depletion clause.

Now, I had other things which I wished to call to the attention of the committee, but I was informed a few moments ago that time was pressing and that I would only be allowed a few moments, and I wish to thank the committee for this opportunity, and I am sorry that I was not able to present the other facts on account of the lack of time.

The CHAIRMAN. Thank you very much, Mr. Swann.

Mr. Davis.

STATEMENT OF RALPH E. DAVIS, PITTSBURGH, PA., REPRESENTING THE NATURAL GAS SECTION OF THE AMERICAN GAS ASSOCIATION

Mr. DAVIS. Mr. Chairman, my name is Ralph E. Davis. I live in Pittsburgh, Pa. I am a geologist, an engineer, and have followed that line of work for more than 35 years.

During the past 20 years, more or less, I have been engaged almost entirely in engineering and geological work in connection with the natural gas and petroleum industry.

I appear before you today at the request of the natural-gas section of the American Gas Association, representing its 220 member companies and a number of associated State and regional associations.

At the time the Ways and Means Committee of the House were having hearings on this subject, the natural-gas section filed with the Ways and Means Committee a brief, and I have placed before the members of your committee copies of that brief, and request that it be made a part of your record.

The CHAIRMAN. Mr. Davis, that is in the House hearings, and the House hearings will be available to us if it is there.

Mr. DAVIS. I am very happy to have you eliminate it, then, from your record. I was not aware of all of that.

The CHAIRMAN. Yes. That will be available to us. (See Ways and Means Committee Hearings on Revenue Revision of 1942, vol. 1, p. 1116.)

Mr. DAVIS. The natural-gas section have also prepared a supplemental brief to bring to your attention a few points that were not discussed in the brief placed before the House, and I have placed before each of your committee members copies of this brief and ask that it be made a part of your record.

Now, I will not take time to read any part of either brief. I would like just a few moments to stress what I consider two or three important points that I want you to have in mind.

In the first place, the natural-gas industry is a major fuel industry. It serves some 35,000,000 people scattered in 34 of the States. The annual production is running at the rate of about 3 trillion feet per year. Our last figure was for 1940, and in that year the production was 2⅔ trillion feet. Approximately two-thirds of this gas was used in industrial plants, one-third domestic.

A great portion of the gas now used in industrial plants is in the manufacture of war materials. The total reserves in the United States are estimated as some seventy-five to eighty trillion feet. That is a supply good for, let us say, 25 years.

Unfortunately, these reserves are not scattered in the places where they can be most easily made use of. Enormous reserves exist in the Southwest, whereas limited reserves exist in the Appalachian region.

In the Appalachian States gas has been produced now for about 60 years. The supply has been largely depleted. The drilling program that is now being carried on is at the rate of about twice as many wells per year as was the annual average in the years preceding 1940.

In spite of that active drilling program, the capacity to produce gas is not being increased. That is because the many thousands of old wells are gradually and slowly declining in their productive capacity.

A gas shortage is not only threatening the Appalachian region—it is imminent. It depends upon the weather next winter whether or not there will be an actual and serious shortage and for the winter of 1943-44, in my judgment and in the judgment of all of the natural gas men whom I know, a shortage in the Appalachian region is certain.

To indicate what this means: The northern extension of the Appalachian region is found in southern Ontario north of Lake Erie, a region that has had natural gas in the territory from Windsor in the west to Hamilton on the east, for a period of 75 years, in all but for 40 years over quite a stretch of country.

During the last 3 years the demands for gas there in the war plants have increased substantially. The capacity of the wells to produce has been declining. Last year 90 percent of all of the wells drilled searching for gas were dry holes. This year there have been removed from houses in the one city of London, Ontario, more than 4,700 gas furnaces, and before the end of the year it is estimated that from ten to twelve thousand gas furnaces will be taken out of service. Those people do not, in many cases, have the equipment for burning any other fuel.

Senator DAVIS. How many dry holes have you had in the last year?

Mr. DAVIS. In what territory, sir.

Senator DAVIS. In the territory from, say, West Virginia up to Canada.

Mr. DAVIS. The dry-hole average in that territory is about—it runs between 20 and 25 percent, Senator. The percentage in Ontario last year was 90 percent, whereas in West Virginia, I presume, the average was something like 15 percent.

Senator WALSH. No new sources available?

Mr. DAVIS. During the last 2 years, I know of no important new pool that has been discovered in that territory. The older pools are being drilled out. That is, a pool that is known, additional wells are drilled enlarging the area of production. But I know of no new pool that has been found in the Appalachian territory in the last 2 years.

I say, generally, that there are only two things to prevent a very serious shortage of gas in that territory: One, the thing that they are doing, drilling lots of wells, but even that will not cure the situation, it will only postpone the evil day. The other thing would be to build a line of sufficient capacity from the fields of the Southwest. That is a thing that will help if it can be done. It takes steel.

The natural-gas industry has been faced in recent years with continued reduction in rates. During this year there have been reductions in rates. Studies are now before the Federal Power Commission looking to future reductions in rates. Taxes, we know, must increase. Our gas supply, we know, is very limited. The finding of additional gas is becoming more and more costly. The men in that industry, gentlemen, are facing a discouraging situation, and furthermore, they believe, and I believe with them, that the natural-gas industry has been paying, under the laws as they have been in effect, a proper share of taxes. Remember, this industry has its rates fixed by public authority. Any earnings that accrue through the advantage of depletion, through the advantage of charging intangibles to expense are taken into account by the Federal Power Commission, by the State commission, when they determine what is a reasonable rate to charge for the product.

Furthermore, the natural-gas industry pays very heavy taxes in many States, not allocated or charged against most industries.

I have in mind the severance tax, which, in West Virginia, in 1940, was slightly in excess of $1,800,000 on natural gas. I feel that I have placed before you the particular points that are possibly peculiar to this natural-gas situation.

The CHAIRMAN. Will you give to the reporter that brief that you wish to have inserted?

Mr. DAVIS. Yes, sir.

Senator GUFFEY. What percentage of this gas is sold for domestic purposes and what for industrial? Do you have those figures available?

Mr. DAVIS. Yes, sir. Senator, I stated that approximately two-thirds—that is, for the whole United States—goes to the industrial plants.

Senator GUFFEY. Does that same feature happen in the Appalachian fields?

Mr. DAVIS. In the Appalachian fields, sir, the percentage that went to domestic consumption was much greater. I would not hazard a statement as to what the percentage was in years prior to, say, 1941, but I think 75 percent or more went to the domestic. The percentage that goes to the industrial plants has in the last year or year and a half been increasing.

Senator RADCLIFFE. Are there many differences in grades in natural gas?

Mr. DAVIS. Natural gas—the fuel value of it is determined by the B. t. u. content of a cubic foot of gas, and the average for the Nation is approximately 1,000 B. t. u.'s per cubic foot. Now, the variation is usually between 900 and 1,150—that is the usual variation—but it grades down from 900 even to gas that will not burn, and it grades up, oil field gas sometimes runs up seventeen, eighteen hundred B. t. u.'s per cubic foot or even more than that, because that gas carries certain hydrocarbons like pentane, butane, in such amount as to make it richer.

Senator RADCLIFFE. Are these distinctions peculiar to certain geological sections of the country?

Mr. DAVIS. Well, in the Appalachian territory, the gas runs about 1,140, I believe. In the Appalachian territory the average is about 1,140 B. t. u.'s per cubic foot. In the fields of Texas, Louisiana, Amarillo field, northwest Texas, Hugoton field of southwest Kansas, the average is right around a thousand.

Some of the Rocky Mountain fields, like in Montana, a gas is right close to a thousand. I think a thousand B. t. u.'s is is a very close average.

The CHAIRMAN. Thank you very much.

Mr. DAVIS Thank you, sir.

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

SUPPLEMENTAL BRIEF OF RALPH E. DAVIS, PITTSBURGH, PA., REPRESENTING THE NATURAL GAS SECTION OF THE AMERICAN GAS ASSOCIATION

In this brief I propose to point out only the more important facts that bring concern to the men of the natural gas industry with respect to the proposed changes in the taxation of their industry.

The present period of national emergency makes necessary a very drastic increase in taxes upon all kinds of business. The natural-gas industry expects to bear its proper share of this increased tax burden. This industry respectfully requests that careful consideration be given to the effects that will result from too drastic an increase in its taxes.

All of you may know that the natural-gas industry came into being some 15 years before the turn of the century and that it had achieved the importance of a major fuel industry just prior to World War I when it embarked upon a period of phenomenal growth which has continued to the present day. During the period of its greatest growth the State public utility commissions and later the Federal Power Commission have exercised regulatory control over natural-gas companies. Most of the companies treat intangible drilling cost as an expense and take depletion allowances as permitted under the law. This, of course, is helpful to their earnings. The resultant earnings are known to the regulatory bodies when dealing with the problem of a fair return on investment. Theoretically, rates can be increased to enable the industry to maintain its credit, but from experience we know that this cannot happen soon. During the past year or so very substantial reductions in income to many of our natural gas companies have been brought about through regulation by government authority, and many cases are now pending in which consideration is being given to proposed further reduction in rates. It is the duty of the regulatory bodies to take into account all factors which affect or determine earnings. I point out to you that these adustments in rates have been made, and are currently being made, in the light of tax laws which have recently been in effect, or which are now in effect. To the extent that the natural gas industry has enjoyed a greater earning because of the right to percentage depletion and the right to expense intangible drilling cost, these earnings have had their influence in determining the revision in rates.

The natural-gas industry is now serving the needs of some 35,000,000 people in 34 of the States. In many parts of the country manufacturing industries engaged in production of war materials are dependent, in whole or in part, upon natural gas as a fuel. This is true in practically every market where natural gas is being used today. In some of these markets the natural gas companies are prepared to deliver the maximum demand of the war plants. This is not true in the very important Appalachian district where there is already a shortage of natural gas. In the States of West Virginia, Pennsylvania, Ohio, and Kentucky the natural-gas companies have stepped up their drilling programs to the extent of using practically every available string of tools that additional wells and additional capacity may be had. In spite of this very active program the delivery capacity is not being increased, due to the fact that the many thousands of older wells are gradually declining in their capacity to produce gas. A serious shortage of natural gas threatens the Appalachian region for the coming winter months and a much more serious shortage is certain for the winter of 1943-44 unless new fields in the region are discovered or unless facilities for transportation of gas from the Southwest be installed.

Within the past few years the search for new gas pools in the Appalachian region has resulted in disappointment. Extensions of previously known fields are under development, but I know of no important discovery of new pools having been made within the past 1 or 2 years. A feeling of discouragement is now prevalent in the industry, caused by the certainty that the gas supply is falling short, by the knowledge that efforts to maintain productive capacity are increasingly expensive, and by the heavy inroads upon income resulting from drastic reduction in rates and very heavy increases in taxes. Only the strong operators are today drilling for either oil or gas in the Appalachian fields.

I want to make clear to you what is meant by a natural-gas shortage. The cities of southern Ontario, from Windsor on the west to Hamilton on the east, have enjoyed natural gas as a fuel for 40 years or more. The gas has been used for cooking, hot-water heating, house heating, and in industrial plants. During the past 3 years the demand for gas in industrial plants has increased substantially. The gas companies have frantically explored for new gas supplies. For 2½ years no new field has been discovered and 90 percent of all the wells drilled have failed to find gas. In February of this year the Power Commissioner of the Dominion of Canada ordered the leading natural gas company of the district to give war-industry plants preference in the delivery of gas over all other consumers, and through cooperation of the gas company and Government authority there have been removed from service in the one city of London, Ontario, approximately 4,700 gas furnaces used for house heating. There is little doubt that the coming winter season will see 10,000 or more disconnected gas furnaces on the system of this single utility. Most of the people are not prepared to burn any other fuel and they do not know where they will get the necessary equipment. There is a possibility that this situation may be met in part, at least, by building an inter-connecting line across the Detroit River, obtaining a gas supply from the eastern end of the system of Panhandle Eastern Pipe Line Co., whose gas comes from western Kansas and northwestern

Texas. That this will be done is not certain. The situation is critical. A similar situation is likely to envelop a portion or possibly all of our Appalachian region within another year and a half. The men in the industry know this and have recognized it for at least 2 years. The fatal day is being postponed by the active drilling now being carried on. With the reduction in gross income forced by regulatory bodies, with reduction in remaining net income resulting from necesary increases in taxes, I suggest to you that it is not wise at this time to further jeopardize our war effort and the domestic fuel situation by drastic revisions in the taxation of the natural gas industry. By limiting the cash available for drilling you will automatically limit the war effort.

If it be said that the natural gas industry should be willing to bear its fair share of taxation, I say let us take into account the fact that this industry is now paying taxes that other industries generally, with the exception of the oil industry, are not required to pay. I refer to the severance or production taxes now levied in most of the oil and gas producing States. The taxes paid by the oil and gas industry in one State alone, West Virginia, were for 1941, $5,801,259 of which $1,800,538, or 31 percent, was a production tax on natural gas not imposed upon other types of business.

We men in the natural gas industry believe that we will be paying our full share of the tax burden even though we be permitted to continue the present system of charging intangible drilling cost to expense and taking percentage depletion as now allowed.

AUGUST 10, 1942.

(The following communications were ordered printed in the record:)

STATEMENT BY GEORGE C. GIBBONS, EXECUTIVE VICE PRESIDENT, TEXAS MID-CONTINENT OIL & GAS ASSOCIATION, ON THE SUBJECT OF THE DEPLETION ALLOWANCE

The Texas Mid-Continent Oil & Gas Association, with headquarters at Dallas, is a service and research organization, representing the oil industry in Texas. Producers, refiners, royalty owners, ranchers, and farmers are represented in its membership, and its primary purpose is to deal with the economic problems common to the oil industry in the State.

The Texas oil industry has been built largely under the congressional policy of depletion allowance and the right to expense intangible drilling and development costs.

A brief review of the industry since 1918 when this policy was established reflects the prophetic wisdom of Congress. At the end of 1918, Texas had an annual production of 38,750,000 barrels from 7,134 wels. Records show that 1,005 operators were engaged in the business at that time and their oil sold at an average price of $1.93 per barrel. In the year 1941, the number of operators in Texas fields had grown to a total of 5,600, producing 507,584,000 barrels of oil from 98,802 wells selling at an average price of $1.08 per barrel. In 1918, Texas had estimated reserves of 500,000,000 barrels, while today it is estimated that we have 11,478,790,000 barrels in oil reserves, or more than 50 percent of the Nation's reserve.

The very thing Congress intended has taken place in the Texas industry. Reserves increased twentyfold. In so doing, the oil men have accepted and carried a high responsibility to their State and Nation. Let us examine the record of our economic problem during these years of progress and accomplishment.

1. Today the Texas oil industry is doing between 40 and 50 percent of the geophysical and exploratory drilling of the Nation, in searching for new reserves to maintain the available oil for the war effort at a safe figure. Because of the shortage of materials, such as steel, drilling efforts are being confined largely to wildcat operations. A study of drilling operations shows a startling increase in the percentage of dry holes drilled. Drilling statistics for June 1942, show that the percentage of dry holes drilled in Texas was 36.9, against 22.8 a year ago. For the Nation as a whole, the percentage of dry holes drilled in June of this year was 36.1, against 19 a year ago. In other words, at the present time 36 cents of every dollar spent for drilling is lost in dry holes, whereas a year ago less than 19 cents of every drilling dollar was lost in dry holes. In fact, 36 cents is a conservative figure since higher prices of equipment and increased wage rates have undoubtedly contributed to higher drilling costs than those of a year ago.

The 27½-percent allowance for depletion is obviously of far greater importance to the oil industry and to the Nation's war effort now than ever before, since the risk of capital necessary to find new oil fields is greater now than at any time in the past 24 years. If the depletion allowance and the right to expense intangible drilling costs are abolished or reduced the risk money left in the industry through the operation of the foregoing provisions will be reduced very substantially with a consequent drastic reduction in this vital exploratory work. Our Government officials have seen fit to allocate vital materials to the petroleum industry in order that exploratory effort to find new oil reserves will not be jeopardized. Yet a greater jeopardy to such effort would be to deprive oil operators of the right to recover at least a part of the capital which must necessarily be risked in drilling unavoidable dry holes.

2. There are now more than 30,000 wells in Texas which produce less than 4 barrels daily. These wells have a long life ahead of them with an estimated 650,000,000 barrels of recoverable reserve, which will be produced if the Federal tax structure of the oil industry is not changed. If the 27½-percent depletion allowance and the right to expense intangible drilling costs are abolished a large number of these wells will be abandoned in the very near future and all of them may have to be prematurely abandoned, with a resultant loss of much of their expected reserves.

While it is true that all stripper well operators do not claim percentage depletion on their stripper operations, they must of necessity risk their capital in exploratory work and development of new properties in order to stay in the oil business. There are very few oil operators who may be classed strictly as stripper operators. Most oil operators own flush production as well as stripper wells. In reality, the 27½-percent depletion allowance and the right to expense intangible drilling costs are vitally important to the continued operation of stripper wells and the ultimate recovery of valuable oil reserves which they represent. It is the benefits derived from these provisions on the profitable properties that furnish the incentive for the oil operator to continue his stripper operations.

3. Since the beginning of oil in Texas we have drilled a total of 204,165 wells. Of these 56,343 were dry holes. At the conservative cost of $18,000 per well this means that more than a billion dollars has gone into dry holes. Yet every dry hole has contributed its part in exploratory work toward the location of producing fields.

4. For many years the scientists of the industry have explored the State for promising areas, and the expenditures for this exploratory work have run from $10,000,000 to $15,000,000 annually.

5. Today 45,000,000 acres in Texas are under lease and payments to farm and ranch owners in lease rentals and bonuses exceed $60,000,000 annually. Royalty payments to farmers and ranchers add $70,000,000 more.

6. In 1918 an estimated 18,000 men found employment in Texas oil operations. Today a total of 245,000 men find their livelihood from oil. They and their families represent more than a million people who are directly affected when the oil business suffers from economic disturbance.

7. The Texas oil industry has assumed a tax responsibility which can only be realized by a recital of the record. Twenty-five percent of all school taxes in the State is paid by oil. Thirty-eight percent of all taxes in the State is paid by the oil industry, and if the gasoline tax, a tax on its chief product, were added, more than 50 percent of all Texas tax revenues comes from oil.

8. Expenditures in Texas oil development have exceeded the returns from the business and any potential profit reflecting to the industry as a whole still remains in the ground. The very nature of the business, of building and maintaining reserves, require a constant reinvestment of capital.

9. The foregoing statement is further evidenced by the record of bank loans and current indebtedness of the Texas oil industry. Our study indicates that our own State banks are carrying loans to our independent oil operators in excess of $100,000,000. Over-all loans, both in and out of the State, through banks and insurance companies, total more than $800,000,000, secured by Texas oil reserves.

10. Years ago Texas enacted sound conservation laws which restrict the daily production of its wells in order to insure the maximum ultimate recovery from them. This greatly restricts the annual income per well while contributing greatly to the public good. For example, the average gross income per well in 1918 in Texas was $10,551, while in 1941 it had dropped to $5,400. The restricted production under sound conservation practices requires a constant exploratory

and wildcatting program, even in face of heavy reserves, in order to meet current demand and produce present reserves without waste.

This presentation of facts shows briefly the growth and development of the oil industry in the major producing State. The 27½ percent depletion allowance and the right to expense intangible drilling costs have been foundation principles on which the industry was built. The sound structure of our Texas industry depends upon the maintenance and continuance of these principles, not only from the standpoint of production practices which will recover present reserves, but to offer a reasonable opportunity for further exploration and development.

While today oil is being produced in 165 counties in Texas, exploratory work is being carried on in all but 1 of the remaining 89 counties. The character of exploratory work is expensive and involves extensive geophysical study, wildcat drilling, laboratory studies, blocking and leasing costs, and much other expense, with the constant risk that even with all of these expenditures production may not be found. If we are fortunate enough to continue our discoveries into these additional counties of the State, regardless of the cost, such production becomes a contribution to the economic wealth of the State and Nation. It will contribute to the war effort, to the payment of necessary taxes, and when the war is over will provide insurance to the public that they may have this vital production in quantity at a reasonable price.

[Telegram]

GREAT FALLS, MONT., *August 10, 1942.*

RUSSELL B. BROWN,
General Counsel, Independent Petroleum Association of America, Washington, D. C.:

Have sent following night letter to Chairman George of Senate Finance Committee and copy to Senator Murray. Shall appreciate your cooperation. "Re hearing on depletion for petroleum and other mineral industries commencing August 10. Oil Conservation Board of Montana, State government oil regulatory agency, respectfully recommends and urges that your honorable committee disapprove and reject any proposed amendments of, or repeal of, existing laws or regulations applicable to depletion allowances and allocation intangible drilling and other mining costs to operating expense because we are convinced that reversal of long-established governmental policies respecting said matters would have such immediate disastrous effects upon mining industries and investors, especially small ones, that loss of income-tax revenue rather than gain may be expected as well as material impairment of production crude oil and other minerals vitally needed during present war emergency.

"We have personally labored in petroleum industries many years and know said policies as to oil and gas mining and production are sound and have been most encouraging and decisive factors in discovery and development of crude oil resources to our present fortunate position of independence as to sufficient supplies to meet current requirements of our country and its Allies. With all due respect to Secretary Morgenthau and assistants, we resent and deny charge that owners oil wells and mines are highly privileged group as to income exemptions and confident it cannot be sustained as to great majority of operators. No doubt there are impressive examples of singularly fortunate individuals or companies available for your consideration but to offset each such case we believe a hundred could be presented showing losses or very limited profits from investment risks and efforts involved. Survey we have made this month of situation of Montana oil producers indicates out of total 205 active in State more than half could not continue operating without benefit of depletion allowances against their small gross incomes.

"Comparative figures for older producing States where small stripper well properties and operators are more numerous undoubtedly afford convincing proof of dangers inherent in making drastic changes in taxation policies affecting all mining industries such as recommended by Treasury officials. We realize you must impose and increase tax rates to provide necessary revenue and we believe majority of citizens in mining industries will cheerfully bear their share additional burdens, but think it neither just nor advisable to cancel rewards for past explorations and discoveries represented by depletion allowances under present laws or to deny such rewards in future to workers and investors who will risk their money and efforts in prospecting for and developing deposits of oil and other minerals to insure adequacy of supplies for war and industrial purposes."

Respectfully yours,

OIL CONSERVATION BOARD OF THE STATE OF MONTANA,
A. B. COBB, *Chairman.*
L. J. YEALY, *Vice Chairman.*
M. R. WAGNER,
CASPER T. OIEN,
DEAN CHAFFIN,
Members.
R. P. JACKSON, *Secretary.*

STATEMENT OF OIL AND GAS ASSOCIATION OF MICHIGAN

To the Finance Committee, United States Senate:

The following statement by the Oil and Gas Association of Michigan in regard to percentage depletion and the option on charging development costs is respectfully submitted for your consideration b ythe depletion committee of that association, consisting of Floyd A. Calvert, chairman; Harold M. McClure; and Arthur H. Ledbeter.

AUGUST 10, 1942.

This association is composed of about 86 percent of the oil and gas producers of Michigan, as well as numerous royalty owners and landowners directly or indirectly interested in the oil and gas industry.

On June 30, 1942, there were approximately 3,216 producing oil wells in the State of Michigan, with an estimated total daily production of 66,193 barrels. Over 88 percent of these wells are producing less than 10 barrels of oil per well per day, and are what we call stripper wells. The remaining 12 percent are now producing various amounts of oil, not to exceed 262½ barrels per well per day; these latter wells may be termed flush production wells.

As an example of the stripper well production, we call attention to the Walker field, near Grand Rapids, in February 1942, consisting of some 466 wells producing approximately 2,553 barrels of oil daily, or about 5½ barrels per well per day.

A great majority of the producing wells in Michigan are being operated on a small margin of profit, and many individual wells are operated at a loss. An operator will frequently continue to operate a well at a loss, or a very small margin of profit, where he can operate a group of wells or an entire lease at a small or fair profit.

At this time there are approximately 524 producing dry gas wells in the State, of which number about 20 percent have a potential producing ability of less than 1,000,000 feet of gas per well per day, and may be treated as stripper gas wells.

The public, as a rule, hears only about the successful oil and gas producer or investor in oil properties. Romantic storybook cases of some successful producers or investors becoming wealthy overnight in the oil and gas business make interesting and delightful reading, but you do not hear about the great majority of failures or unsuccessful ventures. Hence, it is natural that the public should think that most oil and gas investments are profitable, whereas the great majority of same result in a loss to the producer or the investor.

Take the actual case of a Michigan producer who, on November 15, 1938, drilled well No. 1 on an 80-acre lease with an initial potential production of over 2,000 barrels per day, and who, 6 months later, had completed 8 deep wells upon the lease, with an actual production of approximately 33,000 barrels per month. The average citizen would think that this operator had a wonderful and a very profitable investment. However, his production suddenly started to decline about 6 months after his first well was drilled in, and in February 1940, or within 9 months after the peak of his production, as above mentioned, the entire lease was producing only about 2,400 barrels per month, and at this time, on March 18, 1942, the entire lease is producing about 500 barrels per month, and during the year 1941 the operator sustained an operating loss of $1,028.58. The total production from this lease to January 31, 1942, amounted to 234,340.82 barrels, of the total value of $182,383.60. The total investment, development costs, etc., amounted to $194,420.15, thus leaving the operator with a loss on his entire investment to January 31, 1942, of $12,036.55, and the lease is apparently now being operated at a loss.

Take the case of another operator who drilled a shallow well upon one of his leases in December 1940, upon which lease a total of five shallow wells were drilled. The peak in production, of about 8,500 barrels per month, was reached in January 1941. A rapid decline in production then set in, and by April 1941 the lease was producing about 600 barrels per month. It is now producing some 200 barrels per month. The total cost of this lease to January 1, 1942, was $35,373.05, and the total revenue $23,726.78. The estimated total cost for the life of this lease is $37,175.05 and the estimated total recovery for the life of the lease is $27,726 78; thus, there is an estimated loss on this lease during its entire life of $9,448.27.

In another case, the producer drilled a shallow well upon his lease in August 1939, the well reaching its peak of production of about 479 barrels per month in September 1939. Seventeen months later, in February 1941, this lease was producing only 48 barrels per month, and the well was plugged and abandoned; the total cost of the lease being $6,455.64 and the total revenue amounted to only $3,615.43. The net loss was $2,840.21.

We can furnish detailed statements and graphs supporting the above examples of loss, as well as innumerable other loss statements.

These examples of expected or rosy hoped-for profit, but in reality cold, harsh losses, in the oil business, can be multiplied hundreds of times in Michigan, possibly thousands of times, and, of course, can be multiplied tens of thousands of times in the other oil and gas States. As was once aptly said by the learned Chief Justice Matthew J. Kane, of the Supreme Court of Oklahoma: "To undertake to tax an oil or gas lease is to undertake to impose a tax upon the illimitable vista of hope." And while Chief Justice Kane was referring to an undeveloped lease, in a great many cases the same statement might be made with reference to a producing lease.

In many, many cases, the depletion allowance is the difference between profit and loss, and the wells would be abandoned except for this allowance.

The greatly desired statements showing big profits or fair profits in any amount are few and far between, and constitute a small percentage of the total operations of the industry. You may wonder why this should be. The answer is that the oil and gas business is an extremely hazardous and speculative one. It is a fascinating business, like that of mining or any natural-resource business, where the operator cannot tell just what he is going to find until he explores the innermost hidden portions of the earth at great expense. The venture being extremely hazardous and uncertain, the person engaging in same must naturally be willing to risk a great deal. He is willing to lose on a great many ventures if he can only even-up and make a fair over-all profit on all of his operations. The 27½ percent depletion allowance gives him a chance to recover from his producing property some of his losses from dry holes, small nonpaying wells, and wells that have to be prematurely abandoned on account of salt water, etc.

It is well known that oil and gas are irreplaceable minerals, and that the production of same constitutes a depletion of the owner's capital, rather than an income from capital. This theory was adopted as a fact by Congress in 1926 and has practically been the adopted policy of Congress and of the courts since 1918. The oil and gas producer then has no special privileges, but on account of the nature of his business he has been granted the 27½ percent depletion allowance in his Federal income taxes as a fair allowance for the many losses he has in his business, and as an offset to his loss or depletion of capital, and to encourage him to go out and drill for new fields and new reserves.

When an income tax is levied upon the oil and gas producer, he is really being taxed upon his capital, since each barrel of oil and each foot of gas produced result in a lessening or depletion of his capital. It takes millions of years for oil or gas to accumulate by chemical processes in the earth, and, therefore, when such minerals are produced, they are considered irreplaceable. They are not like crops of wheat, corn, cotton, or other crops that may be produced, harvested, and used up, and then sown and regrown the following year; nor like fruit, timber, livestock, fish, and other commodities that may be processed, used, and reproduced.

The oil and gas industry now probably pays a larger amount of the taxes in this country than any other one single industry. The industry pays property or ad valorem taxes upon its tangible property, in addition to its many other taxes, including income taxes. In Michigan, the industry pays some 18 or more direct and indirect taxes, including ad valorem, severance, or gross production taxes, franchise taxes, excise taxes, taxes on intangibles, sales taxes, use taxes, gasoline taxes, oil taxes, pipe-line taxes, privilege taxes, and many others. It has been stated that the oil and gas industry in the United States was, prior to the war, paying directly or indirectly more than one and one-quarter billion dollars in annual taxes out of a total of some seven or eight billion dollars directly paid by all industries; that altogether over 200 different taxes are being paid directly or indirectly by the oil industry in the United States.

The oil and gas industry while already paying its full share of taxes, is willing to bear its proportionate part of any increased taxes necessary to win the war. However, it feels that it should not be singled out and discriminated against in the matter of taxes, but that such increased taxes should be spread out and paid by all industries and the taxpayers as a whole. Too heavy a tax load placed upon the industry will tend to reduce its efficiency and productive ability. It is a well-known fact that while the wholesale commodity price of petroleum products in April 1942, was only about 58.4 percent of what it was in 1926 and the cost of many other products has gone above the 100 percent figure, as shown by the records of the United States Department of Labor, nevertheless petroleum products have increased in efficiency during the same period and the consumer now not only pays less for his petroleum products but receives a much better product than was produced in 1926. Gasoline octane rating is higher, lubricating oils are better refined, and all petroleum products are of a higher grade. Why should we "kill the goose that lays the golden egg?" Why should we discourage wildcatting, the drilling of new wells, the production of oil and gas so badly needed in our present emergency? Why require the producers to abandon at a great loss their small wells and thus decrease our reserves of oil and gas? A very large portion of our oil reserves is under existing stripper wells, now operating at a loss or small profit.

The oil and gas fields in Michigan are strategically located with reference to important war industries. Anything done at this time to slow down oil and gas operations in Michigan naturally also seriously slow down our country's war efforts.

The present law with reference to percentage depletion applying to oil and gas and other mining properties should remain intact, and no reduction or change should be made in same. If the depletion allowance is reduced, we believe such action will result in a big decrease in the number of wildcat wells to be drilled in this State: a decrease in the number of new oil and gas fields that might be discovered in Michigan; a decrease in the production of oil and gas in Michigan; that such action would result in a less amount of oil and gas reserves being maintained in this State and would thus decrease our reserves of oil and gas and would cause the premature abandonment of many small oil and gas wells, not only in Michigan, but all over the country, at a time when we greatly need an increase in oil and gas production to properly carry on the war.

Respectfully submitted.

Oil and Gas Association of Michigan,
Floyd A. Calvert, *Chairman*,
Harold M. McClure,
Arthur H. Ledbetter,
Depletion Committee.

The Chairman. Mr. Broadgate.

STATEMENT OF W. C. BROADGATE, PHOENIX, ARIZ., DIRECTOR, ARIZONA STATE DEPARTMENT OF MINERAL RESOURCES

Mr. Broadgate. Mr. Chairman and Senators, I am W. C. Broadgate, of Phoenix, Ariz., assistant director of the State department of mineral resources and vice president of the Arizona Small Mine Operators Association, and I speak principally for the small-mine operators of our State and of the Southwest.

In order to conserve the time of the committee, I will give this statement in part only, but I ask that the entire brief be included in the record.

The CHAIRMAN. Yes, sir; we will be glad to.

Mr. BROADGATE. This material was prepared by Mr. Charles F. Willis, of Phoenix, Ariz., State secretary of the Arizona Small Mine Operators Association, Arizona consultant for the Metals Reserve Co., chairman of the board of governors of Arizona Department of Mineral Resources, and for the past 22 years editor of the Mining Journal, which is published in Phoenix, Ariz., but which circulates pretty well all over the world. Therefore, he has been in position to observe very closely the effects of the changing economic structure on the mining industry, particularly on the small mines.

The Arizona Small Mine Operators Association is an organization of over 4,000 members who are finding, developing, and operating small mines almost exclusively of strategic and critical metals and minerals. They are the pioneers from whom our great metal industries start.

The Arizona Department of Mineral Resources is an organization supported by the State of Arizona for the purpose of assisting the small-mine operators in solving their economic problems, and there has been no more important problem than that which involves taxation policies.

I want to make it clear in the first place that the mining industry does not want to be out of step with any national program, whether it be taxation or production. The small mine operators have no desire to avoid taxes which are justly and equitably applied. They are seeking no favors, but do not want to be discriminated against simply because the problems peculiar and individual to their industry are not understood.

Furthermore, the small mine operators, and there probably are 25,000 of them in the western United States, are willing to do their utmost in the war effort, but they are beginning to wonder if this so-called shortage of metals is just another cry of "wolf." The reason for this feeling is that the small mine operators see so little being done of a constructive and helpful nature which will bring out added production and therefore conclude that the Federal Government is not as anxious for this production as some would have them think.

The problem which Congress has, to enact an equitable tax bill, is appreciated by the small mine operators. Your object is to get the necessary funds with which to conduct a gigantic war effort. Therefore, in many cases you are called upon to fix a policy—as you must determine with relation to metal production—is it more important to raise tax revenue than it is to get the metals and is it possible that you will place the tax load at a point where it will fail to produce simply because it confiscates the business being taxed?

You must decide whether you want the money or the metals and if you decide that getting the necessary funds is more important than getting the metals, it must be remembered that if you fail to get production of metals you then will not get the revenue the industry should produce in taxes. If the taxes are set up as more important than the metal production, you are likely to get neither.

I believe that we will all agree that the shortage of metals is no cry of "wolf." It is even more serious than we have been told. There is a critical deficiency which threatens our ability to carry on the war effort on the scale on which it is planned and is necessary. This shortage covers copper, lead, zinc, vanadium, tungsten, manganese, and, in fact, almost the entire list.

It has been demonstrated that there is almost no limit to the manufacturing ability of the United States. Mass production methods and the mechanical genius of the American people have proved to us that we can manufacture just as many planes, tanks, guns, ships, and the other implements necessary to warfare as we desire, but that we cannot manufacture the metals from which they are made. We find them only where Mother Nature placed them.

Our limitations are not money, skill, brains, or manpower, but metals and other materials. Most important and fundamental to that war production program are the metals as we require them, not only for the product which is to be made by the manufacturing plant, but for the machinery which is to be used to make that product.

During the past 2½ months the Arizona Department of Mineral Resources has been conducting a survey of all the mines of Arizona. This survey has covered something over 300 mining properties. It has been a study of each individual mine with a view to determining what they have produced in the past, what they are producing now, why they are not producing more, what are the factors holding back increased production, and, if they have failed to keep up their production, what are the reasons for the decrease.

This survey was first conducted among the producing mining properties, and it was immediately followed by a similar survey of nonproducing properties which had ore available but which, for some reason, was not being taken out and marketed.

This survey was not conducted with any idea of determining the effect of taxation, but covered the entire series of economic conditions, and I doubt if there is another section of the country that has as clear a picture of the whole situation as we have in Arizona.

The survey covered a sufficient number of all types of mines, so that it presented a true cross section, and we found that the situation as to metal production will in the near future be far worse than anything which has been recorded so far, even though most frantic efforts are being made to correct it. The fundamental difficulties still exist.

Private or venture capital upon which the mining industry has always been dependent for development and expansion has almost completely dried up simply because there is a natural and inherent risk in mining with no opportunity whatsoever under the proposed tax laws for the return that is necessary to and commensurate with the risk. There is no opportunity even for the return of the capital necessary to be invested. You cannot even borrow money from private sources, as there is no adequate provision in the law for the return of that which may be borrowed.

One of the many functions of the Arizona Department of Mineral Resources has been the bringing together of those who have money with which to open and operate mines and those who have mines needing capital to be opened and operated. It has been a job of bringing private capital and mining opportunities together and seeing to it that each one got an equitable deal.

In the year 1940 the Arizona Department of Mineral Resources made over 40 successful contacts between primary or venture capital and mines to be opened and operated. In the year 1941 that number was reduced to 30, and in the first 6 months of 1942 there was only 1 contact made that resulted in a new mine starting up with private capital.

This record speaks for itself, yet there is much private capital available and seeking mining opportunity. The drying up of this capital is almost exclusively the result of the trends of taxation relating to mines. The reason is not so much the tax laws that have already been enacted but the trend and the threats of that, which is in mining, confiscatory taxation and a failure to realize that the mining industry is one of wasting and definitely exhausting assets.

This very hearing is one of those threats that has driven capital away, the question of whether percentage depletion should remain in the law where it has been for a great many years, or whether it should no longer be allowed. This threat is against even the most fundamental and long-recognized natural resource investment protection. Even the threat against it has dammed the private capital necessary to metal production, and the removal of percentage depletion allowances would be an assurance that the gates of the dam could not be again opened.

It is mighty difficult for those of us who are in small mine operations to understand why there should be any question whatsoever on this subject. A mine is Nature's location of the raw materials from which metals are made. Metals are not found in the ground, but minerals are, and from those minerals which we may find we may or may not ultimately derive metals. It takes more than cash capital. It takes years of sweat, toil, disappointments, and discouragement, which cannot be measured or evaluated in dollars and cents, to make available the raw materials from which the metals come.

If it were a manufacturing plant it would not even be a subject of discussion as to whether there should be allowed in the tax structure compensation for the raw materials with which the finished product is made. And that is all that the mining industry is asking—an allowance for its raw materials which it spent much time and money to find and which will ultimately be exhausted.

It is recognized that there is no possible way in which the small mine operator can be compensated for using up his raw materials measured by the cost of that material. The percentage depletion method was the result of a long period of study of many cases to determine an arbitrary average that was fair and equitable. To disallow depletion allowances on the percentage basis would only mean that the small mine operator could get no recovery whatsoever for the years of toil in trying to open up something which would be an asset to the country and a vital necessity in the time of war.

As a matter of fact, the present percentage depletion allowance is inadequate for small mines in view of the fact that they are being urged to produce in larger quantities as a war emergency.

We have but a limited period for that production, under ceiling prices that are entirely too low, to compensate for the investment made of many years in finding raw materials—minerals. We all hope that it will be short, but we know that it is definitely limited.

Mining costs are materially increased by the bill which is before you, one feature being that portion of the bill which places an excise tax of 5 percent on transportation charges. This is especially burdensome to the mining industry because freight enters so largely into the costs of mining—much larger than in almost any other industry.

We have mines that have only 12 pounds of copper to a ton of rock. The freight, when it is moved to the smelter, is on the whole ton of rock from which only 12 pounds of copper will come. It takes heavy machinery from the eastern States to operate a mine and the product of the mines go to the eastern States, thus freight is a tremendous item in mining costs. Over 80 percent of the tonnage of freight originating in the State of Arizona is from the mines and a similar situation prevails in all of the western States which are producers of raw materials for the manufacturing East.

This 5-percent increase in freight cannot be passed on to the consumer as would be possible in a great many industries. The ceiling prices on copper, lead, and zinc are at the destination points, whereas the ceiling prices on all other commodities are at the points of origin, therefore, the producers would have to absorb any freight increase.

The costs of mining, of which freight is an important part, have gone up tremendously since the ceiling prices were set. We have already had a 6-percent increase in freight; wages are up $1.50 a day; supplies prices have skyrocketed; and taxes have become rather large and probably will be larger. The labor shortage and turnover, and added cost of inefficiency of new labor has greatly increased the distance between the floor of costs and the ceiling of prices. In fact, this distance has been entirely eliminated in many cases and some producing mines have shut down simply because of their inability to live under the present situation. Many have had to limit their operations. Thus production is going backward at a time when it is vital that it should increase.

But let us look for a moment at what this problem of increasing costs is doing to the producing mines. The ore of every mine, no matter how profitable it may be at times, is marginal at some point of the cost cycle. As the costs go up, it becomes necessary to mine only the higher-grade ores. Thus we are skimming the cream from our resources and leaving only the skimmed milk for the future.

Contrary to the ideas of most laymen, mines do not have a uniform ore content. The figures which we hear and see published are averages of contents of many blocks of ore, each one of which may be different. Thus it is possible to mine only such blocks as have the value necessary to bring it out. The great danger in this is that when you remove the blocks of higher value, you often leave the remaining averages so low that the balance of the ore is below the grades that can ever be handled.

It is very true that many of the producing mines are keeping up production in pounds of metal. They have been able to do it, with increased costs and a lessened number of employees, simply because of the higher average metal content of the ore which they have been forced to take out. Many mines have been forced to curtail development work because there was not enough left from the sale of their product after all costs and taxes are paid to do that work which is essential for their continuity.

If we could be assured that the war was going to be over by Christmas, as some wishful thinkers would have us believe, the situation would not be so serious in skimming the cream as we are doing, but if we are to prepare for a long war, it is a most reckless sabotage of our resources to deplete by high costs, low prices, and taxation our ore reserves which we may need very badly in the future. We actually deplete our reserve faster with increased costs than we do by extracting the ores, yet we get no return from the same, either in metal or taxes. Those ores are left in the ground and in many cases are never recovered.

There is no objection on the part of the small mine operators to the principle of excess profits taxes. In the case of mining we customarily misuse the word profits. There are no actual profits from mining until the capital investment is first returned. It is only income as, during the period of the life of a mine, it is necessary to get both a return of the original capital and a reasonable interest on the investment before there are any real profits.

The only excess profits which you can get from a mine are those which come from lower costs or higher prices. Simply because a larger tonnage is mined, and, therefore, produces more dollars within the year, does not make excess profits, but is merely an anticipation of normal profits of future years which come about simply because of the immediate urgency of the demand.

If you have a mine in which you have 100,000 tons of ore, for instance, and you mine that at the rate of 10,000 tons a year, at the end of the 10 years it is definitely exhausted. If, however, due to the urgency of the war demand, you mine 20,000 tons a year and exhaust the ore body in 5 years you have not made excess profits during that 5-year period—you have merely advanced in time the profits you would have made during the second 5-year period.

An equitable mine taxation law requires a unit of production credit, basing excess-profits taxes upon that which is obtained from getting better than normal costs. It is perfectly possible, even under these conditions, to get lower per ton or per pound costs and, therefore, have excess profits because the greater volume often reduces the overhead, but there are no excess profits in the mining industry that come from merely handling a larger tonnage.

Although it is not being done very successfully, the national leaders are urging increased production of metals from new and marginal mines. The reason that we have not been able to interest private capital in doing this job is, as I have previously stated, the fact that they cannot even recover capital and, should they be forunate enough to get anything in excess of their capital recovery, the Government takes the profits. But should they fail to recover their capital—which is the case 9 out of 10 times in mining—they pocket their own losses.

Yet they are being asked to invest their capital, open these mines, and bring out new production with the definite knowledge that the mines which they may open are to produce a raw material which only is of value during the war period and which probably will have no commercial value when the war demand is over.

This has created an impossible situation on which an attempt has been made to answer by the 5-year amortization plan on war industries. This plan, designed for manufacturing, does not adapt itself to mining any more than most of the plans do which are designed from a manufacturing viewpoint. A manufacturing plant has some use for some purpose after the war, but the mine leaves only a ghost town behind it.

Mexico has recognized the peculiarities of mining under war emergency conditions and has just recently written into its statutes a clause which provides for complete relief from Federal taxation until such time as the capital invested has been returned in full. This applies, of course, only to distinctly war industries created because of the emergency need of production.

Under that plan, Mexico is going to find that it will get its necessary minerals and metals by private capital development and there is very distinctly a need for some similar provision in the United States tax structure if we are going to get the minerals and metals needed to equip our huge fighting machine.

We, as small mine operators, are quite willing to assume that under present policies no abnormal profits are to be permitted for anyone. We are not at all critical of that policy provided it is equitable and takes into consideration the peculiarities of particular industries. We are against war profiteering and we certainly do not want to see inflation.

Having removed the profit incentive, and even that unreachable "pot of gold" that is at the end of the rainbow which every prospector and small mine operator hopes that he will some day see near at hand, we can only appeal for material production on patriotic grounds, but to secure that we must make it as simple as possible to do business. Business cannot be strangled by red tape. Now we have the problem of determining whether our tax policies are making the goose decide as to whether or not it is worth the effort necessary to lay the golden egg keep it where it may be produced later.

We are going to get increased metal production—and how we do need it. We have three possible sources: Increased output from the regular producing mines by expanding plants to larger capacity; the marginal mines by removing known ore bodies which cannot possibly be commercially operated under normal conditions; and the small mines which from many thousands of small lots can make a sizable accumulation of minerals.

A comprehensive program has been developed by Government authorities who are responsible for the job of producing enough metals to keep assembly lines going. There are many expansion activities in mining among the large mines fostered by Government cooperation and they have been quite willing to sacrifice their future life and ore reserves for the war effort.

However, their production possibilities are 1 year, 18 months, or 2 years away and during that period they are using manpower, consuming machinery, and producing nothing. The marginal mines and small mines must fill the gap of production between now and the time when the large mines are ready to operate at increased capacity. They can only be handled by having a program that will permit of private capital development and the only private capital you can get for mining today is from those who are ignorant of the proposed tax laws.

This situation has been recognized by the Federal authorities in that they have tried to develop a Government program. They have proposed premium prices, a mine loan program, ore-buying stations, access-road program, Government plants, and other devices, yet the program is not working in that it has bogged down by being too complicated, cumbersome, and slow. The enemy is not going to wait until we unwind the red tape which will bring out copper for shells.

To the small mine operator they seem to say: "We have something for you to help you solve your problems—but try and get it."

The program has been too tough for the small mine operator to qualify for when all there is in it for him is an outlet for his patriotic emotions. He can and does turn to other outlets which will be less difficult to accomplish.

I am not saying this to be critical of the Government program for bringing out metal production. It is a comprehensive plan but the design which Government authorities draft for business under wartime conditions is built for large companies—in fact, most of the men in Washington who draft these understand only large organization charts, and it is impossible for small business, and particularly the small mine operators who are the most rugged of rugged individualists, to follow the same design and stay in business.

Our survey has shown a very large number of small mine operators who have ambitiously started in patriotic fervor and stopped because they have been entangled in routine and red tape and they had to eat while they waited. This has happened to all except a dozen of the 71 mines that have been gotten under way through cooperation of the Arizona Department of Mineral Resources since the beginning of 1940.

Priorities, 75 percent back-haul difficulties, labor problems, increased costs, power permits, requirements to deal with many different departments, and other things have made many a potential producer of badly needed metals say: "What's the use? They do not need these metals as badly as they say they do or they would not make it so hard for me to get them out."

In our survey probably the greatest need demonstrated was that of operating capital, that relatively small amount of money which is necessary to pay the bills from the time production starts until the check for the proceeds comes in. It is a fixed investment, secured, it is true, by ore in process, but nevertheless a rather intangible thing. It would seem as though private sources would be quite willing to finance this operating capital as it is well secured, but it shies away simply because the tax structure provides no method of repaying borrowed money, except that which can be repaid out of the 10 percent that is left after the excess-profits taxes are paid.

Without metals we cannot build the machinery that is required to win this war and, as stated before, the question which the Finance Committee of the United States Senate is being called upon now to decide is the relative importance of the size of the tax bill and the need for metal production. You can only get both through a proper balance of having a tax bill which is not so large that it destroys the industry which pays those taxes. Private capital will bring out the needed metal quickly and in sufficient amounts if given a chance. It is not seeking profit, but only an opportunity to serve.

Senator WALSH. To sum it all up, you don't recommend any change in the law?

Mr. BROADGATE. We do what?

Senator WALSH. Though you think the present percentage is inadequate, you are content with the present law?

Mr. BROADGATE. We will be content with the 1942 House bill provisions.

Senator WALSH. That seems to cover your brief pretty well.

Mr. BROADGATE. I would like to make one small staaement in closing.

The operators of the small mines are trying hard to participate in the war effort. Those not already in operation are making every effort to get into operation. It is no secret that mineral production, which Mr. Donald Nelson considers the base of the war program, has not expanded as rapidly as was expected.

The small mine is in a position to get into production with comparative rapidity, but is subject to many discouragements. The Securities and Exchange Commission has almost driven private capital from the field of small mine investment, and due to various other reasons, including the tax situation, it is no longer a satisfactory speculation because of the increasing hazard of getting the money back, let alone making any.

The Congress, realizing this, has provided means of getting Government financing for strategic and critical mineral properties. However, it frequently takes longer to get Government funds than it does to put the mine into operation. The bonus or premium plan for extra payments on copper, lead, and zinc production is so slow and involved in its operation that the small operator without much capital may be ruined before he gets his money.

The instinct to mine and the desire to help in the war is so strong that in spite of these factors and the rising costs and taxes, together with price ceilings, small mines are opening up. However, if mine operators are not allowed this reasonable figure for depletion provided in the House bill, the result will be further disastrous discouragement for those who are desperately anxious to produce minerals.

You can have the minerals or the money. Not both.

The CHAIRMAN. Thank you for your appearance.

Mr. Callahan.

STATEMENT OF DONALD CALLAHAN, WALLACE, IDAHO, VICE PRESIDENT, AMERICAN MINING CONGRESS, ALSO REPRESENTING IDAHO MINING ASSOCIATION

Mr. CALLAHAN. Mr. Chairman and members of the committee.

The CHAIRMAN. Mr. Callahan, how much time will you require? We are going to have to shorten this particular branch of the testimony because we have had so many witnesses.

Mr. CALLAHAN. Well, the metal department of this depletion investigation has not consumed very much time. We have no other witnesses. I am the only one.

The CHAIRMAN. You are the only one?

Mr. CALLAHAN. Mr. Broadgate and myself.

The CHAIRMAN. Yes, sir.

Senator WALSH. You advocate retaining the present percentage allowance?

Mr. CALLAHAN. Yes.

Senator WALSH. You don't want any change?

Mr. CALLAHAN. I don't want any change in the depletion allowance; no, sir.

The CHAIRMAN. What are you discussing, particularly?

Mr. CALLAHAN. The matter of percentage depletion.

The CHAIRMAN. Of metals?

Mr. CALLAHAN. Yes, sir.

The CHAIRMAN. All right, sir. I would ask you to brief your statement as much as you possibly can. Of course, we will be glad for your statement to go into the record, which we will have, and have the opportunity to read it.

Mr. CALLAHAN. All right, Mr. Chairman.

Mr. name is Donald A. Callahan. I live at Wallace, Idaho. I am vice president of the American Mining Congress, and I also am representing the Idaho Mining Association at this hearing. I appear here to address myself particularly to the question raised by the Secretary of the Treasury in his appearance before your committee on July 23, 1942, relating to the provisions of the law dealing with percentage depletion.

The language of the Secretary clearly indicates that in his opinion percentage depletion as applied to metal mines should have no place in the revenue law. He classifies this provision as a violation of the basic principle of equity, which is so important to an all-out war finance program, and indicates that such an allowance constitutes a special privilege or an avoidance or exasion of tax. Very definitely we, of the mining industry, deny that the allowance of depletion upon a percentage basis constitutes either a special privilege, an avoidance or an evasion of tax.

There is nothing more essential to the success of the war effort than the mining of strategic and critical metals, and those who are responsible for the production of munitions and machines for war will agree with this statement.

We hold that mining is as necessary a war industry as is the fabrication of metals into munitions of war. We hold that the Government should be bending every effort to encourage this essential industry. We are not asking special favors, but we believe in the name of victory that every department of the Government of the United States should join in an effort to increase and not to retard the production from these mines.

Now we are faced with a new peril—a direct attack upon an established provision of the revenue laws as related to mining by the Secretary of the Treasury when he asks for the doing away with percentage depletion and a reversion to the methods employed in determining depletion prior to 1932.

During the last World War the revenue laws were amended to provide incentive for metal production. Now, under a greater stress than existed then, the Secretary of the Treasury proposes not encouragement but rather actual discouragement to those charged with the business of producing for the war effort.

I shall not repeat the observations made by Mr. Fernald in his appearance before this committee several days ago with regard to the attitude of the mining industry and its all-out cooperation in the war effort. He has stated that position clearly and the deeds of those engaged in the industry speak even louder than his words.

What, then, is this percentage depletion to which the Secretary takes exception? I take it that this committee recognizes, as has the Congress since the income tax amendment was adopted, that the owners of properties which are engaged in the extraction of natural wealth should have a return tax free of the value of the property which constitutes the capital of the owner.

Prior to the adoption of the percentage depletion method the determination of the amount of depletion to be allowed was largely a matter of judgment on the part of the Commissioner of Internal Revenue, the principle being laid down in the law that a reasonable depletion allowance should be provided for. Cost or March 1, 1913, valuations were regarded prior to 1918 as the yardsticks by which depletion should be measured, the principle being that the owner was entitled to a complete return, tax-free, over the life of the mine of the valuations so determined.

In 1918, under the stress of a great demand for metals to meet the World War requirements, and to make more equitable the allowance to those mines which had suffered from the application of the unit method, discovery depletion was added to the law, and this feature remained in the law until 1932, when the percentage depletion feature was incorporated. The basis for discovery depletion was the calculated value of the property as of approximately the time of discovery.

Thus the Congress from the beginning of our income tax history has recognized the right of taxpayers to deductions to compensate for the depletion of capital value attaching to the mineral properties.

May I call your attention to the fact that the reason for the adoption by the Congress of the percentage depletion method as applied not only to metal mines, coal, and sulfur, but to oil and gas as well, was the unsatisfactory experience of both the Government and the taxpayers in the allowance of depletion under the older methods. Naturally, the determination of the valuation of the capital which was to be depleted involved a very intricate and uncertain method. This was particularly true as it related to metal mines.

Because of dissatisfaction with the methods theretofore employed, the Joint Committee on Internal Revenue Taxation referred the entire subject to its staff for an investigation and the report (Preliminary Report on Depletion to the Joint Committee From its Staff, vol. 1, pt. 8, 1929) of this staff furnished the basis upon which later on the Congress adopted the amendment extending the percentage feature to depletion of metal mines, coal, and sulfur.

It is interesting, in view of the suggestion of the Secretary of the Treasury, that we eliminate the percentage method to read from this report what the staff of the joint committee had to say. I am quoting now from page 7 of that report:

> The analytic method generally employed by the Bureau in the valuations of gold, silver, copper, lead, zinc, and other metal mines involves at least six important factors which are the subject of individual judgment. In many cases, reliable data from which the engineer may draw his conclusions in estimating these factors are not available. Conclusions in such cases must vary according to the experience and viewpoint of the individual. Reputable mining engineers admit that it is impossible to value a mine accurately as of a specific date by this method, due to the many speculative factors involved.

To support this conclusion the report on the same page carries a comparison of the separate valuations of 10 companies, ranging from some of the smallest to some of the largest in the industry, which tables show as between two reputable engineers a variation in values of from 100 to 566 percent.

In connection with this, I also call to your attention a statement made in 1925 by Mr. A. W. Gregg, formerly Solicitor of the Bureau of Internal Revenue. This statement was made before the Senate Select Committee on Investigation of the Bureau. I quote Mr. Gregg:

> If something could be done in the law to do away with the necessity for valuing mineral properties for the purpose of determining depletion, it would be the biggest help of anything that has ever been done to the Bureau of Internal Revenue. This would help the administration of the Bureau tremendously and would certainly be more accurate than the present system.

Something was not done to remedy the intolerable situation referred to by Mr. Gregg until 1932, when the Congress incorporated the very simple and efficient method of percentage depletion which has been in effect ever since.

Senator CONNALLY. Is it not true that the old system entailed employment by the Bureau of a great army of engineers and estimators and surveyors, and they hardly ever got to the point where there wasn't a squabble between the owner of the property and the Government over the valuation?

Mr. CALLAHAN. That is true, Senator Connally.

Senator CONNALLY. Isn't it further true that the 27½ percent is a little less than the average discovered under the experience of the Treasury?

Mr. CALLAHAN. You mean the 15 percent?

Senator CONNALLY. Whatever it is.

Mr. CALLAHAN. Yes, it is. The average over a 5-year period of the depletion allowed prior to that time under the old method was 17 percent. It was the inequalities in the distribution of that that was recommended by this averaging and the 15-percent rate was a compromise and in relation to that not only did the Government have to employ engineers and accountants and engineers of all descriptions, but the taxpayer also had to in order to meet the situation which might be presented. The larger companies, of course, were able to do that.

In 1932 when I appeared before the committee advocating this change in the law, I called particular attention to the discriminations thereby made to the smaller companies that were not able to maintain such staffs of engineers and accountants and experts to not only determine their valuations, in the first place, but to contest with the Bureau afterward.

The rate of 15 percent of the gross value of the ore at the property for metal mines which was written into the law in 1932 was arrived at by taking the average of the depletion actually allowed under the old methods over a 5-year period. As a matter of fact, this average was better than 17 percent and the rate finally agreed upon was a compromise. To further protect the revenues it was provided that in no case should the allowance exceed 50 percent of the net income.

The report referred to calls attention to the inequalities brought about under the earlier methods of which both the staff of the committee and the Solicitor of Internal Revenue complain. The method of determining mine depletion was, of course, highly technical; and if the Secretary of the Treasury's present suggestion is carried out, will become highly technical once again. That method was based upon a determination of factors with which only the accountant and engineer are familiar. In order to secure a valuation for the purpose of depletion it was necessary to have a valuation made of the units of metal in a mine. This in itself, because of the hidden character of the metal, could only be determined through estimates, reckoning from certain known factors. Under the analytic-appraisal method, which was the one most commonly used, it was necessary to make an estimate of the tons of ore in a mine at the beginning of the mining operation; to estimate the annual rate of extraction of metal; to estimate the duration of the life of the mines; to estimate the production cost per unit of metal; to predict the selling price for the estimated number of years of the life of the mine, and then through a formula to reduce the expected profit to present worth.

One of the reasons for inequalities and discrepancies as between different metals, different sections of the country and individual taxpayers, was that the large operator, with a considerable amount at stake and possessed of the means with which to fortify himself with expert assistance, could better establish the value of his ore body in the first instance, and later could defend that estimate before the Bureau. A smaller operator, of course, who had not the means with which to make a proper valuation in the first place, would be obliged to accept the judgment and final determination of the Government when his returns were made.

This does not mean that the Government or the Bureau intended to be unjust, but it is the common experience of business, so far as technical questions are concerned, that one must be thoroughly fortified in establishing claims which are involved and about which there very often are reasonable and proper differences of opinion.

I wish to call your attention now to variations found in the very industries in the investigation made by this staff of the joint committee.

It was found that in the net returns, gold and silver had received a 37 percent allowance for depletion; copper, 60.5 percent; lead and zinc, 32.5 percent; iron, 41.2 percent; coal, 31.6 percent; and sulfur, 45.8 percent. Those were, of course, upon the net returns, not the gross.

Besides this it was found that in the same branch of the industry, the ratio varied materially for different sections of the country. For instance, the weighted ratio of depletion allowed to lead and zinc was 32.5 percent, but this ratio varied from 43 percent in one field to a trifle over 25 percent in another, approximately 1,000 miles distant.

The same variation was found in the ratio of depletion allowance to net income as between individual taxpayers. It was no wonder, then, that the Congress decided to remedy the inequalities which the staff of its own Joint Committee on Internal Revenue Taxation found to exist. That staff recommended the adoption of the percentage method. It did so because of the following defects in the system then in vogue:

These defects were mentiond as follows:

(*a*) *Administrative difficulties.*—One of the principal administrative defects was found to be the lack of uniformity and certainty in computing depletion. Tables supporting this conclusion are to be found on page 7 of the report.

(*b*) *Instability of revenue.*—In lean years when the tax was sorely needed, it was found that the application of the unit method of depletion wiped out all tax, while in prosperous years, high taxes were collected.

In connection with that, I wish to call your attention to the fact that under the unit method of depletion, whether you had any profit or not, the depletion was taken and if you had a depletion, your units were taken anyway, thereby depriving you entirely of the benefit of the year when you might have some income from it.

(*c*) *Inequitable results.*—A most interesting discussion, with tables showing the effect of the methods, therefore, employed upon different classes of industry bears out the conclusion that inequitable results stemmed from the then existing method of determining depletion.

But it is unnecessary to go further in telling you why this method was adopted. The question is: Should it be changed now and doubtless it has been urged and will be urged that the reason for a change at this time is because, under the percentage method, certain mining companies recover more through depletion than the original cost of their properties. The Secretary of the Treasury, I believe, holds that this is a fact and that this alone is sufficient to warrant the elimination of the percentage method at this time.

It is easy to make computations to support a previously announced theory. But the Secretary must remember that the method of determining depletion must apply to all mines. Both the Secretary and the Congress should reflect very seriously upon the total effect of a change, rather than upon the immediate effect upon certain isolated mining enterprises.

It is perfectly apparent, and the Secretary will admit, that the mining industry as a whole does not recover through this method more than the original cost of mining properties. As a matter of fact, and I am sorry to be obliged to say it, it is true that the mining industry as a whole makes a very sorry showing of recovery of original cost when failure as well as successes are taken into account.

I come from a State which is one of the leading mining States of the Union. It stands first in the production of silver, second in lead, and has a high ranking in the production of zinc. And yet, over a period of 11 years, during which figures of cost and production have been collected and compiled by the association which I represent, the expenditures have exceeded the receipts by more than $10,000,000. And one of the big sources from which those expenditures have been made has been the depletion fund used in the exploration and development of properties which have not turned out to be profitable ventures.

One of the objects of a depletion allowance is to insure a continuous mining industry. A very large portion of the earnings which is regarded as return of capital is invested and reinvested in exhaustive explorations and in underground operations, many of which totally fail to yield return. I am afraid the Secretary has not made any investigation to determine whether depletion allowances have been used in an endeavor to discover and develop additional ore bodies.

To illustrate the difficulties of finding profitable ventures, I cite you the instance of one company, largely interested in exploration and development, which has a history of 15 years.

During that period it has given consideration to approximately 400 to 500 properties annually, and has made field examinations of all of those which indicated commercial deposits of nonferrous metals. Despite the fact that this company has ample capital to employ the best technical service, it has been unable during the past 15 years to find and to bring into successful and profitable production for its own account more than 6 mines and has shared with others in the acquisition and development of 2 more.

The mining companies of the district in which I live in northern Idaho are constantly spending large sums of money in exploration and development, much of which must eventually be charged off.

The fact is that it is from this source that we must expect the development of our mining resources in the future. The time has passed for the discoveries of mines at the grass roots. The day of the prospector, noble figure that he was, has passed.

The exploration of the future must be underground largely through the expenditure of large sums of money by existing mining corporations. They alone can employ technical staffs to solve the mysteries of underlying strata. They alone can furnish the trained engineering staffs to plan development and exploration. They alone can furnish the technical laboratories and the technicians to use them in which low-grade ores which once were discarded can be made commercially valuable. It is from the depletion allowance of companies which perhaps may recover more than the original capital invested in their mine that the strategic and vitally essential metals necessary for a self-sufficient economy must be realized.

Then, again, it is no longer possible to finance primary mining ventures through the methods employed in the development of some of our older and most successful companies. Under the administration of our Securities Act the day of financing small properties is at an end.

The Secretary bases his objections largely upon the fact that certain large corporations receive large depletion allowances. Even if these companies are receiving back tax-free more than the original cost of their properties, which is the exception, the system is still beneficial, both as far as the war effort and the Government revenues are concerned. Where did the vast funds necessary to develop the great Morenci copper property in Arizona come from? What funds have been used to increase the manganese production in Montana and the copper from the Copper Canyon property in Nevada? These are but a few examples of how these funds are used, and the War Production Board can tell you how important they are.

May I be personal and give you an illustration of two companies with which I am connected? One is a silver-gold property which over a period of time under the percentage method had accumulated a fund specifically set aside as a depletion fund.

Within the last year, realizing the necessity for production of vital defense metals, it invested that fund in securities of a lead-zinc company and thereby made it possible for that company to bring its property to a point of production. On the 1st of March this second property entered into production of lead and zinc, and the vital essential metals which the Government must have are now being mined because the first company was able, through its depletion allowance, to make possible their production.

May I say in that connection that an attempt was made but it was found impossible to finance through the sale of stock—raise sufficient money in order to finance this operation which is now in production in building a mill?

That is only one, and I cite it merely as an instance because I am intimately connected with it. It is multiplied many many times, and illustrates what can be done and what is being done with these depletion allowances which the Secretary complains are too large.

The Treasury assumes that it will receive more revenue if percentage depletion is eliminated and that this will in no way affect the production of metal. This is a false assumption. Neither the production of metals nor revenues to the Government come from mines which are not open, developed, and operating. We are not now obtaining the metal production we need from mines. We cannot get this from mines which are not now operating or cannot continue long to get it. New production must be brought in. It is the producing mine, privately owned and operated and yielding a profit on private investment, which produces revenue to the Government. Tax rates or tax provisions which deny or discourage this will not yield increased tax revenue.

Fair depletion allowances are essential. Percentage depletion has not in the past and will not in the future result in the mining industry recovering more than its capital employed. It is an averaging plan adopted for simplicity. Losses and failures must be taken into account in measuring return of capital. By and large, it grants less and not more than a fair return of capital. Under it the Government gains and not loses revenues. From the standpoint of both revenue and production the Government and the war effort benefit.

We are in a great war effort, and the mining industry does not come here before this committee or before the Congress urging special consideration, or protesting against the tremendous tax which is necessary to finance a part of this war. These are days of great concern, but our concern as business men is nothing to the concern of those whose loved ones are called upon to go forth upon foreign seas and into foreign lands to fight the battles of our country on land and sea and in the air. The mining industry has pledged its full cooperation in this all-out war effort. It is busy with production.

The Government has offered a special price to make possible the production of low grade marginal ores and of high cost ores. The War Production Board, the Office of Price Administration, the Metals Reserve Company are straining every effort to bring about that increased production of these essential metals. All that the mining industry asks of this committee, all that it asks of this Congress, is that it remain free to use all of its energies toward this great productive effort. It asks that the laws relating to depletion be allowed to remain as provided in the House bill.

It does not believe that now is the time to upset the economy of all mining enterprises, to bring about a readjustment of its entire program of development and exploration, to become involved in an endless task of determining valuations and costs and figuring out depletion according to methods that were discarded in 1932 because they were unsatisfactory. It has full need of its technical staffs in the work of production; it cannot turn them over to the business of establishing values and wrangling with the Bureau of Internal Revenue.

In the last World War when there was essential demand, the Government revised depletion allowance by permitting discovery. When time had proven this unsatisfactory, the Congress discarded that method and established the percentage method which the Secretary is now subjecting to attack.

Now I wish to call the committee's attention to this. Perhaps it is not entirely a part of it, but it shows the difficulties under which the mining industry is laboring and tells you why, even with the allowance of percentage depletion and the allowance of depletion, that there is dissatisfaction over the production of metals.

We have made a great success in the building of plants for the manufacture of munitions and machines. In doing so, however, a system has been adopted which has steadily syphoned off our mine labor until today there is a shortage in my district of from 10 to 25 percent of the manpower required for maximum production. We cannot feed these metals into the plants that are crying for them unless this situation is remedied. The loss of production in our metal mines today constitutes a threat which must no longer be ignored.

Recently a subcommittee of the Senate Silver Committee conducted hearings throughout the West to ascertain the exact situation with regard to the mining industry and particularly to determine, if possible, the effect which the present and proposed tax laws have had and will have upon that industry. The report of that committee will be before your body for consideration, and I am not going now to burden you with an account of it, but I will ask you if it is possible for you to consult with Senators McCarran and Murdock who were present at those hearings. They will give you a picture of just what the mining situation is throughout the West where those vital metals always are being produced.

I do, however, wish to call your attention to the testimony of the directing head of the largest copper smelter in the world, located at Salt Lake City, Utah. The figures which he produced as to metals received at that smelter over a period beginning in 1937 and embracing the first months of 1942 paint a sorry picture as far as production of these vital metals are concerned.

Leaving out of consideration the ore received from the great Utah Copper Co.'s properties, these showed a reduction in tons of ore received by the smelter of more than 700,000 tons in 1937 to less than 600,000 tons in 1941, and a drop in the gross value of that ore from $21.26 per ton in 1937 to $17.51 per ton in 1941.

At the beginning of this year the Government began to sense the seriousness of this situation. A plan was devised to pay a premium on new production of lead, zinc, and copper. Quotas were fixed for each mining property which were supposed to represent normal production of mines then in operation and zero quotas were fixed for those not in operation in 1941. The premium for all production over and above these quotas is now paid through the Metals Reserve Company.

This, on the one hand, is a recognition by the Government of the necessity for increased production. As a result of this policy (low grade mines have been reopened and mines having metals difficult of separation have become active. Old tailings dumps have begun to move toward the concentrators and early in the year predictions were made that a 25-percent increase in metals production would be realized this year.

Those who were thus optimistic, however, reckoned without their host. They failed to take into consideration the fact that establishment of war plants on the coast and throughout the western area would drain the labor from these mines. The cost-plus-a-fixed-fee policy, coupled with 6 and 7 days' work at overtime pay, has taken the labor from our mines with a result that our production has been going down, and we have been unable to develop reserves for future production.

Let me say to you now that this situation must be cured if we can indulge any hope that we shall be able to supply these tremendous war plants with the metals of which they stand in need. Either the Congress, through legislation, or the Manpower Commission, exercising the broad powers already granted to it, must take drastic action or the situation will grow worse. And, in the end, if production of metals fails, it will be the industry and not the Government which will be blamed for that failure. Even leaving our tax structure as it has been, the tribulations of this very essential industry of mining are sufficient to discourage even the stout-hearted.

Now, it is one thing, gentlemen, to sit comfortably in an office with a calculating machine at your elbow and figure out how by a few changes in the law, additional revenue can be secured from this industry or that. It is a different thing to meet the hard realities of wartime production, and no industry is faced with more difficulties than mining.

The operator must battle with O. P. A. to secure a fair quota for basing the premium price; he must battle with W. P. B. for the right to purchase machinery, equipment, and supplies; or go out through the mining districts of the West to go out and pick up second-hand material; he must spend days and nights in negotiations with labor representatives over increase of wages, creation of shop stewards, and participation in management; he must permit his skilled employees to depart day by day for the armed services; he must sit idly by while contractors building war plants under the "cost-plus-fixed-fee basis," lure employees away in droves so that he never is sure of the next shift; he must watch, as a consequence of this, development work halted and sound mine practices discontinued. His days and his nights are filled with problems for which he can find no solution. He knows the desperate need for production and he responds as best he can.

Now, from the Treasury comes the last straw. Repeal or modify the depletion allowance. Upset the economy of mining, take away the one provision now in our tax laws which makes for continuity in the industry. I do not believe the Secretary wishes to assume the responsibility for this final check upon wartime production of these vital metals.

I ask you gentlemen to see to it that he is saved from his own folly and that this most important of war industries is not further crippled in its efforts to assist in winning the war.

The CHAIRMAN. Thank you very much, Mr. Callahan. We appreciate your appearance.

Mr. Campbell.

STATEMENT OF ROLLA D. CAMPBELL, HUNTINGTON, W. VA., REPRESENTING COAL-PRODUCING MEMBERS OF THE AMERICAN MINING CONGRESS

The CHAIRMAN. Mr. Campbell, are you also representing the American Mining Congress?

Mr. CAMPBELL. I am representing the bituminous coal producing members of the American Mining Congress.

The CHAIRMAN. Will you make your statement as brief as you can in the interest of the committee, because the whole day has been given to that general subject?

Mr. CAMPBELL. Yes, sir, I shall.

The CHAIRMAN. Thank you.

Mr. CAMPBELL. Mr. Chairman and members of the committee, my name is Rolla D. Campbell. I live in Huntington, W. Va. I have been in the coal business for about 22 years. I am the president of a land leasing company which leases to operating mines. I am a lawyer and I have represented land companies and coal operating companies and associations of coal operators for the last 22 years. I am a member of the Bituminous Coal Producers Board for District No. 8, which was organized under the Bituminous Coal Act of 1937.

District No. 8 comprises the high volatile mines of southern West Virginia, eastern Kentucky, southwest Virginia, and Tennessee, and produces approximately one-fifth of the annual production of the United States.

I appear here on behalf of the coal-producing members of the American Mining Congress to oppose any change in the depletion provisions of the House bill as they apply to bituminous coal.

I shall not attempt to cover this subject in great detail. This has been done in the hearings before the House Ways and Means Committee. I respectfully refer you to the very able and comprehensive statements of Mr. Callahan, volume 1, pages 1168–1177; of Congressman George W. Johnson of West Virginia, volume 1, page 1194; of Congressman A. J. May of Kentucky, volume 1, page 1195; of Mr. Marchant, volume 1, page 1206; of Mr. Puterbaugh, volume 1, page 1208; and to the brief filed by Mr. J. D. Battle, secretary of the National Coal Association, volume 1, page 1210.

At the outset I would like to mention that the bituminous-coal industry is a very large and important one. It employs from 450,000 to 500,000 men directly in and about the mines, and that many, or more, in transportation, distribution, and utilization.

It furnishes about 20 percent of the entire railroad freight traffic. Over the past 10 years the production has varied from 325,000,000 tons to over 500,000,000 tons. 1918 was the year of the greatest production. In that year more than 570,000,000 tons were produced. In 1941, the production was in excess of 500,000,000 tons, and it appears that this year's production will be in excess of 550,000,000.

To give you some comprehension of the enormity of 500,000,000 tons, I might say that it is the equivalent of 12,500,000,000 bushels, or about four times the weight of all the grain crops produced each year in this country; or about 166 times the weight of the annual cotton crop, or five times the weight of the annual production of steel in this country, or more than all the dirt which has been removed from the Panama Canal.

This great industry is the principal industry in many of the great coal-producing areas and is an important industry wherever it occurs. In this war effort, it is of vital importance. It undergirds our entire industry effort. The continued production of coal is absolutely essential to successful prosecution of the war.

The present percentage depletion rule contained in the Internal Revenue Code is that coal mines are permitted to deduct, on account of depletion, 5 percent of their gross income but not more than 50 percent of the net income, from their property. For example, if the average gross income is $2 per ton of production, 5 percent of that amount will be 10 cents per ton. But if the net income is 10 cents per ton, then the allowance is 50 percent of 10 cents per ton, or 5 cents per ton. If the net income is 5 cents per ton, the maximum allowance is 2½ cents per ton. If the net income figures out at 30 cents per net ton, the maximum allowance is still only 10 cents per ton.

Under percentage depletion there is no deduction unless there is net income. Of course, it does not guarantee net income. Under unit depletion the allowance must be deducted in those years when there are losses. The principal difference is that percentage depletion does offer an opportunity to get the benefit of the depletion allowance in those occasional years when profits are earned.

The Parker report, which has been called to your attention by Mr. Callahan, advances the essential reasons for the use of percentage depletion in the coal, metal, and sulfur mines. The recommendations of this report were translated into law in 1932.

As I understand the Treasury's position, it desires to eliminate percentage depletion completely as to all extractive industries, or, in the alternative, to reduce and restrict the allowances presently permitted under the law.

So far as I am able to learn, the Treasury has never presented any figures either to the House Ways and Means Committee or to this committee to show that percentage depletion as applied to the bituminous coal industry is a "special privilege." However, the Treasury Department has published statistics covering the 12-year period from 1928 to 1939, inclusive, which have an important bearing on this subject; 1928 was the first year when the Treasury began to publish separate figures on income with respect to bituminous coal. The statistics are as follows. I have reproduced that page in my printed statement.

(The statistics submitted by Mr. Campbell are as follows:)

Profit and loss statistics of the bituminous-coal industry for the 12-year period, 1928 to 1939, inclusive, compiled from U. S. Treasury Department "Statistics of Income" reports on corporations

TOTAL OF ALL ACTIVE CORPORATIONS MAKING RETURNS

[Money figures in thousands of dollars]

Year	Number of returns	Gross income	Net income or deficit—before depletion	Depletion	Net income or deficit (−)	Federal taxes on income	Net profit (+) or net loss (−)
1928	2,705	9 [illegible] 339	−6,514	17,994	−24,508	3,442	−27,950
1929	2,342	992,408	7,345	18,648	−11,303	3,940	−15,243
1930	2,239	874,783	−26,089	15,982	−42,071	2,637	−44,708
1931	2,095	624,693	−37,525	10,220	−47,745	1,039	−48,784
1932	1,864	469,698	−41,488	9,679	−51,167	777	−51,944
1933	1,851	519,032	−35,610	11,939	−47,549	1,029	−48,578
1934	2,017	718,428	7,215	14,790	−7,584	3,308	−10,892
1935	1,975	768,497	1,034	16,610	−15,576	2,750	−18,326
1936	1,945	883,570	15,430	18,740	−3,310	3,214	−6,524
1937	1,815	928,042	17,243	18,020	−777	3,208	−3,985
1938	1,887	717,194	−14,833	11,834	−26,667	1,661	−28,328
1939	1,593	805,575	10,597	15,549	−4,952	2,829	−7,781
Total	24,328	9,251,259	−103,195	180,014	−283,209	29,834	−313,043

RETURNS WITH NET INCOME

Year	Number of returns	Gross income	Net income or deficit—before depletion	Depletion	Net income or deficit (−)	Federal taxes on income	Net profit (+) or net loss (−)
1928	863	517,597	41,400	7,923	33,477	3,442	+30,035
1929	905	532,462	45,494	6,097	39,397	3,940	+35,457
1930	781	428,320	30,124	5,047	25,077	2,637	+22,440
1931	582	166,244	11,719	1,762	9,957	1,039	+8,918
1932	289	84,195	7,602	1,646	5,956	777	+5,179
1933	396	137,659	9,707	2,464	7,243	1,029	+6,214
1934	660	333,523	30,157	6,523	23,634	3,308	+20,326
1935	591	358,168	27,304	7,738	19,566	2,750	+16,816
1936	590	446,424	34,831	9,648	25,183	3,214	+21,969
1937	539	506,523	32,211	9,922	22,289	3,208	+19,081
1938	363	253,467	15,817	4,705	11,112	1,661	+9,451
1939	487	388,628	26,665	8,498	18,167	2,829	+15,338
Total	7,046	4,153,210	313,031	71,973	241,058	29,834	+211,224

RETURNS WITH NO NET INCOME

Year	Number of returns	Gross income	Net income or deficit—before depletion	Depletion	Net income or deficit (−)	Federal taxes on income	Net profit (+) or net loss (−)
1928	1,842	431,742	−47,914	10,071	−57,985	....	−57,985
1929	1,437	459,946	−38,149	12,551	−50,700	....	−50,700
1930	1,458	446,463	−56,213	10,935	−67,148	....	−67,148
1931	1,513	458,449	−49,244	8,458	−57,702	....	−57,702
1932	1,575	385,503	−49,090	8,033	−57,123	....	−57,123
1933	1,455	381,373	−45,317	9,475	−54,792	....	−54,792
1934	1,357	384,905	−22,942	8,276	−31,218	....	−31,218
1935	1,384	410,329	−26,270	8,872	−35,142	....	−35,142
1936	1,355	437,146	−19,401	9,092	−28,493	....	−28,493
1937	1,276	421,519	−14,968	8,098	−23,066	....	−23,066
1938	1,524	463,727	−30,650	7,129	−37,779	....	−37,779
1939	1,106	416,947	−16,068	7,051	−23,119	....	−23,119
Total	17,282	5,098,049	−416,226	108,041	−524,267	....	−524,267

NOTE.—Figures prior to 1928 were not separated as to various kinds of coal.

Mr. CAMPBELL. These statistics show two essential facts: First, that during the period involved there has been a continuous liquidation of the coal industry in the the number of taxpayers filing returns; and, second, that there has been a great loss of capital by the industry, whether or not depletion charges are allowed as a deduction from gross income.

Specifically, these Treasury Department figures show that in this 12-year period the industry lost, before depletion and income taxes,

$103,000,000. After taking into account depletion and Federal taxes on income for those companies which earned profits, the net loss was $313,043,000. The taxpayers who earned profits during that period had a net income before depletion of $313,031,000. After deducting depletion and taxes on net income, the net earnings of these companies during the 12-year period were $211,000,000. This would allow approximately $30,000 per year net profits, after depletion and taxes, for each of the companies showing net earnings.

However, the unprofitable coal companies lost, before depletion, $416,000,000 in the 12-year period, and their depletion charges, which they showed on their tax returns, but which, of course, could not be deducted from net income, were $108,000,000. Their total loss was the sum of these two figures, or approximately $524,000,000.

By referring in my discussion to profitable companies earning net incomes and unprofitable companies sustaining losses, it is not to be assumed that the profitable companies were the same companies in each year or that the unprofitable companies were the same companies in each year, the fact being, of course, that individual companies in some years made money and in other years lost money.

Speaking from the point of view of the industry as a whole, the total depletion claimed by all bituminous-coal taxpayers, including both those who made money and those who lost money, was $180,000,000 during the 12-year period. Of this sum, $72,000,000 were recouped from income and $108,000,000 were completely lost. The average annual depletion claimed by all companies filing returns was less than $7,500 per company.

The performance of this entire industry might be compared with that of but one large industrial corporation for the single year of 1941. This corporation's earnings for that year available for distribution to stockholders were $211,000,000, or about the same as the amount earned by all the profitable companies of the bituminous coal industry in the 12-year period from 1928 to 1939, inclusive.

I think that it can be fairly said that these statistics of the Treasury Department prove beyond a shadow of a doubt that the great bituminous-coal industry is not escaping income taxation by any "special privilege" granted to it by the income tax law. It is true that it is not paying very much income tax, but that is because of the unfortunate circumstance that it is not making much net income.

I should add that the gross income reported in these figures apparently include income from sources other than the sale of coal, such as, for example, dividends from other corporations, interest, rent, and income from other activities. If the income from sources other than the mining and selling of coal were eliminated from gross income, the showing would be much worse than that which I have presented to you.

I think, also, that these figures show that the coal industry is not recouping its capital out of depletion allowances deducted from profits and that there is a definite shrinkage of capital regardless of whether depletion allowances are included or eliminated from computations of losses.

It is also apparent from these figures that if this industry is to continue production, it must have some method by which its capital can be recaptured out of profits in those very rare years when profits come. It is obvious that depletion allowances deducted from losses cannot restore or maintain capital. One of the principal advantages of the percentage depletion provision is that it permits capital to be recouped in those years when there may be a profit and does not force the industry to record depletion allowances in years when losses are incurred, the only result of which is to swell the losses.

Coal mining, like all other mining processes, is hazardous. It has a large element of the unknown in all its operations. The operator never knows what he is going to find under ground in any particular place until his workings actually get there. Unexpected difficulties are frequently encountered. Like other extractive industries, the quality of the product is largely fixed by nature and there is not much the operator can do to change it. A mine is tied down to one spot, and cannot be moved to take advantage of lower freight rates, wages, or taxes. Also the cost of maintaining an idle mine is very high. Over the years the markets fluctuate widely, both in the quality of coal demanded and the quantity of coal demanded. All of these factors make the establishment of unit depletion complex and expensive, and the result at best is largely guesswork as to what the future holds.

We find that the underground workings of a coal mine become more extensive with each year of operation. This means that there must be more rail, more wire, more machinery and equipment, more ventilation, more pumping. Hence, it is ordinarily necessary for a mine as it becomes older to make additional investments in plant and equipment for the purpose of maintaining production. At the present time, the technique of mining is changing and becoming more mechanized. With the labor shortage now prevailing and in prospect, it is essential that this trend toward mechanization continue, as it has the effect of increasing output per man and also of permitting operation of thin seams which otherwise could not be worked.

The cost of installing new mines is constantly rising, and today, for a unit of annual production, is two or three times what it was a number of years ago, when many existing mines were installed.

The industry is forced to provide from its receipts the capital for investing in new equipment and for opening new mines for those exhausted. Public financing of commercial coal operations is definitely a thing of the past. I have not heard of a single publicly financed issue during the past 12 years. Depreciation allowances will not provide this necessary capital for new investment because annual depreciation charges in this industry are more frequently added to losses than deducted from net earnings. In view of the very high income-tax rates proposed by the 1942 revenue bill, it is absolutely essential, if the industry is to be continued, that percentage depletion in the form proposed by the House bill be continued.

Percentage depletion also has another great advantage in that it is simple to determine. During the last 10 years there has been a very great increase in the number of small coal mines, more commonly known as "truck mines," which are operated by individuals or partnerships. For instance, in Senator Barkley's State, Kentucky, there are 2,980 coal mines, of which number 407 are rail connected and 2,573 are nonrail connected or truck mines. There are also many small truck mines in West Virginia, Virginia, Pennsylvania, Ohio, Indiana, Illinois, Iowa, Alabama, and the Western States. These smaller mines are not equipped to keep elaborate accounting records. They need a simple, easy method of computing depletion. They could not establish a proper valuation for unit depletion if they desired, because the process is too expensive and complicated for them to handle.

I think I should also mention that many new mines have been opened up since 1932, when percentage depletion was made applicable to coal mines, and much money has been invested by existing companies, all in reliance on percentage depletion being available to them. To withdraw this accounting method would cause such investors and companies substantial and unjust injury without any adequate reason therefor.

In conclusion, I submit, first, that the Treasury has made no showing that percentage depletion, as applied to bituminous coal, is a "special privilege" which should be withdrawn. Second, that the Treasury's own statistics show that there has been a drastic shrinkage in capital during the period from 1928 to 1939, inclusive, that being the only period for which comparable statistics are available. Third, that the greater amount of depletion claimed during that period was added to losses and was not deducted from net income. Fourth, that percentage depletion should be continued because it is simple and easy to compute, because it permits deduction only in the years in which net income is earned, and because it is essential if the industry is to continue to make capital investments in new equipment and new mines. I would like to suggest that if any change be made in the percentage-depletion provisions as applied to bituminous coal that the 5 percent of gross-income limitation be increased to 10 percent.

The coal industry is doing a fine job of producing to meet the war needs of the Nation. It is wearing out its equipment and depleting its unmined reserves at an accelerated rate. It is investing large sums of its own money in new equipment and new mines, despite the record of losses in the past. It is not receiving any Government subsidy or bonus or premium prices to induce production. The Government is not building it any new plants for it to operate at Government expense and risk. It is not amortizing its investments in new plant and equipment in 5 years, as war contractors are doing. It is the only industry taxed by the Government to pay the cost of its regulation by the Government.

Maximum prices on its products have been fixed by the Government, in many cases being lower than the prices prevailing on industrial contracts in effect when maximum prices were fixed. It is faced after the war with increased competition from Government-financed water-power developments, oil and gasoline pipe lines, and barge lines. It believes that while struggling under these difficulties, this great industry has earned the right to be fairly treated by our Government.

I thank you very much for your attention.

The CHAIRMAN. Thank you very much.

Any questions?

Senator GUFFEY. If I read your figures correctly on page 4, I would say the Bituminous Coal Act is a failure, so far as you are concerned. Am I right?

Mr. CAMPBELL. Senator, the Coal Act was applied to minimum prices on October 1, 1940. The figures published by the Treasury showing income of the coal industry and depletion allowances cover the year 1939 but not any year thereafter.

Senator GUFFEY. Has the coal industry lost money in 1940 and 1941?

Mr. CAMPBELL. My information is that in 1940 the coal industry, according to Treasury Department figures which do not show depletion allowances, averaged somewhat less than one-half of 1 percent of its sales as the net income. Now, that is after deducting dividends, interest, rents, and income taxes by those companies which earned a profit.

Senator GUFFEY. Then the act is a failure as far as your viewpoint is concerned?

Mr. CAMPBELL. The Senator will recall that the act provides for prices to equal the weighted average cost of production so that if the act carries out its intended purpose, the industry would receive its cost of production and no more. The fact of the matter is that the projected minimum prices which were established did not realize by 5 cents per ton the amount which was anticipated.

Senator GUFFEY. Have the new prices evolved recently met that situation?

Mr. CAMPBELL. No; they have not. The wages were increased, you will recall.

Senator GUFFEY. That covers all the fields?

Mr. CAMPBELL. That is right. The wages were increased on May 1, last year, but minimum prices have not been increased, although an examiner has recommended increases of 5 to 20 cents per ton.

Senator GUFFEY. Will the 5 to 20 cents per ton increase meet the conditions that you are talking about?

Mr. CAMPBELL. No; it will not, because the price formula in the act is designed to bring the industry only its cost of production. Now, the fact is it won't even do that, because the act, in defining what is the cost of production to be obtained omits many items of cost which accountants consider properly as cost items. For instance, interest on indebtedness.

The CHAIRMAN. All right. Thank you very much.

Mr. CAMPBELL. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Goodner?

Senator THOMAS. Mr. Chairman, if I may have just a moment, inasmuch as I asked for this particular hearing?

The CHAIRMAN. Yes, sir.

ADDITIONAL STATEMENT OF SENATOR ELMER THOMAS, A UNITED STATES SENATOR FROM THE STATE OF OKLAHOMA

Senator THOMAS. The amendment that I have to present is to section 131 on page 75.

That is a section that deals with depletion generally. The amendment that I have will change the text of the section to include rock asphalt.

The section that is before the committee does not mention oil. It leaves that for the general law to take care of. It does mention minerals and coal and sulphur.

Under this section sulphur is given a depletion of 23 percent, metals a depletion of 15 perecent, and coal a depletion of 5 percent.

The amendment which I submit for the record—and I will ask to be made a part of the record at this point—adds rock asphalt along with metals.

(The amendments referred to is as follows:)

AMENDMENT Intended to be proposed by Mr. Thomas of Oklahoma to the bill (H. R. 7378) to provide revenue, and for other purposes, viz:

On page 75, line 15, after the word "spar" and before the word "and" insert the following: "rock asphalt".

On page 75, in line 19, after the word "spar" and before the word "and", insert the words, "rock asphalt".

On page 75, line 22, after the word "mines" and before the figure "15", insert the following: "and rock asphalt".

On page 76, in line 9, after the word "mines" and before the word "section", insert the following: "and rock asphalt mines or deposits".

In line 11, after the word "fluorspar" and before the word "or", insert the following: "rock asphalt".

Senator THOMAS. The Treasury Department holds that rock asphalt is not oil and it is not a metal. Therefore, under the regulations rock asphalt has no depletion.

Rock asphalt is a product that is produced in some 10 or 11 States. It is produced rather extensively in my State and in the following States——

The CHAIRMAN (interposing). The effect of your amendment would be to give it a percentage of depletion allowance of 15 percent?

Senator THOMAS. The same as metals.

The CHAIRMAN. The same as metals.

Senator THOMAS. Just add the words "rock asphalt" at four or five points in section 131.

The CHAIRMAN. Yes, sir.

Senator THOMAS. And if added it would give rock asphalt a depletion of 15 percent, the same as metals.

The following States produce rock asphalt: Alabama, Arkansas, California, Kansas, Kentucky, Missouri, New Mexico, Ohio, Oklahoma, Texas, and Utah.

Senator VANDENBERG. What is rock asphalt?

Senator THOMAS. Rock asphalt is a sort of sandy substance originally that was impregnated with oil, but because of the location of the oil pool the oil has drained away, leaving a sand containing more or less of the oil on the sand, which makes it a substance that can be taken from the mine. Sometimes it is a rather solid substance like the crust of a concrete sidewalk, but it is a sand containing oil that can be ground, and it contains enough oil that, when it is ground and then put together again and rolled it makes a solid substance again.

Now, that is one form of the rock asphalt.

The second form is found in pools of sand. The sand is more or less black and sometimes you can pick it up in your hand and squeeze it, and you could almost see your oil in the sand.

That sort of asphalt is mixed with more limestone and more sand to make it of a certain consistency.

Then when it is at the proper consistency it is placed on the road or on the street or on the airport landing areas, and rolled cold and immediately it is susceptible of being traveled over, and it is used for the building of roads and for the building of streets and for making, now, runways for airports.

I desire at this point, Mr. Chairman, to include in the record the section 131 rewritten to include the amendments that I have offered separately.

In other words, if the amendment is offered, adding rock asphalt to section 131, then I want the record to show the section with the amendments in place, so anyone can read it and see exactly what it is, and without objection I would like it to go in the record, and then following that I will ask to have placed in the record just a few statements by myself, which will give my viewpoint with respect to the matter.

(The amendment and statement submitted by Senator Thomas are as follows:)

PROPOSED AMENDMENT TO THE INTERNAL REVENUE CODE

PERCENTAGE DEPLETION FOR COAL, FLUORSPAR, ROCK ASPHALT, AND METAL MINES AND SULPHUR

(a) PERCENTAGE DEPLETION.—Section 114 (b) (4) is amended to read as follows:

"(4) PERCENTAGE DEPLETION FOR COAL, FLUORSPAR, ROCK ASPHALT, AND METAL MINES AND SULPHUR.—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, fluorspar mines, and rock asphalt mines or deposits, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph."

(b) DISCOVERY DEPLETION NOT APPLICABLE TO FLUORSPAR MINES AND ROCK ASPHALT MINES OR DEPOSITS.—Section 114 (b) (2) is amended by striking out "metal, coal, or sulphur mines" and inserting in lieu thereof "metal, coal, fluorspar, rock asphalt, or sulphur mines."

STATEMENT BY SENATOR ELMER THOMAS, OF OKLAHOMA, IN SUPPORT OF PROPOSED AMENDMENT

I am appearing before this committee on behalf of the rock asphalt industry of my own State, as well as those of the other named States, to urge upon you an amendment to the pending revenue bill which will extend to these producers the right to percentage depletion which other mineral producers enjoy. I have considerable information regarding this industry in Oklahoma and can assure you that it will be practically stifled under the present revenue bill unless relief is given in some form. A percentage depletion deduction seems to be the solution to the situation.

Rock asphalt is used principally in the construction of roads, streets, and airport runways. The reserves in the Nation are great, but production is very much restricted. This is due to the fact that rock asphalt producers have to compete with producers of other bituminous road materials who enjoy a share in the 27½-percent depletion deduction extended to the oil industry. Rock asphalt is classed as a nonmetallic mineral and, without percentage depletion, is produced at a decided disadvantage, because it comes in direct competition with the other bituminous products.

The present revenue bill imposes an excess-profits tax of 90 percent on all the net income of a corporation over the allowed exemption. The invested capital basis of exemption seems to afford only scant relief to rock asphalt producers.

The exemption based on the average income for prior base years is their only relief. This means that they cannot expand their business to meet the present growing needs beyond the average income of the preceding 4 years. To do so would not only mean that all of the increased income would be consumed in taxes, but that they would be sacrificing their natural resource reserves as well.

It is believed that the granting of percentage depletion to the industry will not result in a loss of revenue to the Government. Once the producers have been given the same consideration that is given to other mining companies in depletion deduction, the rock asphalt industry will be able to materially increase its production. It is estimated that, with the present demand for rock asphalt and a fair depletion allowance, the industry will triple its production—in which event the Government will receive more revenue than it will under the bill as now written.

Without percentage depletion rock asphalt production is practically frozen at the average rate of production in the previous 4 years—and at a time when the United States needs a much larger quantity of this material than has been used in the preceding years.

Not only does the United States need more rock asphalt for its war program in road and runway building, but for its post-war program as well, and there is bound to be great activity in this line.

Senator THOMAS. There are two witnesses who desire to be heard, Mr. Goodner, who will take up the matter from a statistical and economic standpoint, and then Mr. Caldwell from Alabama, who will take it up from a practical standpoint.

In addition to the amendment, and my brief statement, which has been covered generally, I desire to have placed in the record a letter dated August 7 from Mr. Phillips Moore, chief, engineering and construction section of the Airport Division of the Civil Aeronautics Administration.

The War Department, especially in the Airport Division, also the Navy, for that matter, right now is building a great number of airports. They are expanding airports and constructing new ones.

Just recently the Congress passed a bill carrying $200,000,000 for the expansion of existing airports and for the construction of new ones, and those airports are now being designated and some of the work is going on.

The CHAIRMAN. Senator Thomas, are the competitive materials to the rock asphalt treated as minerals?

Senator THOMAS. Yes, sir. The competitive material is what might be termed an oil base.

That is, they take sand and fine gravel and mix that with asphaltic oil, and that makes a comparable material that is used on streets and on pavements and on airports, and at some points they have to use that because the freight rate on asphalt is excessive.

You cannot transport the rock asphalt a great distance, because of the excessive freight rates.

The material is comparatively cheap. It could be mined and mixed and delivered for $4 or $5 a ton a reasonable distance, but it could not be delivered a great distance, because the freight would be more than the asphalt.

As I said, the War Department and Navy Department are very much in need of these runways, and because of the demand for cement, as I understand, the Government has taken over all the cement mills—that is my information—so the cement is now in demand for, you might say, critical war improvements. There is no cement much left for building streets and roads, and especially runways for airports, so there is a demand for this material for the construction of runways.

The letter from the Civil Aeronautics Administration is very short, so, with your permission, I will read it into the record.

This is dated August 7, addressed to me.

CIVIL AERONAUTICS ADMINISTRATION,
Washington, August 7, 1942.

This will acknowledge receipt of your letter of August 5 in which you request that we furnish you all the data and information available regarding the present and future use of rock asphalt used for pavements on national defense airports being constructed under the supervision of this Administration.

We beg to advise that approximately 250,000 tons of natural rock asphalt has been used on airport runways constructed by this Agency.

The rock asphalt has been placed in competition with other types of asphaltic pavements in the regions in which natural rock asphalt is economically available.

Our new program which will be started in the very near future will, undoubtedly, involve the usage of a higher percentage of rock asphalt than has been used in the past, due to the scarcity of shipping facilities for the refined asphaltic cement used in other types.

It is, therefore, estimated that our new E program of which approximately $200,000,000 has been appropriated will involve the usage of approximately 310,000 tons of rock asphalt. The exact amount used will depend upon prices submitted.

If you desire a more detailed break-down of the amount of rock asphalt used by states and individual airports, we will be glad to furnish you this information upon request.

(Signed) PHILLIPS MOORE.

I made this same inquiry of the Public Roads Administration, and Mr. MacDonald replied under date of August 10, which is rather recent, stating that for the present but very few roads would be constructed, so he didn't think, of course, that there would be much demand for asphalt for road improvement, but he makes one significant paragraph, which I will read:

Rock asphalt is suitable and desirable for use in surfacing access roads or other necessary highway projects, and is particularly useful as a top finish for bituminous roadways.

The extent of its use, as stated, is largely governed by the distance from point of production to point of use. We have explained this matter at some length in an endeavor to give you an understanding of some of the basic problems involved as well as the impracticability of furnishing you immediately with any reliable data specifically requested in your letter of August 6.

(Signed) THOMAS H. MACDONALD.

Mr. Chairman, I thank you for permitting me to occupy so much of your time.

I will ask that Mr. Goodner take up the economic aspects, and he will explain to you why it is necessary to increase the production of asphalt.

Under the present law and present procedure these companies could only produce the amount of the last 4-year average. Beyond that they are depleting their supply and at a loss—certainly not at a profit.

I ask that Mr. Goodner be heard.

The CHAIRMAN. Thank you very much.

Mr. Goodner?

STATEMENT OF GEORGE E. H. GOODNER, WASHINGTON, D. C., REPRESENTING ROCK ASPHALT PRODUCERS

Mr. GOODNER. Mr. Chairman and members of the committee: I desire to make a brief oral statement and then ask leave to file for the record a prepared statement.

The CHAIRMAN. Yes, sir. That would be really more helpful to the committee. I wish that practice was followed generally.

Mr. GOODNER. My name is George E. H. Goodner. I am a tax attorney of Washington, D. C.

I appear here representing the rock asphalt producers of the country. There are some eleven or a dozen of them producing in quite a few States.

Senator Thomas has told you a number of States which now have rock asphalt deposits.

Some of those are not producing today, but most of them are producing more or less in quantities.

Rock asphalt, as the Senator has told you, is a material composed of rock—either limestone or sandstone—and the residuum from petroleum or asphaltum.

It was formed by nature thousands of years ago, by the oil impregnating the porous layers of rock or stone. Then, through some geologic process, the oil was drained off or forced off, leaving the residuum which is asphalt, and when a particle or a piece of this rock asphalt is crushed to the minutest particles, every particle is impregnated with asphalt.

Therefore, it makes a very highly desirable road or airport runway material.

It is mined with steam shovels after being blasted out of position. It is crushed to required size, laid on the road, and rolled cold, and as soon as it is rolled the road is ready for use.

It is waterproof; it is solid; it resists wear.

Rock asphalt has been classed by the Treasury Department as a nonmetallic mineral.

It has been held long ago that rock asphalt is not oil, or that asphalt is a residuum from oil.

Therefore, rock asphalt does not participate in the percentage depletion deduction.

It is true that discovery depletion would reach rock asphalt, but the regulations with respect to discovery depletion have been so circumscribed by the Treasury Department that it is almost prohibitive to get a discovery except on a very large property, which involves very large sums of money.

I think the last discovery proceeding, which was tried before the Board of Tax Appeals, cost, in preparation, witnesses, and expense, about $50,000, so that the small operator cannot in any way acquire the discovery value which apparently was originally intended by the discovery provisions of the law, and this amendment which Senator Thomas has offered provides that, if the percentage depletion allowance is made, the discovery provision of the law shall be repealed as to rock asphalt.

Senator BARKLEY. Let me ask you: Where is your home?

Mr. GOODNER. Washington, D. C.

Senator BARKLEY. Here in Washington?

Mr. GOODNER. Originally from Oklahoma.

Senator BARKLEY. You represent the asphalt producers of the country?

Mr. GOODNER. Yes, sir.

Senator BARKLEY. Including Kentucky?

Mr. GOODNER. Including Kentucky; yes, sir.

Senator BARKLEY. We have a number of asphalt deposits in my State which we regard very highly. It is recommended by road builders, and many of our roads have been built with rock asphalt.

As you say, it requires no treatment at all, except the matter of pulverization.

While the process is a little slower, it is almost perpetual, so that there will be no sloughing off at the roadside. It is almost perpetual in its use.

You are asking that the same law apply to that as applies to coal?

Mr. GOODNER. Fifteen percent. The 5 percent given to coal would offer no relief to the rock-asphalt industry.

Senator TAFT. Does this percentage depletion apply to rock? That is, quarries, marble, or paving block?

Mr. GOODNER. No, sir.

Senator TAFT. It does not?

Mr. GOODNER. It does not.

Senator BARKLEY. Have you ever given any consideration to the inclusion of salt in the depletion laws? Salt is a mineral.

Mr. GOODNER. Personally I have, and I think it has received a great deal of consideration over a period of 20 to 25 years, but I understand that the salt mines are not in exactly the same position as rock asphalt.

Senator BARKLEY. No; maybe not. Neither is rock asphalt in the same position as coal.

Mr. GOODNER. That is right.

Senator BARKLEY. It stands in a group by itself?

Mr. GOODNER. It stands in a group by itself, because it is a road preparation made by nature, but it is very closely allied to the oil industry, because the residuum from the oil is what, mixed with the rock, makes the product.

Senator BARKLEY. It is natural asphalt, whereas the kind you have to mix with oil is an artificial asphalt?

Mr. GOODNER. It is prepared, and it comes directly in competition with those, although they have enjoyed the 27½ percent depletion allowed to the oil industry, and the rock asphalt enjoys no such allowance.

The rock asphalt, as found today, was, thousands of years ago, oil sand, and if a well had been drilled then where they find rock asphalt today they would have found an oil well then, so that you can readily see, if you understand the nature of oil, which makes it a highly hazardous proposition, you have the same thing in rock asphalt.

For instance, you may have an outcrop of rock asphalt on the face of a mountain, as you have in Kentucky, or a hill, and pursue it into the hill a short distance and in a short time you will find no asphalt at all, because the rock is too impervious, and no oil penetrated it.

Consequently, rock asphalt requires the same process in discovering it that we have in oil.

In other words, it has to be drilled and outlined, and the producer runs a risk at any time of having his deposit go lean, so he can't use it, or play out entirely.

Senator BARKLEY. Rock asphalt is a rock that is capable of disintegration, which has been at one time saturated with oil?

Mr. GOODNER. Yes, sir; but in a stock pile or in use it does not deteriorate.

As a matter of fact they can take it up after it has been used, lay it, and use it again, and it is just as good as it was before.

Now, this is a small industry—the rock asphalt industry—compared with the ones you have been hearing about today.

Senator CONNALLY. Let me ask you there: Isn't it also true that the rock that it is in has to be a peculiar formation, that every sand wouldn't create rock asphalt?

Mr. GOODNER. That is true.

Senator CONNALLY. And the difference between rock asphalt and other asphalt is that this is in a sand or in a rock. It is porous. Nature just combined the oil and the rock to make a prepared product itself, whereas in the other asphalts it is the residuum or the base of heavy oils, and that is the stuff you see out on the highway, where they heat it, boil it, and then pour it on the rock surface, whereas the rock asphalt is not treated like that but is laid cold, isn't it?

Mr. GOODNER. That is absolutely correct, Senator.

Senator BARKLEY. In what States is this rock asphalt found?

Mr. GOODNER. Alabama, California, Kentucky, Oklahoma, Texas, Utah, Arkansas, Kansas, Missouri, New Mexico, and Ohio.

Now, the reason that we are here is this: The rock asphalt people have been going along under the tax program, producing a minimum amount.

The product has run between four and five hundred thousand tons a year, and they have been able to pay their taxes and have a little profit for themselves, but the rock asphalt producers, as a class, and generally, have no amount of invested capital.

This is due to the fact that they are either lessees, paying a small royalty, or, if they are lessors or fee owners, they acquired their properties years ago at a land price, and therefore they have no relief under the invested capital provisions of the existing law.

The 1940 Revenue Act allowed a different measure for exemption from excess-profits tax, and that was the average of the 4 prior years' earnings.

In other words, if a concern had $50,000 income, and its average earnings for the 4 prior years had been $40,000, it would have $10,000 subject to excess-profits tax.

Now, that was all right until the present bill was drafted, which provides that the excess profits—that is, the amount over the exemption—shall be taxed at 90 percent. The 90 percent excess-profits tax, plus the normal tax, plus the State levies which all of these companies have to make, wipes out the entire excess over the exemption.

Therefore, these small industries are facing the proposition that they must either quit, after they have reached their average income for the prior 4 years, or operate at no profit or a loss, and at the same time be giving away their natural resource deposits.

I have listened to arguments regarding depletion, but there is one word I want to add as to why percentage depletion is more than a gratuity.

If you take a cotton mill, for instance, and should say: "We are going to operate for 25 years, and we will go out and round up all the cotton we can now, and put it in storage, in a stockpile, and then we will have enough to operate on for 25 years," the cost of that cotton would come back as that stockpile was used, just the same as the operator gets that cost as it manufactures each year, but that is in effect what the natural resource industry is doing. It goes out and explores and prospects and develops an ore body, and then it proceeds to develop, to produce.

It has a supply, and the depletion allowance is simply returning the value of that supply, so that when the deposit is exhausted, if it has retained the depletion allowance, it will have the capital again with which to continue in business, so that a depletion is more than a gift; it is really a return of the investment in the natural resource, not the cost, because a cost 25 years ago might be something different from now.

Now, I have said that we are comparable to the oil industry. My last word is that we come in direct competition with the oil industry to this extent: That the residuum of all asphaltic base oil is asphalt which goes into road construction.

That asphalt has had the benefit of a 27½ percent depletion deduction, and the rock asphalt is in the same class of materials as asphaltic concrete, and is about the same cost.

Therefore, it is discriminated against to that extent.

I thank you, and I will ask to place in the record a complete statement.

The CHAIRMAN. Yes, sir. You may place your brief in the record.

(The brief presented by Mr. Goodner is as follows:)

THE ROCK ASPHALT INDUSTRY AND FEDERAL TAXES—A STATEMENT OF THE NEED FOR PERCENTAGE DEPLETION OF ROCK ASPHALT DEPOSITS

Much has been said about the "saturation point" in Federal taxation—a condition which results when the taxes become so severe as to discourage business. A striking example of this is found in the rock asphalt industry of today.

GEOLOGY AND RESERVES

Rock asphalt was formed thousands of years ago by the infiltration in limestone and sandstone of petroleum having an asphalt base. Thereafter, geologic changes caused the lighter oils of the petroleum to run off or to evaporate, leaving the stone impregnated with asphalt amounting generally to from 5 to 15 percent of the combination.[1]

The principal deposits in the United States are located in Alabama, California, Kentucky, Oklahoma, Texas, and Utah. Smaller deposits are found in Arkansas, Kansas, Missouri, New Mexico, and Ohio.[2]

The estimates of rock asphalt in the Nation are incomplete, but some figures are available. Alabama is said to have 1,182,000,000 tons;[3] Oklahoma, in only a few of the counties possessing this natural resource, has 33,750,000 tons;[4] Texas must have 270,000,000 tons in Uvalde County;[5] and Utah claims to have

[1] Vivian, Kentucky Rock Asphalt—A Natural Roadmaking Material, Compressed Air Magazine, vol. 37, p. 3860, July 1932; Jewett, Asphalt Rock in Eastern Kansas, Kansas Geological Survey, Bulletin 29, June 30, 1940; Talmage & Wootton, The Non-Metallic Mineral Resources of New Mexico and Their Economic Features, New Mexico Bureau of Mines, Bulletin No. 12, p. 48; Encyclopaedia Britannica, 14th ed., Asphalt.

[2] Abraham, Asphalts and Allied Substances, 4th ed. (1938), pp. 155–177; Eldridge, The Asphalt and Bituminous Rock Deposits of the United States, 22d Annual Report, United States Geological Survey, pt. I, pp. 219–452 (1901); Nordberg, Quarrying Asphaltic Stone, Rock Products, vol. 41, p. 37, November 1938; Talmage & Wootton, op. cit. note 1, Jewett, op cit. note 1.

[3] Jones, Summary of the Distribution and Occurrence of the Rock Asphalt Deposits of Alabama, Geological Survey of Alabama, Circular 5 (1928).

[4] Snider, The Oklahoma Rock Asphalts and Their Use in Paving, Good Roads, vol. 48, p. 158, Mar. 1, 1918.

[5] Machinery Solves Material Handling Problems in Mining of Rock Asphalt, Good Roads, vol. 69, p. 308, August, 1926. The estimated tonnage is computed from the information given in this article and the amount of rock asphalt required for a mile of pavement as stated in the pamphlet referred to in note 3, supra. Vivian, Quarrying Rock Asphalt in Texas, Compressed Air Magazine, vol. 35, p. 3244, September 1930.

10,000,000,000 tons in one mountain with outcroppings appearing over a distance of 17 miles.[6] Smaller deposits in Kansas and New Mexico are estimated to contain 25,000,000 tons, and 2,000,000 tons, respectively.[7]

PRODUCTION AND TRANSPORTATION

The rock asphalt industry as a whole is still in its infancy, although several concerns are producing in excess of 100,000 tons a y^ar.

The production of this resource in the United States in recent years has been as follows:[8]

	Production			Production	
	Short tons	Sales value		Short tons	Sales value
1931	470,491	$2,244,739	1936	547,333	$2,420,792
1932	314,039	1,415,427	1937	447,213	2,035,410
1933	285,070	1,125,164	1938	449,091	2,219,159
1934	410,453	1,762,376	1939	422,484	2,007,810
1935	314,109	1,449,406	1940	458,665	1,949,166

Imports and exports of rock asphalt are almost negligible and for all practical purposes may be disregarded.[9] In view of the weight of the product a certain limitation on the market is created by freight rates, but, due to the wide distribution of the deposits, shipment to most of the States is possible.[10] In fact, Kentucky has shipped rock asphalt to 33 States.[11]

USES

Since "nature made the mixture," rock asphalt can be used with a minimum of effort, primarily because it can be laid "cold."[12]

The natural product is in every way equal to any other bituminous mixture. According to one writer:

"Superiority for the natural product over a mixed asphalt is claimed, in that the rock grains of the natural product are completely impregnated with asphalt, more so than is possible with the artificial mix."[13]

This complete amalgamation of asphalt and the limestone or sandstone gives the natural rock asphalt a remarkable retention of life and permits it to be taken up and used again.[14]

Probably 90 percent of all rock asphalt being produced in the United States is used for paving surfaces such as highways, airport runways, and factory floors. It is also used on tennis courts and playgrounds.

In recent years rock asphalt has been mixed with cotton and made into plastic planks[15] and has been treated and pressed into building tiles.[16] The results obtained so far from such manufacturing indicates that many more similar products may well be made from this natural resource—if the industry is permitted to expand.

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[6] Martin, Rock Asphalt Mining, Engineering and Mining Journal, vol. 130, p. 339, Oct. 9, 1930; Fleming, Mining and Milling Utah Rock Asphalt, Mining and Metallurgy, vol. 14, p. 192, April 1933.

[7] Jewett & Schoewe, Kansas Mineral Resources for Wartime Industries, Kansas Geological Survey, Bulletin 41, pp. 118–121, May 9, 1942; Talmage & Wooton, op cit. note 1.

[8] Asphalt and Related Bitumens, Minerals Yearbook, U. S. Department of the Interior, for the years involved.

[9] Ibid.

[10] Martin, op. cit. note 6; Schafer, Resurfacing With Natural Sandstone Rock Asphalt, Roads and Streets, vol. 82, p. 53, September 1939.

[11] Vivian, op. cit. note 1

[12] Martin, Rock Asphalt Mining in Utah, The Explosives Engineer, vol. 9, p. 349, October 1931; Fleming, op. cit. note 6; Vivian, op. cit. note 1.

[13] Fleming, op cit., note 6. See also: Snider, op. cit. note 4.

[14] Machinery Solves Material Handling Problems in Mining of Rock Asphalt, op. cit., note 5.

[15] Texas Plant Installs Special Equipment for New Asphalt Rock Products, Rock Products, vol. 35, p. 16, December 10, 1932.

[16] Harker, Tile From Rock Asphalt, Rock Products, vol. 42, p. 85, August 1939.

THE INCREASING DEMAND

During the past year there has been much activity in road and runway construction in our war preparation and defense activities. The demand for bituminous construction (other than rock asphalt) has already exceeded in some localities the ability of the producers to furnish the materials needed or the capacity of their plants to produce. Priorities on the materials necessary to enlarge their plants cannot be obtained. Thus, the road and airport runway building, which is essential to the war activities, is facing a definite curtailment unless the rock asphalt producers are given a chance. It is not necessary to contend that rock asphalt is better than other bituminous road material. It is sufficient to say that it is the equal in every way. It may also be said that the rock asphalt industry is able and ready to step into the breach and make up the deficiency—if it is permitted to do so through the proposed amendment.

Engineers are recognizing more and more the importance of rock asphalt in road construction—and especially in rush jobs. Traffic can be turned on to rock asphalt immediately after it is laid and rolled.[17] When the material has served its purpose in one place it can be taken up and used again. It does not deteriorate either in an open stock pile or when in use. Another decided advantage now is that rock asphalt is shipped in open cars or gondolas, while the residium asphalt from petroleum requires tank cars, which are greatly needed for other purposes.

Not only does rock asphalt meet the present needs of the military branch of the Government, but it will also prove an important factor in the commercial activities and domestic reconstruction after the war is over. It is a certainty that airplane and automobile transportation will greatly increase in years to come. This means more roads and runways, the construction of which will materially aid post-war readjustment.

Thus, in both war and peacetime programs, rock asphalt can play an important part—and will, if Congress will permit the industry to expand.

THE PRESENT LAW AND THE PENDING BILL

One reason for the small production of rock asphalt as compared with the enormous reserves of the material is the fact that the industry has received no consideration in the Federal tax laws. There is a great demand for the product, but under existing tax rates no one can afford to produce more than a minimum amount. A similar situation arose during the First World War in the oil industry. The country needed oil, but the producer who tried to satisfy that need found that increased production meant the depleting of his reserves without compensation because of the high taxes on larger incomes. Congress remedied that situation by enacting legislation permitting a depletion deduction for the oil produced, based upon a "discovery value." [18] The depletion allowance for oil has been continued to the present time, but has now taken the form of a percentage of the sales value.

For some years past the oil and gas producers, sulfur producers, metal producers, and coal producers have been allowed depletion deductions in computing taxable income, based on their gross sales, but limited to 50 percent of their net income from the producing property. Subject to such limitation, the deductions are as follows:[19]

Producer:	*Percent of gross sales*
Oil and gas	27½
Sulfur	23
Metal	15
Coal	5

The revenue bill now pending contains for the first time a provision for the allowance of percentage depletion deductions to fluorspar producers, equivalent to 15 percent of their gross sales, but limited to 50 percent of their net income.[20]

Under existing law, rock asphalt producers are allowed depletion deductions based only on cost or the value of the property on March 1, 1913, if acquired

[17] Fleming, op. cit., note 6; Martin, op. cit., note 12.
[18] Revenue Act of 1918, secs. 214 (a) (10) and 234 (a) (9).
[19] Internal Revenue Code, sec. 114 (b) (3) and (4).
[20] H. R. 7378, 77th Cong., 2d sess., sec. 131, p. 75.

prior to that date.[21] This means that the depletion deductions are negligible as compared with the value of the deposit, or, in the case of lessees who operate on a royalty basis and have no cost, there are no deductions at all. It is true that the discovery basis for depletion [22] is open to rock asphalt producers, but the Treasury Department has so circumscribed the benefits intended by that section that it affords little possibility of general relief to the industry. While asphalt was originally a petroleum and may still be classed as a petroleum product, it has been held that asphaltum (or asphalt) could not be considered in the same category as oil.[23] For years the Treasury Department has classed asphalt as a nonmetallic mineral in its regulations.[24] Thus, rock asphalt producers have been denied the percentage depletion which is extended to producers of oil and gas and other minerals.

The provisions of existing law provide for certain exemptions in arriving at the amount of the net income which is subject to the excess profits tax. The one provision which is here considered, and probably the only one which affords any relief to the rock asphalt producers, is that which exempts from the tax an amount approximately equal to the average income of the prior 4 years. The pending revenue bill proposes to tax at 90 percent all income in excess of this exemption.[25] Thus, when the net income for any year exceeds the approximate average annual income for the prior 4 years, the Federal Government will take 90 percent of such excess as excess profits tax. This exaction, plus the normal tax and State levies, will consume all of the excess. The effect will be that corporate rock asphalt producers must stop producing when they equal their approximate prior base period average or be penalized for not doing so. To continue producing would mean not only no profit, but the loss of the reserves consumed in production as well. The pending bill thus freezes rock asphalt production at approximately the average annual production for the base period and at a time when the Nation needs a large amount of this product in its war effort.

EFFECT OF THE PROPOSED AMENDMENT

In view of the foregoing, it would seem that the solution to this inequity lies in the proposed amendment to the present bill, whereby producers of rock asphalt will be allowed percentage depletion at the rate of 15 percent of their gross sales, limited to 50 percent of their net income. Such an amendement would allow producers to increase their operations, pay the excess-profits tax and other taxes, and still have something left for their efforts. A rate of 15 percent appears eminently fair in view of the relation of rock asphalt to petroleum and the depletion allowance of 27½ percent applying to oil and gas wells; and in view of the fact that rock asphalt producers must compete with other bituminous products whose producers have been enjoying the advantage of a 27½-percent depletion rate on their oil residium (asphalt) product.

One of the purposes of the excess-profits tax is to curb exorbitant war profits, but in the natural resource industry the effect is to retard or stifle progress unless depletion as allowed. Other industries may expand, increase their income, pay the tax, and still keep part of their excess profits as a reward for their efforts because they are permitted to deduct from income their cost of the materials consumed. But in the case of rock asphalt, an increased production means that the producer is simply giving away his natural resource (which is his capital), unless a depletion deduction is allowed.

The following tabulation shows the effect of percentage depletion on taxable income under the rates set out in the present bill, on an assumed net profit of $50,000, without a depletion deduction, and on $100,000 with the maximum depletion allowance under the proposed amendment.

[21] Internal Revenue Code, secs. 23 (m) and 114 (b).
[22] Ibid., sec. 114 (b) (2).
[23] *Webb* v. *American Asphaltum Mining Co.*, 157 Fed. 203 (C. C. A., 8th, 1907).
[24] Treasury Regulations 103, sec. 19.23 (m)-1.
[25] H. R. 7378, op. cit., note 20, sec. 202, p. 194.

	Without depletion	With the maximum depletion allowance under proposed amendment
Assumed net income (without depletion)	$50,000	$100,000
Maximum percentage depletion		50,000
Assumed net income (with depletion)	50,000	50,000

From the foregoing it readily appears that if a producer is allowed the maximum amount of percentage depletion under the proposed amendment and doubles its production, the Government will receive at least the same tax that it will under the present bill. Moreover, if the producer triples his production, the Government will receive almost twice as much revenue.

CONCLUSION

It has been shown above that the demand for bituminous road materials is increasing and that greater production of rock asphalt is practically stymied now unless relief is given through a depletion deduction. No increased plant facilities are required in order to enable the rock asphalt producers to double or triple their present output. It is only necessary to extend to that industry the tax treatment accorded the other mineral producers to enable it to meet the emergency.

Respectfully submitted.

GEO. E. H. GOODNER,
Munsey Building, Washington, D. C.

Appearing for Alabama Asphaltic Limestone Co., Birmingham, Ala.; Kentucky Rock Asphalt Co., Kyrock, Ky.; Southern Rock Asphalt Co., Oklahoma City, Okla.; Uvalde Rock Asphalt Co., San Antonio, Tex.; Ohio Valley Rock Asphalt Co., Louisville, Ky.; White's Uvalde Mines, San Antonio, Tex.; Calrock Asphalt Co., San Francisco, Calif.; Lacey Asphaltic Limestone Co., Birmingham, Ala.; Colbert Limerock Asphalt Co., Sheffield, Ala.

The CHAIRMAN. Mr. Caldwell.

STATEMENT OF W. L. CALDWELL, BIRMINGHAM, ALA., PRESIDENT, ALABAMA ROCK ASPHALT CO.

Mr. CALDWELL. Mr. Chairman, and gentlemen, my name is Wallace L. Caldwell. I am from Birmingham, Ala. I am president of the Alabama Asphaltic Limestone Co. I am speaking as a producer for the entire rock-asphalt industry.

It has been pointed out to you that rock asphalt is an oil sand. We are working an oil sand just the same as the oil industry is, except that our oil sand is one in which the volatile constituents of the oil have been driven out by natural heat and pressure in the earth, leaving an asphaltic residuum in the rock impregnating the pores of the rock. Rock asphalt can either be a porous limestone or a sandstone.

As has been stated, it is found in some 11 of our States, and is mined to some extent in the great majority of those States.

Being an oil sand, the rock-asphalt deposits have many of the same hazards that the oil sands do. The deposits are extremely tricky. To have a commercial rock-asphalt deposit you must have four qualifications in that rock:

First, it must be so located that it can be commercially mined.

Second, the rock must be of such a quality that it will be suitable for roadways or airport surfaces.

Third, the bitumens impregnating the rock must be of such a quality that it will bind that rock properly.

Fourth, bitumens must be present in suitable percentage.

If any one of those four things is missing you do not have a commercial rock asphalt deposit.

Now, it is not generally well known, but rock asphalt is really a very widespread mineral.

Many limestones that are just known as ordinary limestones have maybe a fraction of 1 percent of asphalt—so small a percentage that it doesn't count at all, but bituminous impregnation is very widespread.

But commercial rock asphalts are very rare, and only a small percentage of area in any given territory is commercial. For instance, the Kentucky Rock Asphalt Co. bought 60,000 acres of land, very carefully diamond drilled that whole area, found much rock asphalt scattered through the area, but only a very small part of it was suitable for paving.

I understand that, of the 60,000 acres that was bought and paid for, at the utmost a thousand acres had commercial rock asphalt on it.

Now, in other words, in the rock-asphalt industry we get our dry holes just the same as they do in the oil industry, and the percentage of failure has been great.

There are some few companies in business today—I have been either in or closely connected with the business since about 1914—and 90 percent of all the firms that have gone into the business have failed.

Many have been failures in Texas, Kentucky, Oklahoma, Alabama, California, and almost invariably they have failed because their deposit failed.

They had much less tonnage than they thought they had, or their quality may have been good on the outcrop but as they got back into the deposit it went bad on them.

Now, as has been said by the other men who spoke on this subject, this material is used for roadways, some industrial uses, factory floors, but at the present time practically all of the product of the industry is going into airport runways.

There is little or no highway business today, except some access roads, but there are a great many runways.

Senator Thomas read a letter that the Civil Aeronautics Authority would probably ask the rock-asphalt industry to supply 310,000 tons on projects in their charge.

Now, that certainly doesn't represent much more than a third, I believe, of the amount of tonnage that the industry has been asked to supply by the Army, the Navy, and the Civil Aeronautics Authority.

For instance, the Texas companies have been asked to produce 75,000 tons for the Corpus Christi Naval Air Base alone, so that the industry will have to operate at its maximum capacity in order to supply the need for these airports.

The liquid asphalt, petroleum residuum, is hard to get these days.

There is not enough of it, and the shipping situation is such that the Petroleum Coordinator has issued his so-called asphalt order which greatly restricts the shipment of asphalt. The rock-asphalt industry avoids the use of most of the liquid asphalt and, for that reason, it has been called upon to produce a considerable tonnage for airports; and I would say that, of the total output of the industry, 90 percent must be going into that field of use at the present time.

So far as I know, no unit of the industry has ever been able to get an adequate—or what they consider a fair—allowance for either cost or discovery depletion.

With the workings of the present law, and the 90-percent excess-profits tax, it is perfectly true that the company that produces more than their average of the past 4 years, or produces a profit greater than the average of the 4 years of the base period, would have to produce that extra tonnage without any extra profit, and would at the same time be using up its assets, with no return whatsoever from those assets.

Now, the percentage depletion which the industry has asked for is, I believe, a fair method of arriving at depletion. It would give the industry, for the first time in its history, a chance to deplete its property on a suitable depletion method, and the producers of the industry respectfully ask the consideration of your committee with respect to the establishment of a percentage depletion rate on the products of the rock-asphalt industry.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Caldwell.

Mr. Sutherland?

STATEMENT OF WILLIAM A. SUTHERLAND, OF SUTHERLAND, TUTTLE & BRENNAN, ATLANTA, GA.

The CHAIRMAN. Mr. Sutherland, you may sit down or stand, as you wish.

Mr. SUTHERLAND. I prefer to stand, if it is all right, Mr. Chairman.

The CHAIRMAN. Yes, sir.

Mr. SUTHERLAND. I have several matters to discuss, Mr. Chairman.

1. *Fiscal years.*—I had intended, when I asked for permission to appear, to discuss what I consider the unfairness of the provisions in the House bill, with reference to fiscal years; but I understand that that has been so fully covered, in testimony before the committee, that I will not impose upon the time of the committee to discuss it any further.

I do think that those provisions should be changed, and that the old provisions with reference to fiscal years should prevail.

2. *Processing Tax Board of Review.*—One matter which I would like to discuss here is the matter of the abolition of the Processing Tax Board of Review and the vesting of the jurisdiction which is now vested in that Board in the Board of Tax Appeals.

It doesn't do any good to go back and say what should have been done in the beginning, but I believe that if the Congress had realized how small was going to be the work of that Board they would never have thought of establishing it in the beginning.

I think they thought that a great deal of litigation would come before it, and that the Board of Tax Appeals would probably be swamped by this new type of litigation.

That has not developed to be a fact and, now that the large majority of those processing-tax-refund cases have been settled, the work now before the Processing Tax Board of Review is comparatively small and it is not likely that there is going to be any great volume of work before it throughout the rest of its existence.

The CHAIRMAN. How large is that Board?

Mr. SUTHERLAND. The law specifies nine members. There are three vacancies now, which have not been filled, and I presume will not be filled.

The CHAIRMAN. That is a board within the Treasury Department?

Mr. SUTHERLAND. That is a board within the Treasury Department.

Now, Mr. Chairman, I think that was a great mistake. I know we have to have administrative bodies, but we can certainly divorce them, as the Board of Tax Appeals is divorced, from the control of department heads.

Now, this Processing Tax Board of Review, which exercises exactly the same jurisdiction which the Board of Tax Appeals exercises in its field, is expressly made subject to the Treasury.

Those men have no set terms. The Secretary of the Treasury can remove anybody on there he wants, and put anybody else on.

Senator TAFT. Do you want to abolish the Board?

Mr. SUTHERLAND. I want to abolish the Board, just abolish it, in the present act, and state that all the cases pending before it should be shifted over to the Board of Tax Appeals, which is entirely adequate to handle the work.

Now, there is another reason for that, sir. There are two questions which frequently arise with the same taxpayer. One is under the Unjust Enrichment Tax Act, which is covered by title III of the 1936 act, and the processing refunds, covered by title VII.

Many of those cases should be tried together, and yet we have the spectacle of one of them before a board in the Treasury, and the unjust enrichment tax before the Board of Tax Appeals.

Now, without making any criticism of the personnel of the Processing Tax Board of Review, or any of its functioning, I do feel that a great deal more confidence is held by the public, and by the bar generally, in tribunals which, like the Board of Tax Appeals, are free and independent, rather than under the control of any department head, as the Processing Tax Board of Review is.

At a time like this, when you are seeking in every way possible to economize, I think there is that great added reason for doing what I recommend.

Then you come to the question: If you are going to transfer those functions to the Board of Tax Appeals, whether or not you will set up a special division of the Board to handle these matters as the House bill proposes, in section 213 (d) on page 216, for the handling of the relief provisions under the excess-profits tax.

Mr. Chairman, I respectfully submit that that is unsound. The matter of how those relief provisions are to be handled, and also the matter of how these processing refunds are to be handled, if you transfer that jurisdiction to the Board, should be left to the Board of Tax Appeals to be worked out as they find it wise to work it out. I think that any hampering of their discretion is much more apt to be harmful than it is to be helpful.

The CHAIRMAN. In other words, they ought to have more flexibility?

Mr. SUTHERLAND. I don't see why they can't. The Board of Tax Appeals might well assign a few of its members to handle those questions, but to say that the Board can't review the decisions of this small group would be very unwise. The Board might set up a division of three or four people, and then, in its sound discretion, the Board might conclude that those people have taken an entirely wrong approach to the problem. And yet you would tie the hands of the chairman and the other members of the Board to do anything to bring the consideration of the entire Board to bear upon those questions.

I don't believe it will facilitate—I don't believe it will speed up the hearing of those cases or their decision. I don't believe it will accomplish any good.

I would prefer to see both of those questions—the processing review and the relief provisions—left to the Board to handle in its sound discretion.

Senator VANDENBERG. Does the Processing Tax Board consist of employees of the Treasury Department who have other functions?

Mr. SUTHERLAND. No, sir; they have no other functions. They were taken from the Treasury Department and put over on the Processing Tax Board of Review.

They now have no other functions. They are entirely subject to the control of the Secretary of the Treasury, however.

Senator VANDENBERG. A full-time paid job?

Mr. SUTHERLAND. It is a full-time paid job.

Senator VANDENBERG. You say there are three vacancies?

Mr. SUTHERLAND. There are three vacancies.

Senator VANDENBERG. How did that happen?

Mr. SUTHERLAND. After all, I think there is some desire for economy all through the Government.

I was not making any criticism of any of the Members of the Board.

I think, though, that the whole thing can be entirely satisfactorily handled in the other way, and I certainly hope that that will be done.

Senator Brown asked some questions on page 695 of these hearings as to whether you should create a new special board to hear special relief cases under the excess-profits tax, but I certainly think that would be a mistake.

The Board of Tax Appeals has done a fine job, and if it is necessary to increase the membership by two or three to handle these other questions, there is no reason why that can't be done if it does develop that it is necessary. I don't believe it will be.

Are there any questions?

The CHAIRMAN. Any questions?

(No response.)

Mr. SUTHERLAND. There are a couple of other items that can be dealt with very briefly.

Now, I would not say, as a matter of policy, whether I think it is wise at this time to go back and attempt to relieve against the unreasonable hardships under prior acts. I don't know whether I would ever have thought of recommending that that be done at a time like this.

If, however, the Senate is going back and relieve against one of the obvious hardships under the 1936 act, I certainly think there is another case that is equally entitled to be covered.

What you have done by section 501 is to relieve a corporation from undistributed-profits tax, when it was in such position that if it had paid out money as a dividend, the distribution would not have been taxable as a dividend, and therefore there would be no dividend-paid credit, and the corporation would not be relieved of the undistributed-profits tax.

The original 1936 act relieved from the undistributed-profits tax corporations which were forbidden by contract made prior to May 1, 1936, to pay out money as dividends.

The other obvious injustice which I think should be corrected is this: You did nothing in the original act, and have done nothing here, about those corporations which are prohibited by State law, because they have a deficit, from paying out dividends, and I see no reason in the world why if these two cases—the one that you covered in the 1936 act and the one that you are now covering here by section 501—are going to be covered you should not relieve from the undistributed-profits tax, in those situations where State law forbids the payment of a dividend.

In Georgia, if a dividend is paid when there is a deficit in the corporation, the directors are liable for double damages to anyone who is harmed.

I understand that the Treasury opposes that provision and says that, if you are going to relieve in such a situation, there are some other situations that are equally entitled to relief.

If that is true, I say they ought to be covered, if you are going into the question at all. The fact that there are other situations is no reason for not relieving this situation, which, it seems to me, is just as obvious as the one covered by section 501.

4. *Estoppel income.*—The other question that I wanted to take up just for a moment is this: In section 114 of the present bill, on page 24, you provide by statute what had already been held by some court decisions, that when an item is deducted in a prior year, like taxes which proved to be unconstitutional, a bad debt which is later recovered, and items of that sort, and there is no tax saving on the deduction, there will be no tax on the recovery of the item in the present year.

Now, that doesn't entirely cover the situation. There are many cases where some tax benefit was derived from the deduction of these items, but the tax benefit was very small in proportion to the taxes that will now be paid on their recovery.

Those items are not truly income in the year when they are recovered. They are included in income because they were erroneously deducted in another year. It is a principle analogous to an estoppel. If you are going to have an estoppel, you ought to make it work so that it just about estops and doesn't take three times the taxes that the man saved on the item.

Now, I don't think of any practical way you can handle it in the case of individuals, where taxes vary so greatly, dependent upon the amount of income in the prior years.

But these situations don't arise very often in the case of individuals. Ninety percent at least of the injustice can be covered and eliminated if you will just make a simple provision in the case of corporations that any recovery in 1941 or 1942 and subsequent years of such items which were deducted prior to 1940 shall be subject only to a 24-percent tax, which is the normal tax under the 1941 act.

That will take care of all the deductions taken in years prior to the excess-profits tax years, when the normal tax was normally 13 to 15 percent. Sometimes declared value excess-profits taxes also might have been saved by the deduction, and therefore occasionally the corporation might have saved more than 24 percent. But I would say that if the recovery of such items by corporations is taxed at a rate of only 24 percent, the Government will in 99 percent of the cases be getting more money on the recovery of the items than was lost in the prior years when they were deducted, even when you add interest to the taxes avoided in the prior years.

I do think that great injustice is going to be done under these high rates if you tax those estoppel items at the rates prevailing in these acts, and I hope that you can go back and from 1941 forward tax those items at 24 percent. I don't believe you will find any serious objection on the part of the Treasury to some such provision as that.

Thank you.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you very much.

Mr. Stiles?

STATEMENT OF JAMES F. STILES, JR., VICE PRESIDENT AND TREASURER, ABBOTT LABORATORIES, NORTH CHICAGO, ILL.

The CHAIRMAN. All right, Mr. Stiles.

Mr. STILES. My name is James F. Stiles, Jr. I am vice president and treasurer of Abbott Laboratories, manufacturers of pharmaceutical, biological, and medicinal chemicals, located at North Chicago, Ill.

Permit me to express my appreciation for permission to appear before your committee a second time.

Last year, when I was granted that privilege, I presented to you a formula, which, perhaps some of you recall, has been referred to as a basis for incentive taxation.

I heartily agree with Secretary Morgenthau's statement that none of us should at the present time need any incentive. We have a job to do and that is win the war and pay for it and the sooner the job is completed the less it will cost us.

As the father of two young men who have already entered the military forces of our country, I need no personal financial reward to do everything I can to assist our country in accomplishing whatever is necessary at this time. If the Government needs anything I have, I expect and want it to take it.

As the financial officer of our company, I am faced with a problem just the same as many other men similarly situated in corporations such as ours have indicated to me they are facing. So, instead of talking about incentives, let's talk about protective taxation. One that will protect the economic front of our country as a whole by securing the maximum amount of revenue and at the same time protect the corporate entities which form a large part of the economic front by affording them at least the opportunity to operate in a manner which will not result in financial embarrassment.

It is my conviction that when a corporation enjoys the confidence of the public so that it can sell its common stock whenever it is in need of additional capital, then such a corporation must, if it is to retain the confidence of its investors, continue to pay at least the dividend that it paid at the time the new capital was brought into the company.

The present excess-profits tax penalizes a corporation which has a simple and conservative capital structure. A corporation with a bond issue receives credit for interest paid, whereas, a corporation with preferred or common stock only, receives no deduction for distribution of profits in the form of dividends.

I believe it is just as important for a corporation to pay regularly the maximum dividend that it can afford to its shareholders, who have purchased its stock in good faith, as it is for the corporation which did not enjoy similar confidence of the public, and, therefore, had to raise capital by means of bonds or first mortgages, to meet its interest obligations. Under the present law it is permissible to pay the same contracted interest on borrowed capital in full before taxes but such is not the case with respect to stock.

Most men in industry are, like myself, trying to regulate the production, purchases, and sales of all his company's products in such a manner as will best serve our country during this emergency period.

As far as our organization is concerned, we are happy to be in a position to finance our company and pay the maximum load of taxation that we can safely carry.

We are at this time being called upon by the Government, the medical profession, and the hospitals throughout the country for a greater demand for our products every year.

Slowly but surely our cash is finding its way out of the treasury and into additional equipment, inventory, and accounts receivable. As those assets increase the risk for doing business also increases in the same proportion. Unless we have some knowledge as to what our one biggest liability, the Federal tax, is to be with respect to our net earnings, it is impossible for us to intelligently decide how far we can progress during the current year with safety.

I have made up a little chart to show you the exact effect of Federal taxation on our net earnings during the past 8 years. You will find that chart appended to the back of this statement, gentlemen, and I think it is really very simple and understandable.

The estimate for the year 1942 is based on the first 6 months' experience, with the application of the 45-percent normal and surtaxes and 90-percent excess-profits tax. This enables you to more clearly understand our estimate for 1942. While our earnings before tax will probably increase 21 percent, the earnings after tax will be 27½ percent less than they were in 1941.

We sold to the public 40,000 shares of common stock in 1936 at $50 per share and 74,000 shares of common stock on the issuing of rights at $50 per share in December 1939. In 1941 $1,700,000 additional capital was secured by the sale of 4-percent preferred stock.

We have no bonded indebtedness or mortgages. The sale of the common stock in 1939 was made on the assumption that we would continue to pay a dividend of at least $2 a share and, of course, folks did have hopes that we might go even further. Full credit for this additional capital has been taken into consideration in arriving at the estimated taxes for 1942 as shown on the chart.

We have a moral obligation to these new investors to at least continue to pay them the dividends which were in effect at the time they purchased the stock especially as our company is more than earning that amount after all normal and surtaxes are provided. Most folks who receive the dividends pay a substantial income tax on the dividends when they get them. All we do is create national income and redistribute it for further taxation.

From this chart, you will notice that our profits after taxes in 1942, as proposed in the pending bill, will be practically the same as they were in 1937 notwithstanding the fact that our profits before tax are two and one-half times what they were in 1937 and notwithstanding the fact that since that time our capital has been increased by $7,000,000, $5,400,000 of which represents new capital brought into the company and $1,600,000 earnings above dividends which were left in the business.

In making this statement, please understand I am not objecting to the normal and surtax even though combined they have almost trebled. And, gentlemen, if you will just take a look at that chart, you will see what I am referring to there, because I have tried to make this statement really brief, and I have traveled a mile for every word that is in it.

I am sure you will agree with me that the normal profits during the base period were that amount of profits which remained in the company after the Federal income taxes were paid. If that assumption is correct, then, as you can see by this chart, the proposed excess profits tax law not only taxes 100 percent of our excess profits as determined by the growth formula but also places another tax, call it what you will, of 20.9 percent of our normal profits.

It is my belief that the present method of computing the excess profits tax before computing the normal tax and surtax is wrong in principle. If the excess-profits tax is to be based upon true excess profits, the normal and surtaxes should be deducted to determine what is "excess." Until you know how much is left, how do you know how much is "excess"?

I, therefore, submit the following suggestions:

1. If it is the judgment of Congress to let the excess profits tax rule remain as proposed in the pending bill, then it is my opinion that there should be a restriction so that the so-called excess-profits tax will not reduce the net profits after all Federal taxes of the taxpayer below an amount equal to the excess profits credit base as determined by the 1940 Revenue Act as amended in March 1941.

This suggestion would not alter the high excess-profits tax rates on those profits arising out of the war-expansion program and still would be a restricting influence so that the excess-profits tax would not embarrass a company's earning power which existed prior to 1941, nor would it reduce the taxes of any corporation making more than four times its base period credit before taxes if the excess-profits tax rate is 90 percent, nor would it reduce the taxes of any corporation making more than two and three-quarters times its base period credit before taxes if the tax rate was 80 percent, and still would be a restricting influence so that the excess-profits tax would not embarrass a company's earning power, which existed prior to 1941.

Gentlemen, I never could quite understand why Congress established a method for determining the base credit and then takes 5 percent off that amount before allowing such credit to be used. If it is the intention of Congress to permit corporations who are paying excess-profits taxes to reserve 20 percent of such taxes by means of investing such amounts in war bonds or a post-war refund, as Mr. Davidson has very ably suggested to this committee, then I believe it is very important that the excess-profits tax, when the rate is finally agreed upon, be applied only to true excess profits and not to that portion of a company's earnings which would usually be considered normal profits.

2. Extend the base period so as to include the year 1940 and permit the taxpayer to use the best 4 out of 5 years in computing the average earnings and if it is to his benefit to use the growth formula then the best 4 consecutive years out of 5.

3. After carefully studying the relief section of the House bill, it seems to me that there should be some definite statement to the effect that the limitations of section 713 (f) do not apply if the taxpayer determined the fact that he is otherwise entitled to relief.

Frankly, I am concerned about the use of the word "establish" in section 722 (a). Section 722 (b) might be more helpful to a greater number of taxpayers if it included a statement "or as a natural result of the normal growth of the business" inserted just prior to the words "or any acquisition before May 31, 1941."

To summarize: 1. I recognize that it is absolutely necessary for our Government to maintain the maximum tax rates that can be safely levied against all profits and personal income especially that arising out of the war program.

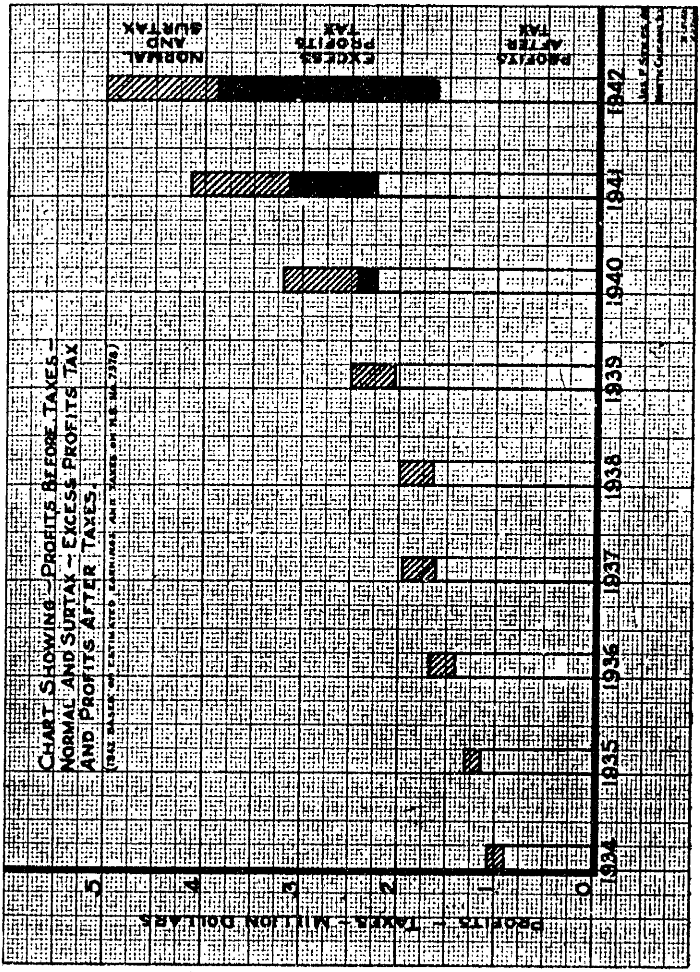
2. I believe it is essential that we assure corporations, which are, in the final analysis, the organizations responsible for the creation of a large part of our national income, at least a definite amount of income on which they can plan and pay for expansion and dividends provided they earn it above normal and surtaxes.

3. Surely you will agree with me that no tax law is safe which forces the institutions which create national income to discontinue or drastically reduce the payment of dividends or to borrow money to pay taxes when, on the contrary, during an expanding period such institutions should be setting up reserves which will be needed to carry them through both the future war expansion and post-war readjustment periods.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

(The chart referred to by Mr. Stiles is as follows:)



The CHAIRMAN. Mr. Garcia, will you come forward, please?

STATEMENT OF ALVARO M. GARCIA, NEW YORK, N. Y., PRESIDENT, CIGAR MANUFACTURERS ASSOCIATION OF AMERICA

Mr. GARCIA. Mr. Chairman and gentlemen of the committee: My name is Alvaro M. Garcia. I am a member of the firm of Garcia &

Vega, manufacturers of cigars, Tampa, Fla., and I also appear before you as president of the Cigar Manufacturers Association of America. I am also authorized to speak in behalf of the Florida Cigar Manufacturers Association.

Our association comprises 64 manufacturers producing collectively about 65 percent of the total production of cigars. Its membership, large and small, includes every type of cigar production covering all of the five classes. In addition, our presentations have the endorsement of leading manufacturers who are not members of our association, so that our representation is well over 85 percent of the total cigar production. We also have the endorsement of cigar tobacco growers of Connecticut and Pennsylvania tobacco areas, importers and dealers in Cuban and Puerto Rican tobacco and domestic tobaccos.

We have prepared a brief with certain charts and schedules, copies of which have been placed on your desk and which we respectfully request to be filed and made a part of the record. We had intended to have six witnesses, but in order to cooperate with the committee and conserve time, we offer for the record the following short statements, namely:

A brief on behalf of the Cigar Manufacturers Association;

A statement of the Connecticut Leaf Dealers;

A statement on behalf of the Shade Tobacco Farmers of the Connecticut Valley;

A statement of the leaf tobacco dealers and importers;

A statement by the Lancaster County, Pa., tobacco farmers;

A brief by Mr. Eric Calamia, president of the Retail Tobacco Dealers of America;

A memorandum on behalf of the National Association of Tobacco Distributors which Mr. Joseph Kolodny has asked me to present.

With your permission, may they be made a part of the record?

The CHAIRMAN. Yes; you may make them a part of the record.

(The brief and statements referred to above are as follows:)

MEMORANDUM OF CIGAR MANUFACTURERS ASSOCIATION OF AMERICA, IN THE MATTER OF THE PROPOSED INCREASE IN EXCISE TAXES ON CIGARS, CONTAINED IN SECTION 605 OF H. R. 7378

The association is deeply concerned over the radical and unfair cigar excise schedule adopted by the House (sec. 605, H. R. 7378) which would not only work severe injury to the industry but would deprive the Government of revenue by driving consumption to the lowest-priced cigars, thus impairing the revenue base.

The industry has for some time been on the decline, in part because of discriminatory taxes, and vigorously opposes the plan now presented which would further weaken it. The cigar industry can provide the Government with a large amount of additional revenue, perhaps as much as double the $13,000,000 in taxes now paid, but the method of taxation must be one which will maintain the industry and not so weaken it by discrimination as to impair the tax base.

The flagrant discrimination in the House schedule is illustrated by the proposed increase of 50 cents per thousand in the tax on 2-for-5-cent cigars, while at the same time imposing an increase of $3 per thousand in the tax on 5-cent cigars. These two types of cigars have for many years been taxed alike and it is unfair and discriminatory to increase the tax on one by an amount equal to 600 percent of the increase on the other. The industry does not object to paying increased taxes, but it does object to flagrant discrimination and the use of taxation as a method of effecting internal changes within the industry and disturbing existing relationships.

The outstanding phenomenon in the cigar industry during recent years has been the drift toward the lowest-priced cigars. And because of the discriminatory features in the House schedule, it will accelerate the gravitation of the industry toward the lowest-priced cigars with consequent loss of revenue to the Government.

The association comprises 64 manufacturers located in the various tobacco areas of the United States, producing collectively well over 65 percent of the total domestic production of cigars retailing at prices within all five of the present revenue classes. Its members include small, medium-sized, and large firms, some producing cigars solely by hand, some by machine, and some by a combined method.

You will find the proposal of our association in appendix A, sheet 1. Based upon withdrawals for the fiscal year ended June 30, 1942, it would have earned a revenue in excess of $24,000,000. This proposal has the endorsement of leading nonmember manufacturing firms whose combined production (in categories from 2 for 5 cents and up) together with members of the association, constitutes approximately 85 percent of the total domestic production of cigars. In addition, groups of cigar-tobacco growers in the Connecticut Valley and in the Pennsylvania tobacco areas and many importers of and dealers in Cuban and Puerto Rican cigar leaf tobacco, whose petitions will be filed with this brief, support our proposal.

We, therefore, urge upon your committee the rejection of the House schedule on the following grounds:

1. It discriminates against the 5-cent cigar in favor of its chief competitor, the 2-for-5-cent cigar, by increasing the tax on 5-cent cigars six times as much, causing a detrimental shift in consumption to the 2-for-5-cent cigar, and thus will fail to yield the expected revenue.
2. It taxes the higher-priced cigar out of existence.
3. It violates the "good-neighbor policy" exemplified by the reciprocal trade agreement between Cuba and the United States by drastically curtailing our use of Cuban tobacco, one of Cuba's most important products.
4. It meets with the disfavor of all segments of the cigar industry—manufacturer, importer, farmer, and labor.
5. It perpetuates and extends a discriminatory method of taxation.

TRENDS IN THE CIGAR INDUSTRY

Appendix A of this brief on sheet 1 supplies an analysis of revenue for the fiscal year 1942 if the schedule of the association had been in effect; sheet 2, the revenue if the rates adopted by the House had been in effect for the same year and sheet 3, the actual revenues at the present time.

These schedules read in the light of a brief statement of the trends in the cigar industry during the last 20 years will establish convincingly that our proposed schedule should be adopted.

Since 1921 this industry has been struggling to adjust itself to changing conditions. It has been faced with a steady decline in consumer demand. In 1921[1] the consumption of cigars was 7,483,000,000, while by 1939 consumption had fallen to 5,453,000,000. By 1942 consumption had risen to 6,101,000,000. The maximum utilization of this increase depends on the enactment of an excise schedule which will distribute the tax burden equitably across the entire industry.

The decline in consumption since 1921 has been accompanied by a shift in price levels. In 1921 class C accounted for 42 percent of consumption and class A only 25.9 percent. By 1942 class C had fallen to 9.2 percent, while class A had risen to 89.2 percent. Moreover, a significant change occurred within class A itself so that today it is estimated that approximately one-half of the consumption of cigars in class A retails at less than 5 cents each. The result has been a decline in dollar volume of the industry's product from $371,274,000 in 1921 to $160,-754,000 in 1939.

Accompanying this tremendous decline in unit and dollar volume has been the change in the methods of production. Until 1917 all cigars were produced by hand. About that time mechanization began but did not take hold until 1924, when it spread rapidly. By 1940, 77 percent of all cigars were machine made.

The effects of mechanization upon the industry have been profound. In 1940 about 84 percent of class-A cigars were machine made. Of cigars in classes B, C, D, and E, 72 percent were made by hand, 23 percent by machine, and 5 percent by combined hand and machine method.

[1] Throughout this memorandum, years referred to are Government fiscal years.

The trends inherent in mechanization have caused the disappearance of thousands of small cigar firms. In 1921 there were 11,109 factories, employing 111,858 workers. In 1939 there were only 3,834 factories, employing 50,987 workers. By 1939 less than 1 percent of all factories produced over two-thirds of all cigars manufactured during that year and it is a fair statement that further concentration has occurred. Submitted with this memorandum are 2 charts portraying vividly the changes which have occurred in the industry.

I. THE HOUSE SCHEDULE DISCRIMINATES AGAINST THE 5-CENT CIGAR IN FAVOR OF ITS CHIEF COMPETITOR, THE 2-FOR-5-CENT CIGAR BY INCREASING THE TAX ON 5-CENT CIGARS SIX TIMES AS MUCH, CAUSING A DETRIMENTAL SHIFT IN CONSUMPTION TO THE 2-FOR-5-CENT CIGAR, AND THUS WILL FAIL TO YIELD THE EXPECTED REVENUE

As indicated, approximately 90 percent of the total present consumption of cigars is in class A and is about evenly divided between the 2-for-5-cent and 5-cent cigars. In 1929 the 2-for-5-cent cigar constituted an estimated 10 percent of the total class A consumption, while at the present time it represents approximately 50 percent. This phenomenal growth was in no way hampered by taxing the 2-for-5-cent cigar during this period at the same rate as the 5-cent cigar.

Under the House schedule the increase on the 2-for-5-cent cigar is only 50 cents a thousand, while the increase on the 5-cent cigar is $3 a thousand. Except for a few very large 2-for-5-cent cigar manufacturers who will be able to absorb the slight increase of 50 cents and remain at 2-for-5-cents, all other 2-for-5-cent cigar manufacturers will be compelled to advance to an odd-cent price. Likewise the increase of $3 a thousand on the 5-cent cigar will force all 5-cent cigar manufacturers to increase the price of their cigar to the odd cent.

The experience of the industry has demonstrated that cigars cannot be sold readily at an odd-cent price. Abundant testimony regarding consumer resistance to the odd-cent price has been given at hearings before the Wage and Hour Division in 1941 with respect to Puerto Rican cigar leaf tobacco, at hearings before the Wage and Hour Division in 1942 in connection with wage recommendations for the cigar industry and at hearings before other governmental agencies. Cigar smokers have been accustomed to purchase their cigars at prices in multiples of 5 cents. An increase in price to the odd cent will find the 5-cent-cigar smoker turning in great numbers from the 5-cent cigar to the 2-for-5-cent cigar, seriously injuring the 5-cent branch of the industry.

Any tax plan which plays havoc with long standing relationships in the industry and favors a part of the industry to the injury of others necessarily produces less revenue than a plan which maintains existing satisfactory competitive balances within the industry, and continues the industry in a reasonably sound and healthy condition. It is certain that the House schedule will yield far less revenue than it yields on paper, since such an unfair and discriminatory tax is bound to curtail consumption. There is no justification for using the taxing power of our Government to prefer some 2-for-5-cent manufacturers to the injury of all other manufacturers in the industry.

We believe the schedule of the association distributes the tax burden equitably within the industry without granting a competitive advantage to any branch. It grants a $1 tax differential to the 2-for-5-cent-cigar manufacturers, notwithstanding the fact that such manufacturers were able to achieve their present position while being taxed at the same rate as the 5-cent cigar. The increased rate on the 2-for-5-cent cigar will require all such manufacturers to increase their prices, at the same time requiring all 5-cent-cigar manufacturers to do likewise. Thus, no preference is granted and the competitive balance within the industry is undisturbed.

The proposal now submitted by the Association, though differing from that submitted to the House Ways and Means Committee, will produce, we believe, a revenue in excess of $24,000,000. Upon reconsideration the change from our first proposal was necessary to unify the views of the industry in the light of changing conditions, and in order to more equitably distribute the tax burden.

The House schedule will yield far less revenue than is estimated. The Treasury is submitting its proposal to the House Ways and Means Committee estimated the yield to be slightly over $26,000,000. The House schedule is substantially the same as that proposed by the Treasury, except that in a few instances, the rates are lower. Despite this lowering of rates, the House Ways and Means Committee report anticipates that its proposal will yield $30,500,000 based upon estimated 1943 consumption. The fact is, however, as demonstrated by sheet 2 of appendix A, that the House schedule on the basis of withdrawals for the fiscal year ended June 30, 1942, would have yielded $27,691,343.

The Treasury and the House Ways and Means Committee have based their estimates on the erroneous assumptions that their proposals would neither curtail production nor cause a shift in consumption to the 2 for 5-cent cigar. Such a shift with the resultant loss in revenue is inevitable. The House schedule must fail to yield even the revenue estimated by the Treasury.

The association's present proposal, based on withdrawals for the fiscal year ended June 30, 1942, would have yielded in excess of $24,000,000, an increase of at least $10,000,000 over the revenue derived for that period (see sheet 1 of appendix A). Moreover, the increase in consumption which took place during the past year will, in all likelihood, continue. This increase will result in an even greater revenue yield for the Government, if the relative consmption as between all classes, remains the same.

Since the Government is a partner of the cigar industry in the sense that the present revenue is more than double the industry's profits, it is in the interest of the Government to maintain this industry on a basis which will yield the maximum revenue. We believe the association's proposal achieves that objective.

II. THE HOUSE SCHEDULE WILL TAX THE HIGHER BRACKETS OUT OF EXISTENCE

The House schedule imposes increases on the higher brackets ranging from 100 to 170 percent. Although ordinarily articles selling at higher prices can bear higher taxes, the history of the higher-priced cigars during the past 20 years proves the contrary. Consumption of classes C, D, and E which in 1921 constituted 44.8 percent of total consumption fell to 10 percent in 1942. The market for these cigars is so small, that to more than double the rate will tax them out of existence.

Despite the fact that these three classes constitute only 10 percent of the total consumption, they nevertheless yielded 23.3 percent of the total revenue for the fiscal year ended June 30, 1942. To impose such greatly increased taxes on these classes as were adopted by the House will deprive the Government of a substantial source of revenue.

III. THE HOUSE SCHEDULE VIOLATES THE "GOOD NEIGHBOR POLICY" EXEMPLIFIED BY THE RECIPROCAL TRADE AGREEMENT BETWEEN CUBA AND THE UNITED STATES BY DRASTICALLY CURAILING OUR USE OF CUBAN TOBACCO, ONE OF CUBA'S MOST IMPORTANT PRODUCTS

Tobacco farming is Cuba's second largest industry. Cuban tobacco was formerly used extensively throughout the world in the manufacture of cigars, but the war has shut off almost all of Cuba's foreign markets. Recognizing the plight of Cuba and in furtherance of our "good neighbor" policy, the State Department in 1941, concluded a supplemental reciprocal trade agreement with Cuba, increasing the amount of Cuban tobacco which could be imported in the United States at lower tariff rates.

Cuban tobacco to the extent of over 15,000,000 pounds is used in the United States in the manufacture of cigars retailing at 5 cents and up, and is the chief ingredient in cigars retailing at 10 cents and over. Any large decrease in the consumption of higher priced cigars coupled with a shift from the 5 cents to the 2-for-5-cents cigar, which is bound to occur under the House schedule will have detrimental effects on an already disturbed Cuban economy. At a time when American diplomacy in the Western Hemisphere is directed toward maintaining on a normal basis the economy of our Central and South American neighbors, Congress should not adopt a tax program, the effect of which would be to reduce our use of one of its most important products, at the same time compelling Cuba to continue to assume the obligations of the treaty.

IV. THE HOUSE SCHEDULE MEETS THE DISFAVOR OF ALL SEGMENTS OF THE CIGAR INDUSTRY

The farmer.—The cigar industry affords the only market for the wrapper and filler tobacco grown by the farmer. Along the Connecticut Valley tobacco is produced on some 23,000 acres in Connecticut and Massachusetts. The value of the annual production of this area represents about $10,000,000. Practically all of this tobacco is grown for use in cigars retailing at 5 cents and over. The evidence before the House Ways and Means Committee, establishes that unless the tax rates are so adjusted as to protect the market of these farmers, their position will become precarious. They joined in the recommendation of the association to the House committee. Accompanying this memorandum, the association will submit the petitions signed by many farmers growing Connecticut Valley cigar leaf tobacco, the acreage of which collectively is substantial and whose total annual production represents several million dollars.

Farmers operating upward of 35,000 acres in the Lancaster, Pa., area produce a crop valued in excess of $6,500,000 which is used almost entirely in the manufacture of cigars retailing at 5 cents each and up. Four thousand of these farmers were opposed to the Treasury proposal and petitioned for adoption of the association's proposal (p. 2215 House record). Accompanyng this memorandum, the association will submit a petition filed by a very representative number of farmers operating a substantial acreage in this area and producing a crop valued at several million dollars.

The experience of tobacco growers in Wisconsin and Ohio is proof of the effect of the growth of the 2-for-5-cents cigar. Deterioration of tobacco quality, prices between 7 and 8 cents per pound, sharp curtailment of acreage from 31,000 acres in 1930 to 10,500 acres in 1942 in Ohio and in Wisconsin from 42,000 acres in 1930 to 20 300 acres in 1942 attest to the destructive effect of the growth of the 2-for-5-cents cigar industry. While it is true manufacturers of 2-for-5-cents cigars now purchase considerable tobacco in the Pennsylvania area, they are able to purchase only inferior parts of the plant, the higher grades being sold to the manufacturers of 5-cent cigars and up. The cost to the farmer is and can only be borne by the manufacturers of 5-cent cigars and higher grades. The 5-cent-cigar field has been correctly characterized as the pivot about which revolves the entire industry. (Swisher, p. 2174, House record.)

Labor.—President Van Horn of the Cigarmakers International Union, representing about one-third of the 51,000 cigar workers, appeared before the House Ways and Means Committee. His main argument was that the 2-for-5-cents cigar is produced on such a narrow margin that both labor and the farmer are squeezed and that the condition of both would improve if the prices were made 3-for-10-cents, with no loss of volume. Mr. Van Horn stated that "the classification proposed by the Treasury would without doubt cause some considerable unemployment." (Van Horn, p. 2179, House record.) The House classification is equally offensive.

The Tampa Cigarmakers Council, representing eight local unions, protested the Treasury proposal. Few 2-for-5-cent cigars are made in Tampa. The 5-cent cigar constitutes about 50 percent of the Tampa production, the other 50 percent retailing at 10 cents each or higher. Mr. Maxwell, attorney for the council asserted that the Treasury proposal would "substantially destroy our industry in Tampa and would result in loss of money to the Government." (Maxwell, p. 2184, House record.) The Tampa Cigarmakers Council described the Treasury classification, which is substantially the same as the House schedule, as one designed to subsidize the 2-for-5-cent cigars by giving them an undue advantage over their competitors in the 5-cent field (Maxwell, p. 2184, House record). The House schedule would impair if not destroy the Tampa industry. The Cigar Manufacturers Association of Tampa, in meeting assembled, approved unanimously the present proposal of our association.

V. THE HOUSE SCHEDULE PERPETUATES AND EXTENDS A DISCRIMINATORY METHOD OF TAXATION

The cigar industry is the only one subject to a manufacturers' excise tax in which there are classifications based on the retail selling price. In many industries the tax is a uniform flat rate on the manufacturers' unit of production.

We have long felt that the cigar industry is discriminated against in thus subjecting it to such a method of taxation. Pressure of time makes it inexpedient to suggest that we now be placed on the same basis as other industries. However, we feel that such a method of taxation should not be further extended, and we have therefore recommended a schedule based on only four classifications.

CONCLUSION

Since the association's proposed schedule will yield a revenue substantially the same as that adopted by the House, it is respectfully urged that the House schedule be rejected and the proposal of the Cigar Manufacturers Association adopted.

Respectfully submitted.

CIGAR MANUFACTURERS ASSOCIATION OF AMERICA, INC.,
By ALVARO M. GARCIA, *President*.

Dated: August 10, 1942.

SAMUEL BLUMBERG,
General Counsel.

APPENDIX A

Revenue for fiscal year 1942 if the rates proposed by the Cigar Manufacturers Association had been in effect

Class	Retail price	Rates per thousand	Withdrawals in thousands	Revenues
A	Up to 4 cents	$3	2,720,185.0	$8,160,555
B	4.1-8	4	2,767,821.0	11,071,284
C	8.1-15	8	565,290.0	4,522,320
D	15.1 up	12	48,104.5	577,254
Total			6,101,400.5	24,331,413

NOTE.—We estimate that the present class A is equally divided between class A and class B of the new schedule.

Revenues for fiscal year 1942, if the rates proposed by the Ways and Means Committee had been in effect

Proposed schedule	Retail price	Proposed rates per thousand	Withdrawals in thousands	Revenue
A	Up to 2.5 cents	$2.50	2,720,185.00	$6,800,462
B	2.5-4	3.50		
C	4.1-6	5.00	2,720,185.00	13,600,925
D	6.1-8	7.00	47,636.00	333,452
E	8.1-11	10.00	452,732.00	4,522,320
F	11.1-15	13.50	113,058.00	1,526,283
G	15.1-20	18.00	42,852.00	771,336
H	20.1-30	25.00	4,727.25	118,181
I	30.1 up	35.00	525.25	18,384
Total			6,101,400.50	27,691,343

NOTE.—We estimate that the present class A is equally divided between classes A and C of the new schedule. Class B of the new schedule includes such a very small proportion of class A production that it is impossible to estimate the revenue. The new class D is the same as the present class B, since no 6-cent cigars are sold at present. Proposed class F: We estimate that 80 percent of the present class C retails at 11 cents each or less and 20 percent at between 11 and 15 cents each. The new class G is the same as the present class D. Proposed class H: We estimate 90 percent of the present class E retails between 20 and 30 cents and the new class I consists of the remaining 10 percent, which retails at over 30 cents.

Actual revenues at the present rates for the fiscal year 1942

Class	Retail price	Rates per thousand	Withdrawals in thousands	Revenues
A	up to 5¢	$2.00	5,440,370.0	$10,880,740
B	5.1-8	3.00	47,636.0	142,908
C	8.1-15	5.00	565,290.0	2,826,450
D	15.1-20	10.50	42,852.0	449,946
E	20.1-up	13.50	5,252.5	70,909
Total			6,101,400.5	[1] 14,370,953

[1] The actual revenue was $14,377,828.13. The difference between this figure and the total given above consists of the figures for the imports from Puerto Rico not available at this time.

Year	Registered as manufacturers of cigars [1]	Number of wage earners [2]	Value of product [2]	Per capita consumption [3]
1919	11,291	114,300	$360,396,000	60.0
1920	11,483			79.8
1921	11,109	111,855	371,274,000	64.3
1922	12,105			65.7
1923	11,576	108,800	360,867,000	66.2
1924	10,628			61.9
1925	9,877	103,000	[4] 350,000,000	60.3
1926	8,533			59.7
1927	8,427	94,600	338,967,000	58.3
1928	7,974			56.6
1929	7,502	84,166	311,664,000	56.4
1930	6,780			50.1
1931	6,195	68,182	227,349,000	45.3
1932	5,982			37.5
1933	5,787	54,558	139,372,000	36.5
1934	5,473			38.4
1935	5,190	56,019	151,269,000	39.5
1936	4,905			42.0
1937	4,522	55,879	169,237,000	42.8
1938	4,157			40.9
1939	3,834	50,897	160,754,000	42.0
1940	3,553			42.0
1941	3,226			

Sources:
[1] Annual Report of the Commissioner of Internal Revenue.
[2] Bureau of the Census.
[3] Bureau of Agricultural Economics.
[4] Estimated.

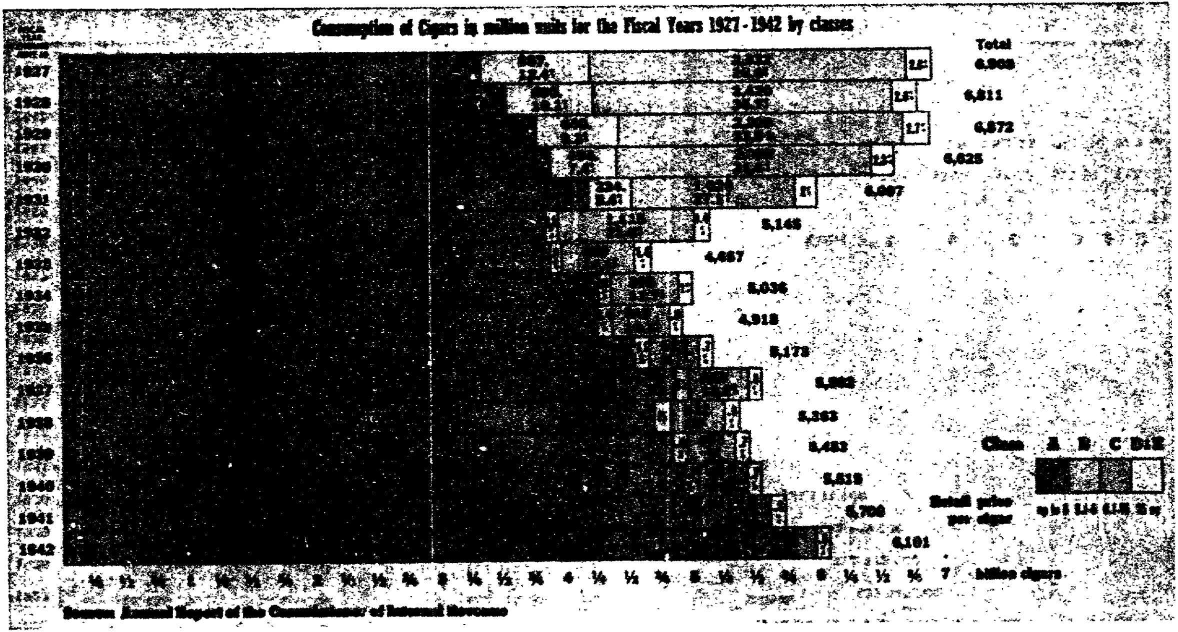

Consumption of Cigars in million units for the Fiscal Years 1927-1942 by classes
Total
6,811
6,872
6,625
4,918
Class A B C D-E
Retail price per cigar
billion cigars
Source: Annual Report of the Commissioner of Internal Revenue

CHART NO. 1.

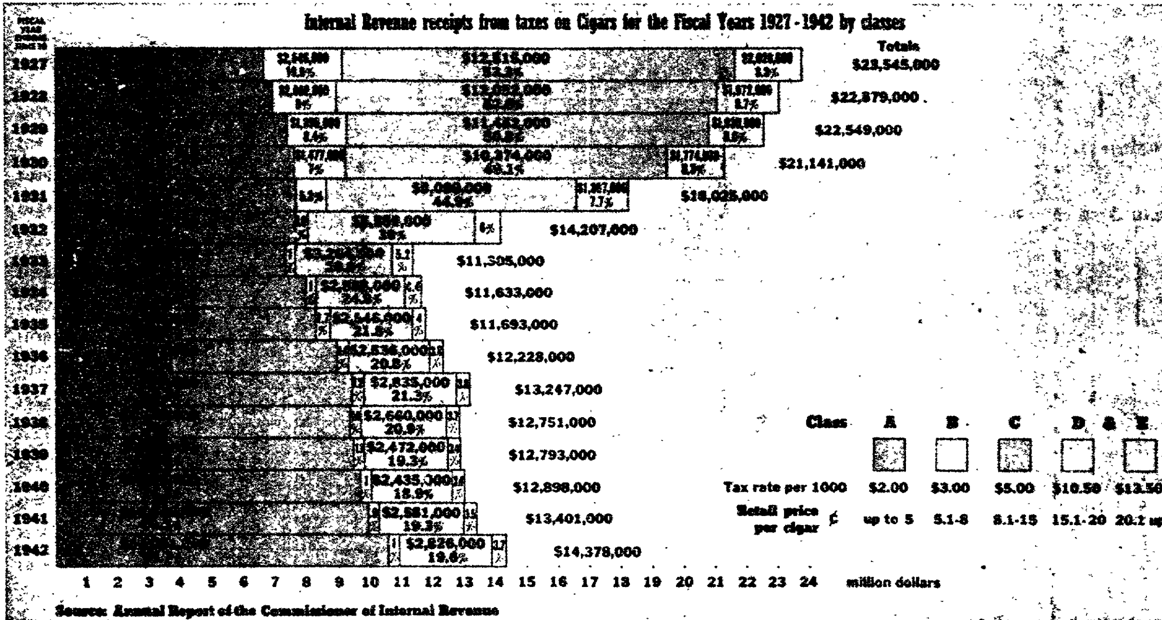

Internal Revenue receipts from taxes on Cigars for the Fiscal Years 1927 - 1942 by classes
Totals
$23,545,000
$22,879,000
$22,549,000
$21,141,000
$18,025,000
$14,207,000
$11,305,000
$11,633,000
$11,693,000
$12,228,000
$13,247,000
$12,751,000
$12,793,000
$12,898,000
$13,401,000
$14,378,000
1927
1941
1942
$2,835,000
21.3%
$2,660,000
20.9%
$2,472,000
19.3%
$2,435,300
18.9%
$2,581,000
19.3%
$2,826,000
19.6%
Class A B C D & E
Tax rate per 1000 $2.00 $3.00 $5.00 $10.50 $13.50
Retail price per cigar ¢ up to 5 5.1-8 8.1-15 15.1-20 20.1 up
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 million dollars
Source: Annual Report of the Commissioner of Internal Revenue

CHART No. 2.

To Senate Finance Committee:

Attached hereto is the petition of companies growing Connecticut Valley cigar leaf tobacco. They are 10 in number and the acreage grown by them is approximately 4,542 acres out of a total of 5,900 acres.

GEORGE F. GERSHEL,
Vice President of the Imperial Agricultural Corporation,
Hartford, Conn.

SENATE FINANCE COMMITTEE,
Washington, D. C.

HONORABLE SIRS: The undersigned are farmers growing Connecticut Valley cigar leaf tobacco. In 1941 this section of the tobacco growing area yielded upward of 20,000 acres, the value of which crop was approximately $15,000,000. This tobacco is used almost entirely for the manufacture of cigars retailing at 5 cents each and over.

We are opposed to the schedule adopted by the House which increases the tax on the present 5-cent cigar from $2 to $5 per thousand, while merely increasing the tax on the 2-for-5-cents cigar from $2 to only $2.50 per thousand.

Such inequality would seriously decrease the demand for cigars now retailing at 5 cents and increase the demand for the 2-for-5-cents cigar. This shift in consumption will leave us with a surplus of tobaccos grown for the 5-cent cigar, which we will be forced to sell for use in 2-for-5-cents cigars at distress prices. This condition will be permanent and in view of the low prices paid for 2-for-5-cents cigar leaf will make it impossible for us to obtain a fair return on our investment and labor.

We are, therefore, opposed to the recommendations of the House and urge instead, adoption of the rates proposed by the Cigar Manufacturers Association of America, Inc., which are as follows:

Class	Retail price	Tax per 1,000 cigars
A	Up to 3.5 cents	$3
B	3.6 to 8 cents	4
C	8.1 to 15 cents	8
D	15.1 cents and over	12

These rates will maintain the competitive balance between the cheap and the more expensive cigar, so that we will be able to continue to sell our products at a reasonable profit, pay fair prices to labor and to our suppliers of materials.

Dated July 30, 1942.

IMPERIAL AGRICULTURAL CORPORATION,
GEORGE F. GERSHEL, *Vice President.*
(And 9 other companies.)

STATEMENT BY OLIVER J. THRALL, PRESIDENT, THE SHADE TOBACCO FARMERS OF THE CONNECTICUT VALLEY, INC., WINDSOR, CONN.

I am a farmer growing Connecticut Valley cigar leaf tobacco and have been for upward of 40 years. I reside in Windsor, Conn., and I am the president of the Shade Tobacco Farmers of the Connecticut Valley, Inc. Our association comprises approximately 30 growers, all of whom, like myself, are engaged in no other business. We own our own land and equipment and depend upon the growing of tobacco as our means of livelihood. Our members collectively operate in Connecticut and Massachusetts with an acreage of approximately 2,750 acres. I should estimate that our product wraps approximately 800,000,000 cigars annually and that is its only use.

We are opposed to the schedule of taxes adopted by the House because that schedule increases the tax on the present 5-cent cigar from $2 to $5 a thousand, while increasing the tax on the 2-for-5-cent cigar from $2 to only $2.50 a thousand.

We are concerned about the House schedule because such an inequitable proposal would force the 5-cent cigar to a higher price and at the same time permit the 2-for-5 cent manufacturer to absorb the tax. Such a situation would inevitably decrease the consumption of 5-cent cigars leaving us with a large surplus of tobacco intended to be used in 5-cent cigars, which we would be compelled to sell at distress prices for its only use would be in the two-for-5 cents cigars. The result would be to drive many of our members out of business.

I believe, as do the other members of the association, that the proposal which the Cigar Manufacturers Association intends to submit to your committee is preferable because it distributes the tax burden equitably among all cigar manufacturers. It does not discriminate in favor of the two-for-5-cent cigar manufacturers to the detriment of the 5-cent cigar manufacturers.

Attached to this statement is a petition signed by substantially all of the members of the association, each of whom have read this statement and support it in every detail.

SENATE FINANCE COMMITTEE,
Washington, D. C.

HONORABLE SIRS: The undersigned are farmers growing Connecticut Valley cigar leaf tobacco. In 1941 this section of the tobacco growing area yielded upward of 20,000 acres, the value of which crop was approximately $15,000,000. This tobacco is used almost entirely for the manufacture of cigars retailing at 5 cents each and over.

We are opposed to the schedule adopted by the House which increases the tax on the present 5-cent cigar from $2 to $5 per thousand, while merely increasing the tax on the two-for-5-cent cigar from $2 to only $2.50 per thousand.

Such inequality would seriously decrease the demand for cigars now retailing at 5 cents and increase the demand for the two-for-5-cent cigar. This shift in consumption will leave us with a surplus of tobaccos grown for the 5-cent cigar, which we will be forced to sell for use in two-for-5-cent cigars at distress prices. This condition will be permanent and in view of the low prices paid for two-for-5-cent cigar leaf will make it impossible for us to obtain a fair return on our investment and labor.

We are therefore opposed to the recommendations of the House and urge instead, adoption of the rates proposed by the Cigar Manufacturers Association of America, Inc., which are as follows:

Class	Retail price	Tax per 1,000 cigars
A	Up to 3.5 cents	$3
B	3.6 to 8 cents	4
C	8.1 to 15 cents	8
D	15.1 cents and over	12

These rates will maintain the competitive balance between the cheap and the more expensive cigar, so that we will be able to continue to sell our products at a reasonable profit, pay fair prices to labor and to our suppliers of materials.

WM. H. DICKINSON,
Hatfield, Mass.
(And 49 others.)

To Senate Finance Committee, Washington, D. C.:

Attached hereto are the petitions of 11 leaf tobacco dealers in and importers of Cuban and Puerto Rican tobacco. These dealers and importers do approximately $10,000,000 business a year and support the proposal of the Cigar Manufacturers Association of America, Inc.

SENATE FINANCE COMMITTEE,
Washington, D. C.

HONORABLE SIRS: The undersigned are leaf tobacco dealers in and importers of Cuban and Puerto Rican tobacco. Our industry serves in the main as middlemen between tobacco growers of Cuba and Puerto Rico and the manufacturers of cigars in continental United States. The undersigned represent in unit volume approximately 50 percent of all such tobacco imported to the United

States from Cuba and a substantial portion of the tobacco imported from Puerto Rico.

Practically all of the tobacco imported from Cuba and Puerto Rico is used in the manufacture of cigars now retailing from 5 cents and up.

The House schedule of taxes on cigars will of necessity decrease the consumer demand for cigars now retailing at 5 cents and up because of its imposition of a disproportionate increase in the tax on such cigars.

Since all of the Cuban and Puerto Rican tobacco which we have on hand was purchased by us for use in 5-cent and higher-priced cigars, we will therefore be forced to sell our tobacco at liquidation prices, and in the future will be unable to pay a fair price to the growers of such tobacco on the islands of Cuba and Puerto Rico.

We are therefore opposed to the recommendation of the House and strenuously urge instead adoption of the rates proposed by the Cigar Manufacturers Association of America, which are as follows:

Class	Retail price	Tax per 1,000 cigars
A	Up to 3.5 cents	$3
B	3.6 to 8 cents	4
C	8.1 to 15 cents	8
D	15.1 cents and over	12

Dated August 1, 1942.

H. DUYS & CO., INC.,
HENRY FISHER,
Assistant Secretary
(And 10 other companies)

To Senate Finance Committee, Washington, D. C.:

Attached hereto are the petitions of 55 representative tobacco farmers of Lancaster County, Pa., who support the revised revenue.

These farmers are growing this year 1,203½ acres. Last year this acreage yielded them a total of approximately $285,750, of which only $14,750 was used in two for 5-cent cigars and $271,000 in 5-cent cigars.

REPRESENTATIVE TOBACCO FARMERS,
LANCASTER COUNTY, PA.

SENATE FINANCE COMMITTEE,
Washington, D. C.

HONORABLE SIRS: The undersigned are farmers growing Pennsylvania cigar leaf tobacco, the acreage of which in 1941 was upward of 35,000 acres. The value of the crop for that year was approximately $7,900,000, of which approximately $7,500,000 was used in the manufacture of cigars retailing at 5 cents each, and $400,000 in the manufacture of cigars retailing at two for 5 cents.

In April 1942 we presented a petition to the Ways and Means Committee of the House of Representatives, objecting to the proposal made by the Secretary of the Treasury for increased cigar taxes. In its place we supported and recommended the adoption of a cigar tax schedule which was submitted by the Cigar Manufacturers Association of America, Inc.

You will find our petition addressed to the Honorable Robert L. Doughton reported in the hearings before the Committee on Ways and Means of the House of Representatives at pages 3280 and 3281. That petition was supported and signed by upward of 4,000 farmers in this area, out of a total of approximately 6,500 farmers. The objection we raised at that time was that if the proposal of the Secretary of the Treasury was adopted a discrimination would result in favor of two for 5-cent cigar manufacturers and against the manufacturers of 5-cent cigars because the increased tax on the 5-cent cigar was $3, an increase of 150 percent while the increased tax on cigars selling at two for 5 cents was 50 cents, or an increase of only 25 percent. That inequality would undoubtedly decrease the demand for cigars retaining at 5 cents because the price of the 5-cent cigar would have to be advanced to the odd-cent, while the two for 5-cent cigar manufacturers could very well absorb the tax. We respectfully refer your committee to that petition, as well as the supporting petitions of the 4,000 farmers mentioned.

The House Ways and Means Committee voted a tax schedule which not only modified the proposal of the Secretary of the Treasury, but also of the Cigar Manufacturers Association of America, Inc. The proposal of the House Ways and Means Committee has since been approved by the House of Representatives. We wish to point out that the vice inherent in the proposal of the Secretary of the Treasury exists as well in the proposal now approved by the House of Representatives because the House Ways and Means Committee's proposal fixes an increased tax of 50 cents a thousand on two for 5 cent cigars and an increase of $3 a thousand on 5 cent cigars.

We farmers cannot raise our tobacco to sell the substantial part of our crop to manufacturers of cigars retailing at two for 5 cents and to whatever extent the sale of 5 cent cigars is affected adversely by the Government's proposal, to that same extent will we, the tobacco farmers in the Pennsylvania area, be similarly affected. We depend entirely upon the income derived from our farms for our livelihood and the growing of tobacco is one of our main sources of income.

The Cigar Manufaturers Association of America, Inc., in an effort to compose the conflicting views of cigar manufacturers in the industry, intend to present a modified proposal to your honorable body. We have seen that new proposal and we believe it to be fair and preferable to the tax schedule approved by the House. The association's tax schedule will place the tax burden more equitably upon all of the cigar manufacturers. It will not single out some for favored treatment. By the adoption of this new Cigar Manufacturers Association of America, Inc., proposal we believe the Lancaster farmers have a better opportunity to sell their crops at prices that will yield them an opportunity to earn a living.

We have not had an opportunity because of the pressure of time to interview as had been done previously the 4,000 farmers and whose signatures were obtained. We are confident, nevertheless, from the views expressed by many that if this petition was submitted to each of these farmers they would be as willing to sign it as they were the previous petition which had been submitted to them.

Because of the pressure upon your time we have refrained from requesting an opportunity to be heard before your honorable committee and we have instead filed this written statement, confident that you will give it your careful

Dated at Lancaster County, Pa., August 6, 1942.

A. R. Wissler

(And 29 other representative Lancaster County Tobacco Farmers).

Senate Finance Committee,

Washington, D. C.

Honorable Sirs: The undersigned are farmers growing Pennsylvania cigar-leaf tobacco, the acreage of which in 1941 was upwards of 35,000 acres. The value of the crop for that year was approximately $7,900,000, of which approximately $7,500,000 was used in the manufacture of cigars retailing at 5 cents each, and $400,000 in the manufacture of cigars retailing at 2 for 5 cents.

In April 1942 we presented a petition to the Ways and Means Committee of the House of Representatives, objecting to the proposal made by the Secretary of the Treasury for increased cigar taxes. In its place we supported and recommended the adoption of a cigar-tax schedule which was submitted by the Cigar Manufacturers Association of America, Inc.

You will find our petition addressed to the Honorable Robert L. Doughton reported in the hearings before the Committee on Ways and Means of the House of Representatives at pages 3280 and 3281. That petition was supported and signed by upwards of 4,000 farmers in this area, out of a total of approximately 6,500 farmers. The objection we raised at that time was that if the proposal of the Secretary of the Treasury was adopted a discrimination would result in favor of 2-for-5-cent cigar manufacturers and against the manufacturers of 5-cent cigars because the increased tax on the 5-cent cigar was $3, an increase of 150 percent, while the increased tax on cigars selling at 2 for 5 cents was 50 cents, or an increase of only 25 percent. That inequality would undoubtedly decrease the demand for cigars retailing at 5 cents because the price of the 5-cent cigar would have to be advanced to the odd-cent, while the 2-for-5-cent cigar manufacturers could very well absorb the tax. We respectfully refer your committee to that petition, as well as the supporting petitions of the 4,000 farmers mentioned.

The House Ways and Means Committee voted a tax schedule which not only modified the proposal of the Secretary of the Treasury, but also of the Cigar Manufacturers Association of America, Inc. The proposal of the House Ways and Means Committee has since been approved by the House of Representatives. We wish to point out that the vice inherent in the proposal of the Secretary of the Treasury exists as well in the proposal now approved by the House of Representatives, because the House Ways and Means Committee's proposal fixes an increased tax of 50 cents a thousand on 2-for-5-cent cigars and an increase of $3 a thousand on 5-cent cigars.

We farmers cannot raise our tobacco to sell the substantial part of our crop to manufacturers of cigars retailing at 2 for 5 cents, and to whatever extent the sale of 5-cent cigars is affected adversely by the Government's proposal, to that same extent will we, the tobacco farmers in the Pennsylvania area, be similarly affected. We depend entirely upon the income derived from our farms for our livelihood, and the growing of tobacco is one of our main sources of income.

The Cigar Manufacturers Association of America, Inc., in an effort to compose the conflicting views of cigar manufacturers in the industry, intend to present a modified proposal to your honorable body. We have seen that new proposal and we believe it to be fair and preferable to the tax schedule approved by the House. The association's tax schedule will place the tax burden more equitably upon all of the cigar manufacturers. It will not single out some for favored treatment. By the adoption of this new Cigar Manufacturers Association of America, Inc., proposal we believe the Lancaster farmers have a better opportunity to sell their crops at prices that will yield them an opportunity to earn a living.

We have not had an opportunity because of the pressure of time to interview, as had been done previously, the 4,000 farmers and whose signatures were obtained. We are confident, nevertheless, from the views expressed by many, that if this petition was submitted to each of these farmers they would be as willing to sign it as they were the previous petition which had been submitted to them.

Because of the pressure upon your time we have refrained from requesting an opportunity to be heard before your honorable committee, and we have instead filed this written statement, confident that you will give it your careful attention.

Dated at Lancaster County, Pa., August 6, 1942.

Harry R. Buneman

(And 24 representative Lancaster County farmers).

Brief Submitted by Eric Calamia, President of Retail Tobacco Dealers of America, Inc., Protesting the Newly Imposed Tax Structure on Cigars as Passed by the House

I am an independent retail tobacconist, having engaged in this business for the past 35 years in New York City. I am also president of Retail Tobacco Dealers of America, Inc., a national trade association representing thousands of small independent tobacco retailers.

This brief is submitted in protest of the schedule of increased excise taxes on cigars as adopted by the House of Representatives which establishes nine different classifications with a graduated tax for each. A careful analysis of it clearly shows it to be comparable to a sales tax of such proportions that it will seriously disrupt the industry, adversely affect consumption, and, I really believe, fail to produce the amount of increased revenue anticipated.

This proposed tax amounts to placing a premium on quality merchandise. The Internal Revenue Department's figures show that whereas 15 years ago, cigars retailing at 10 cents or more constituted 50 percent of cigar production, today they represent but 10 percent of the total volume. Furthermore, the dollar volume of the retail cigar dealer has suffered with the decline in the consumption of better cigars. In other industries where the price of a commodity to the consumer has been reduced by lower production costs, the result has been greatly increased sales volume. The contrary is true in the cigar industry. The figures show a sharp and steady decline in dollar volume as the consumer shifted to cheaper and cheaper merchandise. The tax schedule as adopted by the House further threatens the consumption of higher-priced cigars and experience shows that under it the retailer unfortunately would have no counter balance in volume to compensate for this loss.

No tax, other than the excise tax on cigars, is graduated according to the retail selling price. True, since 1941 there has been a form of ad valorem tax imposed on certain commodities, such as cosmetics, jewelry, and furs, but this is collected at the point of sale and paid for by the consumer, separately. On the other hand, cigar taxes are paid by the manufacturer, added to the cost of the cigar and not recognized or known to the consumer. Hidden taxes resulting in increased prices discourage the consumption of the finer products of our industry and should only be levied with due regard for the law of diminishing returns. The tobacco retailer is dependent upon the sale of the better-priced cigars as is the future of the entire cigar business.

The present plight of the hundreds of thousands of independent retail tobacconists in the Nation is indeed a precarious one. We are fighting for survival against price-cutting practices—against inequitable distribution of scarce merchandise—and now, we are greatly concerned with the manner and the extent to which Congress proposes to levy increased cigar taxes.

We yield to none in our patriotism and in our willingness to support the war effort. If increased taxes must be forthcoming from the cigar industry they should be levied without creating new classifications which would produce chaos in the retail price structure. We know that the survival of the small man in business is essential to the perpetuation of freedom of commerce.

ERIC CALAMIA.

Dated WASHINGTON, D. C., *August 11, 1942.*

MEMORANDUM BY JOSEPH KOLODNY, EXECUTIVE SECRETARY, NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS, ON PROPOSED INCREASES IN CIGAR TAXES

The National Association of Tobacco Distributors, for which I speak, represents the wholesale tobacco trade of the United States. Its membership supplies all tobacco products and kindred lines to approximately 1,000,000 retail tobacco outlets. Our annual aggregate volume reaches the almost atronomical figures of $2,000,000,000.

In this connection, may I interpolate the observation that because of the widespread and efficient methods of tobacco distribution, tobacco, in one form or another, is more easily available to the consuming public and more accessible to it than any other consumer's item.

Last April I had the privilege to appear before the Ways and Means Committee. At that time I pleaded for the exclusion of cigars from any further tax imposts. Our plea was actuated primarily by the reason that the consumption of cigars—except for the last 18 months—had been on a sharp decline during the decade and a half from 1926 to 1940, and that since the industry was in an unhealthy condition it would not have been good economics or good salesmanship to increase its burdens and handicaps.

Even though it seems for the moment to have veered away from the downward spiral, we were certain that the industry was still, metaphorically speaking, an invalid, and that practical business judgment would dictate that it be granted a period of convalescence before being subjected to the inevitable dislocation of a revised tax schedule coupled with heavier taxation.

We believed, and accordingly urged upon the House committee, that it would be good judgment to nurse the industry along in the hope that it again might attain an annual production output of 8,000,000,000 cigars—the production figure of 1920—and that in that reinvigorated state the cigar industry would furnish for the Government a healthy vehicle for the exaction of substantial tax revenue, not merely the additional yield of twelve or thirteen million dollars which is now being sought.

From a hard-headed business standpoint—and considering the longe-range interests of both the Government and the industry—we would be justified by all logic to present an identical plea to your honorable committee. But many far-reaching developments have transpired in recent months and, contrary as it is to the best interests of the industry and the Government, we cannot, at this uncture register any intransigent opposition to an increase in the tax on cigars. Recognizing that the hazards of a severe dislocation of the industry are still inherent in any new tax schedule, we feel that such risks must be assumed so that every available avenue may be tapped to secure adequate revenue to aid in the prosecution of the war.

What then, constitutes a satisfactory formula? Perhaps, to utilize a belabored expression, "There ain't no such animal." Just as it is possible for any industry to make a special case for the exemption of any further levies on its products, so, by the same token, it is concededly possible for a manufacturer of a particular classification or price of cigars to single out his particular brand and argue for its special consideration, but the success of democratic principles requires the discovery of a satisfactory compromise.

A schedule that is conceived in equity ought to prove to a large extent, satisfactory to all the component units of the industry. Obviously, the fears and hysteria which a proposed change in classifications would evoke in any industry are much more acute in an industry which has been the victim of diminishing returns than in an industry whose products have grown and expanded in public acceptance.

Fundamentally, it should be recognized that cigars cannot be placed in the same category as cigarettes, which enjoy a vast public demand and which are dispensed by the retailer almost as easily as the post office sells stamps. Conditions surrounding the merchandising of cigars are totally different. The number of cigars sold is less than 3 percent of the number of cigarettes. Since the volume is not large, and since they require special care and conditioning, cigars demand special attention and merchandising talent on the part of the retailer. Selling at a higher cost per unit and at a slower rate of turn-over, they depend far more on good display and salesmanship than cigarettes, whose sale is virtually automatic. It is absolutely essential to have the full support and cooperation of the retailer.

As distributors of all classes and prices of cigars, transacting business with all manufacturers, we are naturally eager to safeguard and preserve the economic destinies of all of them.

Thus, as distributors, we are exceedingly apprehensive about the schedule included in the new tax bill as approved by the House of Representatives to increase the number of cigar classifications from the present five to nine. We are definitely of the opinion that it would entail not merely a period of reeducation, but an extremely burdensome and perhaps even destructive problem of readjustment, during which not only all manufacturers, but wholesalers and retailers as well, would be subjected to almost intolerable economic stress, and confusion. I am fearful that such a schedule would also cause the loss of interest on the part of the retailer in the sale of cigars.

What is a fair alternative? We have fully analyzed and diagnosed the proposal—before you—of the Cigar Manufacturers' Association.

While, as already stated, it is manifestly impossible to formulate an absolutely fool-proof, faultless plan, it seems to us that this proposed schedule—except for the family squabble pertaining to cigars retailing at two for 5 cents—has given just consideration to all factors comprising the industry and that—subject to a reasonable compromise of the two-for-5-cent issue—it strikes a fair common denominator.

While it will demand marked revamping and readjustment on the part of virtually all manufacturers, that is the consequence of war, and cigar manufacturers, distributors, and retailers cannot escape it. Any proposal must be predicated on the principle that the burdens and handicaps are evenly distributed and no class is discriminated against or put in a more disadvantageous position than the others. In our capacity of impartial distributors of all classes of cigars, we feel that the schedule now offered by the Cigar Manufacturers' Association—except for the foregoing observations—definitely meets these requirements and should be adopted as equitable to the entire cigar industry.

We did not regard in that light the schedule submitted to the House committee by the same association.

We, therefore, urge your honorable committee to accord favorable consideration to the recommendation of the Cigar Manufacturers' Association.

NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS, INC.,
JOSEPH KOLODNY, *Executive Secretary.*

Mr. GARCIA. It has been my privilege, gentlemen, to appear before you in the past on proposed taxation on cigars, on which occasions your decisions have been against further taxation on the cigar industry. You are no doubt aware that in our previous presentations, notably last year and again this year before the Ways and Means Committee, we have expressed a full desire to cooperate with the needs of the Government for revenue, and in spite of our sincere feeling that cigars should not be further taxed, we proposed a base and a rate of taxation which we hoped would be sustained and under which as much or even more revenue would accrue to the Government than it was estimated.

At this time we are confronted with a proposal for taxation on cigars of such a radical nature that we hope that you will recognize it as most unreasonable. We fully realize your tremendous task and the limitations in your time. As I will be probably the only representative for the industry as a whole, my responsibility is a great one, and I hope you will forgive me if I speak very earnestly on this subject and against the proposal of the Ways and Means Committee which so seriously threatens to disrupt our industry and destroy the very objects you seek—revenue for the United States Government.

You cannot, gentlemen, do violence to an industry, weaken it and in certain parts destroy it entirely and still expect it to function and produce revenue.

I respectfully beg to remind you of the present basis of taxation on cigars. These rates are shown on chart No. 2 in the lower right-hand corner, namely, cigars retailing up to and including 5 cents are called class A and are taxed at $2 per thousand. Those retailing at 5.1 to 8 cents are called class B and are taxed at $3 per thousand. Cigars retailing from 8.1 to 15 cents are class C and are taxed at $5 per thousand. Cigars retailing from 15.1 to 20 cents are called class D and are taxed $10.50 per thousand, and from 20.1 cents up they are taxed at $13.50 per thousand as class E.

Senator LA FOLLETTE. Those are the present rates?

Mr. GARCIA. Those are the present rates.

This classification basis on the retail selling price is tax-paid at the factory and made a part of the cost of manufacture. This basis on taxation has been in force since 1917, prior to which time there was a uniform straight rate of $3 per thousand on cigars weighing over 3 pounds per thousand. The present rates on this basis have been in effect since March 1926.

If you have heard, and no doubt many of your have, of the differences in opinions as to what the tax should or should not be on cigars, is it at all surprising when you consider the number of classifications into which one industry has been split? I desire at the same time to make it clear that we speak for a majority not only of the industry as a whole but of every class within the industry. We doubt that there is more than one cigar manufacturer in the whole industry who favors the Treasury Department's proposal. Practically the entire industry unanimously oppose that proposal.

Now, if you will be good enough to refer to chart No. 1, showing the volume of consumption of cigars, starting with class A, cigars retailing up to 5 cents, you will note the total number of cigars produced in 1927, namely, 6,908,000,000, and note that the quantity of the class A 5-cent cigars in percentage is 48.4 percent of the total cigars in 1927 which were 5 cents.

Now, note the figure for the fiscal year ending June 30, 1942, on this same class A, 5-cent cigars, an increase of over 2,000,000,000 and representing at the present time 89.2 percent of the total consumption of cigars. All these cigars in class A have paid the same tax, $2 a thousand, regardless of whether they sold for 5 cents, 4 cents, 2 for 5 cents, or even less.

Within this class A there has been a steady history of a steady tendency year by year toward consumption of cigars of less than 5 cents, and predominantly in cigars retailing at two for 5 cents, until today almost 50 percent of all the class A cigars which are taxed at $2 a thousand are made to sell at retail for two for 5 cents. Actually, the traditional 5-cent cigar has dropped materially in consumption during these past 15 years.

Now, the Treasury Department proposes to divide this class A into three classifications instead of one. You will note under the proposal which is in the brief on page 13, that cigars retailing up to and including two for 5 cents would be taxed at $2.50 per thousand, representing an increase of 50 cents per thousand.

Senator DAVIS. We are interested in those 2-for-5-cent cigars in Pennsylvania, and I wonder what the attitude of the manufacturers would be on the 2-for-5-cent cigars in Pennsylvania; what effect would it have upon them?

Mr. GARCIA. May I answer that later?

Senator DAVIS. Certainly.

Mr. GARCIA. I have tried to cover that in the presentation, but I would be pleased to answer you now if you wish.

Senator DAVIS. Never mind.

Mr. GARCIA. Another class, from two for 5 cents to 4 cents would be taxed at $3.50 per thousand, an increase of $1.50 per thousand. Those from 4 to 6 cents to be taxed at $5 per thousand, an increase of $3 per thousand.

This is proposed on the production of a class of cigars which for years has been taxed at one basic rate of $2 per thousand.

Can anyone fail to recognize the serious danger which threatens to drive the production and consumption of cigars to price levels which must lessen the revenue to the Government, because of discrimination and maladjustment within the industry, and to its labor and to the tobacco grower?

The Government wants money and the cigar industry is your agency for the collection of that revenue, but in the final analysis it is the consumer who pays, based on his voluntary decision and ability to spend.

This proposal of the Treasury Department is objected to as being taxation used as a vehicle for regimenting changes within the industry, disrupting existing practices and relationships, and with the Government the ultimate sufferer.

Please note also on chart I, consumption of cigars—and this is very important: In spite of the steady trend during the past 15 years toward cheap cigars at the lowest revenue producing brackets, there has nevertheless been a steady decline in the total cigar consumption. The last year and a half has shown a slight increase but very small. In other industries, cheaper production methods and lower consumer costs have most generally resulted in marked increases in consumer acceptance. This has not been the case in the cigar industry. In spite of offerings of sizes, prices and quality unequalled in the history of cigars. If the per capita consumption of cigars had maintained itself on a par with the consumption at its peak back in 1920, there would have been produced last year in this country 14,000,000,000 cigars as against 6,000,000,000 which were actually produced.

I trust, gentlemen, that you will understand that there is no intent to depreciate the value of 2-for-5-cent cigars or any other type. Each is very valuable and each must be fostered to the same degree. There cannot be any discrimination either in favor of 5-cent cigars or in favor of cigars produced at lesser prices or at greater prices.

From the standpoint of revenue, however, this class A, the 5-cent and 2-for-5-cent cigars must be given the most careful study. It is in this production—over 5,500,000,000 cigars out of a total of 6,000,000,000—from which the revenue must be obtained. Destroy that and you destroy the revenue. Anyone who believes that the required and necessary additional revenue will be obtained from the small 10 percent remaining, about 500,000,000 cigars in all, of the other classes, certainly does not know his cigar-smoking public.

The next classification is class B, also on chart 1. I am sorry to have to go over all of these various classes, but that is the burden that we have been carrying, and we believe it is very essential to explain it and show the proposed taxation and its results.

The next classification, class B, cigars selling at from 5.1 cents to 8 cents, and on which the present tax is $3 per thousand. On chart No. 1, you will note how this class has practically disappeared from a total in 1927 of 12.4 percent of the total consumption to 0.8 of 1 percent of the total in the last fiscal year.

The proposed new tax for this class of cigars is under a new class called D at $7 a thousand, and representing an increase of $4 a thousand. The reasons for the disappearance of this present class B may be found in the absorption of class A in the trend toward cheaper cigars. History might very well repeat itself in the same disappearance of the present 5-cent cigars which the proposal sets up as class C.

We now come to the very important class, namely, class C, cigars manufactured to retail from 8.1 to 15 cents, and on which the present tax is $5 per thousand. Notice on chart 1, consumption of cigars, how this consumption has gradually dropped away continuously from 1927 to the present time. In 1927, of the total cigars, 36.6 percent were consumed as compared with the last fiscal year of 9.2 percent, a drop from 2,500,000,000 cigars sold at 10 cents and up to less than 500,000,000 in 15 years.

Allow us to couple this class C with the revenue history as shown on chart No. 2. In 1927, the total tax paid was $12,515,000 on the 10-cent and up cigars, representing 53 percent of the total tax collected. For the last fiscal year ending June 30, 1942, the tax collected on class C was $2,826,000, or 19 percent of the total.

The new tax proposal on this present class C recommends that this class be split up into two new classes, namely, a new class E for cigars retailing from 8.1 to 11 cents to be taxed at $10 a thousand, representing an increase of $5 per thousand, and another new class F for cigars retailing at from 11.1 to 15 cents to be taxed at $13.50 per thousand, an increase of $8.50 per thousand.

To complete the picture, the remaining present classes are our present D cigars retailing at 15.1 up to 20 cents, on which the new tax proposal is $18 per thousand, representing an increase of $7.50, and which are to be classed as G. Our present class E, cigars retailing from 20.1 up, it is proposed to tax $25 a thousand, representing an increase of $11.50, and to be known as class H.

Then, under the Treasury proposal, an entirely new class is created for all cigars retailing at 30.1 up, which is to be taxed at $35 per thousand, which would be an increase of $21.50 per thousand.

The charts for both consumption and revenue, Nos. 1 and 2, present the picture of exactly what has happened during the past 15 years, both in the production of the factories and the revenue to the Government on cigars retailing above 15 cents. Please note the discrimination represented in the percentage of rates of tax increase which are proposed on each class of cigars. The roposed percentage of increases are: On the 2-for-5-cent cigars, 25 percent; on cigars up to 4 cents, the proposal is 75 percent increase; on the 5-cent cigars, the proposal is 150 percent increase; on the 6- to 8-cent cigars, 133 percent increase; on the 8- to 11-cent cigars, 100 percent; from 11- to 15-cent cigars, 175 percent; on 15-cent to 20-cent cigars, 71 percent; on the 20-cent to 30-cent cigars, 85 percent, and on the 30-cent cigars and up, 160 percent.

Does it seem reasonable to double and more than double taxes on classes of cigars which are threatened with extinction under the present basis of taxation? How can there be any doubt that this small remaining volume of 10 percent of cigar consumption which remains in the 10-cent up is seriously threatened toward further decline under the increased taxes as are proposed?

If the cigar industry, gentlemen, is entitled to a place in the economic structure of the country, and we think it is, and if the Government expects it to contribute revenue, the satisfaction and the appetite for cigar smoking must be maintained and catered to by the production of cigars of quality in all prices. The Government and the cigar industry have spent millons of dollars toward that end, and particularly on the farmers. Whatever barriers are placed in the path, whether they be in the form of taxes or any other form, must result in injury to the industry and in attendant loss to the Government.

The class C cigars at prices from 10 cents and up play an important part in maintaining tone and quality and smoking satisfactoion not only in their own price brackets but likewise on the classes below them. To further alienate these high grade cigars is to further weaken the very backbone of the industry. It is in these classes that import duties are paid; it is in these classes that the top-grade qualities of domestic tobaccos are used and which market the farmer must have in order to supply the lower-grade leaf types commensurate with the requirements of the manufacturers of cheap cigars. The high-grade manufacturer, the 5-cent manufacturer, and the two-for-5 manufacturer each bear a balanced relation to the farm prices. It is the statement of the farmer that it is not possible to raise tobacco for two-for-5-cent cigars only. It is in these high-grade cigars, 10 cents and up, where are employed by far the greatest number of cigarmakers on hand workmanship, the continued employment of which must depend on all these considerations. They can only survive and prosper as their principal branch of the industry is allowed to prosper.

We consider, gentlemen, that the proposal of the Government for taxation on these high-grade cigars is one of the most serious threats which we have ever been confronted with, discriminatory to the manufacturers, to the workers, to the farmers. The proposal of the Government for increased taxes does great potential injury to Cuba.

First, it most adversely affects the consumption of cigars made in Cuba, and for which the United States is just about its only remaining customer. Just as the proposed taxes will do great injury to our domestic high-grade manufacturer, so will it affect the cigars imported from Cuba, and on which, as you know, there is already an import duty. Just as our American farmer must be adversely affected in any further impetus towards cheaper cigars, so will it affect the second largest industry of Cuba, Havana tobacco imported into the United States for the manufacture of our high-grade cigars; and, as you well know, considerably into the 5-cent cigars.

In like manner, as we object to the proposed basis of taxation on the cigars in class A, so do we most strenuously oppose the basis proposed for the present classes, C, D, and E. The proposal for these classes is discriminatory, will disrupt this branch of the industry, and will destroy the source of revenue to the Government.

As we understand, the present proposed revenue bill for war purposes, this is the bill to obtain revenue for war purposes. It is not intended as legislation to accomplish radical changes within any industry. We have put ourselves on record, much as we feel that our industry should not be taxed at all, that we are prepared to do our share in adding revenue to the Government, and, conditions permitting, perhaps more than they ask for. The proposals of the Government for radical changes in the basis of the taxation are all the more deplorable because it is the only commodity that we know of that is treated in this matter. All other excise taxed articles, such as beer, whisky, liquors of all kinds, wines, playing cards, and other items are all taxed per unit regardless of the retail selling price. A quart of the cheapest liquor pays the same tax as the most expensive. Even in the tobacco industry there is no such type of taxation under which cigars have been burdened these many years, and which the Government now proposes to doubly increase that burden. Cigarettes—one tax per thousand. Smoking tobaccos—so much per pound. Snuff and chewing tobaccos, all are taxed without regard to classifications into the retail selling prices.

Some articles carry excise taxes collected at the retail sale point, such as cosmetics, jewelry, furs, and so forth, which of course is a quite different story from hiding them as part of a manufacturer's cost, and of which the consumer is utterly unaware. Why should the cigar industry be singled out for this type of taxation? Isn't that in itself discrimination to an industry, or is it possible that all of the bases of excise taxation in all the other industries are all wrong?

Many in our industry feel that in this type of taxation may be found most of the reasons for the history of declining consumption and the declining revenue and steady trend toward cheaper cigars. Some advocate that all classes should be eradicated; others feel that this is not a propitious time.

As I have stated at the beginning of my statement, no industry which is not healthy or which is house divided can be expected to render proper service, whether to the Government, the consumer, or to itself in all of its component parts. The history of cigars is one of a declining industry, only just recently showing a spark of revival. The statistics that you have before you in the charts speak for themselves in the portrayals of the declines in cigar consumption and revenue in numbers of manufacturers, in numbers of employees, and the value of material consumed. The revenue now accruing to the United States Government is several million dollars more than the total net profits of the industry.

In summary, if this proposed basis of taxation on cigars and proposed rates were approved, first, the cigar industry in all of its branches would be disrupted and weakened; second, it would represent a discrimination against the cigar industry; third, it would establish discrimination within the industry, class by class; fourth, it would nullify the reciprocal benefits of our trade agreements in imports; fifth, it would react to the detriment of the workers, the tobacco growers, and the retailers of cigars; sixth, it will not obtain for the Government the additional revenue which it seeks.

The cigar manufacturers strenuously object to the acceptance of the proposed tax on cigars. In its stead we present to you a simplified basis of only four classifications, which we believe will be fair to all branches of the industry. You will find our proposal on page 12 of the brief.

Senator La Follette. You divide it into four classifications?

Mr. Garcia. That is correct, sir. It is our hope that you will see the wisdom of simplification in the classification of cigars, getting away from the discriminations which have worked havoc in the industry on the present classification and which, under the proposed schedule, would be intensified.

I thank you very much.

Senator Taft. But you discriminate also between the 2½- and 5-cent cigars? You make a dollar difference in your schedule? You make a distinction between the two-for-5 and the 5-cent cigars which has not existed before?

Mr. Garcia. Yes; we have established a differential in that particular class. There are many reasons for that.

Senator Taft. You are willing to make the 5-cent cigar tax heavier than the two-for-5?

Mr. Garcia. Yes; the industry seems prepared to make that change in the present classification.

Senator Taft. If you move the $3 and $4 up to $3.50 and $4.50, you get almost exactly the Treasury figure, according to your claim?

Mr. Garcia. That is correct.

Senator Taft. Would that make a great difference to you?

Mr. Garcia. It would under present conditions. Of course, it is very difficult to evaluate what tomorrow might bring forth. Farm prices are not ceilinged. Tobacco from Cuba, for instance, I don't need to tell you gentlemen what rates must be paid to bring tobacco from Cuba. And with manufacturing costs, labor, prices for domestic tobacco to the farmer, and so forth, it would seem advisable to keep the tax as low as possible in order to obtain a maximum amount of revenue.

Senator La Follette. Did I understand you to say that you are authorized to represent a majority of the manufacturers?

Mr. Garcia. Yes, sir, that is correct.

Senator La Follette. Of all types of cigars?

Mr. Garcia. Of all types of cigars.

Senator Guffey. Does that include manufacture of cigars in Lancaster and York Counties, Pa., where they make the great bulk of the two-for-a-nickel cigars?

Mr. Garcia. They might not be members of our association; they might be members who have different views, but we are prepared to show that the total production which we represent is as stated, 85 percent. Now, those manufacturers that you mention might be included in the 15 percent.

The Chairman. Any other questions?

Senator Davis. I would like to ask a question here. The two-for-5 cigars, do they pay less taxes than the 5-cent cigar?

Mr. Garcia. Now?

Senator Davis. Yes.

Mr. Garcia. No.

Senator Davis. What does this change in the tax program mean on the two-for-5 cigars?

Mr. Garcia. The change means this, that the two-for-5 manufacturers cannot produce two-for-5-cent cigars with conditions as they are, tax or no tax. That might be excepted to by one firm in the United States, but I don't think I am wrong when I state that no manufacturer can make two-for-5 cigars in this country.

Senator Davis. What effect will this have on the farmer, I mean the farmer up in Lancaster and York Counties, and other farmers as far as that is concerned, on this two-for-5-cent cigar or 5-cent cigar? Will they get a reasonable price for it?

Mr. Garcia. It is to be presumed that any further taxes on the cigar industry must be reflected in the higher prices of the cigars themselves, and the farmers would get more and the laborer would get more.

Senator Davis. What did the farmer get last year in Pennsylvania for his crop, for the two-for-5-cent cigar and the 5-cent cigar?

Mr. Garcia. I am not an authority on Pennsylvania tobacco, but I am given to understand that the two-for-5 manufacturer pays about 5 cents a pound for the tobacco in that area, and on the 5-cent cigars, the price is around 15 cents per pound.

Senator Davis. In Pennsylvania, we believe there is nothing better than two good cigars for a nickel.

Mr. Garcia. It is a question whether under conditions now they should try to continue to produce them for two for a nickel.

Senator Davis. What will be the manufacturers' attitude on that toward this increase in the tax; that is, those who make the two-for-5-cent cigar?

Mr. Garcia. It is my understanding that they are predominantly in favor of the proposal that we make on the two-for-5 cigars. That is my understanding.

Senator Davis. That is the proposal you have submitted?

Mr. Garcia. That is correct.

Senator Davis. Not the one that is now in the tax bill?

Mr. Garcia. No, sir. The reason for that is that there is just one firm who would probably absorb that 50 cents per thousand. The reasons for it, he knows himself. He may have raw materials on hand to last him, or any number of reasons. One concern producing not more than 25 percent of the total two-for-5 production—one concern.

Senator DAVIS. I am told that some of them are thinking that the tobacco growers, with the price they are now receiving without this tax, of attaching a little factory at the back of the farm and making their own cigars.

Mr. GARCIA. The two-for-5 cigars should go for three for 10 in order to provide the increased costs which have come to us all—more for the tobacco, the farmer, and the laborer in the factory.

The CHAIRMAN. Thank you, Mr. Garcia.

Senator Pepper.

STATEMENT OF HON. CLAUDE PEPPER, A UNITED STATES SENATOR FROM THE STATE OF FLORIDA

Senator PEPPER. Mr. Chairman and gentlemen of the committee, I appear here today due to the fact that Senator Whitaker, who was to represent the cigar industry in Florida, and particularly that part of it which is centered in Tampa, was suddenly called back to Florida; and I received a telegram from the president of the Hav-A-Tampa Cigar Co., which is the second largest manufacturer of the class A cigar, the two-for-5 and the 5-cent cigar, as follows:

> I am disturbed in that Pat was forced to leave Washington. I know he has gone thoroughly into this whole situation with you and that, therefore, you realize fully how much it means to me. Under these circumstances may I depend on you to do your very best to enable me to continue in my best efforts to afford employment to worthy and loyal employees and to maintain a business that will enable me to produce revenue to the maximum? I subscribe wholeheartedly to a tax program that will bring forth every cent that an individual, a corporation, or a business can possibly pay as we must have just this to defend that which you and I stand for and to give posterity a reasonable chance, but I am concerned that those who would do just this for us would because of lack of information, destroy the revenues that we need so badly. I realize that this could be construed as a selfish statement but I pledge my reputation on the sincerity of this appeal.

It is signed "Eli Witt."

Now, Mr. Chairman and members of the committee, in Florida we produce almost exclusively the two-for-5 and the 5-cent cigar. The tobacco for those cigars is purchased in the great many States of the Union, Pennsylvania, Ohio, Connecticut, Wisconsin, Georgia, and certain other States. The revenue tax in 1926 imposed on the class A cigar was $2 per thousand. At that time the class A cigars were about 46 percent of the total number produced. That category has increased in proportion to the total production until today the figures I have are that they constitute 91 percent of the total production of cigars in the United States.

At that time the margin of profit was, I imagine, not enormous or not exorbitant, and upon that particular type of cigar. Had it been so, I assume the Treasury would not have made certain reductions which they made at that time. Since that time, that part of the industry engaged in the manufacture of that type of cigar has continually absorbed an increasing cost very steadily growing from year to year until it has reached the point where they cannot absorb any further increased cost unless they increase the price of the commodity, and due to the peculiar character of these cigars, the two-for-5 or the 5-cent cigar, which have an advertised name and which are known to the public, and due to certain established smoking habits, if they ever increase the price they destroy the character of their product and the sales begin to diminish instead of to increase, and therefore the revenue to the Government is less instead of more; in other words, you begin to feel the effects of the law of diminishing returns.

This one company in 1937 paid in social-security taxes $24,000; in Federal income taxes, $64,000; for import duty, $28,000; in revenue stamps, $256,000. That made total payments in those four categories of taxes in the fiscal year 1937 of $375,090.68.

In the year 1941, that company paid for social-security taxes $44,000; Federal income taxes, $128,035 instead of $64,000 as in 1937; import duty, $55,000; revenue stamps, $377,409 as compared to $256,-697 in 1937; or total payments in 1941 of $606,035.75. And they paid these increased taxes without increasing a single mill in the selling price of their commodity. Either the manufacturer had to absorb that continually increasing tax, or the retailer had to increase it—one way or the other.

I made a little compilation from some information I got from the Treasury, to this effect: The class A cigar, which is the 5-cent cigar and the two-for-5, in 1941 consisted of a production of 4,929,-000,000. The total production of all cigars in 1941 was 5,528,000,000. You will see that is 49 to 55 in volume or in numbers. In revenue, the revenue derived from the class A was $10,219,000, whereas the total revenue derived from all cigars by the Federal Government was $13,400,000. So 10 as to 13, I believe, gives about 80 percent of the total Federal revenue derived from this particular category of cigars.

These figures indicate certain peculiar smoking habits established on the part of the public with respect to cigars.

In class B, which was the 5- to 8-cent retail seller, there were only 43,000,000 cigars produced in 1941.

In the class C, the 8- to 15-cent seller, there were 513,000,000.

In the class D, the 15- to 20-cent seller, 39,000,000.

In the class E, above the 20-cent seller, 4,800,000.

That indicates a rather peculiar thing, that the volume of the smoking of cigars is in the 5- or two-for-5-cent category, or in the 8-to-15 cent category, indicating that if a fellow wants better than a two for a nickel or a nickel cigar, that he goes up to one that sells between 8 and 15 cents. He either gets what might be called a cheap cigar, "a poor man's cigar," or he buys what is called a good average cigar from 8 to 15 cents.

Now, here is an interesting indication of how this proposed tax would work out. At the present time the class A cigar bears a tax of $2 per thousand. They propose to increase the two-for-a-nickel cigar which now bears a tax of $2 per thousand to $2.50 per thousand. The effect of that would be to raise the tax on the individual two-for-a-nickel cigar from 2 to 2½ mills. This manufacturer that I am primarily speaking for here this afternoon, because he is typical of that part of the industry which is located at Tampa, manufactures slightly over 100,000,000 cigars a year. That would mean that if this tax were imposed upon this manufacturer, that there would be added to his income tax with respect to this peculiar category of cigars, the two-for-a-nickel,

$50,000. His tax payment for Federal income-tax purposes in 1937 on his whole business was $64,000, and in 1941 was $128,000. If you add $50,000 to that, you increase by nearly 50 percent the burden of his income tax, aside from the fact that this bill carries, of course, the normal increase on the net income of this corporation.

That is due, of course, to the limitation of this manufacturer passing on this tax due to the peculiar nature of this product, to the consuming public. I have estimated that this company produced about a quarter as many nickel cigars as they did two-for-a-nickel. If that is true, then upon the calculation that I have given, there would be an additional tax of about $12,500 for this company, which would make on his normal business an increase in his income tax of about $62,500. That is an extra that is to be imposed upon that corporation in addition to the taxes it would pay if it were engaged in the grocery business or any other business and paying on its net income upon which, of course, everybody has to pay.

Here is the way it affects the individual manufacturer or retailer. As I said, the class A cigar now bearing a tax of $2 per thousand pays 2 mills tax on each cigar. That would be increased by this proposed tax increase to $2.50 per thousand, a half a mill. How is the manufacturer going to pass that half a mill tax on to the purchaser? The Office of Price Administration has established a ceiling upon cigars, and they provide that that ceiling can be exceeded only in the event that the tax is distinctly added to the purchase price and so indicated. When you have got a half a mill increase, you cannot charge the purchaser an additional 9-mill increase without violating the law and without imposing upon the purchaser. And yet if you cannot add it on to the purchaser, obviously it has got to be absorbed by either the retailer or the manufacturer, and we all know that the margin of profit of the retailer has always been very small.

Look what happens to the nickel cigar, according to the same calculation. It is now paying the same tax as the two-for-a-nickel, that is, $2 per thousand. It is paying a tax of 2 mills upon each individual cigar. This proposal is a tax of $5 per thousand upon the nickel cigar, which means 5 mills tax for each individual cigar, which means two and one-half times the tax it is now paying, 5 as to 2, and that means, therefore, that the tax on that cigar—that is a 3-mill increase upon the nickel cigar. How is the manufacturer or the retailer going to pass those 3 mills on? It is 3 mills, and therefore not half of 1 cent, but under the Office of Price Administration regulations, he cannot add a cent on, and you cannot divide a cent up into mills to the individual purchaser, and it means therefore again that the retailer or the manufacturer in this case has to absorb that additional tax.

Senator JOHNSON. His income tax will be smaller, though.

Senator PEPPER. You mean that he will make less?

Senator JOHNSON. Yes.

Senator PEPPER. But it would be a little unfair to reduce it in that way, Senator. As a matter of fact, that is just exactly what the manufacturer is afraid of—his income tax will be smaller because his income will be smaller; but the point is, instead of subjecting his income to the same tax paid by the other businessman who makes the same profit as he does, he is being subjected to an additional burden because he deals in this commodity.

Senator La Follette. What are you advocating, Senator?

Senator Pepper. I am advocating, and I am speaking only for the class A cigar as now classified, that that peculiar type of cigar cannot have any additional tax burden added to it under the existing circumstances and smoking habits without the Government reaching a point of diminishing returns in revenue.

Senator La Follette. Would you advocate the continuation of the existing rate?

Senator Pepper. The continuation of the existing rate of $2 per thousand.

Senator Vandenberg. And you don't want to have a different classification? You don't want to open a "second front" in that category of cigars?

Senator Pepper. That is the way we have been operating for years, and that is the only way the figures are available at the present time.

Now, Mr. Chairman, it is obvious that one of the additional burdens that has had to be borne by this industry is, of course, the increase in wages, and I have here before me a clipping from a Tampa newspaper where, I think justly, the Wage and Hour Administration has just recently added to the minimum wage a minimum of 10 cents an hour, from 30 cents up to 40 cents an hour. Of course, other costs comparable to that are constantly being added on.

I have before me a letter from a manufacturer in Baltimore, Md., whom I do not know, but it came to me unsolicited. He refers to the proposed tax in this bill. He speaks of the proposal of the Cigar Manufacturers Association, to which he does not subscribe, and neither do the Florida cigar manufacturers. And Mr. Garcia may be speaking quite properly for certain other parts of it, but he certainly does not speak for this part of the industry in Florida.

This writer says:

> Ever since the inception of the cigar industry, the manufacturers of the two-for-5-cent cigars have been unjustly discriminated against. The tax on the two-for-5-cent cigars has always been the same as for the 5-cent cigars, whereas the tax on the 5-cent cigars has always been approximately one-half the tax on the 10-cent cigars. In framing this present bill, the Treasury Department recognizes this discrimination.

So he points out that he, too, is up against the same dilemma of being unable to absorb any additional tax with respect to this industry, peculiarly characterized as it is.

The cigar industry in Tampa, which has been the chief industry there for a good long while, has steadily been diminishing in strength and in value, as the cigar industry in the Nation as a whole has been, of course. Although we have been increasing the number of cigars produced in the United States since 1938, the quantity produced is still 2,000,000,000 below what it was in 1938. In Tampa, there used to be 13,500 people employed in the cigar industry. That number is now down to 8,000, even under present conditions. It was the one city in Florida that was losing population until the defense establishments that now exist there were established there. It was the one city in Florida, which, according to the figures of the Federal Housing Administration, has the most empty houses in it and the lowest rental rate, due to the decadence of the cigar industry in that area, because the industry had migrated over from Cuba and from Key West and had centered there and had become the chief industry of that city and section, and due to the fate that was generally overcoming the cigar industry, a part of which has been related here, it has been a decadent industry, and it is respectfully submitted that in respect to this particular type of cigar, it has reached the point where there will be a diminishing return if the tax on this particular commodity is increased.

I thank the committee for the time it has given me.

May I offer this brief to be put in at the end of my remarks?

The CHAIRMAN. Yes.

(The brief submitted by Senator Pepper is as follows:)

FACTS SHOWING AND DEMONSTRATING REVENUE REVISION BILL NOW PENDING IN THE HOUSE OF REPRESENTATIVES WILL UTTERLY DESTROY AND ELIMINATE TWO-FOR-5-CENT AND 5-CENT CIGARS; AND INSTEAD OF INCREASING REVENUE WILL IN FACT RESULT IN DECREASE BY ELIMINATING TWO-FOR-5-CENT AND 5-CENT CIGARS WHICH CONSTITUTE 91 PERCENT OF ALL CIGARS MANUFACTURED AND CONSUMED

HISTORY OF CIGAR TAX

The classifications of United States internal revenue stamps for cigars and the rates of tax to be paid thereunder bear a substantial relationship to the intended retail prices of cigars within the several classes. In dividing cigars into classifications for tax purposes, Congress surely intended that the stamp tax should apply to cigars in a degree, or manner, which would take into consideration the intended retail prices thereof. Cigars coming within the classification A are described as those which are manufactured or imported to retail at not more than 5 cents each. The tax on cigars in such class is $2 per thousand, as provided by the Revenue Act of 1926. The statistics of the Bureau of Internal Revenue will show that the trend for many years in cigar consumption has been and is toward cigars in class A and away from those in the other classes, and it is hardly possible that the consumers will soon return to the other classes of cigars to any appreciable extent. In fact, this is the workingman's or poor man's cigar. The official records show that 91 percent of all cigars which are being manufactured and consumed in the United States at the present time are class A cigars and this has been the approximate ratio for several years.

At the time the $2 tax was fixed in 1926 the margin of profit on class A cigars was small. Since 1926, and particularly within recent years, there have been new and increased impositions and taxes and other incidental burdens, Federal and State, placed upon the cigar manufacturers which have practically eliminated the small margin of profit that existed on this class of cigars. As an illustration, we will list two or three tax items which the Havatampa Cigar Co., Tampa, Fla., which manufactures class A cigars, has had to pay since 1926:

1937:	
Social security (new, since 1928)	$24, 970. 80
Federal income	64, 954. 95
Import duty	28, 467. 82
Revenue stamps	256, 697. 11
Total	375, 090. 68
1941:	
Social security	44, 344. 34
Federal income	128, 635. 33
Import duty	55, 646. 35
Revenue stamps	377, 409. 73
Total	606, 035. 75

The various State licenses, ad valorem, personal property, intangible, documentary stamp, and other State, county, and city taxes have likewise greatly increased.

The production of tobacco in the United States is largely regulated and controlled by Federal agencies, and this, of course, results in curtailment of crops and increased prices to be paid by the cigar manufacturers. Transportation costs on both raw materials and finished products have greatly increased by reason of the authorized increases in freight rates. Other commodities entering into the cost of cigar production have liksewise reflected an increase. All legislation in recent years which in any way affected labor, has resulted in increases in the cost of production. All of these increases, together with selling expenses, which have also increased, have been additional costs of production and have been absorbed by the manufacturer since the year 1926, and are now being so absorbed. Taxes, prior to the year 1926, which, within themselves, were sufficiently burdensome upon the "poor man's smoke," have been augmented by new and additional taxes, which have become almost confiscatory in their nature.

It must be borne in mind that at the time the present tax of $2 per thousand was levied on class A cigars in 1926, this class of cigars bore a ratio of only 46.09 percent to the total amount of cigars manufactured and consumed in the United States. While today, and for the past several years, it has been increased until class A cigars bear the ratio of 91 percent to the total amount of cigars manufactured and consumed in the United States. So it is clear that for the cigar industry to survive at all, it must be enabled to make some reasonable profit out of this class of cigars, because the industry can only make a profit out of cigars which the public consume. On account of these additional and increased burdens which have been placed upon the cigar industry since 1926, at which time this tax was fixed at $2, it has become practically impossible for the manufacturer to realize any profit on 2-for-5 and 5-cent cigars. As a result, we point as an illustration to the local condition in Tampa. The cigar manufacturer and particularly the small manufacturer who employed from 100 to 300 employees has gradually been squeezed out of existence in large numbers. Within recent years in Tampa 17 factories have closed or consolidated; and of 13,500 persons normally employed in the cigar industry in Tampa, there are only employed at the present time approximately 8,000, which has resulted in throwing out of employment 5,500 persons. While this condition referred to is local to Tampa, it is, in fact, the same story nationally. Every-fair minded person must admit that this condition is so acute that it calls for relief instead of increased burdens which the industry cannot bear.

Most class A cigars are made practically entirely out of domestically produced tobaccos. Therefore the elimination of this class of cigars by the passage of present revenue revision bill pending in the House of Representatives in its present form will have a devastating effect upon the farmer who produces the tobacco and the labor employed by him; as well as a devastating effect upon the manufacturer and the labor employed by him, the jobber and his employees, the retailer and the labor he employs. Upon the passage of this House bill and its enactment into law, the manufacturer will be unable to pay the farmer—producer—a reasonable price for his tobacco that goes into the manufacture of these cigars; in fact he will be unable to continue in business at all without a direct subsidy from the Government.

LESS REVENUE FOR GOVERNMENT

As the chairman of the Ways and Means Committee of the House stated during the hearings conducted by that Committee on this question, the prime object is to find more revenue. All-out war is costly—and the American people know they must pay and pay until it hurts. But we also know, no matter how much we pay, we can't run this war on "pay-as-you-go" basis. Our belts and our children's belts will be tightened for generations to pay the necessary bill for the salvation of our national existence. And we agree that we should and must pay as much as we can now. The piddling $13,000,000 raised on cigar stamps is not momentous in meeting annual budgets that pyramid into the billions. But if more revenue can be obtained from this tax—without killing the goose that lays the golden egg—we know Congress feels that it should do so, but does any one honestly think it can be done?

Mr. Swisher, for instance, a large cigar manufacturer of Jacksonville, Fla., testified before the House Ways and Means Committee to the effect that his company could survive under an increase from $2 to $2.40 but not to $2.50 and still sell his cigars two for a nickel. He is one of the "one or two" large manufacturers in the United States who Mr. Garcia, president of the Cigar Manufacturers Association of America, testified before the same committee, might do this. Of course Mr. Swisher might relish the elimination of all competitors in his field. But what is going to happen to the little fellows who are driven out of the field by the tax? Will the revenue be greater or less when all but "one or two" manufacturers are gone? Every witness concurred that the present 5-cent cigar would have to go to 6 cents, or 7 cents and the 2 for 5-cent to 3 for 10 cents. And in the higher-priced field, Mr. Garcia pleaded that they could absorb no more.

Now, this idea that you can sell two-for-fives at three for 10 cents or 5-cent cigars at 7 cents is just wishful thinking. They all admit that there is and always has been a stiff consumer resistance to the odd-cent cigar. One has only to look at the tables of present revenue from present class B cigars to see how unproductive is a tax on the odd cent cigar. I doubt if anyone will claim that more than 2 percent of the present cigar stamp tax revenue is paid by the odd centers. And yet the proposal of the Treasury and all similar proposals made before the House Ways and Means Committee are all based on the theory that by tax manipulation we can get rid of two-for-a-nickel cigars and make this same resistant consuming public accept 3-cent and 7-cent cigars in the same volume that they now buy 2½-cent and 5-cent brands. It just can't be done. America's John Public has certain prejudices you cannot successfully buck. There are numerous 3-cent, 3 for 10 cent, 6 cent, 7 cent, and 7½ cent brands available now. How many of them did you ever buy or see any one else buy?

No. The gentlemen are right. Any of their proposals will "get rid of" both the present two for 5 cent and the present 5 cent cigars. But they will not create any substantial demand for an odd cent substitute. Pipes and cigarettes will get the bulk of the lesser trade and a cheaper 5-cent cigar will step into the place of our present good cigars sold at that price, with the result that when you total the revenue, you will find less money from cigar stamp taxes than the present $2 per thousand law produces.

FEWER SUCCESSFUL MANUFACTURERS

But there are other things besides immediate revenue that Congress should and we feel sure, will consider. If "one or two" manufacturers get all the two-for-5 business, and hand manufacturers are forced to abandon this field, what will happen to the thousands of little men who once were substantial employers and taxpayers? In the struggle for survival set off by such a tax increase as the House Bill proposes, the few big producers with their advertising budgets can be counted upon to decimate the remainder. Success in cigar manufacturing is, even more than in most other industries, dependent on their "brands" or trade names of cigars. The great bulk of cigars sold in any year are those bearing established brand names—Muriel, Phillies, White Owl, Roi Tans, Havatampa, Cuesta Reys, King Edwards, etc. Years of painstaking manufacture combined with millions of dollars in advertising have been expended in establishing a consumer confidence that a certain blend of flavor of smoke is guaranteed by each brand name. Change the blend and you change the flavor. You not only lose a customer for that brand, but you lose his confidence in the integrity of any of your brands. So increased taxation cannot be absorbed by reducing quality of the product without disastrous results to sales volume and the good will of the producer. Nor can the retail prices of the established brand be successfully raised. One who thinks he can. shuts his eyes to the entire experience of the industry. Never has the price of an established brand been raised without ruining the sale of that brand. The price can be reduced but not raised successfully. The only successful way to raise the price is to bring out an entirely new brand name for the product. This means discarding all the labor, effort and enormous expense of developing such abandoned brands over many years.

It seems to us unfair to saddle disproportionate loads on one industry or selected industries. This is everybody's war. We are trying to defend everybody's freedom and right to live. Why should not additional taxes fall equally on all? And we must not forget that cigar manufacturers are taxpayers, and their survival and reasonable prosperity promotes other tax collections—income taxes, payroll taxes, estate taxes, etc. And after the war we shall need industry—undisrupted—to help carry on in the post-war adjustment and probable acute unemployment.

DECREASED EMPLOYMENT

Mr. Van Horn, speaking for a group of labor before the House Committee during the hearings on the House bill, under examination by Congressman Robertson, finally came around to the objective of his group in these words:

"I would rather have 10 people employed at a living wage than 20 people to be employed at starvation wages. We will take our chance on increased employment if we can get wages first through an increase in cigar prices. So our proposal, in a few words, is to eliminate the two-for-5 and go to three-for-10."

And he is exactly right, in our opinion, that the increased tax at this time will eliminate the two-for-a-nickel and will leave 10 employed in cigar factories where 20 worked before. It will also eliminate the present 5-cent cigar. The Havatampa cigar factory alone made over 100,000,000 two-for-5-cent cigars in Tampa last year. If the two-for-5-cent cigar is eliminated we would consider ourselves fortunate indeed to be able to employ half as many workmen making three-for-tens.

The advent of the two-for-5-cent cigar has been responsible to a large extent for the continuation of the cigar industry. Since machine manufacture (and not the depression) made it possible to make a decent cigar at that price, its volume has steadily grown, and even at that there were 2,000,000,000 less cigars made in 1940 than in 1918. Last year nearly half of all cigars made were in this 2½-cent group. Eliminate these 2½-cent and cut your 5-cent-cigar sales in half with a 6-cent or a 7-cent price and what will become of the workmen who made them? Where will your increase in revenue be? You will have a decrease instead of increase in revenue. These workmen as a rule are not capable of fitting into any defense industry. They know only this trade—otherwise they are potentially only unskilled labor. Throw them out of employment and you create public charges of most of them. You have only to look at Tampa's depression relief rolls to verify where unemployed cigarmakers land when their job is eliminated.

We assume that the object of the committee is economic and not social. Other committees of Congress and other agencies of government are concerned with the ambition to raise the wages of those who do work. But we are sure that Congress does not want to do an act which would promote large-scale unemployment, which will be the inevitable result in the passage of the House bill in its present form on this question.

DEPRESSED TOBACCO MARKET

Before machine manufacture made the 2½-cent cigar possible, lower grades of tobacco lay in warehouses and rotted for want of a market. The supply so exceeded the demand that the market stayed forever glutted. That is not true today; two-for-5-cent cigars absorbed it at fair prices. But if Congress heeds the cry to eliminate this cigar and push it into the unsalable 3-cent or three-for-10-cent class, consumer demand will certainly weaken, and as night follows the day, large portions of the growers' crops will be stored to rot while the American farmer goes begging for a market. Those interested in the American tobacco farmer should not pay too much heed to the fellow who does not use any quantity of his crop. We buy tobacco grown in Florida, Connecticut, Ohio, Wisconsin, Massachusetts, Pennsylvania, and Georgia, as well as imported varieties. We know the farmer's problems. To sell part of his crop and lose or sacrifice the remainder is a sure way to hard times for the United States tobacco grower. His tobacco goes almost exclusively into two-for-5-cent and 5-cent brands—the very brands which are the target of this proposed tax. Why subsidize him to raise tobacco by one law and then destroy or cripple his market by another?

UNFAIR PENALTY ON CONSUMER

Everyone has been heard in the hearings conducted except the consumer and yet everybody admits he is the fellow who is supposed to pay the tax. But the consumer's remedy is not appearance before congressional committees. His remedy will be revolt—the original slowdown. And when he slows down the manufacturer slows down, labor is laid off, farmers lay up and store excess crops, and Government loses revenue. This is recognized by the cigar workers employed in Tampa, who are not in accord with Mr. Van Horn as reflected and shown by editorial carried in the Tampa Morning Tribune under date of Thursday, June 25, 1942, attached hereto.

We recognize the injustice in not having a lower tax bracket for 2½-cent cigars. It is inequitable that the poor man's cheroot should carry the same load as the 5-cent cigar. But such a differential must be accomplished by reducing the tax on the cheap cigar, not by raising on all. There is practically no margin in a 2-for-5-cent cigar today and very little more in the 5 center. If Congress cannot now reduce the tax on the 5-cent cigar, in the name of common sense do not kill one cigar and injure another, when these two produce 91 percent of all cigar stamp tax revenue. The object of the present House revenue revision bill being to raise revenue, insofar as the cigar tax is concerned, we feel confident it will not accomplish the intended object.

Respectfully submitted.

HAVATAMPA CIGAR CO. OF TAMPA, FLA,
By ELI WITT, *President.*

The following editorial, under date of June 25, 1942, is from the Tampa Morning Tribune (having the largest circulation of any newspaper on the west coast of Florida):

AN UNWISE TAX INCREASE

Tampa cigar unions are protesting the schedule of higher taxes on cigars as proposed in the new tax bill which has been approved tentatively by the House Ways and Means Committee.

Their criticism is not a run-of-the-mine complaint. The unions do not object to an increased tax that is fair, for members realize that higher taxes are necessary to meet the increasing debt. That was demonstrated when union representatives appeared before the House committee and offered a schedule of rates they said would have raised $2,000,000 more than the Treasury proposed and considerably more than the amount now approved by the committee itself.

The protest is based on the contention that the present schedule is discriminatory. Tampa union leaders claim that the bill would give unfair advantage to certain manufacturers, particularly those who make cigars selling at two for 5 cents. They say it hits hardest at the more expensive hand-made cigars. Since many of the more expensive brands are made in Tampa, the unions are fearful that final adoption of the present program will result in large-scale unemployment among Tampa cigar workers.

We cannot thoroughly agree with the cigar workers in that attitude. While Tampa's fame as a cigar-manufacturing center has been built on higher quality and higher-priced cigars, recognition should be given to Tampa factories which make the cheaper grades. A considerable part of Tampa's output now is 2-for-5-cent cigars. One Tampa house alone made more than 100,000,000 of these last year; and this house paid in taxes for last year the astounding total of $619,000—which, by the way was an increase of $284,000 over the total it paid in 1938. This company makes more than one-third of all the cigars made in Tampa; and last year nearly half of all cigars made in the United States were 2½-cent cigars. So it appears the cheap cigars made in Tampa and elsewhere are paying a large part of the government revenue derived from that industry; and, furthermore manufacturers of the cheaper grades are giving employment to large numbers of workmen, which, they estimate, would be cut one-half if a tax discriminating against their product in that class is adopted.

The unions are right in stating that this is a problem which merits the best of cooperation from organizations and individuals throughout the community. The cigar industry means much to Tampa. Certainly none of us ought to remain silent while the Tampa cigar industry is placed at a disadvantage by increased taxation which will bring less revenue to the Government because it will reduce production and will be injurious also to the industry as a whole, to the tobacco growers and to the consumer who pays the bill.

The entire Florida delegation should be acquainted with the seriousness of the Tampa situation; but time is short. Interested individuals and civic-minded organizations should act now.

(The following communications were ordered incorporated in the record:)

TAMPA, FLA., *August 17, 1942.*

Re: Revenue Act of 1942—Taxes on cigars.

Hon. WALTER F. GEORGE,
United States Senator, Chairman Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: I have received report of hearing before the Finance Committee held on August 10, particularly with reference to the tax on cigars. I am writing this letter as attorney and representative of the Cigar Manufacturers Association of Tampa.

The Tampa association consists of 16 cigar manufacturers manufacturing the so-called clear Havana cigars. About one-half production is clear Havana and the other half is Havana filler with Connecticut shade wrapper. In 1941 they produced the following number of cigars in round numbers in the following classifications:

Class A, all of which retailed at 5 cents	104,000,000
Class B, retailed at 2 for 15 cents and 3 for 25 cents	11,650,000
Class C, retailing at 10 cents, 2 for 25 cents, and 15 cents	88,985,000
Class D, retailing above 15 cents and 20 cents, most of which were 3 for 50 cents sizes	23,264,000
Class E, retailing above 20 cents	333,000
Total	228,232,000

This, of course is less than 4 percent of the total production of the cigars produced. However, we are responsible for the employment of between 6,000 and 7,000 employees, because our factories are the so-called hand factories. This is about 11½ percent of the total number of workers employed in the cigar manufacturing industry on the basis of survey of the Bureau of Labor Statistics of the United States Department of Labor. The members of the association have between eight and nine million dollars invested in the manufacturing of cigars and do an annual business of a little over eleven million dollars.

The association and each member thereof has taken the same position with respect to the tax on cigars as taken by the Cigar Manufacturers Association of America, whose president, Mr. Alvaro M. Garcia, appeared before your committee on the 10th. When he stated that he was speaking in behalf of the Florida Cigar Manufacturers Association, this included our association and our membership.

I notice in the report of the proceedings that Hon. Claude Pepper appeared before the committee, in which he stated he was appearing "due to the fact that Senator Whitaker, who was to represent the cigar industry from Florida and particularly that part of it which is centered in Tampa, was suddenly called back to Florida." As a matter of fact Senator Whitaker represents the Hav-a-Tampa Cigar Co., in whose behalf Senator Pepper filed brief, and I am sure Senator Pepper did not intend for the committee to understand that Senator Whitaker represented the cigar industry of Tampa, and that he (Senator Pepper) was appearing in the capacity. As a matter of fact, the Hav-a-Tampa Cigar Co. specializes in two for 5 cents and 5 cents machine-made cigars, making some hand goods. We notice on page 1454 of the record Senator Pepper states that he is speaking only with reference to class A cigars as now classified.

I am forwarding a copy of this letter to Senator Pepper so that he may understand the position of the Cigar Manufacturers Association of Tampa.

Will you please be so kind as to make this letter a part of the record with respect to the tax on cigars, so that the record will correctly reflect the position of the 16 cigar manufacturers of Tampa who are members of the Cigar Manufacturers Association of Tampa.

Yours truly,

RAY C. BROWN.

MEMORANDUM OF CIGAR MAKERS INTERNATIONAL UNION OF AMERICA IN THE MATTER OF PROPOSED INCREASE IN CIGAR EXCISE TAXES, SUBMITTED BY R. E. VAN HORN, PRESIDENT, WASHINGTON, D. C.

The Cigar Makers International Union of America, representing one-third of the estimated 51,000 workers employed in the cigar manufacturing industry in opposing cigar tax rates as they appear in the revenue bill recently passed by the United States House of Representatives, most respectfuly propose the following as cigar excise taxes:

Class A cigars retailing at 4 cents and less, $4 per thousand.
Class B cigars retailing at from 4 to 8 cents, $6 per thousand.
Class C cigars retailing at from 8 to 15 cents, $8 per thousand.
Class D cigars retailing at from 15 to 20 cents, $12 per thousand.
Class E cigars retailing at over 20 cents, $15 per thousand.

We believe the foregoing proposal is more equitable in tax distribution, and it provides revenue in excess of the House bill.

Your attention is directed to testimony submitted by R. E. Van Horn, president of the Cigar Makers International Union of America, in a hearing before the Ways and Means Committee, United States House of Representatives, April 7, 1942, pages 2177–2183.

Your attention is further directed to the Treasury Department's confidential statement to the Ways and Means Committee, printed on loose-leaf pages 348–351.

It alleges on page 348 that the proposed taxes, which were recommended by the Treasury Department and voted by the House of Representatives, will raise an additional $15,800,000 in revenue.

The table on page 350 shows the Treasury received $14,100,000 for the fiscal year ending June 30, 1942, under the present rate of taxes. The Treasury estimates that for the fiscal year ending June 30, 1943, the Treasury will receive $14,700,000 from taxes levied on the sale of cigars at the rates recommended by the Treasury and voted by the House of Representatives.

As it is expected that these new tax rates will be in force for at least 8 months of the fiscal year (November 1 to June 30), the Treasury therefore estimates that the new rates will increase the income from $14,100,000 to $14,700,000 in revenues.

The increase of $600,000 in revenues in 8 full months would indicate an increase of $900,000 for the entire year instead of the $15,100,000 in additional revenue as stated on page 348.

Further, as some 90 percent of the cigars sold at present are retailed at or less than two for 5 cents, and, as any appreciable increase in revenues should accrue from the increase in taxes levied on the sales of such cigars the comment of the Treasury Department on page 351 is most interesting. The comment or statement reads:

"Class A cigars has not been revised since it is unlikely that manufacturers selling cigars made to retail at two for 5 cents can absorb the tax and other cost increases expected and still maintain a profitable business."

Surely, the Treasury does not expect to collect any appreciable amount of tax revenue from the sale of cigars which they say will not be possible. The Finance Committee should eliminate the proposed class A and combine the proposed class A and class B into one class.

Such would be helpful to all in the industry and would permit of the farmer, the worker, and the producer of cigars getting a fair return while the consumer would benefit through obtaining a much finer cigar for the price paid.

Respectfully submitted.

R. E. VAN HORN,
International President.

The CHAIRMAN. I offer for the record at this point the statement by the Secretary of State in which he calls attention to the fact that he thinks it desirable to avoid the subdivision of class E cigars into two new classes at substantially different rates of tax with a view to preventing any undue injury to the Cuban tobacco industry.

(The statement referred to is as follows:)

STATE DEPARTMENT,
Washington, July 24, 1942.

The Honorable WALTER F. GEORGE,
Chairman, Senate Committee on Finance.

MY DEAR MR. CHAIRMAN: I am in receipt of a note from the Ambassador of Cuba expressing concern regarding the adverse effect which the proposed increase in internal revenue taxes on high quality cigars, provided for in H. R. 7378, would have on the Cuban tobacco industry. The Ambassador refers to the serious crisis confronting this industry, and points out that the increased cost of high quality cigars resulting from the new taxes would cause a reduction in imports from Cuba of cigars and of tobacco for manufacture into domestic cigars of a similar grade.

Section 605 of H. R. 7378 provides for (1) an increase in the tax rates on all classes of cigars and (2) a regrouping of existing price classes for tax purposes with a view to assuring more uniformity in the proportion which the tax will bear to the retail price at which various grades are sold. Under the provisions of this bill, present Internal Revenue class E cigars, which comprise the bulk of our imports from Cuba, would be subject to tax rates of $25 per thousand on cigars selling for more than 20 cents but not more than 30 cents and $35 per thousand for cigars selling for more than 30 cents.

Cigars were included among the products on which this Government granted tariff concessions in the second supplementary trade agreement with Cuba, effective January 5, 1942. In formulating its recommendation on cigars, the interdepartmental trade-agreement organization had occasion to examine the competitive relationship between Cuban and domestic cigars. It was found that Cuban cigars ordinarily sell for from 5 cents to 8 cents more than their nearest domestic equivalents, and that, prior to the agreement, the tariff differential in favor of importing Cuban filler and leaf tobacco for domestic manufacture into "all-Havana" cigars was about 3.98 cents per cigar. Under the agreement, which provided for reduced duties on both cigars and cigar tobacco, this differential was lowered to about 3.21 cents per cigar. Under the new tax provisions proposed, the larger part of Cuban class E cigars would be taxed at $35 per thousand and the bulk of domestic class E cigars at $25 per thousand. This would mean that the differential against these Cuban cigars, which was reduced from 3.98 cents to 3.21 cents per cigar in the trade agreement, would become considerably higher than it was before the agreement was entered into, that is, about 4.21 cents per cigar.

It is apparent that the value of the trade-agreement concession on Cuban class E cigars would be largely destroyed if the provisions of H. R. 7378 in respect of this class of cigars were to be adopted. The following provisions of the trade agreement are therefore pertinent:

"It is further agreed that, in the event that the Government of either country adopts any measure which, even though it does not conflict with the terms of this agreement, is considered by the Government of the other country to have the effect of nullifying or impairing, in an economic sense, any object of the agreement, the Government which has adopted any such measure shall consider such written representations and proposals as the other Government may make with a view to effecting a mutually satisfactory adjustment of the matter; if no agreement is reached with respect to such representations or proposals within 30 days after they are received, the Government which made them shall be free, within 15 days after the expiration of the aforesaid period of 30 days, to terminate this agreement in whole or in part on 30 days' written notice."

Other provisions of the trade agreement involved are those providing reciprocally for national treatment in respect of internal taxes and for the right to levy increased taxes on imported products covered by the schedules of concessions to compensate for increased internal taxes on like products of national origin. The intent of these provisions is to insure that whatever tariff or tax differential there may be between imported articles and like national articles will be measured by the ordinary customs duty on the imported article. However, in the case of imported articles of which there is no comparable domestic production, an internal tax has virtually the same adverse effect as an ordinary customs duty. This is quite clear in the case of such products as tea and bananas. It could be argued that it would be substantially true in the case of cigars selling for more than 30 cents. In any event, the above-quoted provisions were included in the trade agreement with Cuba, and similar provisions have been included in other trade agreements, with a view to providing, among other things, a basis for protesting internal tax measures which would have practically the same economic effect as new or increased customs duties on articles included in the schedules of tariff concessions.

I understand that total taxes collected on class E cigars in the fiscal year 1941 amounted to only $62,000, of which $33,000 was collected on imported cigars. Apparently, therefore, the possibilities of deriving increased revenues from higher taxes on this class of cigars are very limited, and it seems possible that the proposed subdivision of this class might well result in a reduction of imports and hence of tax collections. I appreciate the desirability in general of trying to equalize the relative tax burden on the various classes of cigars, but it seems doubtful that a subdivision of class E would contribute much to this end.

I hope that the Finance Committee, in giving consideration to the pending tax bill, will consider the desirability of avoiding the subdivision of class E cigars into two new classes at substantially different rates of tax, with a view to preventing any undue injury to the Cuban tobacco industry.

A letter similar to this was sent to the chairman of the House Committee on Ways and Means, but arrived too late for committee action.

Sincerely yours,

CORDELL HULL,
Secretary of State.

The CHAIRMAN. Mr. Parker, is it too late for you to come on this evening?

Mr. PARKER. Any time that is convenient to the committee, either now or tomorrow morning.

The CHAIRMAN. About how long would you want?

Mr. PARKER. I think I could conclude in about 20 minutes.

The CHAIRMAN. I think we can hear you, then, before we adjourn.

STATEMENT OF LOVELL H. PARKER, TAX ASSOCIATE, GUY & BROOKES, WASHINGTON, D. C.

Mr. PARKER. Mr. Chairman, and gentlemen of the committee, my name is Lovell H. Parker, tax associate, Guy & Brookes, Washington, D. C. I am appearing in my own behalf for the purpose of making certain comments with respect to the revenue bill of 1942 now before your committee.

Taxes on individuals.—The taxes imposed on individuals by the House bill are very severe. I think they are too severe to be retroactively applied for the year 1942. I think, however, that they might be higher for the year 1943. My suggestion is that the revenue bill of 1942 contain two sets of rates on individual taxpayers, one to apply to the year 1942 at slightly lower rates than the House bill proposes, and another set for 1943 at somewhat higher rates than the House bill proposes.

I fear that the public is not prepared to meet such a sudden increase in rates as is proposed for this year and that they have not set aside sufficient funds out of this year's income to meet the taxes due next March. My proposal would undoubtedly obviate many uncollectible tax items. You may sacrifice a few hundred million dollars this year it is true, but you will make it up next year and the following years and at the same time give individuals opportunity to adjust their obligations and commitments to the new rates.

Under a retroactive bill, many transactions must have been closed before it was possible to know what rates and provisions the bill might contain. The average person never realizes what is in the bill until he comes to make out his return next March.

For example, suppose a man sold some property at a loss last spring. He would be entitled to expect that, as is allowed under present law, he could deduct 50 percent of this loss from his ordinary income. However, the House bill contains a provision that capital losses can only be charged off against capital gains. But suppose, as is the ordinary case these days, he has no capital gains. Then the result is obviously unfair, and faith has not been kept with the taxpayer.

Another example of unfair retroactivity is the proposal to change existing law governing pension trusts, so as to outlaw trusts heretofore set up in perfect good faith and in full compliance with existing law. In effect this proposal forces the repudiation of contract obligations of many corporations to their employees.

It is my opinion that to keep faith with the taxpayer is one of the most important things in our tax system. If we have the taxpayer's confidence and good will, we minimize chiseling and cutting corners on taxes due. I would suggest that if changes in capital gain and loss provisions are to be made, or if other statutes, such as pension trusts are to be changed, such changes be made prospective and not retroactive.

I also believe, with respect to individuals, and for that matter corporations, that for the year 1942 at least, some allowance or credit should be given for the payment of debts. Many people who have committed themselves to debts, such as for buying homes, and for carrying on their businesses, will find themselves in the most serious condition because their budgets have been arranged for the whole year on a different scale of taxation from what is now proposed.

With the permission of the committee, I ask leave to submit for the record a short memorandum which I have written on this subject of debt relief.

That memorandum is attached, but I will not read it.

The CHAIRMAN. We will be very glad to have you do so, Mr. Parker.

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

EXHIBIT A

NEED FOR INCOME TAX DEBT RELIEF

The income-tax burden on both individual and corporate taxpayers who are heavily in debt is a very serious matter under existing high surtax and excess-profits tax rates. This burden, in many cases, will become unbearable under the increased rates proposed for the revenue bill of 1942 unless some relief is provided for.

Secretary Morgenthau, appearing before the Committee on Ways and Means in March of this year stressed in his general statement "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." The Secretary also admitted in his statement that many hardships and inequities existed in the Federal tax laws which should be cured. We fail to find, however, in the detailed statement of the Secretary or of his representatives any recognition of the fact that a taxpayer heavily in debt has less ability to pay taxes than one similarly situated who is not in debt. Nor do we find any mention of a cure for the hardship resulting from extremely high taxes suddenly imposed on debt-ridden individuals and corporations. We will now briefly consider the imperative need for some form of income tax debt relief.

I. INDIVIDUALS IN DEBT

(*a*) In the first place individuals in debt have been unfairly treated by our tax laws because of the retroactive character of recently enacted laws and because of the rapidity and magnitude of the tax increases therein provided.

For example, the Revenue Act of 1940 became law on June 25, 1940, but was effective from January 1, 1940. The Revenue Act of 1941 did not become law until September 25, 1941, but was effective from January 1, 1941, and the probabilities are that the pending revenue bill of 1942 will not be enacted into law until October of this year. Thus, revenue acts have been from 6 to 9 months retroactive. When a man borrows money in the first part of the year he does not know how much tax he will have to pay on the income upon which he may depend to pay the debt. Moreover some, at least, of the recent tax increases have been unexpected as well as drastic. This is readily proved by the following example which shows the tax on a married man with no dependents and with a net income of $10,000 for a series of years, together with the percentage increase in tax:

Total Federal income tax on married man with $10,000 of net income

Year	Total tax	Percentage increase over 1939
		Percent
1939	$415	
1940	528	27
1941	1,305	214
1942 (House bill)	2,152	418

It seems obvious without further argument that under such a situation the individual will often be in grave difficulties in meeting his obligations, especially in cases where those obligations were created before there was any intimation of the extreme tax increases which have recently occurred.

(*b*) In the second place, it is believed that the ability to pay of a man in debt is substantially less than the ability to pay of man with the same income who is not in debt. This is because the man in debt must amortize the principal of that debt and no reduction is made in his net income on account of such debt payments. This is true whether he is on a salary and buying a home, or whether he is conducting an unincorporated business enterprise.

If some relief is not given to the individual in debt, doubtless many will be unable to meet their taxes, so the Government will not secure its expected immediate revenue, and will lose revenue in future years because a taxpayer has been put out of business.

II. CORPORATIONS IN DEBT

Corporations which are in debt are also at a serious disadvantage as compared with corporations doing a similar business which are not in debt.

(*a*) As in the case of individuals, corporations have had to meet sudden and drastic tax increases effective retroactively for a period of from 6 to 9 months. They have also had imposed upon them an extremely high excess-profits tax. The effect of this tax, together with the increased normal and surtax rates on corporations will seriously affect their ability to pay debts unless some relief is provided for.

For example, under existing law (the Revenue Act of 1941) a corporation with an invested capital of less than $5,000,000 can make a profit of 8 percent on such capital before paying any excess-profits tax. However, if it does make 8 percent, it must still pay a normal tax of 24 percent and a surtax of 7 percent, so that it really has left after taxes only a profit of 5.52 percent on its capital, out of which to pay its debts, provide for expansion, increase its inventory, provide for contingencies, and to pay dividends. The very large corporation, under existing law, can make only 7 percent on such capital before paying excess-profits tax, but if it does only make 7 percent it will have left after paying normal and surtax only an earning of 4.83 percent on its capital out of which to pay its debts, provide for expansion, increase its inventory, provide for contingencies, and to pay dividends.

This is bad enough but under the House bill the situation is much worse. The small corporation, while still being allowed an 8-percent profit before paying excess-profits tax, would be allowed to retain, on account of a combined normal and surtax rate of 45 percent, only a profit of 4.4 percent. The very large corporation, to which it is proposed to allow an earning of only 5 percent on a substantial part of its invested capital before subjecting it to excess-profits tax, would be permitted to retain only a profit of 2.75 percent on its invested capital out of which to pay its debts, provide for plant expansion, increase its inventory, provide for contingencies, and to pay dividends. It is believed obvious that corporations with substantial debt will not be able to pay dividends or to expand their business, and may not even be able to take care of debt retirement under such a method.

(*b*) It may be asked what will happen if they do make over 8 or 5 percent, as the case may be. The answer is that, if they do, 90 cents of every dollar of excess will go to the Government at excess-profits tax. In other words, if a large corporation makes 20 percent on its invested capital instead of 5 percent, it can be readily computed that it will have left after taxes only a net earning of 4.25 percent on its capital. Thus, excess earnings will do little to aid corporations which are in debt.

(*c*) Finally, some businesses instead of profiting by the war economy are injured thereby: If such companies make only 3 percent on their capital they will have left after taxes only 1.65 percent because of the 45 percent combined normal and surtax rate. If such businesses are in debt, their financial situation is indeed precarious.

It must be concluded that debt tax relief is necessary for corporations as well as individuals. The question then arises as to the form of such relief, having due regard to the revenue necessities to the Government.

III. SUGGESTED RELIEF

In order to relieve these hardships to a reasonable extent and still protect the revenue of the Government, it is suggested that—

Both individuals and corporations be allowed a deduction from net income of the amount of payments actually made to retire indebtedness, at the due date, in existence on January 1, 1942, where such indebtedness is evidenced by an obligation having a maturity date of 1 year or more from date of issue, provided, however, that the deduction allowed in any one year shall not exceed 20 percent of the taxpayer's net income (before crediting such debt deduction allowance) for such year.

In connection with the above, the following points should be noted:

(1) Actual payments must be made within the taxable year. It is thought desirable from the Government's point of view to exclude deductions arising from the accrual method of accounting, since payments due on debts might be accrued but never paid.

(2) The indebtedness must be in existence on January 1, 1942. This proposal is necessary to prevent tax avoidance. Future debts might be created for this purpose if this limitation was not provided for.

(3) Debts taken into account must have a maturity date of at least 1 year from date of issue. This provision would practically exclude such items as accounts and bills receivable.

(4) The deduction is limited to 20 percent of the taxpayer's net income and is limited to debts paid when due. This limitation is necessary to protect the revenue, especially in the case of the surtax on individuals and the excess-profits tax on corporations. If no limit were provided for, the individual finding himself in the high surtax brackets could unnecessarily pay debts and escape the high surtaxes. Likewise the corporation could speed up its debt payments and take itself out of the excess-profits class.

IV. THE SITUATION OF BANKS

Income-tax debt relief is vitally important to the banks, first because it would assist their customers in paying their debts to the banks and, second, because if the definition of indebtedness is properly provided for in the law, it would make the direct income taxes paid by the banks themselves more equitable.

Many banks went through a reconstruction period after the bank holiday. Sometimes preferred stock was issued and sometimes capital debentures. Most of such stock or debentures is held by the Government. In any case the preferred stock or debentures represent indebtedness and this term should be so defined so as to include these items. Thus the banks would merely secure the same treatment as would be provided for in the case of other taxpayers.

V. CONCLUSION

We believe relief along the lines suggested would prevent much hardship and save many taxpayers from bankruptcy. Moreover, such relief would bring our income-tax system more in accord with the principle of ability to pay. Finally, the suggestion is also in accord with the recent message of the President to the Congress in which he urged all to pay off their debts. If the taxpayers are to pay their debts they much have enough money left after taxes with which to pay such debts.

Mr. PARKER. So far I may have seemed completely critical of the House bill. I desire to say, however, that I believe that many of the changes made by it are meritorious, such as a longer statute of limitations on bad debt deductions, the alimony provision, and a number of others.

Broadly speaking, I think we must secure all the revenue we can compatable with the preservation of our American ideals, which necessarily embrace the profit or incentive motive. It would be an unwise policy to tax at such a scale that through this bill we would secure six billion of additional revenue this year, five the next, and four the next. A long-run plan is obviously much better even if it secures in 1942 only $5,000,000,000 of additional revenue, if it promises six billion in 1943 and and seven billion in 1944.

Taxes on corporations.—With respect to corporations, I believe that the most serious aspect of the proposed system is the high combined normal and surtax rate.

I am convinced that in all cases dividends will be seriously curtailed and in many cases absolutely prevented. We have millions of investors in corporate stocks who depend upon some reasonable return on their investment. Leaving aside the devastating effect on these individuals, if we prevent this flow of money, of course we get little in taxes from the individuals affected. Under the proposed bill, the combined normal and surtax rate is 45 percent and a large corporation is only permitted to earn 5 percent on its capital before the imposition of the 90 percent excess-profits tax. This means that even if a corporation does not make enough money to pay an excess-profits tax, nevertheless it can have left after payment of normal and surtax, only 2¾ percent on its investment. On such net earnings after taxes the great majority of corporations cannot take care of retiring their debt, providing for inventory and plant expansion programs, for necessary working capital and for contingencies, and have anything left for the declaration of dividends, at least on their common stocks. If they have enough left to declare dividends on preferred stock, they will be extremely lucky.

I wish to point out to the committee that, according to my computations, approximately 50 percent of the amount of dividends declared by all corporations go to individuals of small or moderate means. That is to say, about 50 percent of the dividends declared go to persons with incomes of less than $10,000. On this subject, I have written a pamphlet entitled "How the New Tax Bill Treats the Little Investor." I have asked the clerk to distribute copies of this pamphlet to the members of the committee, leaving it to their judgment as to whether they wish to have it printed in the record of these hearings. I put it this way because I do not wish to cause the Government any undue printing expense.

In this pamphlet I suggest a remedy which will allow a reasonable flow of dividends from a corporation to its stockholders and which I believe will not substantially reduce the revenue from the bill; in fact, over a period of years, it may increase the revenue because of its stimulating effect. At all events, it will provide income to tax in the hands of the individual and this income will be taxed in accordance with the ability of the individual to pay. Under the present system, every dollar of income which is taxed to the corporation pays the same rate regardless of whether the stockholder, the ultimate owner, be rich or poor. Thus the principle of ability to pay is disregarded.

As I have shown in the pamphlet referred to, I estimate that dividends will pay an average rate of about 45 percent in the hands of the stockholder. This is the same rate as the combined normal and surtax rate on corporations. Suppose the tax bill in its present form were to prevent entirely the declaration of dividends. In such event, if a credit against normal and surtax net income, to the extent of dividends paid, would result in the declaration of some dividends, then the Government would lose nothing by the process. However, I realize that the present bill will not prevent the declaration of all dividends, that is to say, some dividends will be paid in any event. Therefore, to obviate any serious loss of revenue, I would suggest that a credit against normal and surtax net income only, in the amount of 50 percent of the dividends paid, be allowed.

A modification of the bill which would greatly increase the ability of corporations to pay income taxes generally, without undue detriment, would be to allow some form of debt relief. This is dealt with in detail in a memorandum on this subject which I asked to be included in the record when I was speaking on the subject of taxes on individuals.

As to the 90 percent excess-profits tax, I have no quarrel with the rate. I do think the basis to which that rate would be applied should be made more equitable. This is especially true in the case of corporations reporting on the invested capital basis.

One of the unfair features of the House bill is the proposal to change the present system of treating fiscal year corporations. For the last 10 years corporations keeping their books on a fiscal-year basis have been taxed on each fiscal year's income as a unit. Now it is proposed to split the income of such corporations according to calendar years and tax one portion under one act and another portion under another act. Many corporations on the fiscal-year basis with the full expectation of paying the 1941 rates for such months of 1942 as fell within their current fiscal year, have closed their books, paid dividends, and completed their transactions on that theory. To now retroactively change the system upon which they have justifiably relied is obviously unfair. The present system works out just as well in the long run, for the fiscal year corporations will have to pay a higher rate of tax longer than the calendar year corporations when the time for some lowering of tax rates comes.

Moreover, from personal experience, which I believe will be concurred in by most of your official draftsmen, I doubt that the proposed change is susceptible of being accurately drafted. This is because of the number of sections of the law which must be changed to accord with the proposed treatment of fiscal years.

I wish to reiterate, with respect to corporations, what I have already said with respect to individuals in regard to the proposed retroactive change in the treatment of capital gains and losses. Many corporations have undoubtedly taken losses early this year which will now be denied to them under the proposed bill.

In this connection, I wish to call attention to a hardship in the case of the change made in the law which classifies buildings as capital assets. The result of this is that losses sustained on the sale of business buildings cannot be taken advantage of because the owner frequently will have no capital gain against which to charge such loss. Consequently, a company may be compelled to tear down buildings and plants in order to realize the tax loss involved instead of selling them to parties who could utilize them for some useful purpose. This is waste, yet the corporation may be forced into it if this proposal becomes effective.

Brief list of additional inequities.—With tax rates as high as they must be, even though rates in the present bill are lowered, it is believed that the greatest care must be exercised to prevent inequities. The high rates must be imposed on real net income and not on theoretical net income. I have already discussed some of the inequities of the bill, affecting both individuals and corporations. But there are others. I do not feel that I should take the time of the committee to describe these in detail. Therefore I will merely list a few of them in the hope that the committee itself will take occasion to discuss them with its own tax experts and with representatives of the Treasury Department.

A. In the case of individuals, it is submitted that:

(1) The differential in tax on earned income and unearned income is insufficient and should be broadened.

Senator TAFT. It is entirely abolished, is it not, in this bill?

Mr. PARKER. I thought it was retained.

Senator TAFT. The earned income credit is out, isn't it?

Mr. PARKER. I did not think so. The Secretary of the Treasury recommended it being abolished, but the Committee on Ways and Means of the House left it as it is in the present law.

The CHAIRMAN. I am advised that that is correct. The Treasury did recommend its abolition but it was retained.

Mr. PARKER. Yes; it was not abolished in the House bill.

(2) Some allowance should be made for doctors' bills and hospital expenses.

(3) The basis of a gift in the hands of a donee should be the fair market value at the date of the gift in all cases. This is the amount upon which the gift tax is paid.

(4) The tax basis for property distributed among partners should be clarified.

B. In the case of corporations, it is submitted that:

(1) The personal holding company section of the law should be further revised so as to remove a holding company, the majority of whose income comes from operating subsidiaries, from the personal holding company classification. As long as one man can hold all of the stock of an operating company and pay no personal holding company tax it is hard to see why a parent company holding all the stock of operating subsidiaries and receiving most of its income therefrom should be subject to this penalty tax. Some holding companies because of bonded indebtedness or for other reasons cannot be liquidated.

(2) The relief provisions should be further broadened to give more adequate relief to companies compelled to use the invested capital method.

(3) The relief provisions should be further broadened, with retroactive effect, so that deductions for as well as income resulting from a claim, award, judgment, or decree may be properly spread over the correct years.

(4) Something should be done tax-wise to encourage the production of strategic metals vitally necessary for the war effort. This was what Mr. Nelson recommended—not what I am recommending, but he mentioned the necessity for it. Rapid production exhausts these resources, and the high excess-profits tax takes all the profit. Consequently, the present system tends to retard production which is the exact opposite of what our war effort demands.

I suggest to remedy this situation that for all increased production over the production for the year 1941 of these strategic and critical minerals that a further increase depletion allowance be granted for the duration of the war. Increased production can be obtained by this method at less cost to the Government than by increased price.

(5) Relief should be provided in the treatment of income arising in foreign countries which may be accrued on the taxpayer's books but which cannot be transmitted to this country because of war conditions. Many countries prevent or curtail the transmission of funds to the United States. In fact, the whole system of taxation of foreign income would seem to need revision in view not only of present but past conditions.

Conclusion.—I would respectfully urge this committee to consider the long-range productivity of the tax program which they adopt. I cannot stress too much that the important thing to have in mind is the total amount of revenue which can be collected over the next 5 or even 10 years and not the amount which is to be raised this year. Any program which raises money this year at the expense of immediately future years is improvident.

We cannot get much revenue from our principal source, the income tax, unless we have a substantial amount of income to tax. This was amply provided in 1932 when, although tax rates were substantially raised, tax revenues substantially fell off.

The CHAIRMAN. Thank you very much Mr. Parker.

Are there any questions?

(No response.)

The CHAIRMAN. Mr. Parker's exhibit No. A will be entered in the record, and the committee will also take the liberty of putting the pamphlet in, Mr. Parker.

(The pamphlet referred to is as follows:)

How the New Tax Bill Treats the Little Investor, by L. H. Parker, Tax Associate, Guy & Brookes, Washington, D. C.

FOREWORD

On April 13, 1942, William C. Langley, of New York, head of the prominent investment house bearing his name, testified before the Committee on Ways and Means of the House of Representatives with regard to the effect upon domestic corporations of tax schedules proposed by the United States Treasury Department. (His testimony will be found in full at pp. 2692 to 2705, vol. 3, of the hearings before the committee.)

I was so much impressed by Mr. Langley's principal statement and its implications that I have inserted it bodily in this article.

While the witness confined himself principally to proof of the devastating effect upon the fiscal policies of corporations, of an excessive tax upon their normal income, I have carried on through the corporate fiction and show where the hardship really falls—on the shoulders of millions of small people who are the predominant holders of the stocks of the publicly owned corporations of this country. And I have suggested at least a partial remedy for the situation.

It will be noticed that Mr. Langley addressed himself to the original Treasury proposals. These, of course, have been changed in the revenue bill as it has passed the House of Representatives. Nevertheless, Mr. Langley's conclusions are still completely pertinent and present in bold relief considerations which should cogently influence the Committee on Finance of the United States Senate when the bill reaches it.

STATEMENT OF WILLIAM C. LANGLEY, REPRESENTING W. C. LANGLEY & CO., NEW YORK, N. Y.

Mr. Langley. Mr. Chairman, my name is William C. Langley; my address is Westbury, Long Island, N. Y.

I am going to address myself wholly to the question of surtaxes and normal taxes.

It is my belief that the whole economic structure of America will be seriously affected by the proposal, if enacted, to make the normal and surtax on corporations 55 percent. Companies, confronted with capital-expansion programs, increased inventories, sinking-fund payments and serial maturities, will borrow the money to support such burdens from their stockholders by not paying dividends on common and preferred stock as a matter of prudence, rather than to go to the banks. The result will be that in the post-war period common and preferred stocks, piled high with arrearages of dividends, will be discredited as media of investment or speculation for a long time. This is just at a time when an enormous public debt will make it imperative that equity money be raised if the country is to survive without state socialism, and private enterprise is to be perpetuated.

A combination of normal and surtaxes resulting in an impost of 55 percent does not properly distinguish between the normal earnings of established businesses and increased earnings due to the war. This does not properly recognize such realities as fixed interest and preferred dividend charges.

The individual stockholder should be taxed on his income, both earned and from dividends, in accordance with the principle of ability to pay. It is not equitable to impose on each stockholder, irrespective of his individual income, the same tax burden. To do so has the effect of taxing the individual stockholder's share of corporate earnings at rates in excess of what he would ordinarily be obliged to pay if the principle of ability to pay is to be recognized.

All well-managed corporations are loath to borrow to an extent that will throw their corporate structure or their balance sheets out of line. No company wants to be left with a huge debt at the end of this war. With the effect on dividends, of the surtax, no one will want to buy common stocks, or even preferred stocks, as soon as the full impact of these proposals, if they are enacted, is realized. I maintain that the country at large has not yet arrived at a full comprehension of what these tax proposals will be, despite the fact that since they were announced the value of stocks in the New York market has declined approximately $2,000,000,000. This decline has affected practically every class of stock—good, bad, and indifferent.

The increase in corporation taxes should be confined in the highest degree possible to the excess-profits tax. I believe it is to the economic benefit of a company that during the war the normal tax—and in this I include the surtax—should, if possible, be not increased at all. The place to tax corporate income, when it is paid out in dividends, is in the hands of the recipient. In that way the rich and the small stockholder are each taxed in their proper bracket. There will be instances where the small taxpayer, as the result of this bill, will be taxed 100 percent, for example, if a preferred or common stock entirely omits its dividends. This dividend may be substantially his principal source of income. This is asking a far greater sacrifice from the small investor than from the large one.

I have here a list of operating utility and industrial stocks. Into last year's earnings there have been inducted an increase of 77.4 percent in the normal tax (31 to 55 percent) and a 25-percent increase (60 to 75 percent) in the higher excess-profits tax. The result is amazing.

Please realize that real money was put into these preferred and common stocks by 20,000,000 investors. Without this money put in behind bonds, what would the bonds be worth? Who will buy the bonds of a corporation that has no capital surplus? How are these bonds to be paid off at maturity? What will they be worth in the future and where will our saving banks, insurance companies, banks, endowed institutions, and so on—the holders of these senior securites—come out?

The first line of defense is common-stock money and earned surplus, the second line preferred stock, and when these go out the window, our whole economic corporate structure is threatened.

Please consider the situation corporations will find themselves in as affecting rehabilitation, reinstallation of machinery, and so forth.

Please consider the effect on soldiers and sailors returning looking for jobs.

Also, consider the effect on investors in stocks that are selling at low prices on which no dividends have been paid for some time, when they are asked to purchase or subscribe to new issues of common or preferred stocks.

Do you realize the fact that preferred stocks have grown to be considered as investments, and that the colleges, charitable institutions, educational institutions, fire insurance and casualty companies are large owners of these stocks and dependent on them to carry on their business and to pay their fire and casualty losses?

It seems to me that credit should be allowed for dividend payments as against normal and so-called surtaxes. In many loan agreements and indentures there are covenants to the effect that quick assets, that is to say, accounts receivable, inventories, and so forth, must be in certain relation to quick liabilities, that is, payables, bank loans, and so forth. Any distortion of the quick assets position brought about by excessive normal and surtax taxation would create defaults in these covenants, in some cases making the loans come due and in some cases preventing the dividend payments on preferred and common stocks.

I suppose it is not necessary to call the attention of the committee to the great increase in inventories of corporations helping to carry on this war through the production of war products, and the effect it has had on their balance sheets. As a matter of fact, investors and banks are scrutininzing very carefully the tax liabilities of all corporations on their balance sheets, as having a tremendous effect on their credit.

I want to say one word more in explanation of these tables that I have here.

I have had prepared in my office a list of some companies showing their net income before Federal income and excess-profits taxes, the amount of Federal income and excess-profits taxes for the year 1941, and the amount available for preferred dividends or common dividends, as the case may be.

I have also inducted into these figures what the Federal income and excess-profits tax would have been for the year 1941 had the Treasury's proposal been in effect in 1941.

The figures in most cases have been based upon the annual or other reports of the respective companies. I believe the figures are substantially correct; of course, absolute accuracy cannot be obtained without going over the figures with officials of each company as well as a representative of the Treasury Department, for detailed interpretations of their proposals. There may be a few companies where ther might be a question as to the effect on net income for future years due to possible nonrecurrent items, such as certain reserves and extraordinary losses. These cases, however, are the exception rather than the rule.

The method we have used in determining the effect of the Treasury's proposals on last year's earnings is as follows:

We have taken the actual normal and surtaxes paid last year and increased that amount by 77.4 percent, which is the increase from the present normal and surtaxes of 31 percent to the proposed 55 percent. We have increased the excess-profits tax paid last year by 25 percent, which is the increase from the present 60 percent to the proposed 75 percent rate. Appropriate adjustment has been made for the fact that the excess-profits tax is deductible before the normal and surtax.

A summary of the preferred stocks of 42 utility companies and 23 industrial companies, and of the common stocks of 13 utility and 56 industrial companies, a list of which I am submitting to the committee, shows the following result:

Eight utility companies, or 19 percent, will not earn their preferred dividends; 17 utility companies, or 40 percent, will not earn their preferred dividends and sinking funds; 19 utility companies, or 45 percent, will be border-line cases, earning their preferred dividends by a margin of less than 50 percent. Thirteen utility companies will have their aggregate earnings available for common dividends reduced 44 percent.

Six industrial companies, or 26 percent, will be border-line cases, earning their preferred dividends by a margin of less than 50 percent. Fifty-six industrial companies will have their aggregate earnings available for common dividends reduced 49 percent.

The summary also shows the following estimated effect of the proposed new Federal income taxes up to 55 percent and the excess-profits taxes up to 75 percent. The average coverage for 42 public-utility operating companies—I have not inducted this into a single holding company—shows that the average covering for 1942—and this is not an over-all coverage; this is coverage after interest, amortization, debt, and discount, and after taxes—the average coverage will drop from 2.30 times on 42 public-utility operating stocks to 1.44 times; on 23 industrial-preferred stocks it drops from 5.57 to 2.97 times.

The average earnings per share for 13 public-utility operating company common stocks drops from $2.34 to $1.33, and on 56 industrial common stocks it drops from $4.31 to $2.11.

If any member of the committee is interested, I will be glad to give you the specific names of some of these companies.[1]

(End of Mr. Langley's statement.)

SUMMARY OF LANGLEY'S CONTENTIONS

I briefly summarize Mr. Langley's position as follows:

(1) A combination of normal tax and surtax resulting in an excessive impost does not properly distinguish between the normal earnings of established businesses and increased earnings due to the war. Such an impost, in seeking a maximum tax from corporations whose business is benefited by war conditions, penalizes corporations whose business is unaffected or injured thereby. Thus the continued successful functioning of established businesses and of our American incentive system is threatened.

(2) There is no objection to high excess-profits tax rates provided that a fair basis for such rates is established. The excess-profits tax is the means which should be employed to curb and to tap excessive direct or indirect war profits.

(3) It is mandatory that corporations take care of certain definite financial requirements after paying taxes but before paying dividends. Such requirements include provision for debt retirement, for working capital and plant expansion, for inventories, and for reserves for contingencies. Several of these requirements are today abnormally high. After these requirements have been met, there must be some earnings left for reasonable dividends if the corporate system of conducting business is to survive. If the combined normal and surtax is too high, dividends will be seriously curtailed or eliminated.

(4) "The first line of defense is common-stock money and earned surplus." Substantial investment in common stocks is an essential feature in the maintenance and development of our economy. Curtailment or elimination of dividends on either common or preferred stocks would give them a bad name with investors and render future corporate growth difficult if not impossible. The capital loss entailed will also be tremendous.

At the conclusion of Mr. Langley's remarks one of the members of the committee, evidently impressed by the logic of his statement, made the following comment:

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[1] The tables referred to in Mr. Langley's statement are printed at the end of this pamphlet as an appendix.

"That is a pretty dark picture you paint, insofar as preferred and common stocks are concerned."

I was also greatly impressed by the logic of the quoted remarks and examined with interest the factual data submitted in tabular form by Mr. Langley. His tables analyze the tax results of the Treasury plan on well over 100 companies and the figures given are clearly correct for all practical purposes. The companies listed are representative companies and cover a fair cross section of American industry. While the facts given by Mr. Langley are perhaps sufficient to prove his contention, nevertheless I have developed some additional data which would seem to further confirm his conclusions.

Langley's remarks equally applicable to House bill

In the first place, Mr. Langley addressed himself to the Treasury plan of a 55 percent combined normal and surtax rate and excess profits tax rates graduated from 50 to 75 percent. The House bill provides for a combined normal and surtax rate of 45 percent and a flat excess profits tax rate of 90 percent. After careful consideration, I have concluded that these changes in rates do not go to the basis of Mr. Langley's objections.

For example, take the case of a company with $50,000,000 of invested capital having in 1942 a net income (before taxes) of $4,000,000 (or 8 percent on its capital). Under the Treasury proposal, the total tax would be $2,396,987.50. Under the House bill, the tax would be $2,178,000. In other words, under the Treasury proposal in such a case, the company would have left after taxes 3.2 percent on its capital, while under the House bill it would have left 3.6 percent. Thus, although the House bill is slightly better than the Treasury proposal, it still does not leave more than sufficient funds (on the average) in the treasury of such a corporation to service its debt, provide for additional working capital, increased inventories and plant expansion programs, and for contingencies. The balance finally left for dividends, if any, after these necessary charges will be very small, and such dividends as are paid will represent no fair return on an investment in the corporation. I submit therefore, that Mr. Langley's contention applies equally as strong under the House bill as it did under the original Treasury proposals.

Principle of ability to pay ignored

The witness very properly called to the committee's attention the fact that corporate taxation is levied with complete disregard of the principle of the ability to pay of the ultimate owner of the corporation, that is, the stockholder. Every dollar of taxes extracted from the corporation comes out of the pockets of the owners of the corporation's securities. If the corporation be sound and prosperous the tribute is levied on the common stockholders only. In varying degree, however, depending on the financial condition and earning capacity of the corporation, the tax may also be borne by the preferred stockholders or even by the bondholders. Broadly speaking, however, it is the common stockholders as a class who pay the tax bill. Regarding each share of stock as a unit of participation in corporate ownership it will immediately be evident that each such unit shares in the tax on the corporation's income at exactly the same rate. It is true that if one man owns 10 shares of stock and another owns 100 shares, the latter's share of the total tax on the corporate income is 10 times as great as the former's. However, the rate of tax per unit is exactly the same, which is the important and entirely unfair aspect of this status. To make this even clearer an individual with an income of $5,000 per year owns 10 shares of stock in Corporation X and an individual with an income of $100,000 per year owns 10 shares of stock in the same corporation. Their respective contributions to the payment of the corporation's income tax are at exactly the same rate and in exactly the same amount regardless of the very obvious disparity in their respective abilities to pay.

That this is not a purely academic but a practical situation is shown by the well-recognized fact that stocks of most publicly owned corporations are held today by people who run the whole gamut of economic and social condition. As a matter of fact, as I will shortly develop, it is probable that the actual majority of stocks of publicly owned companies are today owned by people of very modest means.

Double taxation

Mr. Langley did not point out an additional element of unfairness in our scheme of corporate taxation. This consists in the fact that, from the standpoint of the party at ultimate interest, the individual holder of corporate securities, there is double taxation. The earnings of the corporation itself are first taxed in full. Thereafter, such part of the earnings as are received by the security holder are taxed again in his hands. For many years this situation did not exist in such aggravated form. Corporation dividends were expressly exempt from normal tax. This exemption was not removed until the enactment of the Revenue Act of 1936. It is interesting to note that, in net effect, Great Britain has never subjected dividends to normal tax in the hands of the individual recipient.

Who are the stockholders of publicly owned corporations

In discussing the hardships which will be suffered by corporation stockholders, if taxes as presently suggested are imposed, the witness also did not tell the committee, probably because the information was not available to him, the situs of today's ownership of the great publicly owned corporations in this country. Under our scheme of corporate taxation corporations are taxed as though they had an existence separate and apart from their security holders. As a matter of fact, corporations are nothing but a group of individuals investing their money in a cooperative enterprise, and, as I am about to point out, these individuals, in a steadily increasing stream, are predominantly the smaller income group in this country. This class by the very fact of its ownership of corporate securities proves itself to be the thrifty, industrious, self-supporting section of our citizenry who form the real backbone of the nation. If by any scheme of taxation we destroy the results of the past efforts of this class (by forcing great capital losses upon them), or discourage their incentive for the future (by reducing or eliminating the return on their investments), we strike at the very vitals of our national economy.

Following is a short table taken from income statistics published by the United States Bureau of Internal Revenue which serves to give us a key to the financial status of the people in this country who today are the owners of the stocks of corporations. It classifies, year by year, according to taxable income before personal exemptions, the individual recipients of dividends paid by all American corporations. Only sufficient years to establish a trend are included.

Total domestic dividends reported on income tax returns of individuals	Received by individuals with incomes under $5,000	Received by individuals with incomes between $5,000 and $10,000
1928—$4,350,000,000	$340,000,000 (1/13 of total)	$440,000,000 (1/10 of total).
1929—$4,790,000,000	$540,000,000 (1/9 of total)	$500,000,000 (1/9 of total).
1937—$3,500,000,000	$730,000,000 (1/5 of total)	$480,000,000 (1/7-1/8 of total).
1938—$2,200,000,000	$810,000,000 (1/3-1/4 of total)	$320,000,000 (1/7 of total).
1939—$2,500,000,000	$700,000,000 (1/3-1/4 of total)	$350,000,000 (1/7 of total).
1940—$3,430,000,000	$1,160,000,000 (1/3 of total)	$425,000,000 (1/8 of total).

Thus it will be seen that from the period starting with 1928 (1928 and 1929 are inserted as a part of the "old era") and ending with 1940, which is the latest year for which statistics are available, there has been a constantly increasing ratio of participation in corporation dividends by the "little investor," that is, the class of taxpayers with incomes of under $5,000 each. Starting with a participation amounting to approximately one-thirteenth in 1928, the little investor's share of corporate dividends has risen steadily in the present era until now it is about one-third. It is true that this trend is somewhat magnified by decreased personal exemptions, but it cannot be doubted that a substantial trend does exist. In any event, as far as the present is concerned, we find that in the year 1940 individuals with net incomes of less than $10,000 received eleven-twenty-fourths of the total receipts reported, or nearly 50 percent. This figure is obtained, of course, by adding the one-third received by individuals with net incomes under $5,000 to the one-eighth received by individuals with net incomes between $5,000 and $10,000. We venture to say that at the present time such combined holdings have passed the 50 percent mark.

Typical examples

Further bearing on the status of the small investor as a stockholder in American industry are the following interesting statistics:

In the case of General Motors over 80 percent of its shareholders hold 50 shares or less. By latest available figures General Motors now has over 396,000 common-stock holders alone. In the case of American Telephone & Telegraph, whose stockholders number nearly 750,000, over 75 percent of these stockholders hold 25 shares or less. In the case of United States Steel Corporation whose common-stock holders number 164,000, approximately 75 percent in number of shareholders hold 25 shares or less. The stock list of International Paper Co., the largest paper company in the world, shows that 68 percent in number of stockholders hold 25 shares or less and 80 percent in number of stockholders hold 50 shares or less.

Small investor bulwark of free enterprise system

These figures would seem to show beyond peradventure that unless he is frightened off, the small investor will soon become the predominant owner of the stocks of American corporations. This, we submit, is a very healthy condition and will furnish a bulwark for the system of free enterprise, our traditional American policy, in the uncertain times ahead. From this it is apparent that when corporations are taxed at high rates the taxes so extracted come in very substantial measure from the pockets of the smaller income group. As has already been pointed out, these taxes are levied at exactly the same rate against the small investor as against the wealthy owner of these stocks.

Fallacy of the small corporation

At this point I divert for a moment to make a very necessary distinction between the small investor and the so-called small corporation. In the history of our income-tax legislation great solicitude has been expressed by our taxing authorities for the small corporation. There has been and is now frank discrimination in its favor as against the big corporation. This can only be based upon the heretofore unchallenged theory that big corporations are in exactly the same case as wealthy people while small corporations are in the same class as individuals of small means and, therefore, with small ability to pay taxes.

This theory is believed to be completely unsound. The size of a business is no criterion of its relative ability to pay taxes; or, to put this somewhat more fundamentally, of the ability of the individuals who own such corporations to pay taxes. The fact is that the small corporations of the country are, practically without exception, closely held. In most cases they are owned by single individuals, by single families, or in the extreme case by a small friendly group. It is a well-known fact that in most small communities the principal business activities are conducted by corporations owned and controlled by the half dozen or less well-to-do families of the communities. In this class of activity is the general store, the ice business, the fuel business, the amusement business, and frequently the light-and-power business. The stocks of the corporations engaged in these enterprises are not listed and are not obtainable by the general public. The fact of close ownership permits the diversion to the stockholders, most or all of whom are actually engaged in the business, of a substantial part of the earnings in the form of salaries, expense accounts, bonuses or rental of property owned by the individual stockholders. Such payments, within limits, are proper deductions before arriving at net earnings subject to tax. In this respect the small closely held corporation is immediately at considerable advantage from an income-tax standpoint over the large publicly owned corporation.

For the reasons stated, among others, the stocks of large listed, well-known corporations of necessity furnish the principal medium of investment for the small investor. How substantial and far reaching this investment block is has already been demonstrated.

It would, therefore, seem apparent that when our legislative bodies undertake to afford protection, taxwise, to the small corporation, while taxing to the utmost the large corporation, on the theory that by so doing they are favoring the little fellow, they are proceeding under a completely mistaken belief. The reverse is true. When heavy taxes are levied on large corporations the money is coming in very substantial measure out of the pockets of the small investor of the country. When protection is afforded to the small closely held corporation, generally speaking, an umbrella is being raised over a group who are much better able to take care of themselves.

The case of Westinghouse

Supplementing the broad position taken by Mr. Langley is the following statement from a letter addressed to Members of Congress by A. W. Robertson, chairman of the Board of Westinghouse Electric & Manufacturing Co.:

"A preliminary examination of our income for April 1942 discloses a net income of less than $1,000,000 after provisions for taxes on a business of $41,000,000. This represents a return of slightly over 2 percent on such business and less than 50 percent of the net income for April 1941. This is not enough profit to pay even modest dividends to stockholders and continue reasonable wages to employees, without considering the well-recognized necessity to make some financial provision to cover present and post-war conditions. We are alarmed over the situation. We are, frankly, wondering what is to become of the company."

And yet the Westinghouse Co., one of our best known industrial operations, has only $20,000,000 of bonds outstanding and 80,000 shares of preferred stock which is a comparatively small charge ahead of its approximate 3,125,000 shares of common stock. If its chairman, with his company earning over $4,000,000 net after taxes for the first quarter of 1942, is not only worried about dividends and wages but even about the future of the company, what must be the feelings of the executives of the many publicly owned companies which are not nearly so strong financially as Westinghouse?

It is interesting to note that the Westinghouse Co., although it made about 70 percent more before taxes in the first quarter of 1942 than it did in the first quarter of 1941, had 27 percent less profit left after taxes in the first quarter of 1942 than it had in the corresponding period of 1941.

The case of A. T. & T.

K. S. McHugh, vice president of American Telephone & Telegraph Co., appearing before the Ways and Means Committee of the House on the Treasury proposals, stated that these proposals would reduce his company's earnings by more than $4 per share. (Under the revenue bill of 1942 as it now stands the corporation certainly fares no better.) This company has for years paid a dividend of $9 per share and its stock has been bought by thousands of investors at prices reflecting this dividend. The result of a reduction of from $4 to $5 a share in dividend declarations of American Telephone & Telegraph can readily be realized.

I am convinced that preservation of reasonable dividends on the stocks of our domestic corporations, if and when earnings before taxes permit, is very much in the interest of our whole economy. It remains, therefore, to take counsel as to whether there is not some way of achieving this without unduly diminishing Federal tax revenue.

Suggested remedy

In suggesting what seems to me to be a helpful expedient in the difficulty which confronts us, I do not wish to be understood as subscribing to the soundness of a tax on the normal income of corporations anything like as high as the proposed combined normal and surtax. Mr. Langley and I have both made clear, I hope, that an excessive impost on normal income threatens the very vitals of our domestic corporate activity. A tax of 45 percent on such income is definitely too high.

The obvious and soundest remedy is, therefore, to reduce this rate.

However, practical need for revenue is the pressing thing today, and for this reason and this alone, I suggest a sort of compromise which will serve at least to ameliorate an otherwise desperately unwise and improvident taxing program.

Careful consideration of the prospective effect of present tax proposals on corporation dividends suggests a way out without serious diminution of Federal tax revenue. This remedy would consist of an allowance of a credit against the proposed normal and surtax net income of a percentage of amounts declared as dividends. Such a plan in a general way was suggested by Mr. Langley.

My suggestion is that the percentage of dividends paid which shall be allowed as a credit be determined on average considerations but at a point which will not cost the Government any substantial amount in revenue. Obviously such a result can only be achieved by balancing the loss of corporation taxes against the gain in taxes upon the recipients of dividends.

In arriving at a percentage figure, we are assuming that the dividends received will be subject to surtax at the highest rate applicable to each taxpayer's income. We are also assuming, of course, that the credit given will greatly stimulate the payment of dividends. Examination of the surtax rates on individuals proposed by the House bill shows that surtax net incomes between $12,000 and $14,000 are subject to a 36-percent surtax. When to this is added the proposed normal tax rate of 6 percent we have a total rate of 42 percent. The minimum tax on dividends received by any individual will be 19 percent under the bill, and the maximum tax will be 88 percent. For these reasons and because of other computations too voluminous to be given here, we think dividends will bear an average tax rate of at least 45 percent in the hands of the stockholder. This conclusion is also borne out by the fact that about 50 percent of the dividends go to individuals with net incomes of less than $10,000, and 50 percent go to individuals with net incomes of more than $10,000.

If, therefore, as far as the revenue is concerned, a credit was given, against normal and surtax only, for every additional dollar of dividends paid by the corporation over and above what it could and would pay without regard to the credit, the Government would lose nothing on balance. It would lose 45 percent on the corporate tax on the amount of such dividends, but gain approximately the same amount from the tax on individuals. The advantage would be that the tax on individuals would be collected in accordance with their respective abilities to pay.

However, we must recognize that it is impractical from an administrative standpoint to determine the amount of additional dividends over and above the amount of dividends which might be paid in the absence of any credit.

It may be necessary therefore, in order to fully protect the revenue, to allow something less than 100 percent of the dividends paid as a credit against corporate normal and surtax net income. Just what reduction should be made is a matter of judgment. Personally, I believe, in view of the very high combined corporate normal and surtax rate, that the allowance of the credit will have the effect of substantially increasing the amount of dividends paid. This, of course, cannot be proved. However, on the basis of my experience in prognosticating tax yields, I venture to recommend that at least a 50 percent credit for dividends paid be allowed, with the strong feeling that no substantial revenue loss will follow.

CONCLUSION

The principal purpose of this memorandum is to raise the question whether the bill, as now drafted, is not so severe in some of its provisions as to defeat its own ends because of the long-range damage which it will cause.

These ends I conceive to be to secure to the Federal Government by taxation the greatest possible revenue compatible with the continuation of a sound national economy.

I conceive the condition stated to be an absolute condition precedent to any tax or fiscal program voluntarily adopted. For if the bounds thus set are exceeded not only will the sources of future taxes be dried up but the sources of necessary borrowing will be similarly and simultaneously constricted.

"Too little and too late" has proved to be a deplorable condition in the conduct of actual warfare. "Too much, too fast" is equally to be avoided in any money-raising program, particularly when the program must of necessity continue for a period of years.

I believe that the tax program for 1942, as presently drafted, has already reached the point of diminishing returns. Agreeing that amounts heretofore unthought of must be raised for the conduct of the present war—and thereafter—by borrowing and by taxation, I submit that there is today substantially more leeway for additional sound Federal borrowing than there is for additional sound Federal taxation upon sources thus far tapped. If new and proper sources of revenue by taxation are resorted to, well and good. But I believe that the tax rates now proposed, if they actually do not amount to confiscation, have reached the point where they will detrimentally affect our future economic welfare and thus set up a vicious cycle in which there will be a steadily diminishing income to tax and a steadily diminishing fund from which to borrow.

That "the power to tax is the power to destroy" is still as true as it ever was despite the revolutionary social and economic changes which are upon us, and without regard to the extent to which Government may hereafter usurp the functions of the free enterprise system, short of outright Government ownership of all property.

L. H. Parker,
Tax Associate, Guy and Brookes, Washington, D. C.

APPENDIX

(Tables submitted by Mr. Langley)

Estimated effect of proposed new taxes on certain public utility operating company preferred stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes up to 55 percent and excess-profits taxes up to 75 percent]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends times earned	Annual sinking fund requirements
Alabama Power $6 and $7	$5,718	$2,182	$3,536	$2,269	$1,267	1.55	$1,500
	5,718	3,444	2,274	2,269	5	1.00	1,500
Arkansas Power & Light $6 and $7.	3,153	*1,128	2,025	949	1,076	2.14	
	3,153	*2,001	1,152	949	203	1.21	
Birmingham Electric $6 and $7.	1,231	*322	909	429	480	2.12	
	1,231	*571	660	429	231	1.54	
California Oregon Power $6 and $7.	1,425	525	900	755	145	1.19	
	1,425	843	582	755	[1] 173	0.77	
Carolina Power & Light $6 and $7.	3,996	*995	3,001	1,255	1,746	2.39	230
	3,996	*1,766	2,230	1,255	975	1.77	230
Central Illinois Public Service, $6	3,858	[3] 1,853	2,005	1,708	297	1.17	600
	3,858	2,892	966	1,708	[1] 742	.56	600
Central Maine Power, $2½, $6, and $7	2,776	[4] 748	2,028	1,347	681	1.50	50
	2,776	1,327	1,449	1,347	102	1.07	50
Central Power & Light, $6 and $7	2,127	[4] 821	1,306	842	464	1.55	700
	2,127	1,291	836	842	[1] 6	.99	700
Consolidated Edison of New York, $5	49,893	*15,972	33,921	10,922	22,999	3.11	
	49,893	*27,175	22,718	10,922	11,796	2.08	
Consumers Power, $4½ and $5	17,227	7,882	9,345	3,425	5,920	2.73	125
	17,227	16,279	5,948	3,425	2,523	1.73	125
Florida Power & Light, $7	3,695	*1,197	2,498	1,153	1,345	2.16	
	3,695	*2,122	1,573	1,153	420	1.36	
Georgia Power, $5, $6, and $7	7,604	* [5] 2,238	5,366	2,676	2,690	2.00	1,687
	7,604	*3,970	3,634	2,676	958	1.36	1,687
Illinois-Iowa Power, $2½	4,650	1,744	2,906	1,209	1,697	2.40	274
	4,650	2,945	1,705	1,209	496	1.41	274
Indianapolis Power & Light, $5¼	3,988	[6] 2,133	1,855	738	1,117	2.51	900
	3,988	3,162	826	738	88	1.12	900
Jersey Central Power & Light, $5½, $6, and $7	2,954	*820	2,134	1,346	788	1.58	530
	2,954	*1,455	1,499	1,346	153	1.12	530
Kansas Gas & Electric, $6 and $7.	1,853	[7] 807	1,046	521	525	2.01	
	1,853	*1,432	421	521	[1] 100	.81	
Kansas Power & Light, $4½	2,982	1,351	1,631	626	1,005	2.61	520
	2,982	2,079	903	626	277	1.44	520
Louisville Gas & Electric, Kentucky, 5%, $25 par	4,895	2,142	2,753	1,076	1,677	2.56	
	4,895	3,107	1,788	1,076	712	1.66	
Minnesota Power & Light, $6 and $7	2,693	1,008	1,685	991	694	1.70	200
	2,693	1,610	1,083	991	92	1.09	200
Mississippi Power & Light, $6	719	*240	479	404	75	1.18	
	719	*425	294	404	[1] 110	.73	
Mississippi River Power, $6	2,322	809	1,513	494	1,019	3.06	156
	2,322	1,341	981	494	487	1.98	156
Montana Power, $6	6,349	2,834	3,515	957	2,558	3.67	480
	6,349	4,097	2,252	957	1,295	2.35	480
New York Power & Light, $6 and $7	3,655	*[8] 1,071	2,584	1,589	995	1.63	
	3,655	*1,900	1,755	1,589	166	1.10	
Northern Indiana Public Service, $5.50, $6, and $7	4,653	[9] 1,886	2,767	1,377	1,390	2.01	1,000
	4,653	3,057	1,596	1,377	219	1.16	1,000
Ohio Edison, $6, $6.60, and $7	7,547	3,649	3,898	1,867	2,031	2.08	
	7,547	5,276	2,271	1,867	404	1.21	
Ohio Public Service, $5, $5.50, $6 and $7	4,333	2,065	2,271	960	1,311	2.37	160
	4,336	3,074	1,262	960	302	1.31	160
Oklahoma Gas and Electric, $6 and $7	3,857	1,468	2,389	1,159	1,230	2.06	475
	3,857	2,329	1,528	1,159	369	1.32	475

See footnotes at end of table.

Estimated effect of proposed new taxes on certain public utility operating company preferred stocks—Continued

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes up to 55 percent and excess-profits taxes up to 75 percent]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends times earned	Annual sinking fund requirements
Pennsylvania Edison $2.80 and $5	$1,562	*$471	$1,091	$852	$239	1.28	----------
	1,562	*836	726	852	[1] 126	.85	----------
Pennsylvania Power & Light $5, $6, and $7	10,349	3,300	7,049	3,846	3,203	1.83	$850
	10,349	5,576	4,773	3,846	927	1.24	850
Public Service of Indiana $5	4,941	*[10] 1,782	3,159	741	2,418	4.26	1,242
	4,941	*3,161	1,780	741	1,039	2.39	1,242
Public Service of Oklahoma $5	2,598	[11] 855	1,743	440	1,303	3.96	200
	2,598	1,384	1,214	440	774	2.76	200
Rochester Gas & Electric $5 and $6	3,306	*1,028	2,278	1,393	885	1.63	----------
	3,306	*1,824	1,482	1,393	89	1.06	----------
San Antonio Public Service $6	2,126	[12] 1,078	1,048	270	778	3.88	270
	2,126	1,536	590	270	320	2.19	270
Texas Power & Light $6 and $7	2,560	855	1,705	865	840	1.97	----------
	2,560	1,301	1,259	865	394	1.46	----------
Toledo Edison $5, $6, and $7	3,519	1,320	2,199	945	1,254	2.33	362
	3,519	2,094	1,425	945	480	1.51	362
Utah Power & Light $6 and $7	2,778	*811	1,967	1,705	262	1.15	----------
	2,778	*1,439	1,339	1,705	[1] 366	.78	----------
Virginia Electric & Power $6	7,091	3,260	3,831	1,172	2,659	3.27	670
	7,091	4,786	2,305	1,172	1,133	1.96	670
Washington Water Power $6	2,657	*743	1,914	622	1,292	3.08	----------
	2,657	*1,319	1,338	622	716	2.11	----------
West Penn Power $4½	9,543	3,792	5,751	1,337	4,414	4.30	320
	9,543	5,800	3,743	1,337	2,406	2.80	320
West Texas Utilities $6 [14]	1,419	[13] 280	1,139	432	707	2.64	452
	1,419	497	922	432	490	2.13	452
Wisconsin Electric Power $4½ and $6	7,233	3,332	3,901	1,512	2,389	2.58	----------
	7,233	5,083	2,150	1,512	638	1.42	----------
Wisconsin Power & Light $6 and $7	2,611	[15] 1,101	1,510	1,116	394	1.35	370
	2,611	1,755	856	1,116	[1] 260	.77	370

* Income taxes only (no excess-profits taxes).
[1] Deficit.
[2] Includes $1,570,000 payable except for refunding.
[3] Includes $34,000 payable except for refunding.
[4] Includes $250,000 payable except for refunding.
[5] Includes $2,132,000 payable except for refunding.
[6] Includes $650,000 payable except for refunding.
[7] Includes $358,000 payable except for refunding.
[8] Includes $486,000 payable except for refunding (estimated).
[9] Includes $436,000 payable except for refunding.
[10] Includes $520,000 payable except for refunding.
[11] Includes $410,000 payable except for refunding.
[12] Includes $434,000 payable except for refunding.
[13] Includes $266,000 payable except for refunding.
[14] 12 months ended Sept. 30, 1941.
[15] Includes $799,000 payable except for refunding.

Estimated effect of proposed new taxes on certain public utility operating company common stocks

[First line shows 1941 actual results: second line shows estimated effect of proposed new Federal income taxes up to 55 percent and excess-profits taxes up to 75 percent]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Earned per common share	Annual sinking fund requirements
Central Hudson Gas & Electric	$1,604	*[1] $480	$1,124	$316	$808	$0.54	....
	1,604	*851	753	316	437	.29	....
Cleveland Electric Illuminating	11,549	4,942	7,057	1,147	5,910	2.54	....
	11,549	6,807	4,742	1,147	3,594	1.54	....
Commonwealth Edison	44,566	17,818	26,748	....	26,748	2.10	....
	44,566	27,908	16,656	....	16,656	1.31	....
Connecticut Light & Power	5,753	2,001	3,752	374	3,378	2.94	$200
	5,753	2,794	2,959	374	2,585	2.25	200
Consolidated Edison of New York	49,893	*15,972	33,921	10,922	22,999	2.00	....
	49,893	*27,175	22,718	10,922	11,796	1.02	....
Houston Lighting & Power	4,727	1,805	2,922	315	2,607	5.21	....
	4,727	2,775	1,952	315	1,637	3.27	....
Indianapolis Power & Light	3,988	[2] 2,133	1,855	738	1,117	1.56	900
	3,988	3,162	826	738	88	.12	900
Louisville Gas & Electric, Kentucky	4,895	2,142	2,753	1,076	1,677	1.85	....
	4,895	3,107	1,788	1,076	712	.78	....
Oklahoma Natural Gas	3,246	*748	2,498	592	1,906	3.47	475
	3,246	*1,327	1,919	592	1,327	2.41	475
Pacific Gas & Electric	33,255	10,792	22,463	7,970	14,493	2.31	1,303
	33,255	17,894	15,361	7,970	7,391	1.18	1,303
Public Service of Indiana	4,941	*[3] 1,782	3,159	741	2,418	2.18	1,242
	4,941	*3,161	1,780	741	1,039	.94	1,242
Washington Gas Light	1,715	[4] 508	1,207	270	937	2.20	160
	1,715	860	855	270	585	1.37	160
West Penn Power	9,543	3,792	5,751	1,337	4,414	1.50	320
	9,543	5,800	3,743	1,337	2,406	.82	320

*Income taxes only (no excess profits taxes).
[1] Includes $340,000 payable except for refunding.
[2] Includes $650,000 payable except for refunding.
[3] Includes $520,000 payable except for refunding.
[4] Excludes $16,000 credit applicable to 1940.

Estimated effect of proposed new taxes on certain industrial preferred stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes up to 55 percent and excess profits taxes up to 75 percent]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends, times earned	Earned per common share	Annual sinking fund requirements
American Bank Note, $6	$2,135	$1,098	$1,037	$270	$767	3.84	$1.17	....
	2,135	1,752	383	270	113	1.42	.17	....
American Can Co., $7	37,545	18,700	18,846	2,886	15,960	6.53	6.45	....
	37,545	26,561	10,984	2,886	8,098	3.80	3.27	....
American Rolling Mill, $4.50	24,143	12,915	11,228	2,025	9,203	5.54	3.21	$1,500
	24,143	18,219	5,924	2,025	3,899	2.92	1.36	1,500
American Tobacco, $6	44,260	20,376	23,884	3,162	20,722	7.54	4.58	5,849
	44,260	30,230	14,030	3,162	10,868	4.42	2.40	5,849
American Woolen, $7	19,144	12,200	6,[illegible]	2,450	4,494	2.83	11.23	....
	19,144	16,351	2,793	2,450	343	1.14	.86	....

Estimated effect of proposed new taxes on certain industrial preferred stocks—Con.

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends, times earned	Earned per common share	Annual sinking fund requirements
Bethlehem Steel, $7	$116,958	$82,500	$34,458	$6,537	$27,921	$5.27	$9.35	$4,960
	116,958	107,990	8,968	6,537	2,431	1.37	.81	4,960
Celanese Corporation, $7, $5, $7 2d	13,972	6,866	7,106	2,656	4,450	2.68	3.23	1,200
	13,972	9,930	4,042	2,656	1,386	1.52	1.01	1,200
Crucible Steel, $5	22,237	14,798	7,439	1,672	5,767	4.44	12.95	250
	22,237	18,893	3,344	1,672	1,672	2.00	3.75	250
B. F. Goodrich, $5	19,418	10,810	8,608	2,060	6,548	4.17	5.02	1,875
	19,418	14,365	5,053	2,060	2,993	2.45	2.29	1,875
Hershey Chocolate, $4+$1	9,162	3,218	5,944	1,269	4,675	4.68	6.82	....
	9,162	5,154	4,008	1,269	2,739	3.16	3.98	....
Marshall Field & Co., $6	10,076	5,390	4,686	900	3,786	5.20	1.95	....
	10,076	7,256	2,820	900	1,920	3.13	.99	....
Maytag, $6, $3 2d	2,705	1,080	1,625	1,017	608	1.60	.38	....
	2,705	1,684	1,021	1,017	4	1.00	.02	....
National Biscuit, $7	19,043	8,311	10,732	1,736	98,996	6.19	1.43	....
	19,043	13,554	5,489	1,736	3,753	3.16	.60	....
National Gypsum, $4.50	3,399	1,865	1,534	288	1,246	5.32	.94	253
	3,399	2,505	894	288	605	3.10	.46	253
Pure Oil, $5, $6	23,030	7,745	15,285	3,909	11,376	3.90	2.86	....
	23,030	13,583	9,447	3,909	5,538	2.41	1.39	....
Radio Corporation, $3.50 first, $5B	26,565	16,373	10,192	3,219	6,973	3.16	.50	....
	26,565	22,192	4,373	3,219	1,154	1.36	.08	....
Republic Steel, $6 PP, $6 P	70,288	46,250	24,038	2,037	22,001	11.81	3.87	4,428
	70,288	60,284	10,004	2,037	7,967	4.91	1.41	4,428
Schenley Distillers, $5.50	10,202	*2,724	7,478	925	6,553	8.08	5.20	1,200
	10,202	*4,832	5,370	925	4,445	5.82	3.53	1,200
Sharon Steel, $5	4,233	2,600	1,633	298	1,335	5.47	3.40	400
	4,233	3,372	861	298	563	2.89	1.43	400
United States Rubber, $8	29,775	16,113	13,662	5,208	8,454	2.62	4.80	2,000
	29,775	22,126	7,649	5,208	2,441	1.46	1.41	2,000
United States Steel, $7	234,871	118,700	116,171	25,220	90,951	4.60	10.45	11,973
	234,871	180,441	54,430	25,220	29,210	2.15	3.35	11,973
Wilson & Co., $6	10,133	*3,086	7,047	1,948	5,099	3.62	2.56	1,415
	10,133	*5,474	4,659	1,948	2,711	2.40	1.36	1,415
Youngstown Sheet & Tube, $5.50	37,624	21,500	16,124	825	15,299	19.55	9.13	3,960
	37,624	29,295	8,329	825	7,504	10.09	4.48	3,960

*Income taxes only (no excess-profits taxes).

Estimated effect of proposed new taxes on certain industrial common stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes up to 55 percent and excess-profits taxes up to 75 percent]

[000 omitted]

	Net income for common before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for common	Earned per share, common	Annual sinking-fund requirements
Adams-Mills Corporation	$1,046	$122	$624	$4.00	....
	1,046	654	392	2.51	....
Air Reduction Co	14,756	7,639	7,116	2.62	....
	14,756	10,656	4,100	1.50	....
Allen Industries, Inc	861	425	436	1.66	....
	861	626	234	.89	....
American Brake Shoe & Foundry	6,495	3,300	2,680	3.48	....
	6,495	4,672	1,308	1.70	....
American Home Products Corporation	7,775	3,411	4,363	5.12	$240
	7,775	5,607	2,167	2.54	240
American Laundry Machine Co	3,666	1,500	2,166	3.96	....
	3,666	2,307	1,359	2.48	....
Armstrong Cork Co	7,556	3,526	4,029	2.86	....
	7,556	5,017	2,838	2.00	....
Atlantic Refining Co	*20,988	7,233	13,754	5.16	....
	*20,988	12,832	8,155	3.06	....
Autocar Co	3,174	1,709	1,466	7.27	....
	3,174	2,689	485	2.31	....
Bath Iron Works Corporation	3,327	1,931	1,396	3.33	....
	3,327	2,995	331	.79	....
Babcock & Wilcox Co	15,732	11,480	4,252	6.33	....
	15,732	14,471	1,260	1.87	....
Beech-Nut Packing Co	5,861	3,152	2,709	6.19	....
	5,861	4,366	1,494	3.42	....
Bendix Aviation Corporation	36,714	23,446	13,267	6.30	....
	36,714	32,898	3,815	1.82	....
Borden Co	11,762	*3,491	8,270	1.88	....
	11,762	*6,194	5,568	1.27	....
Bridgeport Brass Co	6,716	4,805	1,911	2.03	....
	6,716	6,063	652	.67	....
Budd Wheel Co	5,688	3,950	1,738	1.82	....
	5,688	5,022	665	.67	....
Bullard Co	6,381	4,404	1,977	7.16	....
	6,381	5,505	876	3.17	....
Butler Bros	3,773	1,700	2,073	1.85	....
	3,773	2,850	923	.82	....
Carnation Co	4,776	2,359	2,417	3.97	....
	4,776	3,453	1,322	2.17	....
Chicago Pneumatic Tool Co	8,021	5,960	2,061	6.15	....
	8,021	7,430	590	1.76	....
Chrysler Corporation	68,814	28,700	40,114	9.22	....
	68,814	43,637	25,177	5.79	....
Clark Equipment Co	7,331	5,150	2,181	8.67	....
	7,331	6,523	686	2.47	....
Commercial Solvents Corporation	5,343	2,728	2,615	.99	....
	5,343	4,654	689	.26	....
Congoleum Nairn, Inc	4,279	2,262	2,016	1.62	....
	4,279	3,223	1,056	.85	....
Container Corporation of America	6,742	4,415	2,327	2.98	600
	6,742	5,696	1,045	1.34	600
Continental Can Co., Inc	12,194	4,724	7,469	2.62	....
	12,194	7,256	4,937	1.73	(1)
Corn Products Refining Co	19,357	9,091	8,545	3.37	....
	19,357	13,337	4,299	1.70	....
Eastman Kodak Co	49,818	28,229	21,218	8.57	....
	49,818	39,824	9,623	3.88	....
Eaton Manufacturing Co	11,864	7,500	4,364	6.20	....
	11,864	9,664	2,199	3.12	....
Electric Auto-Lite Co	13,686	7,820	5,866	4.90	400
	13,686	10,456	3,230	2.70	400
Fairbanks, Morse & Co	8,620	5,699	2,920	4.87	....
	8,620	7,368	1,252	2.09	....
Flintkote Co	3,363	1,720	1,643	2.34	225
	3,363	2,369	994	1.42	225
General Foods Corporation	25,215	11,737	13,478	2.56	....
	25,215	17,341	7,873	1.50	....
General Motors Corporation	480,564	287,992	192,572	4.42	....
	480,564	397,165	83,378	1.91	....

See footnotes at end of table.

Estimated effect of proposed taxes on certain industrial common stocks—Continued

	Net income for common before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for common	Earned per share, common	Annual sinking-fund requirements
Hazel-Atlas Glass Co.	$5,744	$2,863	$2,881	$6.63	
	5,744	4,087	1,657	3.81	
Johns Manville Corporation	16,046	10,385	5,661	6.66	
	16,046	14,586	1,460	1.71	
Jones & Laughlin Steel Corporation	27,952	14,342	13,610	10.85	
	27,952	20,481	7,471	5.81	
Kennecott Copper Corporation	83,519	34,268	49,251	4.65	
	83,519	49,145	34,374	3.17	
Kresge Steamship Corporation	17,223	7,775	9,448	1.72	
	17,225	11,687	5,535	1.08	
Lambert Co.	2,129	*779	1,350	1.81	
	2,129	*1,382	747	1.00	
Lehigh PortlandCement Co.	4,728	2,710	2,018	2.78	
	4,728	3,795	932	1.14	
Lerner Stores Corporation	2,673	1,285	1,388	3.47	
	2,673	2,032	641	1.60	
Loew's Inc.	13,997	3,747	10,250	6.15	
	13,997	6,631	6,366	4.42	
Loose-Wiles Biscuit Co.	1,749	740	1,008	1.98	
	1,749	1,218	531	1.04	
McCrory Stores Corporation	4,099	1,877	2,222	2.24	
	4,099	2,619	1,480	1.50	
Mesta Machine Co.	7,009	3,402	3,607	3.60	
	7,009	4,898	2,011	2.01	
Minneapolis-Honeywell Regulator Co.	6,513	3,899	2,614	4.20	
	6,513	5,217	1,296	2.09	
Monsanto Chemical Co.	15,941	9,609	6,331	4.90	
	15,941	12,736	3,204	2.58	
National Acme Co.	9,770	6,625	3,145	6.29	
	9,770	8,428	1,341	2.68	
Newport News Shipbuilding & Drydock Co.	13,814	8,923	4,891	6.11	
	13,814	11,904	1,910	2.39	
Otis Steel Co.	3,815	2,400	1,415	1.54	
	3,815	3,318	496	.54	
J. C. Penney Co.	33,628	16,500	17,128	6.24	
	33,628	23,362	10,266	3.73	
Pullman, Inc.	16,087	*5,168	10,919	3.31	
	16,087	*8,850	7,237	2.19	
Simmons Co.	7,226	3,715	3,511	3.03	
	7,226	5,146	2,080	1.80	
United States Gypsum Co.	13,667	7,181	6,486	5.42	
	13,667	9,892	3,775	3.17	
United States Tobacco Co.	4,140	*1,252	2,888	1.58	
	4,140	*2,367	1,773	97	

*Income taxes only (no excess-profits taxes).
[1] Company has $6,000,000 bank loans.

The CHAIRMAN. I think it is time for the recess now until tomorrow morning at 10 o'clock.

(Whereupon, at 5:35 p. m., a recess was taken until 10 a. m., Tuesday, August 11, 1942.)

REVENUE ACT OF 1942

TUESDAY, AUGUST 11, 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.

The first witness is Mr. Charles M. Howell, Kansas City, Mo.

STATEMENT OF FLOYD E. JACOBS, KANSAS CITY, MO., COUNSEL FOR AMERICAN RECIPROCAL INSURANCE ASSOCIATION

Mr. JACOBS. Mr Chairman and gentlemen of the committee; I am Mr. Howell's partner. He was unable to be here. My name is Floyd E. Jacobs. I live in Kansas City, Mo., and I appear here as counsel for the American Reciprocal Insurance Association, which is composed of a number of reciprocal or interinsurance exchanges, which represent many leading exchanges of the country, and with the permission of the chairman and the committee I would like to leave with the secretary a statement with respect to the particular matter about which I would like to make just a few remarks.

The CHAIRMAN. Yes, Mr. Jacobs. Mr. Howell will not be here?

Mr. JACOBS. Mr. Howell will not be here, Senator George.

The CHAIRMAN. I understand.

Mr. JACOBS. The revenue bill of 1942, and the portion with respect to which I am particularly interested, is section 207, which is the taxing section of the bill relating to mutual insurance, so-called. Interinsurance or reciprocal exchanges are not specifically named therein, but are apparently treated as a form of mutual insurance, and while that is not accurate, strictly accurate, we have no particular quarrel with that designation.

The representative of the Treasury Department on yesterday stated that interinsurance or reciprocal exchanges are perhaps the most perfect form of a mutual activity in the realm and in the field of insurance. Under the present law interinsurance or reciprocal exchanges are entirely exempt.

Interinsurance is a non-profit-taking activity in the insurance world, and the subscribers at a reciprocal exchange are both insured and underwriters. There is no joint fund, but the moneys that are advanced by a subscriber at an interinsurance exchange are always set up as individual or separate credit on the books of the exchange. The exchange itself has nothing. The exchange itself is merely a place, and the activities of the subscribers at an exchange, while they were originally accomplished by acting directly one with the other in the exchange of contracts of indemnity, due to the increase in the business are now exchanged through an attorney-in-fact, or an agent of the various subscribers under what is called a power of attorney or a subscriber's agreement, and the subscriber deposits a sum of money, and upon the deposit of that sum of money it is credited to his individual account upon the books of the exchange, and there is paid out of that deposit the moneys which he permits to be paid and which he has agreed shall be paid under the terms of the subscriber's agreement or power of attorney, such as losses, and so forth, and the remainder simply represents a saving to the subscriber. There is no joint fund of any kind. No profit is made by anybody, excepting that the attorney-in-fact receives compensation for his or its services in acting as the agent for the subscribers in providing for the exchange of these interindemnity contracts. Of course, upon that compensation, which is a compensation for management, he pays taxes under the income-tax law.

Under this measure as it now appears in the revenue bill of this year, passed by the House, the reciprocal exchanges are not taxed upon these deposits, because the Treasury Department recognizes that there was no fund there against which a tax could be levied. The reason being, as I stated, that these moneys that are deposited by the subscribers always remain throughout their moneys, and all moneys of every kind and character in a reciprocal exchange ultimately find their way back to the subscriber and represent savings in the matter of his insurance, and upon those savings the subscriber naturally is required to pay an income tax.

However, the Treasury Department felt that reciprocal exchanges should pay a tax upon investment earnings, and while this is not, in our view, a logical position, because the separate funds of the subscribers are invested and the earnings upon those funds are immediately credited in the separate account upon the books of exchange of the subscribers, and therefore they always remain the moneys of the subscribers, as earnings upon their own moneys and upon which they ultimately, upon return to them as savings, pay a tax under the income-tax law.

However, we have no particular quarrel with that. We were concerned with two things about this bill, and upon these two matters we are in full accord with the Treasury Department and with Mr. Colin Stam, who is the chief of staff of the Joint Committee of Internal Revenue Taxation of the Congress.

One was a provision that section 207, that apportioned surplus which is a deductible item under section 207, should only be considered apportioned surplus if it was distributed within 5 years after the termination of the policy under subparagraph (a) in that language, and in effect the same language in subparagraph (b) of section 207.

The only difficulty about that matter was that a subscriber at an exchange might have a year policy but be a subscriber for 20 years, and if there was a requirement of distributing his surplus—which is credited to his account at all times, his personal individual account—within that period it would be impossible for an exchange to set up a proper surplus, or to accumulate a proper surplus in order to make the operatiton of the exchange and the exchange of inter-insurance contracts safe, and indeed to comply with the solvency statutes of various States of the Union.

The Treasury Department states, and authorized me to say to this Committee, that they had made a mistake in the wording of this particular matter, and that they purpose to offer an amendment which would read that the distribution should be within 5 years after the policyholder ceases to be such. So that Mr. Stam, the representative of the Treasury Department, and we are in full accord upon this matter, and this amendment would entirely cure what the Treasury Department said was a mistake in its wording of the original measure.

Senator CLARK. You mean this amendment would obviate the requirement of disposing or paying out the surplus in case of renewals? Where it was for a term of 2 years and renewed for 2 years more it would not be necessary under this proposed amendment to make the exchange pay out the surplus but still continue it for 5 years after he ceased to be in the exchange?

Mr. JACOBS. That is right. And, of course, the Treasury Department says if any other mutual organizations sought to come within the theory of reciprocal insurance to the extent of return of surplus, that they could take advantage of the situation as well, and, of course, with that we have no objection.

The other matter was this, and with this we are in accord with the Treasury Department, having discussed the matter with the representatives of the Treasury Department and with Mr. Stam, as well——

Senator VANDENBERG (interposing). You seem to be in a very happy position this morning.

Mr. JACOBS. Senator Vandenberg, I have never been in a happier position excepting, as I stated awhile ago, that logically and strictly speaking, under this theory of reciprocal insurance investment earnings should not be taxed to the exchange but rather to the subscriber, but with that I am not making an immediate quarrel, because I sort of recognize the futility when I meet it in the middle of the road.

But with respect to this latter matter, as I stated to you gentlemen of the committee a little while ago, section 207 deals generally with mutual insurance and not specifically with interinsurance. Interinsurance is only named under section 147, which is the exempt section applying to mutuals and reciprocals which have mean invested assets of less than $100,000. Under the House bill they are entirely exempt, but in section 207, which is the taxing section, reciprocals are not specifically mentioned.

We are in accord with the meaning of this statute as applied to inter-insurance, and it is agreed that all the moneys of subscribers are always apportioned to subscribers and that there is nothing that belongs to the exchange except with respect to this money that is taxable, and in order to clarify the matter, the Treasury having determined that there should be a tax upon investment earnings, I am asking and requesting the committee that it appear in the committee report that the intent of this measure is to tax only the investment earnings of inter-insurance or reciprocal exchanges, and I am authorized to say, by both Mr. Stam and Mr. Friedman representing the Treasury Department that they are fully in accord with that request, because it is their construction of the bill and it was the intent of the Treasury in preparing its position in the matter that it should mean just exactly that.

Those are the only two matters that I desire to bring before the committee, with the hope that the committee would give consideration to those two matters, and with permission, Senator George, if possible, to leave with the clerk this statement which I have.

The CHAIRMAN. Yes, sir; you may do so.

Mr. JACOBS. Thank you gentlemen for your attention.

The CHAIRMAN. Thank you, Mr. Jacobs.

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

BRIEF STATEMENT OF AMERICAN RECIPROCAL INSURANCE ASSOCIATION, SUBMITTED BY FLOYD E. JACOBS, KANSAS CITY, MO.

Mr. Chairman and gentlemen of the Senate Finance Committee: I appear before you today representing the American Reciprocal Insurance Association, said association comprising most of the leading reciprocal insurers of the country. For the purpose of clarification, reciprocal insurers are sometimes also referred to as interinsurers and the terms are used more or less interchangeably; but for convenience the term "reciprocal insurance" will be used in this presentation.

Reciprocal insurance contemplates the reciprocal exchange of indemnity contracts between individuals, firms, and corporations whereby they are enabled to protect themselves from loss by fire or other casualty at actual cost. These individuals, firms, and corporations, who constitute the real parties in interest, are commonly designated "subscribers." They select a common attorney in fact or manager, generally designated the "attorney," who establishes an office at some convenient point to effect this exchange of contracts. This attorney, under the supervision of an "advisory committee" selected by the "subscribers," keeps the books and records, passes upon and classifies risks, makes frequent inspections, adjusts and pays losses and, in fact, does everything incident to the exchange of the indemnity provided for.

The office so conducted and operated by the subscribers, through the attorney, at and through which the subscribers exchange these contracts for their own protection, is commonly designated as the "Exchange," and because of this situation and relation the assemblage of subscribers in the particular groups are commonly referred to as "exchanges" with the addition of some descriptive name to properly identify the particular group. The subscribers make an annual deposit with their attorney, the amount of which is usually determined by the rate which is paid for stock-company insurance on the same class of risks, or else by an elaborate system of inspection resulting in the formulation and application of rates on the part of the exchange itself. This deposit remains to the credit of each subscriber; his pro rata portion of losses being charged off on his account from time to time as they occur. A fixed percentage of the subscriber's deposit is set aside in the attorney's account to cover expenses of management, including compensation of the attorney. All subscribers' funds are handled severally and not jointly, there being a separate account for each subscriber to which funds deposited by him are credited. At all times these funds remain the property of the subscribers, respectively. At the end of the policy period, all sums that remain after the payment of losses and fixed expenses, revert to the subscriber and are returned to him as savings, except that in the discretion of the attorney and within limits provided in the written appointment of the attorney, certain portions thereof may be retained as a reserve fund, by whatever name denominated, to provide against the contingency of unusual losses. Upon the retirement of a subscriber and the consequent cancelation of his policy, all funds remaining in his account, whether accumulated for surplus or otherwise, are returned to him, less his proportion of any losses which have been incurred to the date of his retirement. The subscribers at an exchange constitute no company or association and there is no profit contemplated or made; protection at absolute cost being the end sought to be obtained.

It is apparent that this simple plan would effectively dispose of the problem of the high cost of insurance. The plan has only to be explained in order to be understood and its benefits appreciated. The result is that reciprocal insurance extended into practically all the States and Provinces of Canada as well.

In the beginning the parties who executed the original contract attended to all the incidental transactions themselves, including the admission of new participants, then as now termed "subscribers," the inspection of risks, the execution and issuance of policies and the adjustment and payment of losses. Later on as te transaction widened, the participants became too numerous to admit of such procedure and a change was made which resulted in the development of the present plan of reciprocal insurance. A skilled underwriter was selected for this purpose and by written power of attorney, each of them authorized this individual, as their common attorney in fact, to establish an office, equipped in such manner as to perform all of the underwriting activities incident to the exchange of protection between themselves. This power of attorney set out in specific terms the kind and character of the protection desired and the manner in which it should be provided. There was thus created and instituted that which was in the beginning an anomally in the insurance world, to wit: A modernized plan of insurance "of, by and for" the insured. The attorney was authorized by his appointment to do all things necessarily incident to the indemnity provided for, which in general terms meant the exercising of all the functions exercised by the management of insurance carriers generally. The difference between their plan and other existing plans is that the subscribers proposed to operate it for themselves and according to their own ideas. The original plan, including the form of appointment of attorney and the general powers conferred is in effect at thi sdate without material change; and considering the beneficial results which have been obtained, it would seem to be inconsistent with public policy to alter it.

A thorough understanding of reciprocal insurance can lead only to the fair conclusion that a reciprocal exchange has no income. As is, of course, known to the members of this committee, section 101 (11) of the present Income Tax Act specifically exempts reciprocal underwriters. In addition to this, under section 207 (c) (3) of the same act, certain deductions are allowed reciprocals in computing income, which deductions result in no taxable income.

A reference to the plan briefly stated above will show that no insurance is purchased as such by the payment of a premium therefor. In contrast, the subscriber or insured merely makes a deposit, out of which his proportionate share of losses and expenses is paid. What remains of such deposit at the end of the policy period, except for sums allocated to a surplus or guaranty fund, is returned to him. These returned funds may in no sense be classed as a dividend for the very apparent reason that they are merely savings from a fund previously advanced by the subscriber or insured and constantly remaining to his individual credit. With regard to the surplus or guaranty fund, the laws of the various States require such funds in varying amounts and over and above this the principles of sound business and insurance judgment clearly dictate the advisability of such funds to provide against unusual losses and the possibility of assessment of subscribers. Wherever the funds are, however, they remain the absolute property of the subscribers in their several capacities. The reciprocal exchange itself has nothing and is, in fact, nothing more than a name or place. Any taxation of these funds, therefore, whether it be on investment income or underwriting income, is merely a tax on the individual subscribers comprising the reciprocal exchange and they, of course, already pay income tax on their incomes. Surely then, any further income tax on them would be the most direct form of double taxation.

The only profit or income that is realized in connection with a reciprocal exchange is realized by the manager or attorney-in-fact, be it corporation, firm or individual, and these parties of course pay income tax on such income. For instance, when the attorney-in-fact is a corporation it pays all forms of general corporation taxes, including income taxes, the same as any other business corporation. The exchange itself being cooperative, no profit goes to third parties, the savings of the exchange, of whatever nature, serving merely to reduce the cost of insurance to the subscriber members or policyholders.

It is difficult for us to see how the Government could in the last analysis gain any revenue from a tax on the alleged income of an insurance organization of this type. For instance, if a man insures his business in a stock insurance company he pays a certain premium which is deducted from the income of his business as a business expense. The same of course is true if he insures in a reciprocal exchange but the savings which are returned to him are taxed to him either as additional income or the amount of his deduction as a business expense is reduced by that amount and hence more money flows to the government. If, on the other hand, the funds of a reciprocal are taxed, the savings to the subscriber or insured are reduced by that amount and the government will receive that much less from the individual. Looking at the matter in this light then, we see that the revenue of the Government would be about the same whether it imposes a tax upon this type of insurer or exempts it and yet a cardinal principle of the theory of cooperatives will have been invaded. We have searched the laws in vain for any tax of this nature levied against any of the other cooperative enterprises over the nation and it is difficult for use to understand why an insurance cooperative should be singled out for taxation. Reciprocal or interinsurance, as the very names imply, are the very essence of the cooperative scheme. Where profits flow to third parties, those profits should be taxed; where there are, as here, no profits to third parties, a tax would be an anomaly.

It may be contended that some reciprocals issue nonassessable contracts and that they thereby lose their cooperative standing. This is fallacious reasoning, however, as it must be admitted that all parties have the constitutional right to contract among themselves as they may see fit so long as such contract is not against public policy. Each subscriber or policyholder at a reciprocal exchange signs a power of attorney authorizing the attorney-in-fact for the reciprocal exchange in question to exchange for him with other subscribers thereat contracts of insurance under certain well defined conditions. Each subscriber is, therefore, the insurer as well as the insured. In most exchanges an assessment liability is provided, usually of one additional deposit should the situation require. In others all liability is limited to the funds of subscribers on hand at the exchange. In either event all subscribers at an exchange are similarly situated and are insuring one another in a cooperative manner.

In over 30 States of the Union where there are specific sections of the law regulating the exchange of contracts of reciprocal insurance, reciprocal exchanges due to the nature of their organization, are specifically exempted from the general insurance laws of such States. It is interesting to note that they are also specifically exempted from most State laws regulating rates. The reason for this is not that any preferred treatment should be accorded them but that they are primarily not interested in rates as such. The size of the deposit to be put up by the subscriber is of no importance so long as it is adequate, and stock company rates are therefore generally used as a matter of practice in fixing the amount of the deposit. It is of no concern to the subscriber since he knows the unused portion of his deposit will be returned to him.

There are certain special features which apply particularly to reciprocal insurance and which distinguish this plan of indemnity from any other plan. It will be observed that they all naturally flow from its fundamental idea, which is to provide adequate protection at actual cost. Anything which results in the lessening of an expense item is in accord with this fundamental idea. The local agency system is not employed at the exchanges for the reason that it is an overhead item which can be eliminated without any loss in the high character of the protection furnished and with great pecuniary saving to the subscribers. The management at an exchange employs special representatives who are trained in the particular class of risks covered until they become highly proficient as inspectors. The principal functions of these inspectors is the actual inspection of risks. The contract of insurance itself is effected by the subscriber through the central office, the traveling representative of the management simply being a sort of intermediatry as to the preliminary steps of this transaction. This traveling representative is on a salary basis. Under this plan, the annually recurring collection of commissions by local agents is eliminated. The result is a great saving to the policyholder.

With the rapid development of this form of protection the question of reserves to meet catastrophe losses became important. For many years, the attorneys-in-fact have pursued the policy of retaining a portion of the subscriber's savings by way of a reserve to his individual credit on the books until such reerve represents a substantial surplus or guaranty fund. The exchanges are thus able to maintain what corresponds to the reinsurance reserve of stock companies and a substantial surplus over and above this amount. It should be borne in mind, however, that this reserve is not a real liability as it is always available for the payment of losses. When a subscriber retires, he is entitled to the amount standing to his credit on the books, less his proportionate share of losses and expenses to the date of his retirement. This amount may be great or small in the proportion that losses incurred during his term as a subscriber have been small or great.

From the above it will readily be seen that an insurance organization of this type is not a commercial venture for profit but rather a seeking of mutual protection at cost.

In the statement of Mr. Randolph Paul, tax adviser to the Secretary of the Treasury, made before the House Committee on Ways and Means, on March 3, 1942, it was urged that the exemption given certain mutual companies in section 101 (11), which exemption includes reciprocal exchanges (reciprocal underwriters or interinsurers as it is phrased), had resulted in a disparity in tax treatment between mutual and stock companies. It is respectfully submitted that such a disparity might seem to exist if we merely regard the amount of taxes paid by each type of insurer. When, however, we examine into the organization and business methods of each, the disparity vanishes and leaves the taxing laws in an equitable light. In other words, where there are corporate profits as in stock companies a tax is justifiable. Where, as in a reciprocal or other cooperative, there are no profits to third parties a tax is not justifiable. Mr. Paul suggested that the exemption be confined to the smaller mutual type companies and further suggested that others be taxed on the sum of their investment income and additions to surplus which are free from claims of policyholders.

With regard to reciprocal exchanges there are no funds that are free from claims of policyholders. As to investment income this too is the sole property of the individual subscribers or policyholders and is apportioned to their several and separate accounts, finding its way finally into the inevitable channel of reducing the cost of insurance by being returned to subscribers in the form of savings. H. R. 7378, now before this body, nevertheless taxes investment earnings of reciprocals.

The entire question seems to hinge on whether or not funds are retained by some sort of a corporate entity or either returned to the policyholder or retained for a so-called claimable reserve. If it were contended that funds placed in a reserve or guaranty account held by a reciprocal exchange were in the nature of corporate reserves, the obvious answer would be that they are also claimable reserves because returnable to the member upon retirement or liquidation.

However, it is interesting to note that the question of taxing investment income seems to be made a separate issue. We submit that since the investment income of a reciprocal exchange is actually the income of the separate accounts of the members who make up the reciprocal exchange, it likewise should not be taxed to a reciprocal exchange.

We have within the time available gone into the organization and theory of reciprocal insurance for the reason that an understanding of it is essential in considering any question concerning it. The crux of the entire matter is to keep foremost in mind the fundamental principle that all premium deposits or other funds as received are distributed to the separate accounts of the members as individual underwriters, and as losses and expenses are incurred, they are ratably distributed to the subscribers' respective accounts.

Under House bill 7378, section 207 (A) (B), in order to be deductible, surplus apportioned to policyholders must be distributed within 5 years after termination of policy. For many reasons best explainable perhaps by the Treasury Department, it is recognized that this particular limitation is not a feasible one. It is my understanding that the Treasury Department itself will propose an amendment in which it will be provided that the surplus apportioned to policyholders must be distributed within 5 years after the policyholder ceases to be such. The exact form of this amendment I do not know, but the above constitutes a suggestion I have received and would be entirely satisfactory. Section 207 of the bill taxes investment income of reciprocal exchanges. It is clear that no other form of income of a reciprocal could be taxed since it has no income, all moneys being the separate property of the subscribers and always credited to their respective separate accounts. This is recognized in the House bill referred to by both the House and the Treasury Department. I desire to call your attention to the fact that with respect to investment earnings, these earnings are always the individual moneys of the respective subscribers and are continuously and immediately credited to such respective accounts of subscribers. Therefore, investment earnings are always the money and the property of the individual subscribers and such subscribers pay income tax upon such earnings. They are never the property of the reciprocal and should not be taxed to the exchange. In truth and fact, the exchange as such has no money of any kind. It is a mere place through which subscribers exchange interinsurance contracts.

It clearly appears to us, therefore, and we earnestly so urge, that there should be a clean-cut exemption for all funds received at a reciprocal exchange in excess of losses and expenses, which are returned to the subscribers either in the form of cash savings or as a credit to their reserve balances at the exchange subject to withdrawal upon termination of membership, including investment earnings. If this is acceptable, then there appears to be no substantial reason why reciprocal exchanges should not be exempt by a clear statement of exemption in the law because of the fact that all funds are distributed to their respective accounts.

In conclusion and in summary, we submit that reciprocals should be exempt from income tax for the following reasons:

1. The cooperative nature of their organization.
2. No other nonprofit cooperative is subject to taxation, nor is such tax proposed.
3. The lack of any profit to third parties.
4. Tax on a reciprocal exchange would result in double taxation of its members, including the proposed tax on investment earnings.

We sincerely appreciate the opportunity to be heard on this issue before this honorable committee and wish to express our thanks for your time and attention.

Respectfully submitted.

American Reciprocal Insurance Association,
By Floyd E. Jacobs,
Counsel.

The Chairman. I wish to put into the record a memorandum on post-war refunds, by Mr. L. C. Vallier, treasurer, Buffalo Foundry & Machine Co., Buffalo, N. Y.

Mr. Vallier was scheduled to appear as a witness and he has submitted this memorandum; but, I am informed, he has been called out of the city.

(The memorandum referred to is as follows:)

Memorandum by L. C. Vallier, Treasurer, Buffalo Foundry & Machine Co., Buffalo, N. Y.

We believe that the 1942 tax rates as passed by the House, without a suitable post-war refund, would be so drastic as to adversely affect war production, and that the ultimate effect would be to force many corporations into bankruptcy.

This, of course, is not the desire of Congress nor the administration, and we all are fully cognizant of the part industry must play during the war as well as the post-war era.

If corporate enterprise is stinted there can be no prosperity, for without normal employment in industry workers are unable to purchase the products of the farms or of manufacture.

It appears that the present bill seeks nearly 90 percent of additional taxes from present taxpayers, while seven-eighths of the gainfully employed would not bear this burden.

To tap the reservoir of tax sources hitherto practically untouched, new tax sources, such as a sales tax or withholding tax, should be carefully considered.

I believe that corporations are not so affluent as is generally supposed. The last depression left an indelible smudge upon corporate finances, as in the case of my own company. The fiscal years from May 1, 1930, to April 30, 1941, provided total net earnings over losses of 11 percent of capital stock outstanding, or less than one-half of 1 percent on invested capital, over the 11-year period (available dividends 1 percent annually), not considering the amounts required for the acquisition of capital assets; and I believe ours is not an isolated instance.

I further believe that the proposed taxes without a liberal refunding plan is discriminatory to the corporations that financed their own emergency facilities, inasmuch as they will be unable to recover all of their investments; in fact, only as much as is afforded through tax relief by accelerated amortization, and as yet I have heard of no proposals indicating such relief from State taxes.

Accelerated amortization relieves taxes but does not increase profits by virtue of increased overheads, because of price ceilings imposed some months ago.

At proposed 1942 rates $1,000,000 in earnings on an invested capital of $3,000,000 would dwindle to a net of $152,000 after Federal and New York State taxes equivalent to 2½ percent on sales value of $6,000,000 or 5 percent on invested capital.

We know the extreme necessity for revenue; however, it must be judiciously imposed. Let us consider this necessity together, with the necessity of maintaining sound, fiscal policies for the post-war era, and thereby perpetuate corporate life, by refunding a reasonable portion of these taxes.

Our company is all out for war production and by extending our facilities to the utmost, have been able to produce materials and equipment far in excess of our fondest hopes. Our plant and equipment are taking a terrible beating and it is our best estimate that we shall be obliged to replace equipment to the value of at least $600,000 for peacetime production.

Post-war refunds will be the only solution.

L. C. VALLIER.

AUGUST 11, 1942.

The CHAIRMAN. Mr. George E. Foss, of Harrisburg, Pa.

(No response.)

The CHAIRMAN. Mr. Homer Strong, of Rochester, N. Y.

(No response.)

The CHAIRMAN. Mr. James M. Weil, of Rochester, N. Y.

STATEMENT OF JAMES M. WEIL, SECRETARY-TREASURER, MICHAELS, STERN & CO., INC., ROCHESTER, N. Y.

The CHAIRMAN. On what subject do you appear, Mr. Weil?

Mr. WEIL. The fiscal-year corporations, sir.

The CHAIRMAN. The fiscal year?

Mr. WEIL. Yes.

The CHAIRMAN. You are for the fiscal year?

Mr. WEIL. We follow the fiscal year; yes, sir.

The CHAIRMAN. And you are against the change?

Mr. WEIL. We are against the proposed change.

My name is James Weil, I am secretary-treasurer of Michaels, Stern & Co., Inc., of Rochester, N. Y. The corporation I represent manufactures men's clothing. While the present company is comparatively young, having been incorporated in 1938, the corporation succeeded a partnership of the same name that was over 90 years old. Through all these years there has been a continuity of family ownership.

I am sure that I am not telling you a new story—it is one that you have undoubtedly heard from many businessmen—when I say that we would willingly have you gentlemen tax all of our profits 100 percent if we could be guaranteed that our working capital would be in the same position, neither better nor worse, at the end of the war as at its beginning. I appreciate that it is not the function of this Government to give such guaranties—and that the need for tremendous revenues from taxation is paramount. The fact remains, however, that the ability of a business such as ours to continue during a post-war depression period is dependent on our ability to keep our working capital intact. To do this we must have some way to build up our reserves to take care of the inevitable and substantial inventory losses that have always occurred in our industry following a period of comparative prosperity. We are willing to forego accumulating these reserves through retained profits because of the greater national need, but we do ask for some form of credit against our top tax brackets which can be used after the war instead of the reserves we would have normally accumulated. By giving us this, you are helping business it is true, but you are also helping a great many more people retain their employment after the war.

I did not come here today, however, to talk about post-war credit, which I am sure has been ably presented to you by others. I asked for this hearing principally to discuss the problem of the fiscal year corporation, and the proposed changes in taxing such corporations now in the House bill.

I have here a book—a ledger of the old partnership that goes back to 1883—it shows that the company closed its books then—nearly 60 years ago—as it does now, on November 30 of each year. I point this out only to show that this fiscal-year period was not adopted as a tax avoidance scheme—in fact, this was 30 years before our Constitution was amended to give Congress the power to levy an income tax.

You may ask, then, if this date was adopted that many years ago merely through accident. No, it was chosen because ours is a seasonal industry, and it is good accounting practice to close your year and take your inventory at a natural date, after one season's business has been completed, and before you get too far along into the next. No date is perfect, but some are much better than others. There is some argument as to whether October 31 or November 30 is the better closing date, but all agree that December 31 is not good, as manufacturing operations for the next season are then approaching their peak. Here are our own figures: In 1941 our ending December inventory was 25 percent greater than our ending November inventory; in 1940, 26 percent greater. You realize, of course, that a fiscal year should close if possible at the lowest inventory period of the year. The figures tell only part of the story, however; not only are December inventories higher, but they are made up in greater part of work in process and finished merchandise which are more difficult to take and value, in contrast to the larger percentage of raw materials in a November inventory.

I have heard that one argument advanced for changing the method of taxing fiscal year corporations is that the present method gives a competitive advantage to certain concerns in an industry over others who remain on a calendar basis. Perhaps this is true in some lines of business, but here is a list of 25 of the larger companies who manufacture men's clothing. Opposite each name is the date each ends its accounting year. This information was obtained from the National Credit Office, the subsidiary of Dun & Brandstreet that specializes in the reporting on apparel manufacturers. Of the 25, 8 close on November 30, 11 on October 31, 3 in May, June, or July, leaving only 3, or about 10 percent that close December 31.

To the best of my knowledge only 1 of these 25 concerns has changed their accounting period from December 31 during the past few years, and you will note that 17 of these companies have chosen October or November—obviously, this is no coincidence and bears out what I have said about these being natural closing dates for this business. Two of the three houses who close in the summer months are specialists in summer apparel and consequently, have a different natural accounting period. This evidence certainly indicates that by far the largest number of companies in the business adopted the fiscal year for sound accounting, rather than for tax reasons—and because of having done this, have no competitive advantage one against the other, in having the present method continued. The American Institute of Accountants has long recommended that business adopt the natural fiscal year rather than the calendar year, and I feel it would be a constructive move to encourage all businesses to follow this procedure rather than discourage it through an administrative change in the law.

For eight years or so, we—and I am sure others on a fiscal-year basis—have thought ourselves justified in feeling that our tax rate was certain, and was fixed by the rates in effect at the beginning of our fiscal year. Our budgets and our commitments have been made and our planning done on the assumption that there would be no retroactive changes made in the law. If such a change must be made, should it not be done now to become effective for the years beginning in 1942 rather than in 1941, so that with advance notice we have an opportunity to prepare for the change?

Here is what the proposed change will mean to our company for this year ending November 30, 1942. Based on estimated profits of $400,000 before taxes, our total income and excess profits taxes under the present law, will be $211,000. If we must pay one-twelfth of our taxes under the 1941 taxes and eleven-twelfths under the rates in the 1942 House bill, our total taxes will be approximately $296,000, a difference of $85,000.

This may seem a small amount to you, but gentlemen, we are a small company compared to many, a small company operating on a small margin of profit. Last year was considered a better than average year in our industry, certainly the best our own company enjoyed for a decade, and yet our profits amounted to 5.19 percent of sales before taxes, and only 3.55 percent after taxes. Our estimates this year even under the 1941 rate, show only 2.93 percent profit on sales after taxes. If our business were one that enjoyed a fast turn-over, these profits might not seem low, but our inventory is turned less than four times a year, while our combined investment in inventory and accounts receivable turns just a fraction over twice each year. In addition, we must make our commitments for raw materials from 4 to 6 months before they are put into process. It surely cannot be claimed that our low rate of profit on sales is justified by the small amount we have invested subject to the hazards of business. Nor is our company a marginal one in the industry. A report of the Robert Morris Associates, a copy of which I have here, shows the consolidated earnings of the reporting manufacturers, amounted to 4.47 percent of their gross sales last year.

It is the small company, especially in an industry whose earnings during the past 10 years have been negligible, that is hardest hit by these increases in taxes; because they have not been able to build up their reserves and their surplus accounts as have the large corporations.

So you see $85,000 additional taxes may have a greater effect on our business than a $1,000,000 or more on some company whose surpluses are proportionately greater than ours, and whose debt is relatively smaller.

This company is not a "war baby." As I have told you, we are over 90 years old. Nor are we we war profiteers. Government contracts will account for only about 12½ percent of our business during this current year. Our earlier contracts not only showed us no profit, but covered only a small part of the overhead applicable to them. Later ones do show some profit, but the rate of profit is always less than on civilian business. Even though we are able to convert a larger proportion of our business to war work, the competitive situation in this industry will always give the Government insurance that we could not profiteer from it, even if our own conscience didn't restrain us.

We are willing to pay our just share of taxes as rate increases become necessary. We recognize the need for higher tax rates and more revenue. To pay these taxes as they come due, requires planning, however. You realize, of course, that profits are rarely in the form of cash at the year-end, but must be converted into cash to pay the tax liability. We have planned this year on the jump in rates involved in the shift from 1940 to the 1941 act, and will plan next year on the new increases in the change from the 1941 to the 1942 act. To take substantially the entire 2 years' rate increase in 1 year, however, creates a most difficult problem of debt liquidation, especially when it arises on such short notice.

I hope and believe that you gentlemen agree that a company operating as we do on a small margin of profit year after year, with several intervening years of net loss, without the opportunity to build up large reserves, should not be taxed retroactively through an administration change in the law such as this.

The CHAIRMAN. Mr. Weil, we thank you.

Mr. William Reid of Madison, Wis.

(No response.)

The CHAIRMAN. Mr. Henry Brach, of New York.

STATEMENT OF HENRY BRACH, REPRESENTING APPEL & BRACH, TAX CONSULTANTS, NEW YORK, N. Y.

Mr. BRACH. Mr. Chairman, I am having a typed statement prepared and it will not be ready for about a half hour. I would appreciate it if you pass me and put me on in a half hour.

The CHAIRMAN. We will be glad to do so. You will have to take your chances on it, but we will check you for the time being, unless you wish to make the statement now.

Mr. BRACH. I will be glad to make my statement orally, and then file a complete statement for the record.

The CHAIRMAN. How long would you want?

Mr. BRACH. Mr. Chairman, I would like approximately 20 minutes.

The CHAIRMAN. Cannot you shorten it to less than that.

Mr. BRACH. I will try.

The CHAIRMAN. You know your subject.

Mr. BRACH. There will be no oratory, sir.

The CHAIRMAN. You do not need to say a lot of things that the committee is bound to know, if it knows anything. If you shorten your statement it is more helpful to us than a long statement. I am making that statement very frankly to you. A short, direct statement is actually more helpful to the committee. We do no want to limit the witnesses, but we have a long list of them on the schedule.

Mr. BRACH. My name is Henry Brach. I am a member of the firm of Appel & Brach, tax consultants, 19 Rector Street, New York.

I appear before this committee to advocate a number of technical changes in the Internal Revenue Code and in prior revenue acts. None of the proposed changes is in any way controversial and each of them seeks to correct a situation where, because of errors in draftsmanship or unduly narrow interpretation, a particular section of the code or of a prior revenue act produces an inequitable tax situation which, I am certain that you will agree with me as I explain each point, was not intended when the statutes were enacted.

The proposed changes are six in number, and as to each I state briefly the inequitable tax situation created by the law as it now stands and the specific change necessary to remedy the inequality.

Section 500 of subchapter A of chapter 2——

The CHAIRMAN (interposing). Will you give us the page, if you can?

Mr. BRACH. Just a second. My reference was to the law as it now stands, section 500 of subchapter A. It imposes a penalty tax on personal holding companies designed to force a distribution of their profits to shareholders. A corporation is classified as a personal holding company if in addition to meeting certain tests as to stock ownership at least 80 percent of its gross income is "personal holding company income" such as interest dividends, profits on sale of securities.

You would therefore not expect that provision to apply to a corporation the greater part of whose gross income is derived from the operation of the business, yet because of faulty draftsmanship it does.

The way it comes about is this: In the case of foreign corporations, they are taxed only on gross income from sources within the United States. Likewise corporations operating in Puerto Rico and the Philippines are taxed on gross income from sources within the United States. The sections relative to those corporations contain a statement that the term "gross income" as applied to those corporations means only gross income from sources within the United States. Now, at the end of your personal holding company tax section, section 507, you have a provision that the terms as used in this subchapter shall have the same meaning as used in chapter 1, and on the strength of that, the Treasury Department and courts have held that in the case of a foreign corporation you will look, in making the test as to whether or not it is a personal holding company, to its income from sources within the United States. We have this absurd situation, in the case of the Puerto Rico Coal Co., decided in March of this year by the United States Circuit Court of Appeals for the second Circuit. The Puerto Rico Coal Co. was a bona fide operating company engaged in the sale of coal in Puerto Rico. It had about a $6,000 investment income from sources within the United States, and on its operations for the entire year it lost money. Nevertheless, the court held that because of the way the statute was drawn it was a personal holding company with respect to its United States income and taxable for failure in having distributed that income, when it had no profit at all for the year.

That is something you obviously did not intend—at least, I assume so, and the simple way to correct it is to put, at the end of section 507 and at the end of the corresponding sections of the earlier acts, a statement that in the case of foreign corporations and corporations subject to the provisions of section 251 the term "gross income" means, for the purpose of section 507, income from all sources, including sources without the United States. That change will not permit any corporation which is really a personal holding company corporation from escaping taxes, and it will avoid the absurd situation that every foreign corporation that meets the stock ownership tests which has any investment income from the United States is a personal holding company.

Senator TAFT. Are you submitting the amendment in specific terms.

Mr. BRACH. I am. My statement will have the exact wording of the proposed amendment, Senator.

The CHAIRMAN. All right.

Mr. BRACH. My second proposal is an amendment of the net loss carry-over provision as applied to personal holding companies and companies subject to tax under section 102. Since 1939 you have been allowing, for the purpose of the penalty taxes, net losses to be carried forward, yet the way the law is drafted, if the loss is big enough you do not get it. Let us take two companies, each with a $100,000 income in 1940. If one had a $40,000 loss in 1939 it carries that forward and pays the tax on $60,000, but if it had $100,000 losses in 1939 it cannot carry anything forward and pays taxes in 1940 on $100,000. I do not think you ever mean that. That is the result of a change that took place after these sections were first drafted. In 1940 for the first time you made the operating net losses deductible for normal tax purposes and as such it became a deduction in arriving at the adjusted net income. Then you said: "Since we have got this net loss carry-over as part of the dividend-paid credit we cannot allow it twice," and therefore you provided that the personal holding companies must start their calculations by adding back the net losses which were deducted for the normal tax purposes, but you left in, in section 26 (c) (1), a limitation which said that the net loss carry-over could not exceed the adjusted net income.

Now that net loss has already been deducted in arriving at the adjusted net income, so if we have a company with $100,000 income before losses and $100,000 net losses, it has no adjusted net income, and therefore that limitation says the company cannot get any net loss carry-over.

The Treasury Department has recognized that and has amended section 26 (c) (1). That is done in section 124 of the House bill, but it is not retroactive. Now, that situation is so absurd as applied to the years 1940 and 1941 that it should be given retroactive effect.

The CHAIRMAN. I am a little bit disturbed about several of these relief provisions that are not given retroactive effect. I realize that tax rates have gone up. If the taxpayer is entitled to relief it is pretty difficult for me to see why the relief should not be made retroactive.

Mr. BRACH. Mind you, Senator, these are sections that relate to penalty taxes, which even in the past ran to 82½ percent, and when imposed on nonexistent income, or the sort of income that should not be penalized, it is just plain murder.

The CHAIRMAN. I just call attention to that fact so that the Treasury will give some consideration to it.

Mr. BRACH. In many cases they have made it retroactive.

The CHAIRMAN. I know, but in some cases they have not.

Mr. BRACH. My third suggestion is an amendment of consent dividend provision to permit dissolved personal holding companies to take advantage of the new provision for retroactive consent dividends.

Subdivision (e) section 185 of the revenue bill of 1942 contains a provision which enables companies to retroactively declare consent dividends, so as to get out of personal holding company tax liability, the theory being if the stockholder is willing to pay the tax you do not want the penalty tax on the corporation.

Now, due to the heavy rates many personal holding corporations have been dissolved and therefore there is nobody who can act for them, and this provision says that the application to take advantage of this section must be made by the corporation and certain consents must be filed by it.

My proposal is that you add in the appropriate place a provision that in the case of a dissolved corporation, those who were the stockholders at the date of the first distribution and liquidation should be permitted to act for the company.

The CHAIRMAN. I think we get the point.

Mr. BRACH. My fourth proposal is an amendment of the personal holding company tax provision to permit a personal holding company filing its returns on a cash basis to deduct, in arriving at its undistributed subchapter A net income, income taxes and surtaxes accrued during the taxable year.

If a company starts in 1942 and has an income of $100,000 that is going to be subject to a $45,000 income and excess-profits tax, assuming the rate stands at that. It will then, to avoid tax, have only $55,000 that it can distribute, but if it is on a cash basis its taxable income is still $100,000. It distributed really all that it had available to distribute because it had to provide for this tax, and, nevertheless, it is going to be penalized at the rate of 80 percent for not distributing something that it has not. You avoided this situation with respect to the income tax and the excess profits by providing in the 1940 act that the current year's income tax should be deducted in arriving at the net income, subject to excess-profits tax, and by providing in the 1941 act that the current year's excess-profits tax should be deducted in arriving at the net income subject to income tax. Now, there is no similar provision in the personal holding company section. If we are on a tax basis, a personal holding company can deduct only the tax paid during the year, not the tax accrued.

My suggestion is that you permit the deduction on an accrual basis, and to avoid companies losing one tax deduction provide that they can also deduct the tax paid during the year, with the appropriate restrictions on doubling up. The restrictions are rather technical and I will not burden you with them. They are set forth in the statement.

My fifth proposal is an amendment of the provision relating to the nontaxability of certain recoveries of bad debs, taxes, and so forth, so as to have them apply to certain cancelations of accrued interest.

Section 114 of the revenue bill of 1942 contains a rather elaborate provision to exempt from taxation certain recoveries of bad debts, taxes, and so forth, the deduction of which did not result in any tax benefit. I think that that should be extended to certain interest cancelations.

You frequently have the case of a real-estate corporation that has been in difficulty; it has not been able to pay the full amount of interest owing on its mortgage obligations; its accounts are kept on an accrual basis and it has therefore been compelled to accrue the full interest, even though that accrual created a loss which did no good for tax purposes; and then, in a subsequent year, as the result of negotiation, the interest rate is modified retroactively, and then the interest that has been canceled in order to help the company becomes taxable income in the first year that it is sticking its head above water. I think that type of interest should not be taxed to the extent it represents an accrual which did no good for tax purposes, and my statement suggests the manner in which that can be done.

The CHAIRMAN. Yes, sir.

Mr. BRACH. My next and final proposal is an amendment to section 27 (i), relating to dividends-paid credit, to provide that a foreign corporation shall receive credit for dividends paid, even though all or part of the dividends paid to nonresident alien shareholders are not subject to tax because of the provisions of section 119.

A nonresident alien is not taxable on a dividend from a foreign corporation if, within the 3 years preceding the year in which the dividend is paid, more than 50 percent of the gross income from that corporation was from sources outside of the United States. Now, we get many situations where foreign corporations have an income from sources within the United States. They are classified as personal holding companies, and they are perfectly willing to distribute that profit. If they distribute the dividend it is not taxable, because most of the income is from sources without the United States, and they come under that exemption; but you have a provision which either is, or may be, interpreted to say that the corporation, even though it distributes everything to its shareholders, is subject to this penalty tax, because the dividend is nontaxable.

Now, that restriction on dividends is found in section 27 (i), and the statement is that if any part of the distribution, including stock dividends and stock rights, is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this chapter for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit. That section was probably put in to bar dividends-paid credit for stock dividends of the kind that did not constitute taxable income in the hands of distributee shareholders, but it can also be held, on a very literal interpretation, to say that it is not taxable in the hands of shareholders because of any reason, and section 119 applicable to nonresident aliens would be one of the reasons. You have the absurd situation of a corporation having income and distributing every cent of that income to its shareholders and yet held subject to a penalty tax for not distributing.

The remedy for it is to add, at the end of section 27 (i), a statement that that subdivision shall not apply to bar a credit for a dividend paid solely because it is paid to a nonresident alien shareholder who is not taxable because of section 119.

I think I can say this, that none of these proposals involve any question of policy, they are solely questions of clearing up your draftsmanship of the act. Applying the changes retroactively would afford relief in cases where a great injustice has been done.

I ask permission to file a statement as soon as it is ready.

The CHAIRMAN. You may file it.

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

BRIEF BY HENRY BRACH, OF APPEL & BRACH, TAX CONSULTANTS, NEW YORK, N. Y., ON THE REVENUE BILL OF 1942

A. IDENTIFICATION

My name is Henry Brach. I am a member of the firm of Appel & Brach, tax consultants, of 19 Rector Street, New York, N. Y.

B. PURPOSE OF APPEARANCE

I appear before this committee to advocate a number of technical changes in the Internal Revenue Code and in prior revenue acts. None of the proposed changes is in any way controversial and each of them seeks to correct a situation where, because of errors in draftsmanship or unduly narrow interpretation, a particular section of the code or of a prior revenue act produces an inequitable tax situation which, I am certain that you will agree with me as I explain each point, was not intended when the statutes were enacted.

The proposed changes are six in number and as to each I shall state briefly the inequitable tax situation created by the law as it now stands and the specific change necessary to remedy the inequality.

C. CHANGES RECOMMENDED

1. Change in classification of certain foreign corporations and corporations subject to tax under section 251 of the code

Section 500 of subchapter A of chapter 2 of the Internal Revenue Code and corresponding provisions of the Revenue Acts of 1934, 1936, and 1938[1] impose a heavy tax on the undistributed income of personal holding companies. A corporation is classified as a personal holding company if in addition to meeting certain tests as to stock ownership at least 80 percent of its gross income is "personal holding company income" such as interest, dividends, profits on sale of securities etc. One would therefore not expect this tax to be applied to a corporation the greater part of whose gross income is derived from the operation of a business having nothing to do with interest dividends, or profits on sale of securities. Yet either because of error in draftsmanship or because of an unnecessarily literal interpretation of the statutes, corporations of this kind have been classified as personal holding companies and held subject to the tax.

This situation arises because of the seemingly innocent statement in section 507 (a) of the code that "The terms used in this subchapter shall have the same meaning as when used in chapter 1."[2]

Chapter 1 of the code relates to the normal income tax and surtax. Foreign corporations and certain domestic corporations which fall within the provisions of section 251 of the code by reason of having the requisite percentage of their gross income derived from sources within a possession of the United States are subject to normal income tax and surtax only on their income from sources within the United States.

Therefore, section 231 (a) of the code provides that "in the case of a foreign corporation, gross income includes only the gross income from sources within the United States."[3] Likewise, section 251 (a) contains the statement that "in

[1] Sec. 351 (a) of the Revenue Act of 1934; sec. 351 (a) of the Revenue Act of 1936; sec. 401 of the Revenue Act of 1938.

[2] Sec. 351 (b) (4) of the Revenue Act of 1934; sec. 351 (b) (4) of the Revenue Act of 1936; sec. 408 of the Revenue Act of 1938 contain almost identical provisions.

[3] The same statement appears in sec. 231 (a) of the Revenue Act of 1934, sec. 231 (d) of the Revenue Act of 1936, and sec. 231 (c) of the Revenue Act of 1938.

the case of citizens of the United States or domestic corporations, satisfying the following conditions (conditions relating to the percentage of gross income from sources within a possession of the United States), gross income means only gross income from sources within the United States." [4]

Because of these definitions of gross income as applied to foreign corporations and corporations deriving income from sources within a possession of the United States, it has been held that as to such corporations the term "gross income" as used in the personal holding company tax section likewise means only gross income from sources within the United States. With this premise, it has been held that a foreign corporation or a section 251 domestic corporation which meets the stockholding test is a personal holding corporation if more than 80 percent of its gross income from sources within the United States is personal holding company income. This produces the absurd result that in the case of *The Porto Rico Coal Co.*, [5] the United States Circuit Court of Appeals for the Second Circuit held that a foreign corporation deriving a gross income of $40,000 from the operation of a business in Puerto Rico and a gross income of $6,000 from personal holding company income within the United States, but sustaining a loss on its entire business, was subject to the heavy personal holding company tax on its income from sources within the United States. In its decision in the *Porto Rico Coal Co. case*, the court stated that—

"It is apparent that the decision of the Board has brought about a harsh result by imposing a surtax, to say nothing of the penalty for failure to file a return, upon a corporation which had no net income to distribute; but if it finds itself, because of the way it was organized and did its business, within the scope of a statute primarily designed to make the failure to distribute actual net income too expensive to be worth while and was, therefore, taxed when it did not in fact do what the statute was aimed to discourage it must endure its misfortune as best it may."

This anomalous situation can be cured by stating clearly that for the purpose of determining whether or not a corporation is a personal holding company, reference should be had to its entire gross income, including income from sources without the United States, as well as sources within the United States. This proposed change will not permit any corporation, which reasonably should be subject to the personal holding company tax provisions from being classified as a personal holding company. On the other hand, it will prevent certain corporations which derive more than 80 percent of their income from personal holding-company income sources from escaping classification as personal holding companies by deriving a small amount of nonpersonal holding-company income from sources within the United States. The specific changes recommended are as follows:

Revenue Act of 1934.—Section 351 (b) (4) of the Revenue Act of 1934 should be amended to read as follows (the amendment being in italics):

"The terms used in this section shall have the same meaning as when used in title 1: *Provided, however, That in the case of a foreign corporation and in the case of a corporation entitled to the benefits of section 251 the term 'gross income' as used in subdivision 1 of this subsection means gross income from sources both within and without the United States.*"

Revenue Act of 1936.—Section 351 (b) (4) of the Revenue Act of 1936 should be amended to read as follows (the amendment being in italics):

"The terms used in this section shall have the same meaning as when used in title 1: *Provided, however, That in the case of a foreign corporation and in the case of a corporation entitled to the benefits of section 251 the term 'gross income' as used in subdivision 1 of this subsection means gross income from sources both within and without the United States.*"

Revenue Act of 1938.—Section 408 of the Revenue Act of 1938 should be amended to read as follows (the amendment being in italics):

"The terms used in this title shall have the same meaning as when used in in title 1: *Provided, however, That in the case of a foreign corporation and in the case of a corporation entitled to the benefits of section 251 the term 'gross income' as used in section 402 (a) (1) means gross income from sources both within and without the United States.*

Internal Revenue Code.—Subdivision (a) of section 507 is amended to read as follows (the amendment being in italics):

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[4] The same statement appears in sec. 251 (a) of the Revenue Act of 1934, sec. 251 (a) of the Revenue Act of 1936, and sec. 251 (a) of the Revenue Act of 1938.

[5] Decided March 3, 1942.

"General rule: The terms used in this subchapter shall have the same meaning as when used in chapter 1: *Provided, however, That in the case of a foreign corporation and in the case of a corporation entitled to the benefits of section 251 the term 'gross income' as used in section 501 (a) (1) means gross income from sources both within and without the United States.*"

These amendments should be effective as of the date of the enactment of the laws amended.

2. Amendment of net loss carry-over provision as applied to personal holding companies and companies subject to tax under section 102

Commencing with the year 1939, personal holding corporations and corporations subject to tax under section 102 upon improper accumulation of surplus have been permitted a deduction, in arriving at the undistributed income subject to tax, for the net loss of the preceding year. This was accomplished by making the net loss carry-over a part of the dividend paid credit.[6] Until 1940, a net loss of a preceding year could not be deducted for the purpose of the normal tax. In 1940 the law was changed so as to allow the net loss carry-over to be deducted for normal and surtax purposes. This was accomplished by making the net loss deductible in arriving at "net income" and "adjusted net income".[7] But, at the same time, the net loss carry-over as part of the dividend paid credit was retained. To avoid a double deduction the sections relating to the personal holding-company tax and the tax on improper accumulation of surplus were amended to provide that in computing the income subject to these taxes the adjusted net income should be computed without the net operating loss deduction.[8] But, there was left unchanged section 26 (c) (1) which provided that the amount of the net operating loss deduction entering into the dividend paid credit should not exceed "the adjusted net income of the taxable year." The failure to amend section 26 (c) (1) produced the following anomalous result:

If a personal holding company or company subject to tax under section 102 had a net income for 1940, exclusive of any net loss deduction, of $100,000 and it had a net loss of $40,000 in 1939, it pays the penalty tax on $60,000. But, if its net loss for 1939 was $100,000, it would pay the penalty tax on $100,000. This is so because in the first example, the company had an adjusted net income of $60,000 ($100,000 less $40,000). It had a net income for penalty tax purposes of $100,000. Since its operating loss of $40,000 was less than its adjusted net income of $60,000 the limitation of section 26 (c) (1) was not applicable and the $40,000 loss was deducted from the $100,000 net income as a dividend paid credit, leaving $60,000 subject to tax.

In the second example the adjusted net income is "zero" ($100,000 less $100,000). The net income for penalty tax purposes is $100,000. But because the adjusted net income is zero the limitation of section 26 (c) (1) becomes effective and no part of the net loss deduction enters into the dividend paid credit. Consequently the company is subject to the penalty tax on $100,000, whereas the intent of Congress must have been that it should not be subject to the penalty tax at all.

The remedy is to amend section 26 (c) (1). Section 124 of the House bill does this in a satisfactory manner but it provides that the amendment shall be applicable only to taxable years beginning after December 31, 1941. There is no reason why corporations should be penalized by the error made in the 1940 amendments to the code and I therefore urge that section 124 (e) of the House bill be amended by substituting the date "December 31, 1939" for the date "December 31, 1941."

3. Amendment of consent dividend provision to permit dissolved personal holding companies to take advantage of the new provision for retroactive consent dividends

Subdivision (e), section 185 of the revenue bill of 1942, as passed by the House, liberalizes the provisions relating to consent dividends. This liberalization is explained in the Ways and Means Committee report (p. 137), as follows:

[6] See secs. 26 (c) and 27 (a) and 27 (b) of the Revenue Act of 1938.
[7] See sec. 23 (s) and sec. 122 of the code.
[8] See secs. 102 (d) (1) and 505 (c) of the code.

"If for any such prior taxable year there was no distribution, or an inadequate distribution to shareholders, the corporation even though it has no accumulated or current earnings or profits may secure relief from the personal holding company tax for such year by using within 1 year from the date of the enactment of this consent dividends under the amendment made by subsection (e)."

The liberalization is accomplished by amending section 28 (d) (1) of the Internal Revenue Code and section 28 (d) (1) of the Revenue Act of 1928, to read:

"(1) Unless it files (in accordance with the regulations prescribed by the Commissioner with the approval of the Secretary) with its return for such year, or within one year after the date of enactment of the Revenue Act of 1942, in the case of a corporation which is a personal holding company for the taxable year with respect to which it claims the benefit of this section, signed consents made under oath by persons who were shareholders, on the last day of the taxable year of the corporation, of any class of consent stock and * * *."

Note the requirements that the benefit of this section must be claimed by the corporation and that the consents be filed by it.

Many personal holding corporations have been liquidated and dissolved and there is no one who can act for them in complying with section 28 (d) (1) as thus amended. If a deficiency in personal holding company tax is asserted against such corporations the Government can collect from the former shareholders as transferees. Such shareholders should be allowed to take advantage of the retroactive consent dividend provision.

To accomplish the amendment section 28 of the code and section 28 of the Revenue Act of 1938 should be modified by adding to section 28 an additional subdivision reading as follows:

"(k) The benefit of a consent dividend credit may be claimed for a dissolved corporation by all of the persons who were shareholders of the corporation at the date of its first distribution in liquidation."

4. *Amendment of personal holding company tax provision to permit a personal holding company filing its returns on a cash basis to deduct in arriving at its undistributed subchapter A net income and surtaxes accrued during the taxable year*

In a recent decision, *Alsworth Trust* (46 B. T. A. 140), the Board of Tax Appeals held that in determining the amount of earnings available for distribution by a cash-basis corporation the earnings computed on a cash basis must be reduced by the income and excess-profits tax payable with respect to such earnings. Congress has recognized this principle in the Revenue Acts of 1940 and 1941 as applied to the normal and surtax and the excess-profits tax. Thus under the Revenue Act of 1940 a cash-basis corporation was allowed to deduct the income tax accrued for 1940 from his net income determined on a cash basis in arriving at the net income subject to excess-profits tax and under the Revenue Act of 1941 a cash-basis corporation was allowed to deduct the excess-profits tax accrued for 1941 in arriving at the net income subject to income tax and surtax.

Neither the code nor the revenue bill of 1942 contains any provision permitting the deduction of accrued income tax and surtax to be deducted in arriving at the net income subject to the personal holding company tax.

This omission produces the following anomalous situation: A personal holding corporation is organized in 1942. Its net income before taxes, determined on the cash basis, is $100,000. On this income it is subject to a normal tax and surtax of $45,000. As the law now stands it must distribute $100,000 to its shareholders or its shareholders must consent to pay tax on $100,000 in order for it to eliminate all personal holding-company tax liability. Yet its earnings properly available for distribution to shareholders is only $55,000.

The remedy for this situation is to deduct for the year 1942 and subsequent years the income tax, the surtax, and the declared value excess-profits tax accrued during the taxable year both in the case of corporations, on a cash basis, and in the case of corporations on an accrual basis. To make this change retroactive as certain other changes have been made would involve more administrative difficulty than is warranted.

Cash-basis corporations organized prior to 1942 should also be entitled to deduct the tax paid in 1942 on income of prior years since such tax has not heretofore been deducted in arriving at the net income subject to tax. On the other hand, such corporations may have deducted in the years in which they were subject to personal holding-company tax certain taxes applicable to income for years in which they were not subject to personal holding-company tax. To illustrate: A corporation organized in 1940 was not classified as a personal holding company for 1940, but it is a personal holding company for 1941 and 1942. Its income for 1941 was $50,000, on which it paid in 1942 an income tax of $15,000. Its income for 1942 is $100,000, on which the tax is $45,000. During 1941 it paid income taxes for 1940 of $7,000. In 1941 it paid dividends of $43,000, which eliminated its personal holding-company tax liability, its subchapter A net income being $43,000 ($50,000 less $7,000).

Its income available for distribution for the years that it has been a personal holding company is computed as follows:

Year	Net income	Applicable tax	Available for distribution
1941	$50,000	$15,000	$35,000
1942	100,000	45,000	55,000
Total	150,000	60,000	90,000

Since by reason of the provisions of the law applicable to 1941 it showed $43,000 as distributable for 1941 it should be required to show only $47,000 of distributable income in 1942 so that it will be required to either distribute or pay personal holding-company tax on $47,000.

I believe that the following proposed amendment will accomplish this result:

"Section 505 (a) (1) of the Code should be amended to read as follows:

"(1) Federal income, war-profits, and excess-profits taxes accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 500, or a section of a prior income-tax law corresponding to either of such sections, and in the case of corporations keeping their accounts on the basis of cash receipts and disbursements an additional deduction for the first taxable year ended after January 1, 1942, equal to the excess of the amount of the Federal income, war-profits, and excess-profits taxes (but not including the tax imposed by section 102, section 500, or a section of a prior income tax law corresponding to either of such sections) accrued during the taxable years prior to the taxable year ending in 1932 in which the corporation was a personal holding company over the amount of such taxes paid during said years but not to exceed the amount of such taxes paid during the taxable year ended in 1942."

5. Amendment of the provision relating to the nontaxability of certain recoveries of bad debts, taxes, etc., so as to have them apply to certain cancellations of accrued interest

Section 114 of the revenue bill of 1942 as passed by the House amends section 22 (b) of the Code and corresponding sections of prior revenue acts so as to provide retroactively for the exclusion from gross income of amounts otherwise includible in gross income which are attributable to the recovery during the taxable year of a bad debt, prior tax or delinquency amount to the extent that such debt, tax or delinquency amount did not operate to reduce the income-tax liability of the taxpayer for any prior taxable year.

An analogous situation which is not covered by the amendment is that of an owner of real estate who is unable to pay the full amount of interest on a mortgage on the real estate, who because his accounts are kept on an accrual basis is required to accrue and deduct the full amount of interest without obtaining any tax deduction from such deduction, and who thereafter obtains a retroactive reduction in the rate of interest.

It is possible that in some cases the amount of accrued interest canceled as a liability will be held not to constitute taxable income because of the provisions of section 22 (b) (9) relating to discharge of indebtedness of taxpayers in "an unsound financial condition." But section 22 (b) (9) ultimately taxes the amount of liability canceled by requiring a reduction of the basis as provided in section 118 (b) (3). Furthermore, section 22 (b) (9) requires that the commissioner be satisfied as to the "unsound financial condition." Also said section does not apply to discharge of indebtedness occurring before the date of enactment of the Revenue Act of 1939.

There is really no reason why a cancelation of an interest deduction which has not resulted in a tax benefit should not be treated in the same manner as a cancelation of a tax deduction.

This can be accomplished by amending the new section 22 (b) (11) added by section 114 of the House bill to read as follows:

"(11) Recovery of bad debts, prior taxes, delinquency amounts and cancelation of liability for interest accrued income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount or cancelation of liability for interest, to the extent of the amount of the recovery exclusion with respect to such debt, tax, delinquency amount of interest liability for the purposes of this paragraph:

"(A) Definition of bad debt: As in House bill.

"(B) Definition of prior tax: As in House bill.

"(C) Definition of delinquency amount: As in House bill.

"(D) Definition of interest liability: The term 'interest liability' means the amount of interest payable accrued on account of which a deduction was allowed in a prior taxable year.

"(E) Definition of recovery exclusion: The term 'recovery exclusion', with respect to a bad debt, prior tax, delinquency amount, or interest liability, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, delinquency amount, or interest liability which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provision of prior revenue laws reduced by the amount excludible in previous taxable years with respect to such debt, tax, amount, or liability under this paragraph.

"(F) Special rules in case of section 102 tax and personal holding company tax: In the application of subparagraphs (A), (B), (C), (D), and (E) in determining the tax under section 102 or subchapter A of chapter 2, a recovery exclusion allowed for the purpose of chapter 1 shall be allowed for the purpose of such section or subchapter whether or not the bad debt, prior tax, delinquency amount, or interest liability resulted in a reduction of the section 102 tax or subchapter A tax for the prior taxable year; and in the case of a bad debt, prior tax, delinquency amount, or interest liability not allowable as a deduction or credit for the prior taxable year under chapter 1 (except section 102) but allowable for the same taxable year under such section or subsection a recovery exclusion shall be allowable for the purpose of such section or subchapter if such bad debt, prior tax, delinquency amount or interest liability did not result in a reduction of the tax under such section 102 or such subchapter A. As used in this subparagraph reference to chapter 1, section 102, and subchapter A in the case of taxable years not subject to the Internal Revenue Code, shall be held to make to corresponding provisions of prior revenue acts."

6. *Amendment to section 27 (i), relating to dividend-credit, to provide that a foreign corporation shall receive credit for dividends paid even though all or part of the dividends paid to nonresident alien shareholders are not subject to tax because of the provisions of section 119*

The tax imposed by section 102 and the personal holding-company tax are penalty taxes designed to force corporations to distribute their earnings by way of dividends in order that the normal tax and surtax may be collected from the shareholders. Consequently, the tax is imposed on an undistributed net income determined after a credit for dividends paid. The provisions with respect to the dividends paid credit are contained in section 27 of the code. Inasmuch as certain types of distributions such as a dividend paid in common stock on common stock may be constitutionally exempt from income tax, section 27 contains a subdivision (i), which reads as follows:

"If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under the chapter for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit."

But it is possible that this provision operates without Congress having so intended to impose the penalty taxes on certain corporations even if they distribute all of their profits to their shareholders.

As I pointed out in point 1 of my recommendations, foreign corporations may be classed as personal holding companies, and these corporations may have gross income from sources within and without the United States, such corporations are often owned in whole or in part by nonresident aliens, while nonresident aliens are subject to the United States income tax they are taxable only on income from sources within the United States. Under section 119 (2) (B), a dividend paid by a foreign corporation to its nonresident alien shareholders is not income from sources within the United States if in the 3 years preceding the declaration of such dividend more than 50 percent of its gross income was from sources without the United States.

We therefore have the following situation: A foreign corporation owned by nonresident alien shareholders has an office in the United States and qualifies as a personal holding company. Its gross income from all sources is $100,000 and its net income from all sources is $75,000. Its gross income from sources within the United States is $20,000 and its net income from sources within the United States is $18,000. If the corporation pays a dividend, it will not be taxable in the hands of its nonresident alien shareholders. Therefore, if section 27 (i) is interpreted literally, the corporation will be denied a dividend paid credit and it will be subject to the penalty tax on its United States income of $18,000. Nor can the company escape the tax by having its shareholders pay tax on $18,000 by way of a consent dividend for the reason that section 28, relating to consent dividends, contains a provision, subdivision (c), which reads as follows:

"There shall be allowed to the corporation, as part of its basic surtax credit for the taxable year, a consent dividend credit equal to such portion of the total sum agreed to be included in the gross income of shareholders by their consents filed under subsection (d) as it would have been entitled to include in computing its basic surtax credit if actual distribution of an amount equal to such total sum had been made in cash and each shareholder making such a consent had received on the consent dividends day, the amount specified in the consent."

I think this situation can be corrected by amending section 27 (i) to make it clear that a dividend paid credit shall not be denied because it is not taxable to nonresident alien shareholders because of section 119 (2) (B).

I therefore recommend that section 27 (i) be amended by adding to the end thereof the following sentence:

"This subdivision shall not apply to a distribution which is not a taxable dividend in the hands of nonresident alien shareholders by reason of the provisions of section 119 (2) (B)."

The CHAIRMAN. Dr. Klein.

STATEMENT OF JOSEPH J. KLEIN, CERTIFIED PUBLIC ACCOUNTANT, NEW YORK, N. Y.

Mr. KLEIN. My name is Joseph J. Klein; I appear on my own behalf. I have been before this committee and the Ways and Means Committee on many occasions, but in the last 2 or 3 years I have not inflicted my views upon you. I am here now because I share with you, the Treasury, and so many others, grave concern about our fiscal affairs.

Senator BARKLEY. What is your business, Doctor?

Mr. KLEIN. I am a lawyer and accountant, specializing in tax matters. I have been a professor of taxation. I have written textbooks on that subject and on accounting.

I propose to deal with three matters:

(1) A sane approach to the solution of the current war finance problem;

(2) War taxation canons as guides to wise legislation; and

(3) Specific revenue and procedural recommendations.

I shall skip most of the material in the memorandum which has been distributed, and I ask permission to have it filed for the record.

The CHAIRMAN. Yes.

Mr. KLEIN. I shall deal with very few items, and shall do so very briefly.

First, "A sane approach to the solution of the current war finance problem." I shall use as my text canon 4, which appears on page 11 of the memorandum, "War taxation requires maximum contribution from all consistent with ability and survival."

Throughout modern history, wars and preparation therefor have been notorious factors in the evolution of governmental fiscal policy. World War II is no exception. Many fear that estimated national indebtedness at the end of the fiscal year—over $125,000,000,000, or a per capital of $930—and possible indebtedness of over $200,000,000,000—a per capita of $1,500—before victory is achieved means national bankruptcy. I understand and sympathize. But national bankruptcy could come even more quickly through unbearable tax burdens. If we must choose, I would rather risk economic collapse through indebtedness than through taxation. There is greater national danger in overtaxation than in undertaxation. Excessive taxation is self-destructive. I recall the words painted in giant letters on the roof of a "Madison Square Garden" of a central European city shortly after World War I: "Closed—Killed by Taxation."

In the middle of the eighteenth century, England consolidated her national indebtedness and adopted the policy of not amortizing the consols. While we do not yet have to cross the bridge, in the presence of a prospective national indebtedness of $200 billion or more, to deal with which our own history furnishes no guide, it may be wise to adopt a similar nonamortization or low post-war amortization policy. Here fundamental policy is important because it may determine whether to risk national economic collapse by attempting to impose the last measure of tax squeeze or permit the fixed debt to grow by the amount of dangerous tax foregone. I am not ready to embrace a fiscal formula embodying permanent national indebtedness, but as a realist I must appreciate the relative disadvantages of increased debt principal versus potentially death-dealing taxes. After all, we are in a struggle for survival. Nothing can be permitted to interfere with war financing making maximum contribution to the war effort; yet we should avoid crippling our economy so as not to unfit it for post-war survival and rehabilitation.

You know the fiscal situation: A current budget of $77,000,000,000, estimated revenue under the House bill of $23,250,000,000, existing social security collections of $1,500,000,000, and therefore a prospective cash deficit of about $52,000,000,000. If social security levies are increased, as the President suggested, by a maximum of $2,000,000,000 and if we meet the Treasury's hope of raising $12,000,000,000 per year from voluntary purchases of stamps and bonds, and overlooking the overlapping period, $38,000,000,000 must still be raised. About $5,000,000,000 may be obtained from insurance companies, mutual savings banks and other investment sources, leaving $33,000,000,000 to be provided by additional taxes, involuntary savings and commercial banks. While spending agencies may not be directly concerned whether their funds come from taxes or loans, it may make a fundamental difference.

I propose to analyze, if you permit me to do so, the two principal tax and loan sources, in the belief that thus you may be aided in your deliberations.

First, as to noncommercial bank possibilities, I ask: "Is there any more tax gold in the corporate hills?" And I also ask: "Is there any more tax gold in the individual hills?"

Let's see. First as to corporations. I anticipate my conclusion: Under the House bill rates, the prospective "take" from corporations exceed their estimated net income after taxes and after dividend distributions at the rate which prevailed during the first quarter of 1942 by about $100,000,000.

Estimated corporate net income after Federal taxes under existing rates, but before dividends, $6,500,000,000.

Add estimated Federal taxes under existing rates, $8,000,000,000, or a total net income of $14,500,000,000, or an over-all corporate tax levy of 55 percent at rates under existing law. The House bill proposes an increase of $2,600,000,000, thus raising the levy to 73 percent. The prospective "take" under the House bill rates, if the dividends are continued at the rate at which they were reported during the first quarter of this year, will take $100,000,000 more than the Department of Commerce estimate of current 1942 corporate income. If that is true, you cannot waste much more time in looking for more taxes from corporations. Indeed, under the House rates, unless provision for post-war refundment is made—and I need not go into that; you have heard much about that—it seems as though you have already taxed corporations to death.

With dividend distributions at the rate of $4,000,000,000—$4,600,000,000 paid during 1941—it appears that dividends and Federal taxes—overlooking corporations' share in $9,000,000,000 of State and local taxes mostly deductible in computing Federal net income—will exhaust all estimated corporate net income plus $100,000,000. To cut dividends, as is being done, will not lower the corporate tax, but will decrease the tax on dividend recipients.

No, there is no more tax gold in the corporate hills. In fact, there is economic danger in the House bill rates unless post-war refunds are provided, and with a 90-percent excess profits tax war and civilian costs and taxes must suffer, for we cannot expect maximum economy in production, and, further we must not expect enthusiastic investment in needed war production facilities, even if borrowed funds could be obtained. You cannot save the day, from your point of view, by decreasing dividend payments, because as you do so you do not decrease the corporate tax but you do decrease what you collect from individuals.

Let me not be misundertood. While the over-all picture is as I have described it, this does not mean that in special situations of war profiteering and related corporate gains every effort should not be made to cover into the Treasury maximum amounts from such reprehensible sources. And this goes for noncorporate taxpayers as well.

Now, as to tax and loan possibilities from individuals.

First, let me observe that as between temporary overtaxation of corporations and noncorporate business enterprises on the one hand, and such taxation of individuals on the other hand, the latter is less dangerous. Once business enterprise is destroyed, unemployment adds its woes to passing of interest and dividend payments, and bankruptcy injures the investor, the employee, and the Government. If you kill the corporation and therefore industry, you run the risk of doing away with the possibility of post-war rehabilitation, survival, and employment. That is not quite as true in the case of individuals.

Now, is there any possibility of more taxes than the House bill provides, or greater loans from individuals than has been estimated? Let us see.

The Treasury recently estimated, in response to Senator Vandenberg's request, that if all net incomes above $25,000 were to be taxed at 100 percent, and if the House bill rates were to be applied to the remaining net income, the total yield would be only $660,000,000. Let me add, if all net incomes of $10,000 and over were similarly treated, the 385,000 taxpayers in that group, with average net incomes of $22,770, would provide $8,767,000,000, or about $5,000,000,000 more than the $3,693,000,000 of estimated tax under the House bill. This is no inconsequential amount, but the imposition is unthinkable because of the economic and social havoc which would be wrought. I do not say that such burdens may never come under war conditions, but I join with others in the hope that no national calamity will ever require such tax confiscation.

How about possibilities at the other end of the net income area? The Treasury estimates that, under the House bill, 26,500,000 taxpayers, in the net income area up to $10,000, with average net incomes of $1,920, have aggregate net incomes of $50,900,000,000, on which the estimated taxes amount to $4,200,000.000, or 8.28 percent, or $159 per taxpayer. Here there are over $46,000,000,000 to think about. And here is one of your major problems. I merely point out that a 5-percent additional tax or loan would average $94 and aggregate about $2,500,000,000. Ten percent would double the yield.

The national income for 1942 is estimated at $108,000,000,000—$115,000,000,000 to $120,000,000,000 in 1943—or $105,500,000,000 for noncorporate recipients, of which $59,700,000,000—$63,600,000,000 before estimated deductions—is subject to income tax, and approximately $39,500,000,000—$41,900,000,000 of net income before estimated deductions—is not now subject to income tax. Is this low-earning group, consisting of, I should say, about 25,000,000 individuals, with average net incomes of about $1,580, after estimated allowable deductions of 6 percent, a potential tax and loan source? I merely point out that a 5-percent tax or loan would average about $79 and aggregate about $2,000,000,000. Ten percent would double the yield. Here is another of your major problems. In all, almost $86,000,000,000 as a "tappable reservoir" for taxes, additional taxes and loans to the Treasury.

Senator DANAHER. Did you say million or billion?

Mr. KLEIN. Billion, sir. It is so easy to get mixed up with billions and millions in these figures, as you know.

Senator DANAHER. We have that difficulty, too.

Mr. KLEIN. I return to the query: "What can be done about the remainder of the cash deficit of $33,000,000,000?" Perhaps the answer could be given by Senator Vandenberg, whom I saw, reported on that subject in yesterday's press. Please bear in mind that I am not recommending action, but that I am discussing possibilities. Recipients of wages, salaries, and other compensation are estimated to receive, in 1942, about $11,000,000,000 more than in 1941. The same group will be unable to spend a very substantial part of the $5,000,000,000 spent in 1941 for automobiles, radios, and similar items. Further, the reduction in the supply of other consumer goods may become accelerated. Then there is an estimated 1942 increase in noncorporate income of about $2,000,000,000. The approximate $17,000,000,000 will be decreased per the House bill, inclusive of excise taxes, by not quite $3,500,000,000 in taxes. Despite the rise in living costs, could not the balance of this inflationary surplus, threatening the price structure and amounting to over $13,000,000,000, be drained off without hardship? The Treasury's sales of stamps and Government bonds have this effect.

Senator TAFT. Would you mind being interrupted?

Mr. KLEIN. I would be very glad to be interrupted by you, sir.

Senator TAFT. Dr. Klein, I figure if you take all the additional income, under this bill, from everybody after $10,000 you would get $5,000,000,000, and that there is $36,000,000,000 that is not taxed at all, which is income of people who make no returns of any kind.

Mr. KLEIN. Yes; but your figure is too low, Senator.

Senator TAFT. That is approximately right.

Mr. KLEIN. Over $10,000?

Senator TAFT. Over $10,000, the total net income is $8,700,000,000, the tax is $3,700,000,000.

Mr. KLEIN. Yes; you would get $5,000,000,000 more if you took all of it away.

Senator TAFT. That would be $5,000,000,000 left, if you took all of it.

Mr. KLEIN. Yes.

Senator TAFT. There is $36,000,000,000, which is the income of people who make no taxable returns of any kind—who pay no tax.

Mr. KLEIN. There are two segments we have got to get after. Here is the group under $10,000 that have an income of some thirty-billion-odd dollars that escapes tax.

Senator TAFT. On that $36,000,000,000 there is no taxable return at all.

Mr. KLEIN. My point is this, Senator—perhaps I have not made it clear: The Treasury's estimate of taxpayers with net incomes up to $10,000 deals with such taxpayers who have average net incomes of about $1,900. The members of this group, after paying the estimated tax on their net incomes, have left an aggregate of over $46,000,000,000. There is another group, consisting of those who file no income tax returns at all and who file tax returns which do not disclose taxable net income. These people have average net incomes of about $1,580, that is, only about $300 less, on the average, than those who pay taxes as members of the group with net incomes up to $10,000. The aggregate net income in this nontaxpaying group is over $39,000,000,000. What I tried to say before was that here we have between $85,000,000,000 and $86,000,000,000 constituting a potential "tappable reservoir" for taxes, additional taxes and Government loans. It is to this huge amount—corresponding to which there will be an even larger amount in 1943—that the Government must look as a source of additional revenue, as a source of loans, and as the primary source of effective resistance to danger from destructive inflation.

But there is another approach to tax possibilities in the noncorporate area. The estimated 1942 national income of $108,000,000,000 is about $37,000,000,000 higher than the national income of each of the 2 best years between and including 1931 and 1939, namely, $70,800,000,000. If, during the emergency, we decided to restrict our aggregate living expenses, debt reduction, and insurance premiums to $65,800,000,000—only 6 percent less than a national income of $70,000,000,000 entirely available to individuals—there would remain a surplus of $40,000,000,000 as the approximate amount available to individuals for Federal taxes and Government loans. After deducting estimated income and excise taxes under the House bill, there would still remain a net surplus of $30,000,000,000 available for additional taxes and Government loans. Now deducting the $12,000,000,000 Treasury goal for voluntary stamp and bond purchases, the net balance would be $18,000,000,000 as the amount available for additional 1942 taxes and savings sources. There it is. Get it if you can. The public will be with you if you handle it equitably, for there is general realization of the danger to all of us from wild inflation.

What would be the effect of a sales tax? A 5-percent retail sales tax on an estimated $53,000,000,000 base would yield about $2,500,000,000, the figure which Mr. Iglauer was reported to have presented to you. With exemptions for sales to Federal, State, and local governments, to contractors dealing with the Federal Government, to hospitals, orphanages, and other charitable organizations, on medicines and on essential foods—all of which exemptions have been suggested by others—the yield would be less. Not much of a dent in the $18,000.000,000 inflationary surplus.

How about a withholding tax, not against the tax liability as provided in the House bill, but as an additional tax or for conversion into Government bonds? Don't be frightened by this figure, sirs, I am just mentioning it. A 20-percent withholding on estimated 1942 personal compensation would yield approximately $15,000,000,000. As an additional tax the levy is unthinkable in 1942. As a basis for conversion into Government securities, the step would be impracticable, because it would ruin the voluntary purchase campaign and yield only $3.000,000,000 more than the Treasury goal.

It is apparent that, regardless of heroic tax and imposed loan action by Congress, recourse must be had for a very large part of the estimated net cash deficit to borrowings from commercial banks. The figure with which we are dealing, as I have stated, is $33,000,000,000, computed as follows:

1942 Budget		$77,000,000,000
Less:		
Estimated House bill yield	$23,250,000,000	
Social Security collections	1,500,000,000	
Maximum additional Social Security collections	2,000,000,000	
Voluntary stamp and bond purchases	12,000,000,000	
Purchases by mutual savings banks and other investors, other than commercial banks	5,000,000,000	
Total in sight		43,750,000,000
To be borrowed from commercial banks, except to extent that tax or other loan sources are tapped		33,250,000,000

I return to commercial bank loans. Because continued sales to commercial banks of substantial amounts of Government bonds appear unavoidable for the present, let us examine the inflationary danger. The war must and will be financed, come hell fire or high water.

Banks which purchase Government securities may secure loans of 100 percent thereon at the Federal Reserve bank. The net result of such transactions may be the maintenance of the cash assets of the lending banks, increase of the bank's indebtedness to the Federal Reserve offset by Government bonds, and a credit against which the Government can draw for its disbursements. Essentially, such Government credits are hard to differentiate from printing press money. For a very limited period of time, under stringent Federal Reserve control, but only in association with rigorously enforced rationing and price and compensation ceilings, the process can be continued without economic collapse and dire inflationary effect. Not until and unless people became actively suspicious about the soundness of the currency and rushed to withdraw deposits and even to borrow for the purpose of buying goods and "anchoring" their money to land and staples is there real imminence of dangerous inflation. No informed observer is happy at the prospect, but for the time being one need not become unduly stampeded. I should add that, while at the moment, we need not became unduly stampeded about the inflationary threat inherent in governmental borrowings from commercial banks, the danger is real and that it should and I hope that it can be avoided. The public will soon realize the danger. Here is where enlightened leadership and courageous statesmanship may possibly show the way. If the public would lend the Treasury, in addition to the $12,000,000.000 now sought through voluntary stamp and bond sales, the $18,000,000,000 which I have shown were available on the basis of the excess of estimated 1942 national income over the highest national income from 1931 to 1939, and the considerably greater amount which should be available out of 1943 national income, the inflationary threat would be avoided. That is so, for I believe that commercial banks for a few years could safely finance from $10,000,000,000 to $15,000,000,000 of Government securities annually. Moreover, let me not forget to say, skillful draining off, as governmental loans, of the potentially inflationary part of the income of individuals in all earning groups, would not only not injure these persons but indeed would benefit them immeasurably in the avoidably trying days of the post-war period.

Mr. Chairman, you may wish to have the Treasury insert at this point the latest asset and liability figures for the commercial banks. I have no data for these banks beyond last December 31, when cash on hand amounted to $26,600,000,000 and investments in direct and guaranteed United States securities were $21,800,000,000. This last figure has been considerably increased, of course.

I ask permission at this time to insert a restatement of the famous Adam Smith Canons of Taxation as guides to wartime taxation. They are discussed in my memorandum, beginning at page 9:

(1) War taxation should be limited to the duration.

(2) War taxation should not be inflationary.

(3) War taxation should prevent profiteering.

(4) War taxation requires maximum contributions from all consistent with ability and survival.

(5) War taxation should be equitable.

(6) War taxation should be imposed on true net income.

(7) War taxation should be economical of ascertainment and collection.

(8) War taxation should provide for convenient payment.

(9) War taxation should be enacted speedily.

(10) War taxation should avoid grave injury to States and their political subdivisions.

In indicating the application of these wartime canons of taxation, I comment on a number of changes in the House bill, and on some of the suggestions of earlier witnesses and of the Treasury. I shall not stop to summarize these comments.

I conclude by offering a few specific recommendations and suggestions, and I shall avoid repeating most of those that are already before you.

(1) The first: A 2-cent stamp tax on bank checks and drafts; such a levy during the fiscal year 1934 produced $41,000,000.

Let me interpolate, if you will permit it, that in the consideration of the World War No. 1 revenue measure I was tax editor of the New York Globe, and some associated papers. I appeared before the House Ways and Means Committee. Congressman Kitchin was then chairman. I submitted a list of excise and stamp taxes which I prophesied would produce over a billion. Many of my suggestions were included in the House bill. That bill was facetiously called the Kitchin-Klein bill. The check stamp tax is my only excise tax recommendation at this time.

(2) A 90-percent tax to be levied retroactively on the gross commissions and other compensation received for aiding, abetting, or representing in connection with securing of war contracts and war subcontracts, and that the payors with respect to such contracts entered into after the enactment of the new law be not permitted to deduct from their income the amount of commissions paid. The 90-percent gross income rate is also suggested with respect to income from other reprehensible sources—see memorandum, canon 3 and suggestion 2.

(3) In canon 10 and in suggestion 7 of the memorandum I discuss tax exempt interest. Here let me say that in order to avoid, at this time, irreparable injury to States and their political subdivisions, especially communities outside of war producton areas, interest on their future obligations should not be subjected to tax for the duration. If the suggestion is adopted, it would be unthinkable, also for the duration, to tax presently exempt interest from outstanding issues.

(4) A simplified withholding procedure is needed and is possible. The House bill procedure aptly illustrates the curse of seeking theoretical perfection. Bookkeeping and auditing would become automatic and payors would be relieved of the horrible burden imposed by the House bill if withholding were based on gross payments and if payors were to give payees, at the time when making payment, specially created Government stamps which could be pasted in Victory Stamp Books. If withholding were to be for the purpose of conversion into Government securities, equity would demand that some corresponding acquisition of Government securities should be required with respect to noncompensation income. The memorandum filed contains, in suggestion 4, a procedure to accomplish this objective.

(5) Fiscal year taxpayers should be permitted to report their tax liability in accordance with existing law. The present procedure was

introduced in the revenue bill of 1934, in order to avoid the prior complicated rule which the House bill now seeks to reinstate. This should not be done for a number of reasons, including, as most important, the greatly complicated existing and prospective tax structure—see memorandum, canon 7 and suggestion 5.

(6) Mandatory joint returns are objectionable on equitable grounds. Political hesitancy to close community property State loopholes should not be made the excuse for unfair taxes on the residents of other jurisdictions—see memorandum, canon 5 suggestion 6.

(7) Because of the complexity of the House bill, it is recommended in suggestion 9 of my memorandum, that representatives of the tax committees of the American Institute of Accountants, the New York State Society of Certified Public Accountants, American Bar Association, and the Comptrollers Institute of America be requested to cooperate with committee draftsmen for the purpose of assuring maximum clarity and simplicity in a measure which can never be really simple. I am not venting carping criticism when I say that the draftsmen of the House bill display the highest technical skill, but that they themselves cannot be completely satisfied with the result. We appreciate the time pressure and the other handicaps under which they labored.

Let me stress that for a moment, if I may, sir, and I am about through. On a number of occasions you and your colleagues have permitted bills to go to vote long before you were satisfied with the language or the terminology of the statute. If you call these groups in that I have suggested now, you will not get a perfectly drafted bill, but you will got a much better one than the horrible verbal monstrosity that has been dumped into your laps.

(8) Finally—and this I consider my most urgent and most important recommendation, set forth in canon 6 and suggestion 8 of my memorandum, is that every practical measure must be taken to insure the imposition of dangerously high business tax rates on true income with allowance for inventory reserves, post-war reserves, and a post-war net loss "carry-back." There is no surer way of inviting national economic disaster at the end of the war than to fail to take the precautionary steps advocated.

I am certainly grateful to you, sir, for the time you have given me.

The CHAIRMAN. Thank you very much, Doctor.

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

MEMORANDUM BY JOSEPH J. KLEIN, NEW YORK, N. Y., RE 1942 REVENUE REVISION

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee.

In this memorandum I address myself to three matters:

I. The fundamental fiscal problem with which you are wrestling and a sane attitude toward its solution.
II. A restatement of the well-known Adam Smith canons of peacetime taxation as possibly helpful in formulating a program for wartime taxation.
III. Some specific revenue and related suggestions.

I. THE FUNDAMENTAL FISCAL PROBLEM WITH WHICH YOU ARE WRESTLING AND A SANE ATTITUDE TOWARD ITS SOLUTION

Before the current rate of spending was reached, the Treasury's ambition was to finance defense expenditures on the basis of two-thirds through taxation and one-third from borrowing. Early in the year this goal was publicly abandoned, as it had to be.

The revenue yield under existing law has been estimated at approximately $17,000,000,000; the increase under the House bill has been estimated at about $6,250,000,000; the total, exclusive of social security collections, is, therefore $23,250,000,000.

The existing social security yield is about $1,500,000,000. For our present purposes round figures will do.

Regardless of the increased tempo of war expenditures and augmented appropriations, let us assume that the 1943 Budget will not exceed the estimated figure of approximately $77,000,000,000. Even if we consider, for our present purposes, social-security collections as revenue, a 1943 fiscal year deficit of $53,-000,000,000 is indicated, the amount which the Secretary recently estimated as the Government's borrowing need during the present fiscal year, if the House bill becomes law. This deficit must be met by borrowing. To some extent it will be met by voluntary lending. The fact remains, however, that the national debt appears bound to become over $125,000,000,000 by the end of the current fiscal year. Many believe that a national indebtedness of $200,000,000,000 will be reached before victory is ours.

The Secretary recently presented to you interesting and illuminating data comparing the ratio of taxation to expenditures in the United States, Great Britain, and Canada. I should like to review some comparative data relating to World War No. 1 and World War No. 2. To June 30, 1943, for the 3 years then ending, our World War No. 2 expenditures for defense and war, including lend-lease aid, according to Budget Director Harold D. Smith, will aggregate $105,000,000,000. Corresponding appropriations are more difficult to estimate, but by July 8, 1942, they exceeded $200,000,000,000. Budgeted expenditures for the present fiscal year amount to approximately $77,000,000,000. In the annual report of the Secretary of the Treasury for the fiscal year ended June 30, 1934 (p. 392, table 43), the cost of World War No. 1 is given as $41,765,000,000. This figure was arrived at by including "continuing costs," representing veterans' administration, interest on war debt, and settlement of war claims aggregating $16,036,000,000. To June 30, 1921, a date selected because of the Presidential proclamation that declared that war with Germany had ended on July 2, 1921, World War No. 1 expenditures amounted to $25,729,000,000. While this figure of World War No. 1 costs differs from that of E. L. Bogart in his War Costs and Their Financing (pp. 87–88), and from that of E. R. A. Seligmann in his Essays on Taxation (p. 767), the official figures of the Treasury may be assumed to be correct for our present purposes.

As has been observed by so many, the figures of World War No. 2 costs are too astronomical to mean much to the average mortal. Translated into approximate per capita figures, already incurred and contemplated war expenditures represent a per capita cost of over $1,500. Total national expenditures during the 4 years of World War No. 1 (fiscal years 1917–18 through 1920–21) for both war and nonwar purposes amounted to approximately $30,000,000 per day, while the highest daily expenditures were made during November 1918, when a figure of $55,168,366 was reached (Bogart, War Costs and Their Financing, p. 86); the corresponding daily figure for World War No. 2 is already $150,000,000 and is approaching $200,000,000, about four times as great as the highest World War No. 1 expenditure.

On June 30, 1921, the national debt amounted to $24,000,000,000, a per capita indebtedness of about $220. The high World War No. 1 point was about $25,500,-000,000 on June 30, 1919, when the per capita indebtedness was about $240. Between World War No. 1 and today, the low point in national indebtedness was June 30, 1930, when the debt was about $16,180,000,000 and the per capita figure about $131. By June 30, 1943, it is estimated that the national debt will amount to more than $125,000,000,000, or over $930 per capita. If the figure of $200,000,-000,000 is reached, it will represent a per capita indebtedness of about $1,500.

War finance

Under ideal fiscal conditions, governmental budgets are balanced; every unbalance is a source of grave concern; appropriations are discouraged unless the revenue wherewithal is provided. In the presence of war expenditures and appropriations which dwarf the experience of fiscal history, not alone of our country but of civilization itself, normal-period concepts of Budget balancing are out of place Our fiscal experience furnishes no practical guides for extinguishing a de' ' the magnitude of $125,000,000,000 to $200,000,000,000. Consolidation of na ıl obligations may be decided upon, as England did in the middle of the eighteenth century, with consols bearing relatively low interest rates, and without fixed annual amortization provision. In this setting a guide to war taxation policy is indicated: We must become reconciled to raising by immediate direct and indirect taxation a much smaller percentage, than until recently was hoped, of ever-increasing total war expenditures, and make up the deficit by delayed taxation; that is, by borrowing. Instead of squeezing the last tax dollar out of individuals and business, borrowing is preferable as avoiding, on the one hand, too great a strain on morale and, on the other, destruction of industry which must be maintained for post-war rehabilitation. However, as between a tax squeeze on individuals and the risk of inflation, of which more soon, the latter is much more to be feared.

Our fiscal policy is one of war finance. Obviously, war taxation is one of the essential elements in war finance. War taxation has as its obvious primary objective maximum contribution toward the war effort. With this nothing must be permitted to interfere, but, without interfering with that objective, we should avoid crippling our economy. Otherwise, we shall be unprepared for peace and its problems, for our war aim, in addition to decisive victory, is the continuance of the American way of life, with ever higher living standards for ourselves and all liberty-loving peoples.

Have we not been overstressing the relative importance of a billion or two in current revenue, in the presence of a prospective national debt of $200,000,000,000, the carrying charges on which could be limited to approximately $4,000,000,000 per year? It is not necessary here to discuss the eventual handling of the national debt, or indicate how it could be liquidated on the basis of specific allocations from inheritance taxes or special levies varying with changes in national income over a period of 50 to 100 years.

As I address myself to the next topic, I wish to leave the thought with you that the solution of World War II fiscal problems may not be feasible or possible on the basis of orthodox procedures which have as their objective the draining off of the very last tax dollar in the normally laudable endeavor to reduce deficits to a minimum. I am not embracing deficits or welcoming them enthusiastically; I am merely attempting to review realistically a distressing situation and not permit my thinking to be stampeded. I venture the belief that a thorough study of the problem by the Senate Finance Committee will lead it to conclude that today there is infinitely greater national danger in overtaxation than in undertaxation, with the result that some of the hazardous tax burdens which have been urged in the name of dire fiscal necessity may lose their appeal. Briefly, war costs must be financed; disbursing agencies do not differentiate between tax funds and loan funds; slogans about not passing on burdens to the next generation are hardly helpful; the Congress should provide revenue with full regard for survival and in consonance with anti-inflationary controls in fields other than taxation.

Analysis of Treasury revenue and receipt potentialities.—While alive to the danger of excessive taxation and of the wisdom of favoring a relatively slight increase in national debt rather than risking national economic collapse and destruction of post-war revival possibilities by imposing the final and fatal tax blow, nevertheless, and as a matter of course, no remunerative and safe "tappable" revenue source should be overlooked.

Let us now survey tax potentialities. We must do so on the basis of somewhat conflicting estimates, but I believe that the conclusions predicated on the available data are reasonably dependable.

National income for 1941 may be taken at $94,500,000,000. The minimum increase during 1942 may be assumed as $13,000,000,000, or a minimum national income of $108,000,000,000 for the current calendar year. While estimates of 1943 national income are, naturally, less reliable than those for the current year, we may assume a figure of $115,000,000,000 to $120,000,000,000.

(*a*) *Corporations.*—On the basis of the Department of Commerce first-quarter 1942 estimated income figures, in its Survey of Current Business, 1942 net income of corporations, before dividends but after Federal taxes, at existing rates, will amount to almost $6,500,000,000, a decrease of about $900,000,000 from last year. Total corporation income, excess profits and capital stock taxes, under existing law, per the Treasury's recent estimate, aggregated almost $8,000,000,000. Accordingly, under existing law, corporations are estimated to pay over 55 percent of their estimated net income of $14,500,000,000 in Federal taxes. Under the House bill, the estimated revenue increase (without adjustment for the overlapping period) is almost $2,600,000,000. It follows, therefore, that 1942 Federal taxes on corporations, under the House bill, will take over 73 percent (compared to 52 percent in 1941) of their aggregate estimated net income of $14,500,000,000. And, of course, a tax on corporate income is an indirect tax on the income of the stockholders.

But that's not all. We must not entirely overlook the percentage of the approximate $9,000,000,000 of State and local taxes paid by corporations, even though such taxes reduce the net income subject to Federal taxes. Nor, in a study of further corporate tax possibilities, should we forget that corporations pay dividends (which are taxable to the recipient stockholders), so that it is only in the field of retained profits or corporate savings that we may possibly find lucrative tax sources. But here we are bound to be disappointed. On the basis of 1942 first-quarter dividends, out of not quite $6,500,000,000 of estimated net profits after Federal taxes, under existing law, corporations are disbursing dividends which, at the first-quarter rate, will aggregate during 1942 over $4,000,000,000 ($4,600,000,000 were paid in dividends during 1941).

We find, then, that corporations with estimated net income of about $14,500,000,000 may pay, if the House bill rates prevail, about $10,600,000,000 in Federal income, excess-profits and capital-stock taxes (not to mention State and local levies deducted in computing the estimated Federal net income) and if they disburse $4,000,000,000 in dividends, they will have exceeded their 1942 net income after Federal taxes by about $100,000,000. And pursuing our analysis, we must, as realists, bear in mind that in the computation of the foregoing net income figure, no deduction was taken for inventory reserves and for inevitable post-war losses to plant, equipment, and merchandise. Because "earnings" are seldom in cash, when post-war "settlement day" arrives, both under existing law and the House bill, corporate taxpayers will find themselves saddled with worse than useless equipment, cash tax debts, and no cash with which to pay. This is a dismal picture, but it does not go beyond the probable facts.

No, there is no leeway for increased over-all corporate taxes, and without provision for conversion of part of the proposed House bill corporate tax increase into non-interest-bearing Government securities redeemable in the post-war period, productive enterprise in the United States faces a dark future. Our concern, of course, is not so much for such enterprises per se as for the related consequences on post-war rehabilitation and employment possibilities.

And before I leave the corporation phase of the discussion, just a word about the unavoidable effect of a 90-percent rate on excess profits. I shall not be guilty of a killing-the-goose cliche. The businessman engaged in war and related production is as patriotic and as much devoted to country as you and I. But he is human and consciously or instinctively reacts to materialistic forces. When bent on increased economy, with the irritations and labor conflicts which such endeavor sometimes engenders, he sooner or later realizes that savings mean only 10 percent for the risk-taking enterprise and 90 percent in increased taxes. When moved to expand his plant, he may become palsied at the thought that resulting profits are divided on a 10-90 basis, while he may be saddled in the post-war period with all of the losses associated with high-cost buildings, plant, equipment and merchandise. The set-up does not make for national economy. I cannot tell how much will be added to the Nation's costs—public and private—and how severely post-war rehabilitation will be affected by a tax policy which fails to permit deductions of reserves and provision for post-war losses, and imposes an unwisely heavy tax burden on business, but both costs and post-war conditions cannot escape the indicated consequences.

I should emphasize that I am dealing, of necessity, with the over-all picture. Some individual corporations are making unconscionable profits. A few have been exposed by the Treasury. Appropriate dealing with such organizations furnishes no clue to the wise treatment of ordinary corporate taxpayers, especially those in nonwar industries.

I am not happy in the conclusion reached through analysis of the available estimated 1942 corporate net income, tax, and dividend data. But I cannot escape the conclusion—and, what is infinitely more important, neither can you. The over-all take in aggregate corporate taxes is more than the estimated net income will provide. Unless the dividend pace is reduced—with resulting loss in taxes from individuals—some of the corporate distribution will come out of sources other than 1942 net income. No; not only are there no more choice tax pickings in the corporation field, but even the House bill increases cannot be borne.

(*b*) *Individuals.*—During the first quarter of 1942, 70.5 percent of the national income was represented by wages, salaries, and other compensation for personal services. (Net interest and rents, dividends, and royalties aggregated 11.4 percent; net income of unincorporated business, 15.9 percent; and net income of corporations, after dividends and Federal taxes under existing law, 2.2 percent. Payments for compensation, interest, rents, dividends, and royalties, shown above and based on data in the June 1942 issue of "Survey of Current Business," are before taxes, of course.)

Of the estimated 1942 national income of about $108,000,000,000—one hundred and fifteen to one hundred and twenty billion dollars in 1943—70.5 percent goes to those who are paid for personal services. This group received 68.5 percent of the estimated 1941 national income of $94,500,000,000. It follows, therefore, that the 1942 income of this group will be about $11,000,000,000 greater than last year. Most of this $11,000,000,000 clearly represents additional spending power, despite the rise in cost of living since 1941. To this $11,000,000,000, adjusted for living-cost increases, must be added a very substantial part of the $5,000,000,000 spent during 1941, and not spendable in 1942, for automobiles, refrigerators, oil burners, and other household equipment, for radios and other electrical devices. Therefore, possibly eleven to thirteen billion dollars of "spending surplus" is in this area of individual consumers. In addition, we must give some weight to accelerated reductions in the supply of consumer goods other than those mentioned, and, with adjustments, to the decreasing number of civilian consumers. On the whole, perhaps as much as $15,000,000,000 are in the indicated potential buying stream, threatening the price structure, all or most of which could be "attached" without serious over-all hardship. The anti-inflationary effect is quite the same, whether "attachment" is through taxation or loans to the Government, or combined taxes and loans; the morale effect is decidedly more wholesome if loans rather than increased taxes are sought.

The estimated increase in 1942 over 1941 net income in the noncorporate area other than compensation for personal services is approximately $2,000,000,000.

How can the approximately $15,000,000,000 surplus in the compensation area and the approximately $2,000,000,000 in the other noncorporate area be made best to serve our country's needs? In the subsequent analysis, for the sake of desirable simplicity, I proceed on the theory that taxes and loans can be made effective during 1942 and on the basis of 1942 estimated income. Actually, considerable 1942 surplus income is no longer reachable. On the other hand, however, the conclusions are available for 1943 tax and loan legislative guidance, especially because estimated 1943 surplus income before taxes will be substantially greater than that for 1942.

First, the increased taxes on individuals, per the House bill, will reduce the foregoing estimated "spending surplus" of about $17,000,000,000 by the estimated increase in income tax of $2,870,000,000 and by perhaps as much as one-half billion dollars of increases in miscellaneous revenues. The proposed reduction in exemptions and increase in rates will reach the 20,000,000 income-tax payers under existing law. The Treasury's estimate shows that reduced exemptions will bring in 7,000,000 new taxpayers and subject $8,000,000,000 of new net income to taxation. The Treasury studies show that of the estimated $2,870,000,000 increased individual income tax, $105,000,000 will come from 6,646,000 new taxpayers with net incomes under $2,000 and $1,100,000,000 from 10,250,000 old taxpayers on this net income level, a total of $1,200,000,000 from 16,900,000 taxpayers. There will be 25,634,000 taxpayers in the group with net income not over $5,000, per the House bill; of the proposed total revenue increase of $2,870,000,000, this group will furnish over $2,000,000,000, the 881,000 taxpayers in the $5,000–$10,000 net income group will provide over $400,000,000, and the rest of over $440,000,000 will come from the 385,000 taxpayers in the group with net incomes over $10,000.

Another analysis, based on the Treasury figures, discloses the tax burden on individuals as compared with the corresponding over-all tax burden on corporations already presented.

	Number of taxpayers (in thousands)		Percent of total net income paid in income tax		
	Under existing law	Under House bill	Under existing law	Increase per House bill	Total
Under $1,000	2,493	4,257	0.8	4.4	5.2
$1,000 to $2,000	7,765	12,647	2.5	3.3	5.8
$2,000 to $3,000	5,697	6,031	3.1	4.2	7.3
$3,000 to $4,000	1,877	1,893	4.3	4.7	9.0
$4,000 to $5,000	804	806	6.2	6.4	12.6
$5,000 to $10,000	881	881	9.2	7.3	16.5
Over $10,000	385	385	34.4	7.7	42.1
Total	19,902	26,900	9.4	3.9	13.3

The pertinent factors, on the basis of the foregoing analysis and other available data, insofar as they might influence congressional action for the balance of 1942 and for 1943, are:

(1) That the distribution of the estimated minimum 1942 national income of $108,000,000,000 is approximately as follows:

Corporations, after taxes at existing rates and after dividends, about $2,500,-000,000.

Individuals, from all sources, including unincorporated business, about $105,-500,000,000.

(2) That the foregoing figure of $105,500,000,000, before deducting any Federal taxes applicable to 1942 income (and also before deducting the share of the approximate $9,000,000,000 of State and local taxes borne by individuals and deductible, for the most part, in the calculation of Federal net income, compares with the figure of approximately $91,900,000,000 for 1941.

(3) For all of the years between and including 1931 and 1939, estimated national income did not exceed $70,800,000,000. Let us assume that $70,000,-000,000 of national income was received by noncorporate recipients during each of the 2 best years in this period, and also that such income was not subject to any tax. Surely, during the present sacrificial war period, especially if price ceilings and rationing are enforced, a reduction from the assumed $70,000,000,000 level of 6 percent would not prove an unbearable hardship (despite some rise in living costs) in meeting personal living needs, debt reduction, and insurance savings.

(4) Accordingly, the difference between $105,500,000,000 and $65,800,000,000, or about $40,000,000,000, is the approximate amount apparently available for Federal taxes and for Government loans.

(5) This $40,000,000,000, on the basis of the House bill income and other revenue rates, should be reduced by approximately $8,000,000,000 for income taxes and by not more than $2,000,000,000 for other revenue. It follows, then, that about $30,000,000,000 remains available as 1942 excess or surplus individual income (and considerably more in 1943) for the purpose of increased taxes and Government loans.

(6) If we assume success for the Treasury's voluntary stamp and bond purchase plan, then $12,000,000,000 of the foregoing surplus income is deductible from the figure of $30,000,000,000, leaving $18,000,000,000 as the maximum for 1942 additional taxes on individual income and as the source of savings.

(7) You were recently supplied with figures by Senator Vandenberg, which he obtained from the Treasury, to the effect that if all individual incomes were reduced to $25,000, and if the House bill rates were to apply to all incomes, including those so reduced, the yield would be $660,000,000. On this basis, no appreciable part of the $18,000,000,000 is to be found among those whose net incomes are over $25,000.

(8) Of the $59,700,000,000 estimated total net income of individual taxpayers under the House bill, only $8,770,000,000 is in the area of net incomes of $10,000 and over. It follows, as others have pointed out, that appreciable revenue and Government loans out of current income can come only from the great body of relatively low net income recipients, the $26,500,000 individuals with net in-

comes under $10,000. Individuals with net incomes below the minimum taxable level are the recipients of 1942 national income estimated at $38,500,000,000. Is this low-earning group a potential tax and loan source? That is one of your major problems.

(9) If withholding is adopted, and even if rates are as high as 20 percent of gross income, the amount produced, if withholding were made applicable to all compensation for personal services, would be approximately 20 percent of $76,000,000,000, or $15,200,000,000. If dividend and interest income were also made subject to withholding, the additional collection would amount to 20 percent of about $8,500,000,000, or about $1,700,000,000.

(10) Any such withholding rate as 20 percent could not be borne at this time, in the presence of the House bill rates, as additional taxes. At least part would have to be applied in reduction of the tax liability disclosed on the return. Preferably, I believe, any such withholding should be for conversion into Government securities. But withholding on the scale under discussion would ruin the voluntary stamp and bond purchase plan, which the Treasury hopes will yield a maximum of $12,000,000,000 per year, so that, for the most part, voluntary acquisition would become involuntary.

But how does this leave the Treasury in its truly stupendous task of financing a $77.000,000,000 Budget with tax prospects, per the House bill, of no more than $23,250,000,000 with not more than a few additional billions in taxes possible, even if post-war economic collapse were to be risked, and existing social security collections of about $1,500,000,000 with no possibility of more than $2,000,000,000 additional from this source, a total of, at most, $27,000,000,000. This leaves the $77,000,000,000 Budget short by $50,000,000,000, a figure which closely corresponds to the deficit of $53,000,000,000 previously mentioned. I have shown that the maximum amount collectible, as a result of 20 percent withholding at the source, is about $16,900,000,000, an amount which for practical reasons must be reduced to a maximum of $15,000,000,000. If the amounts withheld were to be converted into government securities, most, if not all, of the voluntary bond purchases, which the Treasury hopes may yield a maximum of $12,000,000,000 annually, will disappear. If withholding were to be entirely substituted for voluntary bond purchases, then withholding would yield about $3,000,000,000 more than the Treasury's hope for its present bond-selling program. At any rate, this analysis discloses that there will remain approximately $35,000,000,000 to be secured from insurance and other investment sources and from commercial banks; and a recent report of the Economic Policy Commission of the American Bankers Association indicates that $5,200,000,000 may be raised in 1943 from sources other than commercial banks, thus leaving $30,000,000,000 to be supplied by such banks. The A. B. A. report indicates commercial bank absorption of only $16,400,000,000 (before the current Budget was increased by $14,000,000,000).

Many hold that Government borrowing from commercial banks inevitably leads to dangerous inflation, even if free funds not in demand by business are used. Is this necessarily so? The existence of such free funds indicates there is no borrowing demand for them. True, the banks which buy United States securities can immediately secure 100 percent advances from the Federal Reserve bank. If this is done, then the lendable funds of the banks are not decreased by their purchase of Government securities. The process of buying Government securities and borrowing 100 percent with respect thereto could, theoretically, be continued indefinitely, thus creating the equivalent of printing-press money. Historically, such cheap money makes for higher prices and, eventually, there is economic disaster. But, with price ceilings for wages and commodities rigorously enforced and with rationing effectively applied, continuance for a very limited period of substantial commercial bank purchases if lendable funds are under Federal Reserve control, and especially in the absence of business borrowing demands, I am hopeful that the deplorable situation need not produce the feared inflationary effect.

As in the case of my analysis of the corporate situation, I should add that while the over-all picture is as I have presented it, here and there may be found opportunity for equitably increased taxes. Thus, on principle, there is no reason why substantially increased compensation should not be subjected to a quasi-excess profits tax levy during the emergency. Also, as I point out elsewhere, "profiteering" gains may be subjected to special levies.

II. A RESTATEMENT OF THE WELL-KNOWN ADAM SMITH CANONS OF PEACETIME TAXATION AS POSSIBLY HELPFUL IN FORMULATING A PROGRAM FOR WARTIME TAXATION

In addition to the need of a realistic appreciation of the limits of safe taxation and of becoming reconciled to the fact that, during the war emergency, it is safer and wiser to permit the national debt to grow rather than to seek to decrease it slightly at the possible cost of wide-spread economic ruination, it is desirable that there be available norms or principles which might guide legislators to wise tax legislation. Such a guide may possibly be found in a restatement of the Adam Smith canons of taxation which, as you well know, hold that taxes should be imposed with regard to equity, convenience, certainty, and economy. My tentative restatement is:

(1) War taxation should be limited to the duration.
(2) War taxation should not be inflationary.
(3) War taxation should prevent profiteering.
(4) War taxation requires maximum contributions from all consistent with ability and survival.
(5) War taxation should be equitable.
(6) War taxation should be imposed on true net income.
(7) War taxation should be economical of ascertainment and collection.
(8) War taxation should provide for convenient payment.
(9) War taxation should be enacted speedily.
(10) War taxation should avoid grave injury to States and their political subdivisions.

I shall not discuss the foregoing decalogue of war taxation canons at length, but shall deal with each of them as briefly as possible.

Canon 1—War taxation should be limited to the duration.—War taxation should terminate at a date specified in the enactment, say, 1 year after peace (i. e., the taxpayer's tax year within which the terminal date falls). Temporary taxes have a tendency to become permanent. War taxation is emergency legislation. War taxation embodies economic burdens and social restrictions which should not be automatically extended beyond the war's duration. The citizen will be the readier to accept a war tax measure if he is assured of its automatic extinction when peace comes. If post-war needs require continuance of part or all of war taxation, extension should result from majority action of the Congress then in office.

Canon 2—War taxation should not be inflationary.—War taxes should not be inflationary. Preferably, they should be antiinflationary. Inflation not only increases the Government's war costs,[1] thus further burdening taxpayers, but because of its frightening and depressive effect on the population, especially on the poorer group whose purchasing power is disproportionately reduced, is ruinous of national morale.

While taxation is not the only factor available with which to combat inflation, it is an indispensable factor. When employed in conjunction with rigorously enforced universal price and compensation ceilings, rationing, licensing, and limitations on consumer credit, there need be no fear of a dangerous degree of inflation. Incidentaly, reversal of such controls may be necessary to combat post-war deflation. But in the presence of mounting income in the hands of wage earners, a significant phenomenon in the distribution of the rapidly rising national income,[2] attempted controls over inflation, without heavily increased taxes on income, are doomed to failure. It is the "inflationary gap," the excess of increasing purchasing power over declining available supply of consumer goods, that must be bridged by the "tax stop-gap," the amount of additional taxes needed for such bridging. It is too much to expect that efforts in this direction can

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[1] On September 19, 1941, Mr. Bernard Baruch stated before the House Committee on Banking and Currency that price stabilization would reduce the cost of war by at least 50 percent (hearings re price-control bill, pp. 1066–1069). Mr. Leon Henderson recently stated that stabilization at the present price levels would effect a saving of $62,000,000,000 in war costs within the next 20 months (New York Times, July 4, 1942). Senator Robert F. Wagner, in a radio address on July 11, 1942, stated that price control had "saved American taxpayers $6,000,000,000 from June 1940 to April 1942, by keeping down the cost of war supplies."

[2] Department of Commerce figures show that the national income was $77,200,000,000 in 1940, $94,500,000,000 in 1941, and estimated at $120,000,000,000 for 1942 (Charles E. Egan in the New York Times, May 24, 1942). Salaries and wages constituted 63.8 percent of the national income in 1940; 64.8 percent in 1941; and for the first 4 months of the current year about 70 percent of the total income payments consisted of salaries and wages (New York Times editorial, June 8, 1942).

ever be entirely successful. The President, in his budget message of last January, in discusisng the need of higher taxes, well expressed our fears: "Any tax is better than an uncontrolled price rise."

The higher individual normal and surtax rates in the House bill, in the presence of lowered exemptions, find sanction in the second canon. These increased and new taxes remove from the buying stream funds which would otherwise exert upward pressure on the price level. Very indirectly, such taxes may have an offsetting inflationary tendency, due to the fact that they might induce wage rise pressure, a factor which is subject to control through enforced wage ceilings.

Sales taxes likewise have the sanction of the second canon, because they, too, reduce the effective purchasing power of the increased earnings in the hands of individuals. A tax on spending obviously would also have the sanction of this canon.

Withholding or collection at the source has similar sanction of this canon, because such procedure eliminates from the purchasing stream money which otherwise might encourage or tempt spending. The delay in enacting withholding legislation is therefore regrettable. Whether withholding should be of a separate and additional tax at a flat rate or as prepayment of the income tax as provided in the House bill, depends greatly on the tax rates finally enacted and the exemptions ultimately allowed. On principle, if the income-tax rates are high, especially at the lower-income levels, and if the exemption is low, then withholding should be by way of prepayment of the income tax and not as an additional tax. On principle, too, income tax rates may be made sufficiently high and exemptions sufficiently low to counteract the dreaded "inflationary gap." A flat withholding tax, as an additional tax, would, like a sales tax, be inequitable in that those at the lower income levels would pay as high a rate as those in the higher levels. Here is a violation of canon 5. Such an additional tax anti-inflationary itself, would beget, in the absence of wage ceilings, wage increase demands, inflationary factors. But withholding for conversion into Government securities, maturing after the war, can be supported on many grounds.

Canon 3—War taxation should prevent profiteering.—War taxes should prevent profiteering, or at least make profiteering unprofitable. The President, in his message of July 8, 1940, suggested, and the Legislature reaffirmed, that no millionaires must be created out of the war effort. The House Naval Affairs Committee has shown the unconscionable profits already made on some war contracts. A few weeks ago, Chairman Vinson announced recaptured excessive profits on war contracts aggregating $673,946,103. Who did not share Secretary Morgenthau's indignation in his recent disclosure[3] of defense profit dissipation revealed by the audit of 31 tax returns for the year 1941, and who did not applaud his determination not to let anyone "get away with it"? National morale requires that the profiteer shall not be permitted to keep and enjoy his spoils, when so many are cooperating sacrificially, wholeheartedly, and patriotically in the war effort. A special excise levy of 90 percent on the gross commissions of "war brokers" and on other reprehensible war profits would deserve popular acclaim. The levy on "commissions" not yet paid should be withheld at the source, and reports relative to agency and brokerage contracts should be required monthly.

Profiteering can be curbed by wise taxation; limitation of profits or income is both unnecessary and unwise.

Canon 4—War taxation requires maximum contribution from all consistent with ability and survival.—War taxes should take from each the maximum that the national economy can possibly spare. How much taxation can the American taxpayer stand? There is no available empirical test. For a limited period, during the war emergency, the Government could take for its war effort all above subsistence needs. The Government must decide how much less to take. The average taxpayer will cooperate patriotically, especially if convinced of maximum governmental economy in nonwar activities.

From individuals the Government can take, with comparative safety, except for minimum post-war cushions in the form of Government bond investments or post-war refunds, all current income above the requirements for a generally reduced standard of living, if this much is essential for victory. Many will have to encroach on savings, but to what better purpose can savings be put? Social and economic disturbances are bound to be terriffic; many commitments will have to remain unmet; moratoria may become universal, unless ample provision

[3] Statement of Secretary Morgenthau before the Joint Committee on Internal Revenue Legislation, May 28, 1942.

is made for deduction from gross income of payment of existing debts, existing life-insurance premiums, rent, and other commitments. Compensation for bearing necessarily severe tax burdens would be twofold: on the psychic level, in the knowledge that each is making maximum personal sacrifices on behalf of country; and, on the material level, in the realization that the danger of inflation is being met aggressively and successfully.

The House rates on individuals and the lowered exemptions result in obviously severe tax burdens, but they do not violate our fourth war-tax canon. These rates could possibly be increased, after a year of trial, without seriously affecting morale, and especially if price ceilings are enforced and rationing is extended. To the extent that further increase in rates and reduction in exemptions are shown to be necessary in order to combat inflation, I believe that there would be, if not popular approval, at least understanding acquiescence. But under the House rates and more so, of course, if these rates are increased, provision has been urged for a special deduction of a limited amount and limited percent of net income if invested in nonnegotiable, non-interest-bearing Government securities not redeemable until the post-war period, unless in the event of special hardship.

Under Canon 2 I referred to the distressing effects of runaway inflation, particularly in its impact on the lower income groups of the population. Taxation, otherwise unbearable, might have to be imposed in order to diminish to a maximum extent the upward spiral pressure on the price level. As between reduced current income and avoidance of inflation on the one hand, and larger income in the presence of inflation on the other, there can be but one choice. Fortunately, the country at large appears to be keenly conscious of the inflationary peril, and the administrator and legislator may safely assume that popular backing will support revenue measures clearly directed against, and demonstrably effective in, the battle against inflation.

From business and industry, in corporate and other forms, the Government could likewise take all income above that needed for survival. This limit (which, as I have shown, may have been reached) should not be attempted, however, because—and it cannot be repeated too frequently—while we are at war to defend ourselves from annihilation and slavery, yet we are fighting to preserve our way of life, with post-war restoration of a substantial proportion of our accustomed freedom of individual initiative, opportunity, and enterprise. Diminishing returns exist in war as in peace, for even in war there appears to be no way of avoiding extravagance and inefficiency when efficiency and economy are discouraged by excessive taxation. Here history and logic point the same lesson. A tax of 90 percent cannot encourage the type of economy demanded by the war effort. Under the House bill, if any portion of a corporation's income is subject to the excess profits tax, expenses involve a cost of 90 percent to the Government and only 10 percent to the taxpayer.

Except as necessary for the war effort, with which, I repeat, nothing must be permitted to interfere, the limit of safe taxation on business income is that aggregate burden which will not prevent post-war rehabilitation. Provision for such post-war needs may, perhaps, best be found in tax rebates in the form of post-war maturing non-interest-bearing bonds. (The suggestion to levy a 15-percent tax, at the time of redemption, is indefensible.) Economic destruction must be avoided; industrial liquidation must be prevented. The limit of "wise and enlightened" taxation, as contrasted with "safe" taxation, is that levy which will encourage economy and discourage extravagance.

Canon 5—War taxation should be equitable.—This is the equity canon of Adam Smith. War taxation must be demonstrably fair. Even in peacetime it is very important that taxation should neither discriminate against nor favor classes or groups. While absolute success can never be attained, it is essential to morale that taxpayers should be convinced of the integrity of tax legislation, i. e., avoidance of discrimination and favoritism.

As a matter of equity, if there is withholding at the source, it is desirable, at least theoretically, that a portion of the tax on nonwithholding income be paid as earned. The difficulties of ascertaining the tentative interim taxes on a monthly or similar basis are almost insurmountable and administratively almost impossible. A device such as is provided in section 153 (d) of the House bill is a compensatory step. I suggest later, another expedient.

This fifth canon sanctions such Treasury or House proposals as elimination of special privileges favoring married couples who are residents of the community property States,[4] temporary increased capital gain rates to keep pace with increases in rates on other income and other capital gains and loss changes, correction of inadvertent error adversely affecting personal holding companies, deduction of investment expenses, taxing of alimony to divorced wives, dependency credit for school children, deduction of extraordinary medical expenses, retroactive technical amendments to the excess-profits tax sections of the Internal Revenue Code,[5] inventory reserves,[6] war and post-war reserves, post-war refunds and loss, "carry-back," at least elimination or reduction of percentage depletion, extension of the amortization option to noncorporate taxpayers, elimination of restriction of use on "LIFO" to those who made no interim financial reports on other than the "LIFO" basis (but inventory and war and post-war reserves[7] and post-war refunds and loss "carry-back" should be provided), and taxation of recoveries of bad debts and taxes only when prior deductions resulted in reduced taxes. But this canon would not sanction a recent proposal of the Treasury to have the decedent's basis carry over to the estate and the beneficiaries, or to limit charitable deductions available to decedent's estates, or to subject to estate tax transfers by donors over 65 years of age. On the basis of this canon, the Treasury's recommendation for elimination of the capital stock tax and related declared value excess-profits tax should be approved.

Canon 6—War income and profits taxation should be imposed on true net income.—With income and excess-profits rates as high as they must inevitably become, it is of paramount importance that the basis of the tax, to wit, net income, be fairly ascertained. Artificial restrictions on deductions and failure to recognize sound accounting reserves result in the imposition of a tax stated at one rate but effective at a higher rate. There is no reason why the taxing statute should not recognize, as the basis on which to impose income tax, net income as disclosed by the consistent application of sound accounting principles.

Moreover, recognition must be given to the fact that the requirement to ascertain net income annually frequently imposes a task impossible of accomplishment. Here there is frequently an irreducible margin of error. The British excess-profits tax recognizes this fact, and provides, in effect, for annual reascertainment of aggregate excess profits, thereby imposing the excess-profits tax on true excess profits for all of the war years as a unit. Experience amply establishes that book and tax profits may turn out to be "fool's profits." Book "profits" are often in bricks and mortar, machines and tools, while taxes are always demanded in cash. There should be no excess-profits tax except on actual excess profits and no income tax except on true net income.

The existing law permits ordinary domestic corporations to file consolidated returns for excess-profits tax purposes. The House bill extended the privilege to cover the income tax coupled with the proviso that if a consolidated excess-profits tax return is filed a consolidated income-tax return must also be filed, and vice versa; also, that the surtax rate for consolidated returns be increased by 2 percent.

In many instances true income cannot be disclosed except through the medium of consolidated returns. Thus, such returns are sanctioned by our canon 6. It also meets the requirements of canon 7. There is no rational warrant for the imposition of the 2-percent penalty, and its imposition violates our equity canon No. 5. In fact, consolidated returns should be made mandatory in many situations where they are now optional.

Canon 7—War taxation should provide economical ascertainment of liability and collection.—This embodies two of the Adam Smith canons of taxation—

[4] Mandatory joint returns are sponsored, some believe, because of effective political resistance to elimination of the community-property State tax advantage. Opposition to mandatory joint returns need not be predicated on grounds of morality, religion, and women's rights; on what equitable principle can one person be taxed at highly progressive income-tax rates on the basis of another person's earnings, regardless of marital or other relationships? The argument predicated on ability cannot withstand analysis. At least for the duration, the earner of income, even in a community-property jurisdiction, should be made subject to tax thereon.

[5] Recommendations for revision of Internal Revenue Code, submitted by committee on Federal taxation of American Institute of Accountants to the Ways and Means Committee, April 13, 1942; Ways and Means Committee hearings, pp. 171–191, testimony of Robert N. Miller, chairman of excess-profits tax committee of the American Bar Association.

[6] The Treasury has recommended inventory reserves commencing January 1, 1941, and continuing until 5 years after the close of the war. The Ways and Means Committee has tentatively adopted the Treasury recommendation, but the provision is not in the House bill.

[7] See research bulletin issued by American Institute of Accountants, Accounting for Special Reserves Arising Out of the War.

certainty and economy. If economy in the determination and administration of peace taxation constitutes a canon of taxation, how much more is this true under war economy? When manpower is at a premium, waste of human energy is deplorable. A revenue measure which lacks clarity and simplicity requires excess manpower to interpret and apply. The greater the clarity and simplicity of a tax measure, the more certain the determination of liability thereunder. Maximum simplicity and clarity result in minimum wastage of manpower.

This canon would approve the elimination of the "earned income credit." It would likewise approve elimination of the House provision for reenactment of 1932 and earlier treatment of fiscal-year taxpayers. Such treatment was discarded by the Revenue Act of 1934. The then chairman of the Senate Finance Commitee, in his report on the revenue bill of 1934, at page 22, stated: "This complicated rule has been eliminated in the proposed bill for the purpose of simplicity and ease of administration." I submit that the sound reason advanced in 1934, in the presence of infinitely less complex legislation, should guide the Senate's action now. While the House proposal would increase current yields, no one knows to what extent present benefits would be offset by future detriments when taxes are ultimately reduced.

Advocates of a sales tax are in error when they assert that it is simple of administration on a national scale, if many exemptions are provided. A really simple sales tax would be one levied on a few articles in universal demand (including substitutes), at a high rate, at the manufacturing, production, and import level. But such a tax has no political appeal.

The excess-profits provision cannot be expressed in simple language. Thus, these provisions, no matter how amended, clarified and modified, are bound to violate this seventh canon. We must become reconciled to the realization that, as a practical matter and for the time being, this is unavoidable. Nevertheless, we should seek as great clarity and simplicity as can possibly be attained.

Canon 8—War taxation should provide for convenient payment.—The third of the Adam Smith canons of taxation is to the effect that the payment of the tax should be made as convenient as possible. With rates as high as they will be in the war tax legislation, it is even more important than under normal circumstances that this canon be observed. In a very real sense, convenience of the taxpayer may be thoroughly consistent with Government benefit. I doubt that there can be much serious disagreement in informed circles that the most convenient manner of paying a heavy tax is currently out of the earnings subject to tax—a pay-as-you-earn plan. This involves withholding or collecting of the tax at the source, or purchase of tax anticipation notes, or both. Withholding procedure has been urged only with respect to fixed and determinable income, such as salary, wages, other compensation, rents, royalties, annuities, interest, and dividends. From the administrative point of view, withholding is a most desirable form of tax collection. True, burdens are imposed on the payor, and they are especially severe in the procedure provided in the House bill. Elsewhere I suggest simplification of such procedure.

Withholding at the source, as already stated, is an indispensable element in the anti-inflation campaign. Earlier collection of revenue, as is well known, would benefit the Government in at least two ways:

(*a*) Funds would be currently and, therefore, more quickly available for war use.

(*b*) Ultimate loss of collection would be minimized by current collections. The longer the collection is delayed, the greater the danger of taxpayer insolvency and other financial reverses, which make collection difficult and sometimes impossible.

Canon 9—War taxation should be enacted speedily.—There should be no undue delay in enacting war-revenue legislation. So far as excise taxes are concerned, it is probably true that endless discussion and debate will not produce a more scientific and more equitable set of levies than concentrated effort with a time limitation for action. The loss in revenue is irretrievable; an untaxed sale today will never produce revenue in the future. President Roosevelt was recently reported as urging that action be expedited on the excise tax provisions by dividing pending legislation into two parts. Revenue loss is estimated as at least $1,000,000 a day. Not only is there loss in revenue but there is delay in applying one of the few available positive anti-inflationary devices.

As to the nonexcise provisions, speed too is an essential, but, because the rates (except on gifts and estates) can be made retroactive to the first of the year, the criticizable factor is not revenue loss. Delay in enactment creates suspense, which is bad for morale.

Canon 10—War taxation should avoid grave injury to States and their political subdivisions.—Federal taxation, even war taxation, should not ignore the fact that States and their political subdivisions depend to a great extent on the same tax sources as are levied upon by the Federal Government. With the inevitable increase in Federal taxes, both in rates and in items taxed, and with business losses and suspension in nonwar production localities, there are signs of fiscal danger to States and municipalities.

Consider a statelike city, my own New York, for example. Disinterested observers have commended the handling of its finances through the depression. Such fiscal success has contributed much to morale. This is likewise true of other communities. The continued impact of the war is bound seriously to affect the finances of States, cities, and towns. If the shift from peace to war industry, augmented by Federal taxation, were to cripple municipal finances, the repercussions would necessarily be extremely harmful to the war effort. And what is true of cities is likewise true of other political subdivisions of States. Would it not be advisable for the Federal Government to forego some additional revenue, if thereby jeopardizing the finances of other governmental divisions would be avoided? Destruction of morale which would follow general and widespread financial embarrassment of States and their political subdivisions should lead Congress deliberately to avoid ruination through taxation. Cost of avoidance is comparatively small.

The Treasury has recommended taxation of interest on obligations of States and their political subdivisions. In my opinion, there was no legal compulsion to continue the exemption of such interest after the adoption of the sixteenth amendment. I appreciate that among those who take an opposite view are some of our leading consitutional lawyers. Many people have been led to believe that such interest is constitutionally exempt, and all realize that representations to this effect may have induced the great majority of purchases of such governmental securities. It is partially for this reason that I do not at this time advocate the elimination of the exemption on outstanding securities, although I agree with those who claim that there is no moral obligation on the part of the United States to recognize the exemption. Was it not equally "immoral" to subject to tax the compensation of elected officials and civil-service employees of States and their political subdivisions who had been led to believe that their salaries were tax exempt? Obviously, the moral argument does not apply to future issues, and yet it is the taxation of future issues which would be most harmful to State and cities. Despite the Treasury estimate that under the House rates $200,000,000 annual revenue is involved, I believe that the tenth canon is the one which should guide us for the duration. The fiscal plight of cities and States, through causes beyond their control, may become extremely grave. I believe that, for the duration, logic must yield to instinct, and that a bad situation which should not have been permitted to develop should remain undisturbed for the present.

It has been suggested that, as a compromise, exempt interest might be subjected to a preferential rate at, say, one-third or one-half of ordinary rates. The basis of the suggestion is the allegation that such reduced tax would not be unfair because the exemption privilege increases in value as tax rates on ordinary income rise. While I recognize the apparent equity involved, nevertheless I believe it wiser to permit the situation to remain unchanged for the time being. It should be noted that no differential rate would be justified with respect to future issues.

III. A FEW SPECIFIC REVENUE AND RELATED SUGGESTIONS

In connection with my restatement of the Adam Smith canons of taxation, I indicated my views with respect to a number of pending revenue proposals. Here I wish to refer very briefly to a few of these and some other and related matters.

(1) *Two-cent stamp on bank checks and drafts.*—During the fiscal year 1934, the Treasury collected $41,000,000 from a flat 2-cent stamp tax on bank checks and drafts. If there exists any sound administrative reason for not imposing such a levy during the emergency, I am not aware of it.

(2) *War contract commissions and "black market" traders.*—I suppose there will always be a few who will seek to profiteer out of the Nation's woes and seek means of enrichment out of war. Criminal statutes can discourage and punish such practices. It is undeniably the province of this committee to try to take the profit out of profiteering. I have in mind not excessive profits from ordinary war contracts which high tax rates will reach, but rather such activities as war contract brokerage and participation in "black market" transactions. I suggest that a tax of, say, 90 percent be levied retroactively on the gross commissions or other compensation received by individuals and organizations for aiding, abetting, or "representing" in connection with securing of war contracts and war subcontracts. I further suggest that contractors and subcontractors be not permitted to deduct from their gross income commissions and other compensation paid for assistance rendered, from and after the enactment of the bill, in securing war contracts and war subcontracts. Further, I would empower the Commissioner to issue needful regulations providing for information at the source at monthly, or even shorter, intervals, so as to aid in the administration of the proposed tax. The suggested 90-percent rate on gross income should apply to "black market" earnings and to income from other reprehensible sources.

(3) *Potential yield from exempts.*—In connection with canon 10, I discussed the subject of exempt interest.

The Treasury has estimated that $200,000,000 annual revenue is lost due to exemption from Federal income tax of interest from obligations of States and their political subdivisions. I wish merely to point out that a 20 percent withholding rate on all interest, for conversion into Government securities, would bring into the Treasury about $120,000,000 annually from presently exempt interest on approximately $20,000,000,000 exempt securities, of which almost $5,000,000,000 are held by exempt entities.

(4) *Withholding or collection at the source.*—Withholding at the source, regardless of its purpose, arrests purchasing power at its point of origin, and provides the means of speeding and safeguarding collections by the Government.

The first decision to reach regarding withholding is whether it is to be against the current or other tax liability, as provided in the House bill, or as an extra or additional levy, or for investment in Government securities, or some combination among these possibilities.

Personally, I am inclined to favor withholding at relatively high rates on income from compensation, dividends, and interest, the amount withheld during 1942 and 1943 to be converted into non-interest- (or 1-percent interest) bearing Government securities, one-half maturing 1 year after peace and the other half a year later. Converted Government securities from withholdings in 1944 and subsequent years should mature similarly in correspondingly later periods.

The withholding procedure provided in the House bill exhibits great ingenuity but it would prove extremely costly to administer and would impose burdens on the payor that should not be inflicted unless unavoidable. Withholding procedure, especially in connection with pay rolls and other compensation, could be extremely simplified if the payor of the income were to deliver to the payee, for the amount withheld, specially designed revenue stamps. Denominations might be in 25 cents and in multiples thereof; any fractional amounts of 15 cents or less should be disregarded; fractions between 15 cents and 24 cents should be regarded as 25 cents. Stamps could be sold by post offices and perhaps by banks. Stamps, together with currency or check compensation, should be deliverable simultaneously. The recipient of the income could be furnished by the Government with simply designed "Victory Stamp Books" into which the stamps would be pasted.

Equitably, if withholding is made with respect to wages, salary, commission, and bonuses, it should be made with respect to interest, dividends, rents, royalties, fees, and other income.

Withholding at the source with respect to dividend and interest payments could be made feasible, especially of interest paid to banks and licensed loan organizations.

It would not be practical to provide withholding for rent payments nor, for example, for fees to physicians.

If withholding is to apply against the tax liability, it would be sufficient, in the initial stage, to concentrate on compensation and dividend payments.

But if withholding is as a preliminary step to Government bond acquisition, all taxpayers should be treated alike, except corporations which are subject to excess-profits taxes, normal and surtaxes, capital stock, and related excess-profits taxes.

To attain a measure of desirable equity, income not subject to withholding should be subject to some bond purchase liability. If the suggestion here made is adopted, tax returns of noncorporate taxpayers should disclose the amount of tax withheld at the source, evidenced by the "Victory Stamp Book" or books, and bonds must be purchased at the time the tax return is due in an amount which might be expressed, tentatively, as follows:

The amount of bonds which must be purchased shall be either:

> (1) Twenty percent (or the withholding rate provided for the tax year) of the gross income (exclusive of capital gains and losses), less the amount withheld during the taxable year,
>
> *or*
>
> (2) the sum required, if any, to bring the amount withheld during the tax year plus the tax liability for the year to 50 percent of the net income, whichever is less.

It is necessary to provide for refund or credit in situations where withholding plus current taxes exceeds a given percent of the net income. This can be done readily.

(5) *Fiscal year taxpayers.*—In discussing the economy canon (No. 7), I referred to the House bill which would reinstate the 1932 and prior revenue act treatment of taxpayers reporting on other than the calendar year basis. I quoted the then chairman of the Senate Finance Committee in his report on the revenue bill of 1934 (p. 22):

"This complicated rule has been eliminated in the proposed bill for the purpose of simplicity and ease of administration."

What was said in 1934 obviously is much truer today, because of the infinitely more complicated tax structure. True, the House proposal would result in more immediate revenue collection but who can tell what the net long-term result will be when tax rates eventually recede? Equity recoils from imposing the proposed higher levies on taxpayers which have declared dividends, made capital and other goods commitments, and entered on plans based on the justified belief that the fiscal year tax reporting would remain undisturbed. So much for retroactive changes. Even for the future, for sound reasons known to you and to the Treasury, the existing procedure should not be disturbed.

(6) *Mandatory joint returns.*—There is no equitable basis for taxing A's income at highly progressive rates because of B's income, regardless of marital or any other relationship between the two. The excuse—there is no reason—for the proposal is because of political difficulty in reaching true taxable income in community property jurisdictions. I can find no moral sanction in the mandatory joint return proposal. Incidentally, how can one logically justify a $500 exemption for single persons, $1,200 for married couples, and $300 for each spouse filing a separate return if "two together can live more cheaply than two apart?"

(7) *Exempt interest.*—In my opinion, after the enactment of the sixteenth amendment, there was no longer any excuse for exempting interest on obligations of States and their political subdivisions. Nevertheless, this is the worst of all times since 1913 to disturb a status which should never have been permitted to develop. Because of circumstances over which States and political subdivisions have no control and for which they are not responsible, even such splendidly managed finances as those of the State of New York and the city of New York (and I mention them only because I know them best) are not free from danger. For the duration, the Federal Government, for reasons of public morale, should avoid steps which would tend to jeopardize the fiscal soundness of States and their subdivisions. This means that interest on future issues should not now be subjected to Federal taxation. From this point of view, States and cities have no immediate fiscal concern with the taxation of outstanding issues. However, as a practical matter, I do not see how outstanding issues could be taxed, if future issues were even temporarily exempted.

(8) *Reserves and net loss "carry-backs."*—Canon 6 asserts that war income and profits taxation should be imposed on true net income. With income and

excess-profits rates as high as they must inevitably become, it is of paramount importance that the basis of the tax, to wit, net income, be fairly ascertained. Artificial restrictions on deductions and failure to recognize sound accounting reserves result in the imposition of a tax stated at one rate but effective at a higher rate. There is no reason why the taxing statute should not recognize, as the basis on which to impose income tax, net income as disclosed by the consistent application of sound accounting principles.

The aftermath of the last war revealed that cash taxes quite generally had been collected on unrealized and unrealizable paper profits—"fool's profits." Many bankruptcies resulted. Unless available steps are taken now, the evil economic repercussions of this war are bound to be immeasurably severer than was suffered two decades ago. Among the steps which should be taken by appropriate provision in the pending revision are: (1) In addition to the circumscribed and limited reserve provided through permission to use the so-called Lifo inventory method, to permit the use of inventory reserves in the determination of taxable net income (the Ways and Means Committee had announced approval of a Treasury proposal for such a reserve limited to the period from 1941 to 5 years after peace, but the House bill contains no such provision); (2) to permit the use of other post-war loss and adjustment reserves clearly described in a recent research bulletin issued by the American Institute of Accountants entitled "Accounting for Special Reserves Arising Out of the War"; and (3) to permit the carrying back from a "loss" year to the war "profit" years of the net loss with resulting refund, in effect equivalent to the British excess-profits tax practice of annual reascertainment of aggregate excess profits, thereby imposing the excess-profits tax on true excess profits for all of the war years as a unit.

(9) *Drafting of the revision.*—Those of us who have studied the House bill appreciate the technical skill of the draftsmen. Their task and ours would have been simpler if they had used a print which showed the existing law and the Ways and Means Committee changes. Despite the excellence of the draftsmanship, the bill is extremely complicated. I am not ready to concede that even in so technical a field as income and profits taxation greater simplicity and clarity cannot be attained. Experience justifies the fear that the Internal Revenue Code, amended five times already since 1939 and now proposed to be amended for the sixth time, will not be entirely free from avoidable ambiguity or that it will not lack some measure of clarity and simplicity. Hitherto, on a number of occasions, it was deemed necessary to submit revenue bills to vote, despite known need for clarification and simplification. I suggest that, with respect to many of the technical provisions of the bill, especially those which deal with noncontroversial excess-profits tax sections and other technical features, the chairman of the Senate Finance Committee invite the chairmen of the Federal tax committees of the American Institute of Accountants, the New York State Society of Certified Public Accountants, the Controllers Institute of America, and the excess-profits tax subcommittee of the American Bar Association, to cooperate with the committee's draftsmen for the purpose of attempting clarification and simplification particularly of those sections of the bill regarding which there is no controversy. I am confident that the response to your chairman's invitation would be cordial and immediate. The groups to which I have referred are professionally concerned with the interpretation and application of the taxing statute, and their competence for the task which I have suggested is known to this committee, and, I believe, would be approved by your own technical advisers.

(The following telegram was subsequently received from Mr. Klein, and ordered incorporated in the record:)

[Telegram]

NEW YORK, N. Y., *August 12, 1942.*

Hon. WALTER F. GEORGE, *Chairman,*
Hon. ROBERT A. TAFT, *Member,*
Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATORS: Judging by today's newspapers I must have failed to make my point clear in response to Senator Taft's query or comment regarding amount of individual net income untaxed under House bill. Perhaps you may kindly agree to put following statement into record:

"Estimated, on corporate 1942 national income, per department of Commerce figures, is 10.5 billion dollars, after deducting estimated exempt interest and allowing 6 percent for deductible expenses, etc., balance is net income of approximately $99,000,000,000. Three hundred and eighty-five thousand returns of net incomes above $10,000 account for 8.76 billion dollars of net income on which tax liability is 3.69 billion dollars, leaving approximately 5.07 billion dollars after taxes. Twenty-six million five hundred thousand dollars taxable returns of net incomes up to $10,000 account for 50.94 billion dollars of net income, on which tax liability is 4.22 billion dollars, leaving approximately 46.71 billion dollars after taxes. There are approximately 25,000,000 others who file no tax returns or nontaxable returns, accounting for aggregate net income of almost 40 billion dollars.

I would say, therefore, that 40 billion dollars of net income entirely escapes income tax liability under House bill and that after House bill tax liability an additional $46,000,000,000 remains to those who have net incomes up to $10,000, that the "tappable" reservoir for income taxes, additional income taxes, and loan to Government, to which I referred during my remarks, is over $86,000,000,000.

Faithfully,

JOSEPH J. KLEIN.

The CHAIRMAN. Mr. Greenfield.

STATEMENT OF SAMUEL C. GREENFIELD, NEW YORK, N. Y., REPRESENTING THE TEACHERS UNION OF NEW YORK CITY

Mr. GREENFIELD. My name is Samuel C. Greenfield. My address is 882 East Tenth Street, Brooklyn.

Mr. Chairman and gentlemen of the Finance Committee, a few weeks ago a large public utility placed an advertisement in the newspapers in which they asked: "Will it help win the war?" If we ask the same question with regard to the tax bill that the House of Representatives passed on July 20, our answer would be that it does not.

The House bill levied too large a burden on the lower-income groups. It increased the taxes on individuals who earn less than $2,000 a year by $885,000,000, an increase of 275 percent over last year. This was done by lowering the tax base and by increasing the tax rates. The source for the figures given is your committee's hearings on the Revenue Act of 1942, part 1, unrevised, page 59.

At the same time the total increase in taxes on those who earn more than $10,000 a year was $442,000,000—only 14 percent more than last year. The source for these figures is the same as above.

The contrast in the treatment of the two groups at the opposite ends of the income poles is even more striking when we note that of the $11,000,000,000 increase in the income that will be received by individuals during 1942, only $1,400,000,000 will go to those who earn less than $2,000 a year, while five times as much, or $7,000,000,000 will go to those who earn $10,000 and over——

Senator TAFT. Where do you get those figures? I just cannot believe that. I do not know anybody that makes more than $10,000 except a few war contractors who will not have a great deal less this year than last year.

Mr. GREENFIELD. Practically all the figures I cite are taken from the hearings of the House, and I will give you the exact page. You will note the reference figures in parenthesis and on the back page of my statement the corresponding source is given.

Senator TAFT. Who did it? Whose estimate is it?

Mr. GREENFIELD. I will give you that in a moment, sir. This was done by the staff of the Joint Committee on Internal Revenue Taxation. All of the sources are right here on the back page.

Senator BARKLEY. Do you mean by your statement that the increase in the total national income this year is only $11,000,000,000 over last year?

Mr. GREENFIELD. According to the figures that I have given, Senator, the increase in income to individuals is going to be $10,806,000,000, sir. I have a summarization of that, if you want to see it here.

Senator BARKLEY. What is the total increase, if you have it?

Mr. GREENFIELD. I do not have that. Some of it will go to corporations. I am talking about the total increase to all individuals.

Senator BARKLEY. It has been estimated here that this year the total income of all the people of the United States will be approximately $30,000,000,000 greater than in 1941. If that is true, that means that some $19,000,000,000 is going to somebody besides individuals.

Mr. GREENFIELD. That is quite possible, sir.

Senator WALSH. Are you speaking only of the taxable group?

Mr. GREENFIELD. No, sir; you have the source right there, sir.

Senator TAFT. This came from the Research Division of the Office of Price Administration. I question the figures. I do not think there is the slightest basis for maintaining that the aggregate income of persons over $10,000 a year is increasing in one year from $18,000,000,000 to $27,000,000,000. I do not think there is any support for the statement, and I do not think the Office of Price Administration, the Research Division, is reliable in making any such estimate. It is contrary to every fact that anybody can see or know.

Mr. GREENFIELD. Well, gentlemen, those are the only governmental figures that I have seen released anywhere, and those are the only figures that have been released. If there are any other figures I certainly would like to see them. However, I am quoting you the official figures.

Senator TAFT. I can show you official figures that are different. Those are the figures of the Treasury itself, in its estimate of what the income tax will produce from men over $10,000 in 1942, and it is one-third of the estimate of the Office of Price Administration. I mean the Treasury estimate of income of persons over $10,000 a year is one-third of the estimate that you just read from the Office of Price Administration.

Mr. GREENFIELD. The increase?

Senator TAFT. No; the total net income for 1942 of persons over $10,000 a year, as estimated by the Treasury, is $8,000,000,000, and as estimated by the Office of Price Administration it is $24,000,000,000, and either one or the other is wrong. I do not know which one, but we are working on an estimate that this tax will produce from a gross income of people over $10,000 only one-third of what it would produce if the O. P. A. figures were right.

Mr. GREENFIELD. All I can say is this: I have the figures here; also I have the O. P. A. figures, from the same source, for 1935–36. At that time there were some 331,000 individuals in the $10,000-and-over group, and they earned $7,500,000,000. Now, according to the O. P. A. figures there will be three times that many this year, and therefore the $25,000,000,000 figure. If there will be 1,000,000 people earning $10,000 and over, as indicated there, then the $25,000,000,000 figure is not out of the way.

Senator TAFT. Incidentally, the O. P. A. figures are based on so-called consumer units, whatever they are, whereas the Treasury figures are based on individuals. But all of our estimates here are based on gross income for people over $10,000, which is one-third of the figure you are using. If the other figure is right, we ought to be able to get about three times the income out of the income tax that the Treasury is figuring on.

Mr. GREENFIELD. I hope the Treasury Department will submit the official figures for the committee so we will not have the problem of the staff of the Joint Committee giving one set of figures and the Treasury giving another.

Senator TAFT. That is not the staff of the Joint Committee, that is the Office of Price Administration.

Mr. GREENFIELD. These are the only figures we have, that we citizens have available before us. I think we should have the correct figures if there are other figures. Throughout my discussion, of course, I am basing my argument on the only figures I have, gentlemen, and if there are other figures, the argument, of course, will have to be modified to that extent.

The CHAIRMAN. You may proceed. We will try to verify the figures.

Mr. GREENFIELD. The House tax bill favors the 2½ percent of the population that will earn $10,000 and over during 1942 as against the remaining 97½ percent of the Nation. Figures that were presented to the House Ways and Means Committee by the staff of the Joint Committee on Internal Revenue Taxation show that the income groups under $10,000 a year will receive only one-third of the income increases for individuals for 1942 but will pay five-sixths of the tax increase.

The discrimination in the treatment of the lowest income groups, below $2,000, is particularly bad when we realize that they are already living on a substandard income level. According to the Heller committee of the University of California, $2,567 is the minimum that is needed to maintain a family of four on a wartime budget. The source of this is the C. I. O. Bulletin, Economic Survey, July 1942. The substandard-income groups are a majority of the Nation. They are our war workers, farmers, and soldiers. We cannot afford to undermine their health, for in doing so we are endangering our entire war effort.

The House bill doubled the taxes on the group that I represent, the group from $2,000 to $5,000. We accept these increases cheerfully because we agree with Mr. Morgenthau that "War is never cheap; but it is a million times cheaper to win than to lose." In making recommendations and criticisms we are motivated only by the desire to spread the necessary sacrifices uniformly throughout the Nation in order to achieve maximum efficiency for the war effort.

We are waging this war for our lives with a most powerful and treacherous foe. It will require the sacrifice of blood and fortune on a scale scarcely conceived before the war. If we are to win, we should not weaken national unity by soaking the lower-income groups disproportionately. Rather, we should strengthen national unity by distributing the burdens and sacrifices uniformly.

We, therefore, recommend the restoration of exemptions to their former levels—namely, $750 for single people and $1,150 for married people.

We recommend that revenue be increased by several billion dollars through additional taxes on the income groups above $10,000 commensurate with the increases that were levied on the rest of the Nation. A large part of the $7,000,000,000 income increase for this group should be diverted to war use.

We recommend that the loopholes that were enumerated by the Secretary of the Treasury be closed.

In particular we recommend that small deductions be allowed to individuals for the following:

1. Medical expenses above a certain amount.
2. Dependent children between 18 and 21, who are attending school.
3. For a widow or wife who works and who has dependents.
4. In addition to the above, which were recommended by Treasury Department, we also recommend that a partial credit be allowed for the purchase of war bonds as an incentive to increase sales. Limitations should be placed on such allowances in order to prevent its use as a tax-avoidance device.

We oppose a sales tax.

We oppose a sales tax because it falls most heavily on the poorest people and only lightly on the wealthiest. Comparing the income group below $1,750 with the group earning over $10,000, we note that the aggregate group income is approximately the same for both. Yet the lower-income group will pay three times as much in taxes under a sales tax. These facts can be seen from the following table:

Income group	Number of people	Total income, 1942	Tax paid on 5 percent retail sales tax
Under $1,750	25,000,000	$27,000,000,000	$685,000,000
$10,000 and over	1,000,000	25,000,000,000	240,000,000

The figures as to total income for 1942 were taken from your committee's hearings on the Revenue Act, 1942, part 1, unrevised, page 59; and the figures as to tax paid on 5 percent retail sales tax were taken from the House Ways and Means Committee hearings on Revenue Revision of 1942, volume 1, page 378.

The above facts show that a sales tax aggravates poverty by shifting the tax load from those who can pay to those who cannot pay.

What are the arguments that have been advanced in favor of a sales tax? Several newspapers have been clamoring for it. Two arguments have been presented. The first contends that price stabilization is endangered by the excess buying power of the millions of people in the lower-income brackets and that only a sales tax can siphon off enough money to reduce their buying power.

What are the facts? The two-thirds of the population that earn less than $2,000 a year, spend 60 percent of their income for food, housing, and medical care. It would certainly be unfair to curtail the expenditures of this group for food, especially when an oversupply exists. Expenditures for housing in the lower-income groups is another item that cannot be readily reduced. If anything, war workers in the lower groups are forced to spend even more for housing of lower quality in this period. We certainly cannot conceive of anyone advocating a curtailment of expenditures for medical care for the low-income groups. It is therefore not economically sound nor is it necessary to seek curtailment in these categories of expenditures. The only point of attack is the remaining 40 percent which amounts to $12,000,000,000.

The goods and services that they buy with this sum is but one-third of the total expenditures of the entire Nation for such goods. It is in this category of goods that inflationary tendencies exist because of their scarcity. Does anyone advocate that the two-thirds of the Nation who buy but one-third of the scarce goods should have their purchases of these commodities restricted still further through the imposition of a sales tax? On the contrary, they should be lifted rather than depressed.

The second argument that has been advanced is that the major portion of the increases in income has gone to those in the lowest income groups and that they, therefore, should bear larger taxes. The facts, as presented by the staff of the Joint Committee on Internal Revenue Taxation to the Ways and Means Committee of the House can be found on page 364 of their hearings. They show that of the $11,000,000,000 increase in income to individuals, $7,000,000,000 will go to the 2½ percent of the population who will receive $10,000 and more this year. The remaining $4,000,000,000 of the increase will go to the 97½ percent of the population that will earn less than $10,000. And of this sum but $1,400,000,000 will go to the two-thirds of the population that will earn less than $2,000.

The 97½ percent of the population will actually have less buying power this year because of increased taxes, increased cost of living—at least 10 percent—and their purchase of War bonds.

The 2½ percent of the population, on the other hand, will have greater buying power. They will receive $25,000,000,000 in income this year, or one-fourth of the total income of the Nation. Their savings alone were $8,300,000,000 last year and will certainly be larger this year. In addition, they have large reserves in banks. Thus they represent a real threat to price stability. A sales tax will hardly touch this group; the House bill taxed them very lightly.

A sales tax will increase the cost of goods without regard to their scarcity, abundance, or the source of excess purchasing power. It will increase prices on goods such as food which are purchased mainly by the lower-income groups. It will tend to distort the price structure and increase any tendencies toward inflation that now exist. In addition, it would increase malnutrition. It would reduce the market for the farmer by curtailing purchases of food. It would discourage the great majority of our people who would resent their disproportionate sacrifices while profiteering in the upper-income group continues.

The administration has very properly opposed such a tax. The net effect of a sales tax will be to injure the national unity which is so essential to the winning of the war.

Concerning the prevention of inflation, which is uppermost in your minds, the President has shown the way through his seven-point program. Increased taxation of the upper-income groups is part of that program. We recommend that the House bill be amended to increase the yield from those who will earn more than $10,000 by several billion dollars.

Senator BARKLEY. By how much?

Mr. GREENFIELD. I said by several billions. All we ask is that the upper income groups pay increased taxes in proportion to the increases that were levied by the House on the rest of the Nation.

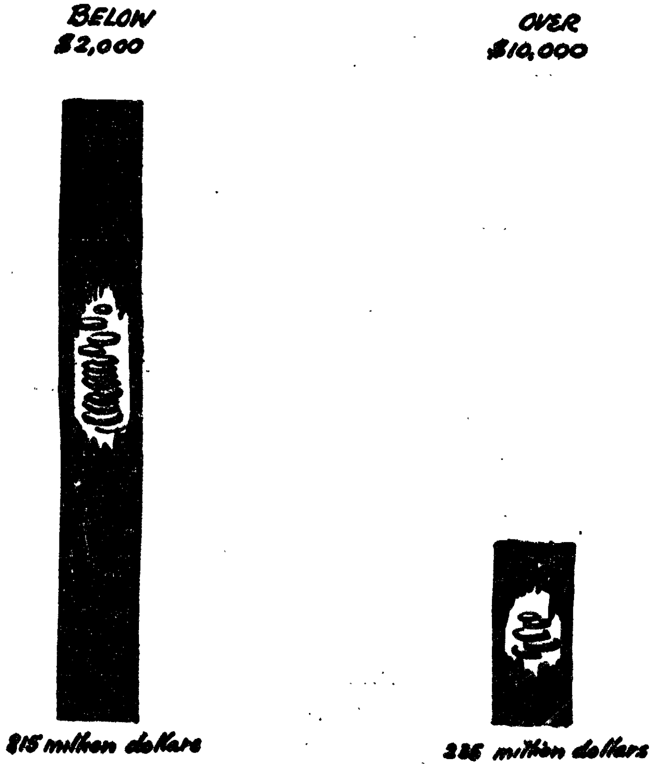
We support the administration in its desire to close the existing loopholes which benefit those in the upper-income brackets.

We recommend raising the exemptions to their former levels. We also recommend allowing small deductions for medical expense above a certain amount, for school dependents over 18, for widows and working wives, and for War bonds purchased.

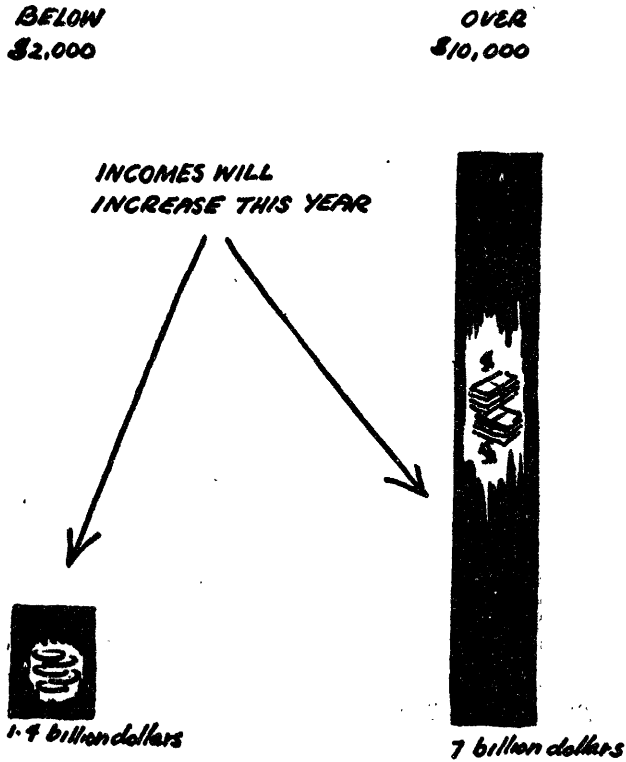
Finally we ask that the House bill be amended to unify the Nation by distributing the tax burden equitably so that no group profits from the sacrifices of others.

(The charts submitted by Mr. Greenfield are as follows:)

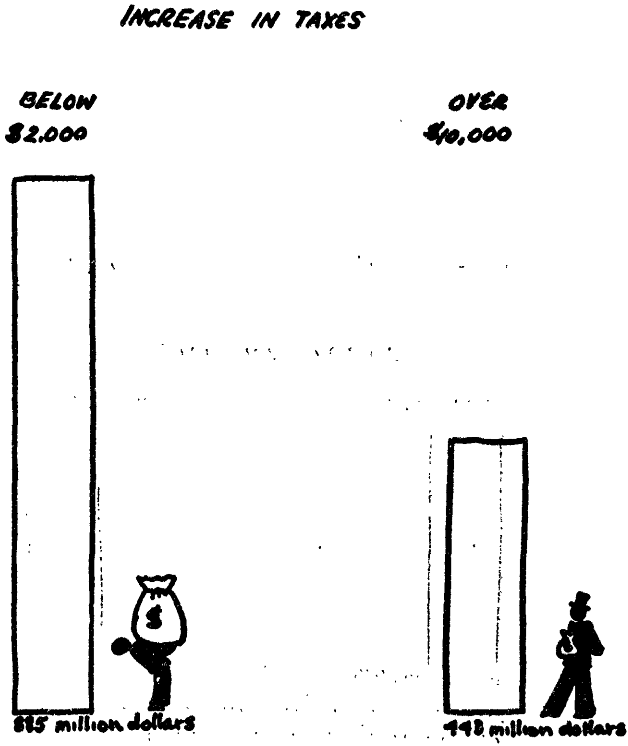
The Poor Pay Most Under a Retail Sales Tax (5%)

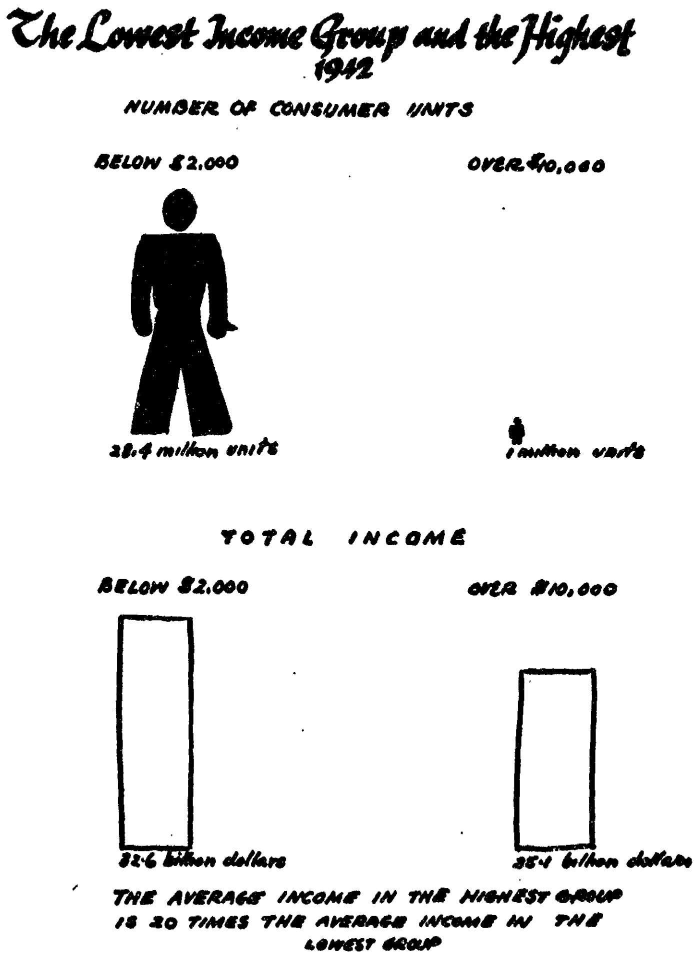


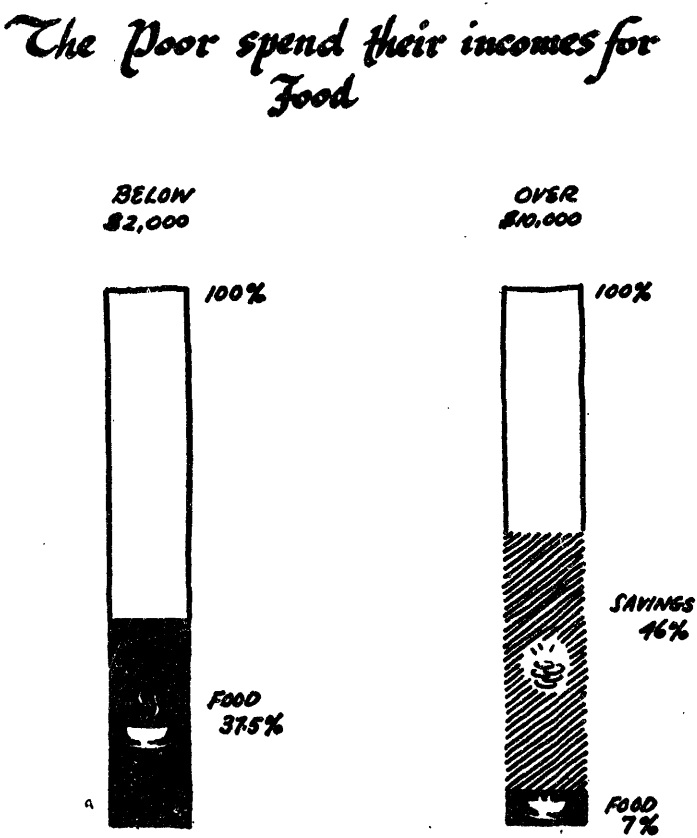
Increases in Income Go to the Highest Income Group



House Tax Bill Penalizes the Lowest Group




The Lowest Income Group and the Highest
1942
NUMBER OF CONSUMER UNITS
BELOW $2,000
OVER $10,000
28.4 million units
1 million units
TOTAL INCOME
BELOW $2,000
OVER $10,000
32.6 billion dollars
25.4 billion dollars
THE AVERAGE INCOME IN THE HIGHEST GROUP
IS 20 TIMES THE AVERAGE INCOME IN THE
LOWEST GROUP



The CHAIRMAN. Dr. Townsend.

STATEMENT OF DR. FRANCIS E. TOWNSEND, FOUNDER, TOWNSEND OLD-AGE PENSION CLUBS

The CHAIRMAN. Dr. Townsend, the committee has often heard you. A request has been made for your appearance. How much time would you want?

Dr. TOWNSEND. Thirty minutes.

The CHAIRMAN. We cannot give you 30 minutes.

Dr. TOWNSEND. I have only six pages here. I think I can get through with it in much less time than that.

The CHAIRMAN. We have heard your matter time after time. We will be glad to hear you, but we cannot give you 30 minutes.

Dr. TOWNSEND. All right, sir, I think I will get through in 15 minutes. I will try it.

The CHAIRMAN. We are very liberal by giving you 15 minutes. I think your views are known to the committee. I do not think it is unreasonable to ask you to come directly to the point of what you are recommending in regard to taxes.

Dr. TOWNSEND. Then I will confine my remarks to my printed draft.

Gentleman, you have been listening to arguments on the new proposed tax bill by the representatives of various economic groups. I come to speak for that portion of our population which will most deeply feel the tax burdens of this war. I refer to the 70 percent of our population whose incomes are below the level that would assure them of health and decency. It is upon this group that any form of retail sales tax would fall most heavily. A report has just been issued in the city of Chicago showing that 225,000 dwelling units in that city alone are substandard, many of them lacking the simplest of convenience such as running water, plumbing, heating, and so forth.

Obviously any taxation such as the iniquitous retail sales tax must be taken directly out of the hide of our aged pensioners, the three and one-half million younger workers who are still unemployed, and the other millions on farm and in factory who, while often receiving a high hourly rate of pay, have pitifully small annual incomes. Yes, every penny of a retail sales tax must appear in milk taken from their children, in bread denied their stomachs, in shoes, clothing, and decent housing. There is no place else for it to come from, for this two-thirds of our population live up every penny they can possibly obtain. The things these poor people buy are, for the most part, commodities we have in abundance.

I tell you, gentlemen, that the people for whom I speak must and will bitterly resent a retail sales tax. For those in high-income brackets even a retail sales tax can easily be paid and the money will not be taken from their food or their backs.

We know there is a form of taxation that will not fall with undue weight upon these, the poverty stricken of our land. This system has been tried and tested in the Hawaiian Islands and proven successful. I refer to the gross income tax. By using this form of taxation it will be possible to exempt that portion of the miserably inadequate incomes by which two-thirds of our people must live. The gross income tax can be levied above the first $100 per month, for instance, or whatever amount the Congress sets.

Let us at once free the small-income people from the fear that they shall have to take needed bread from the mouths of their dear ones while others are piling up fortunes, crediting themselves with enormous corporate pensions, or in some other way evading the intent of the law.

If you would uphold the morals of the little people—the backbone of this Nation—you will demand a limitation on large incomes so that no man can earn more than $25,000 per year for the duration of the war, as suggested by the President, and you will direct your efforts toward establishing a truly scientific system of taxation to replace the hodge-podge we now have, embracing, as it does, tens of thousands of separate local, State, and National authorities, each levying and collecting taxes. Let us start by the enactment of a gross-income tax of, say 5 percent.

Let us ask here what the ideal tax form should be. Obviously, on that form the tax will produce the greatest revenue from the greatest number of people with the least inconvenience to them.

Fortunately, the gross-income tax has been tried, and has been found equitable and successful from every standpoint. It has also been advocated by a gentleman whose experience and sagacity have been recognized by the Congress. Mr. Lovell H. Parker, formerly an adviser to the Joint Committee on Internal Revenue Taxation.

In a letter dated December 12, 1941, to Senator Edwin C. Johnson, a member of this committee, Mr. Parker spoke out strongly in favor of this type of taxation. In fact, he said, and I quote:

> I have no hesitation in saying that under present conditions, in my judgment, we must have some such tax.

Now, as to the gross-income tax in operation in the Territory of Hawaii, let me call your attention to a significant statement by William Borthwick, tax commissioner of the Territory. In discussing the Hawaiian gross-income tax in 1940, Mr. Borthwick said:

> Insofar as the experience of this Territory is concerned, as it pertains to the collection of taxes upon a fair and equitable basis, nothing can begin to compare with the results demonstrated by the gross-income tax since its inception.

Mr. Borthwick, in speaking of the fairness of the law, states as follows:

> The scope of the law reaches out to practically all persons engaged in any and all activities for financial gain and economic benefit. It is not a law which seeks to derive a source of income from a selected few; instead, its distributes the scope of its authority to all. This has been proven in the case of those liable under our net income-tax law, where it was discovered that persons with gross volume of business amounting to thousands of dollars annually paid no income tax.
>
> Whereas, now, under the gross-income tax law the same persons pay their proportionate share according to law.

Curiously enough, gentlemen, the Hawaiian gross-income tax law was adopted when the Territorial legislature was stumped for a new way to levy taxes to meet its expenses. A crisis somewhat like that which we now face nationally had been reached. The legislature was willing to cast aside all of its outmoded and worn ideas and conceptions regarding tax systems. It was looking for something practical and all-inclusive to raise the revenue necessary to carry on its government.

I would like to suggest that you call in Security Administrator, former Gov. Paul V. McNutt, of Indiana, for his remarks about the Indiana gross-income tax which he so ably instituted, and that you ask Representative Samuel King, of Hawaii, to tell you about the success and operation of the gross-income tax in that Territory.

There is an urgent need for someone to testify in behalf of the common people. They pay the bills and the bills that are piling up as debts in these strenuous days are becoming frightening to the people. Just now we are averse to having the people frightened. It is going to take all the courage inherent in all of us to do the task this war has imposed upon us. Fright and courage do not go well together.

Therefore, I come before you to remonstrate against the continuous accumulation of public debt that is being imposed upon our people. The voters of this country are not going to object to paying the costs of the war once, no matter how high they run, but they are going to object to paying those costs over and over again in the form of compound interest on the public debt, generation after generation.

Gentlemen, our taxing system has broken down and is proving totally inadequate to meet the requirements of the times. All the material things in existence today are taxed to such an extent that the costs of living are becoming the nightmare of everyone.

Now it seems to me that it should have become apparent to lawmakers ages ago that to tax the things mankind creates for his comfort and pleasure imposes a direct penalty upon his creative effort—fines him for doing the things he is encouraged to do. If continued long enough, this policy of taxing created things will result in stifling production. Men will not produce just to see the result of their production taken away from them in taxes. Is it not possible for this Nation to find some immaterial thing, some intangible possession common to us all to tax and release the ingenuity of men from the restrictive processes of taxation that stultifies their every effort now?

Gentlemen, there is such a possession that we all have in common, a possession that we all help to create and maintain and which is indispensable to our very existence. I speak of the public market. In it our goods and our services are measured and a price put upon them. Everybody must have access to the public market in which to dispose of the goods or services through which he makes his living or perish. Without a market he will starve or perish from the cruelties of the elements.

Let us make a beginning at least, to get away from penalty taxation and adopt an encouraging form of taxation. Let us tax the use of the public market. Let us say to all adult people in our country, "Whatever you sell, be it goods or services, you must pay to your Government a definite percentage of the price you receive in the market for those goods or services." Let us have a universal gross income tax, a tax that will compel everyone to report fully and frequently—we suggest once every month—on the gross amount of money he has taken in and order him to compute a stipulated fraction or percentage of that amount, reckoned by the rate of tax, and attach his check in payment to the Government for the use made of the market for the designated period.

The gross income tax is the fairest tax that can be conceived of. It bears equally upon all in proportion to the use made of the market. It will produce the greatest amount of revenue for Government with least hardship and discomfort to the people, and it will make everyone conscious of the fact that he is supporting a fair and just government, one which imposes the obligation upon the rich and poor alike to carry their respective shares of the cost of maintaining the Government.

I know of nothing that would so raise the morale of all the people as to give them the definite assurance that each and every citizen owns a definite share in his Government and must fortify his ownership by keeping up his share of its expenses.

Let us examine the possibilities of this public market tax, the gross income tax, in the matter of raising revenue for the Government. Obviously the costs of Government are continually expanding. Hence we shall require a tax that will produce more as the wealth of the country increases. This, the gross income tax will do, without raising the rate, so long as the market is expanding, and that ought to be the purpose of the Government, to keep it expanding. If we are sensible and keep our tax money judiciously distributed throughout the population, we can always have an expanding market.

Where the gross income tax has been tried, even partially, it has proven a most satisfactory and prolific money raiser. The Hawaiian Islands have now had this form of tax for 5 years and not only has it saved the island government from bankruptcy but it has kept the treasury fully supplied with cash and made government free from the necessity of borrowing. I quote from the report of the deputy tax collector's statement covering the 1937 biennium:

> Since the inception of the act, it has not been necessary to borrow a single penny from the banks, as the tax is payable monthly and the Territory of Hawaii has always had more than sufficient funds with which to carry on.

Here is a recent statement from Mr. Borthwick, Territorial Tax Commissioner, addressed to Mr. John C. Cuneo, of Modesto, Calif., national director for the Townsend Plan in California:

> Replying to yours of April 15, will say that the gross income tax still is proving its worth and notwithstanding the war is producing more than was estimated.
> We consider it our best form of taxation. There is nothing new that I could say.

In a second letter dated July 20, 1942, Mr. Borthwick says:

> The gross income tax is still working wonders for us. It's the solution of the tax problem due to its simplicity and that it will produce the revenues needed.

In view of this enlightening statement from Hawaii, let us ask how much money could our country expect to raise by a gross income tax. That, of course, would depend upon the volume of business done and the rate of tax imposed. Let us assume that we are imposing a tax rate high enough to meet the needs of the Government in these times of enormous expenditure, remembering that enormous outlays will entail great increases in the volume of business.

What is the gross income of the United States at this time? No one knows accurately, for no one has even taken the pains to find out. But we have certain criteria from which we can make a close estimate, at least close enough to astound us with the possibilities of our proposed taxation. We know that a very large percentage of the gross sales of the country finds its way into the banks in the form of debits. We do not have a list of all the debits of all the banks, only those of the Federal Reserve banks; but a majority of all debits of all banks are represented in the Federal Reserve reports.

This current year will probably show the greatest turn-over of business of any in our history with the exception of 1929, and this turnover will certainly accelerate rapidly, the latter half of the year exhibiting a much greater volume than the first half. This prediction is justified by the report just received from the statistician of the Federal Reserve Board, who tells us that a preliminary estimate of the debits to individual accounts in the Federal Reserve banks of the Nation will show about $400,000,000,000 for the first 6 months of 1942.

We need not call your attention, I am sure, to the fact that if corporate and business firms' deposits were added to these deposits the $400,000,000,000 would be vastly augmented. We would call your attention also to the fact that there are in all probability billions of dollars of sales made throughout the Nation that are never recorded in any bank; so it would seem that if we used ultraconservative estimates of the volume of taxable gross income and placed them at $400,000,000,000 per year, instead of a half year as reported, our proposed 5-percent tax would produce $20,000,000,000 of returns to the Government annually.

Here, gentlemen, I hold a tax proposal in my hand that has been thrown in your laps by a committee of the lower House of Congress. Have you tried to read it? Don't. You will go dotty if you do; I started on it bravely and waded in 8 or 10 pages and got away over my head. My thinking apparatus went into a tailspin. I had to back out. I predict that if any of you get much beyond my book marker you will be calling for help to get back.

I understand that the Ways and Means Committee of the lower House employed a tax expert to concoct the prodigy. It must have been so. No 24 men on this continent could have been found whose minds were so sterile as to have fathered this abortion. It is a mystery of mysteries where the committee could have found one man so mentally befogged as to perpetrate this enormity on the American public and ask that it be fastened upon them by law. This bill—look at it, 320 pages of stuff—the very antithesis of what we declared in the beginning that a tax law should be, namely, one that would bring in the greatest revenue from the greatest number of people with the least inconvenience to them. This proposed House tax bill, if adopted, steadily tightens the strangle cord around the neck of business until the garrotting would be complete.

The author of this bill—I will not impugn the intelligence of the Ways and Means Committee by saying "authors of this bill." The author of this bill must have searched the universe for suggestions of more things to tax, dumped them all into some kind of witches' cauldron, stirred up the mixture, and by some subtle alchemy, probably obtained from the prince of darkness and confusion, been able to withdraw this abomination. Note its total inadequacy. It fails by several billions to produce the amount of money needed for the prosecution of the war and will stir up the greatest hornet's nest of protest and disagreement between the Congress and agencies it proposes to tax that could possibly be devised. Gentlemen, I urge you to disregard it entirely. It has already cost the Government a tremendous amount of money and time—the latter so precious just now—that to increase that cost by further consideration of it would be little less than criminal. Note the cost. The committee members' salaries at $20.000 per month for 9 months or more since it began this orgy of fiddling while the country burned with impatience. What the salary paid this so-called expert was I do not know, but I know it was aplenty. Note the cost of the deficiency bill that will be entailed upon the Government by reason of this bill's inadequacy throughout all the coming years.

Let us begin a new, bright page of taxation history for our country, a page that will inaugurate a system of justice, fairness, and equity for all citizens; a system that will make all men conscious of their obligation to their Government; that will insure them a definite equity in the entire wealth of the country; that will give every mother's son of us the opportunity to acquire possessions of his own in abundance, in this age of abundance, and bring about an era in which every citizen will have reason to love and revere his Government and the flag that represents it.

Gentlemen, I bespeak you for a national gross income tax applied on everybody.

Thank you.

The CHAIRMAN. Thank you, Doctor.

Mr. Millard Cox.

STATEMENT OF MILLARD COX, LOUISVILLE, KY., REPRESENTING THE DISTILLED SPIRITS INSTITUTE

Mr. COX. My name is Millard Cox. I am from Louisville, Ky., and I speak for the Distilled Spirits Institute.

The Revenue Act of 1942, as passed by the House of Representatives, increases the alcoholic beverage excise tax on distilled spirits from $4 to $6 per gallon. That measure is now before your committee for consideration and recommendation.

In addressing ourselves to this subject, it may be helpful at the outset to state certain broad principles on which there can be no cause for disagreement between the industry and this committee.

Alcoholic beverages constitute what is known as a luxury item among the economists.

As such, they have universally been recognized as a legitimate source of taxation.

The rate of tax has been determined by the two time-honored principles of (1) What is the amount of revenue to be raised? and (2) What will the traffic reasonably bear?

You will note that I have used the word "reasonably." I have done so because I can say with conviction that I believe that the Congress has shown genuine concern over the reasonableness of each of the three previous increases in this tax since 1938. The very fact that the present increase, however, is so much higher than any of the previous ones would seem in itself sufficient to raise the question of its reasonableness.

At the time of the repeal of the eighteenth amendment, the tax was increased from $1.10 to $2 per gallon. The $2 rate was arrived at as the result of a study made by a committee appointed by the President. It was thought then by the Congress that this was all the traffic would reasonably bear in view of the fact that enormous quantities of the bootleg product was then being offered in competition with tax-paid merchandise.

In 1938 the tax was raised from $2 to $2.25; in 1940 as a part of the defense tax legislation, 75 cents was added and lastly, in 1941, an increase of $1 brought the amount to $4 per gallon. Under the House proposal, $2 more will now be added.

Having learned at first hand from our contacts with the War Production Board the magnitude of some of the plans now in the making, we can only view with sympathy and understanding the necessary hunt for additional revenue even though that search has found its way for the third successive year to the doors of our industry—an increase of 200 percent.

Such are the fortunes of wartime, that the distilling industry which a year ago was engaged solely in a luxury business now finds itself a major producer of alcohol for war purposes. It is proud of the fact that it has been called upon to fill an essential war need and that it has been able to respond to the call to service which under present plans of the War Production Board call for 100 percent alcohol production by November 1, 1942.

Without opposing this or any other tax which the chosen representatives of the people may find advisable for the prosecution of the war, we nevertheless ask your consideration of the present effect of the proposed 50-percent increase and of certain post-war aspects of this increase, bearing in mind the mutuality of interest of the Federal Government and the industry as its chief collector of industrial excise taxes.

The proposed increase of $2 a gallon will bring the total excise tax to $1.50 for a quart of 100-proof whisky. Frankly we are afraid that this may be too large an increase for distilled spirits to bear at one time without disrupting consumer demand with a consequent loss in revenue, defeating to some extent the purpose of the tax increase. Marketing experts are unanimous in the opinion that well-accepted products can stand successive small increases in price without materially disturbing consumer purchasing power but that one large increase in price is apt to drive the consumer to substitutes. The only substitute for tax-paid distilled spirits is the illicit product of the bootlegger. In saying we believe the proposed increase may be too precipitous, we are not unmindful of the fact that these are not ordinary times and that there has been a substantial increase from the past year in consumer purchasing power. Despite this increased spendable income, however, there has been only a small increase in public consumption since October 1941. Since that date there has already been a tax increase of $1 per proof gallon. The stimulation in sales which might have been expected from the increased purchasing power has been offset by the rise in price incident to this tax increase so that consumption for the past 9 months has remained practically static. It does not seem reasonable to expect that purchasing power will continue to increase at the rate of the past year, and a tax increase twice as large as any in recent years is, in our opinion, apt to result in a smaller number of tax-paid gallons. How much smaller we do not know, but we are convinced that the decrease in purchases of tax-paid liquor will likely be much less if the tax should be increased not more than $1 for the present with future increases, should they be necessary, to be dictated as circumstances seem to warrant in the light of experience.

Conclusive evidence that there is a price level beyond which the public will not go is afforded by imported whiskies which have shown a decline in consumption of over 30 percent since the last dollar tax rise of October 1. Imported whisky which carries an import duty of $2.50 per gallon had reached the level in price to which the price of domestic whisky will be moved should a $2 additional tax be imposed. The reduced demand for imported whisky at these price levels shows the speed of public reaction when price is too high.

Senator GUFFEY. Did it curtail imports, do you know, Mr. Cox?

Mr. COX. No Senator, I do not know. There is now in the stocks, I am told, 7,500,000 gallons of imported whisky which they would be very glad to dispose of.

Senator TAFT. What would be the effect of the $1 raise? Did that reduce the consumption in any way last year?

Mr. COX. The $1 raise on domestic whisky, no, Senator. The withdrawal figures show a slight increase.

Senator TAFT. The withdrawal figures show a slight increase in spite of the $1 in tax last year?

Mr. COX. That is right. However, the per capita consumption has apparently remained the same in the last 3 years.

Senator BARKLEY. Is that true of beer and ale?

Mr. COX. I do not know, sir.

Senator BARKLEY. It would be purely speculative. Have you any knowledge as to whether the figures would have been greater if the $1 tax had not been added?

Mr. COX. If there would be an increase in consumption, you mean?

Senator BARKLEY. Yes.

Mr. COX. I think it probably would have, Senator; yes, sir. That is only an expression of an opinion, however.

Senator BARKLEY. Yes.

Mr. COX. It now seems assured that the manufacture of beverage spirits will cease altogether on November 1, 1942, for the duration of the war or will be so greatly curtailed as to prevent a continuity of inventory in sufficient amounts to supply the normal demand.

Under these circumstances the existing stocks of aged beverage spirits will be so depleted that following the war, the demand will have to be met by new and immature distillations. In short, there will be a return of conditions as they existed immediately following repeal, when the tax was cautiously increased from $1.10 to $2 per gallon.

Is it not reasonable for the industry to be alarmed over the prospect of a $6 tax under those conditions? Should not the Treasury be equally concerned? There is inherent in such a situation disaster not only to the industry but to the public revenue as well.

The condition we have pictured would be made to order for the bootlegger. A $6 tax on the legal product inadequately matured will invite illicit manufacture on a scale comparable to the prohibition era.

Senator JOHNSON. How about the added tax last year? Has that increase the illicit liquor?

Mr. COX. The seizure of stills is slightly up, Senator. I do not think it is a great deal.

Senator BARKLEY. Does that indicate that the seizures have not increased in proportion to the stills?

Mr. COX. I do not think you would want me to answer that.

In order to combat this post-war situation, the tax will have to be reduced and the Treasury will be confronted with the necessity of employing a greatly augmented number of enforcement officers. I am speaking of post-war conditions now. If provision for the reduction of the war tax is postponed until after the war, the result will be most serious for the industry as well as disruptive of the flow of Government revenue. Once a reduction appeared in prospect after the war a buyer's strike would follow in which either the consumer would refuse to buy merchandise prices on the basis of the high tax or a race would ensue between distributors to unload tax-paid stocks which would have to be sold at prices below cost resulting in bankruptcy for the sellers.

We have pictured what we believe to be not only a likely situation but one that is almost certain to present itself.

The problem is peculiar to our industry and consequently calls for special consideration. Given the opportunity, we believe that with assistance from a technical adviser to this committee, working with Treasury officials and industry representatives, an equitable measure can be agreed upon and drafted to prevent the occurrence of the situation we have described.

There are certain statements of fact and convictions in connection with this subject which we desire to place in the record in the hope that they may be helpful to you not only at this time but in future consideration of this subject. They are these:

(1) In October 1917 the tax was raised from $1.10 per proof gallon to $3.20. Consumption in 1917 was 167,000,000 gallons. In 1918 it dropped to 91,000,000 gallons—a decline of 46 percent.

Senator DANAHER. Did we have wartime prohibition at that time, too?

Mr. COX. Wartime prohibition did not take effect at that time, Senator. I think that took effect July 1, 1919.

Senator DANAHER. What was the reason for the drop? The withdrawal of 2,000,000 men in the military service?

Mr. COX. I think undoubtedly that had something to do with it, sir; and I think maybe the increase in tax had something to do with it.

(2) The adult per capita consumption of distilled spirits has been arrested since 1937 when the tax was raised above $2 per gallon, the figures being as follows: 1937, 1.73 gallons; 1940, 1.74 gallons; and 1941, 1.74 gallons.

(3) The illicit traffic still exists and, according to reports of the Alcohol Tax Unit, now accounts for some 10 percent of total consumption. Ingenious ways of overcoming the present ban on critical materials will undoubtedly be discovered and employed by the bootlegger. Alcohol for war purposes can and is now being made in stills which do not involve the use of critical materials. There is no reason to believe that the bootlegger will not employ the same means.

(4) The increased tax of $2 will necessitate additional capital of $90,000,000 in order to finance the tax payments on floor stocks. This burden will fall most heavily on thousands of small retailers throughout the country whose limited credit was strained almost to the breaking point in order to borrow the money for the payment of the floor stock tax when the last increase became effective. That was the first increase, by the way, in which there was no exemption.

(5) Although the adult population of the country has increased from 41,000,000 in 1901 to 81,000,000 in 1941, per capita consumption has declined during the same period from 2.44 gallons to 1.74 gallons.

(6) For the 9-month period—October 1941 through June 1942—following the imposition of the $1 increase, consumption has risen slightly. Any conclusion based on this fact alone, however, is likely to be misleading because the increase in withdrawals all took place in January, February, and March following press reports that the man-

ufacture of spirits might be stopped or sharply curtailed for the period of the war.

Senator RADCLIFFE. Did our population double in those years?

Mr. Cox. That is based upon the years 1901 to 1941. Those are figures on the adult population from the Census Bureau.

Senator RADCLIFFE. It doubled in 40 years?

Mr. Cox. Yes, sir.

Withdrawals for January, February, and March were 57 percent, 36 percent, and 17 percent higher than corresponding months of the year before indicating an avalanche of "scare" buying and hoarding on the part of distributors, State monopolies, retailers, and the public at large. This is borne out by the fact that inventories in the hands of wholesale liquor dealers for April 1942 were 20 percent higher in the corresponding month of 1941. Retailers' inventories are up 24 percent and inventories in the monopoly States were also correspondingly higher. Following the heavy buying of January, February, and March, withdrawals for April, May, and June fell off 2 percent, 18 percent, and 20 percent over the corresponding months of 1941.

(7) While any increase in tax may, under recent O. P. A. regulations, be passed on by increasing the price of the product to the extent of the increase in tax, the industry will have to stand the cost of financing the increase in tax, since the regulations have been interpreted to mean that there can be no mark-up on future taxes.

Conclusion: It is not our function to say what the rate of the tax should be and we want it understood that our appearance here is not to be construed as a protest against the present proposal.

With this understanding, we respectfully advance the following conclusions:

(1) The increase of $2 or 50 percent is the most precipitous increase since 1917, when under a similar increase consumption declined from 167,000,000 gallons to 91,000,000 gallons. The same result may follow in this case since conditions are much the same as they were then.

(2) There may likely follow a sharp increase in illicit operations.

RECOMMENDATIONS

(1) In view of the obvious necessity for further revenue measures in the near future, we respectfully suggest, that instead of the rate increase of $2 all at one time that the committee might well consider for the present an increase of not more than $1 until experience has shown its effects on consumer buying and the public revenue.

(2) That, since the O. P. A. by regulations has treated future increases as wartime measures, consideration be given to the collection of any present and future increases at the point of sale so as to avoid the chaotic results of any reductions which may become advisable or necessary following the war.

(3) That if collection at the point of sale is regarded as unacceptable or impractical, that the industry, together with a technical advisor to be designated by this committee, be authorized to confer with Treasury officials immediately for the purpose of submitting for consideration some other agreeable method of providing for any prospective reduction dictated by post-war necessities.

We appreciate the courtesy of the committee in permitting us to make this presentation.

Senator WALSH. I take it that your position is that regardless of the policy of Congress to increase the tax to $6, that you do not believe it should be a tax that should be imposed in normal times?

Mr. Cox. I do, Senator.

Senator WALSH. What would be the fair tax in normal times?

Mr. Cox. That, of course, is difficult to say. I am willing to accept the Treasury's views on that point. I believe that you would find that they would be very much afraid of a $6 tax under normal conditions.

Senator BARKLEY. To what extent will the freezing of the distilling facilities of the country for the manufacture of industrial alcohol for war purposes affect the withdrawal for tax purposes of the present quantities of liquor on hand?

Mr. Cox. You refer to depletion of stocks on hand, Senator?

Senator BARKLEY. Yes. Will that reduce the amount of revenue by reducing the withdrawals over a period? That may depend on the length of the emergency.

Mr. Cox. Of course, you would ultimately come to a time when the amount of stocks in warehouses would be so small that the withdrawals would naturally be governed by the amount in the warehouses.

Senator BARKLEY. If the war lasted long enough and the facilities which have heretofore been used for the manufacture of whisky should be almost completely used for the manufacture of industrial alcohol, it is conceivable that the stocks in bonded warehouses, which would be subject to withdrawal and tax payment, would be very largely depleted.

Mr. Cox. Yes.

Senator BARKLEY. They might even go to the point of exhaustion.

Mr. Cox. Yes.

Senator BARKLEY. In that case the tax that the Treasury would receive would also decline in proportion.

Mr. Cox. Either that or we would have to go, Senator, as I stated in my statement there, to an immature distillation.

Senator BARKLEY. Of course, if the distillation for the making of whisky is not to be resumed, you would not even have immature distillation.

Mr. Cox. We would reach the point of exhaustion eventually, yes, sir.

Senator RADCLIFFE. How long would the stocks on hand last, according to the present rate of consumption?

Mr. Cox. I would say, Senator, from 4 to 5 years.

The CHAIRMAN. Senator Davis, did you wish to ask the witness a question?

Senator DAVIS. This statistical information that you give here includes importations as well, or just the liquir produced in the United States?

Mr. Cox. On the per-capita consumption?

Senator DAVIS. Yes.

Mr. Cox. Yes.

Senator BARKLEY. What effect do you think the closing down of the distilleries for the manufacture of liquor will have upon importations?

Mr. Cox. I assume if you came to the point where stocks were so depleted that there was not a sufficient quantity on hand to meet the demand, that we would have to go to heavier importations.

Senator BARKLEY. That would not be the immediate effect, though, would it?

Mr. Cox. No, sir.

Senator GUFFEY. Mr. Cox, are all of the distilleries in the country members of the Distilled Spirits Institute?

Mr. Cox. Are all of them?

Senator GUFFEY. Yes. Do you represent the entire distillery industry?

Mr. Cox. I am speaking for the distilled spirits industry today, Senator, which includes the Distilled Spirits Institute, and a group which I represent in Kentucky known as the Kentucky Distillers Association, the Allied Liquor Industries, the Conference of Alcoholic Beverage Industries, and I would like to have filed in the record two statements for two more groups.

Senator GUFFEY. I would like to know if all agree with you.

Mr. Cox. So far as we have been able to ascertain, they do. I think we do have certainly 90 percent representation, based on production and marketing.

Senator GUFFEY. We have whisky manufacturers in Pennsylvania, but I have had no protest yet on this tax.

The CHAIRMAN. What are the statements you wish to file?

Mr. Cox. One of them, Senator, is a statement by the president of the National Retail Liquor Package Stores Association, which I would like to file for the record; and the other one is a statement by Mr. Sol Cilento, secretary-treasurer of the Distillery, Rectifying, and Wine Workers' International Union of America.

The CHAIRMAN. Yes, sir; you may file them.

(The statements referred to are as follows:)

MEMORANDUM BY JOSEPH REGAN, PRESIDENT, NATIONAL RETAIL LIQUOR PACKAGE STORES ASSOCIATION

Representing the retail liquor package store groups of the country has proven to be a great burden upon my shoulders. Part of my problems require my seeking governmental understanding and aid. Now gentlemen, on behalf of the thousands of the retail package store owners throughout the country, I come to you asking your assistance, for it is a matter that only you can help us with.

Our position for the last few years has not been very favorable from either a financial or regulatory viewpoint. More and more rules and regulations force restrictions both reasonable and unfair upon our business. In many States, bills to liquor stores have to be paid in cash on delivery or within 30 days, although our merchandise may not be sold for many months after we receive it. Dim-outs today as a result of civilian defense and Army orders, cause a loss of business. Many of the prospective customers for our alcoholic or malt beverages are now in the armed forces, while we in our own way are attempting whenever and wherever possible to assist in the efforts of our great country through the sale of stamps and bonds, through working for the United Service Organizations' movement and in cooperating with law-enforcement authorities.

A number of our stores were forced by reason of the last tax increase to go out of business. They can't get bonds to insure the payment of the tax, and every time liquor costs go up, proportionate profit diminishes and the small and poor retailer gets it in the neck again.

We plead this time for your aid through the granting of a floor-tax exemption, not of 1,000 gallons, but for 250 gallons. In asking for your help, we feel we should bend backward to avoid seeking anything unreasonable. A 250-gallon exemption is not unreasonable.

Deliveries being rationed today and not being able to make deliveries often, our losses of business have placed us under great handicaps. We just managed to get over paying the last tax, and now this new tax may mean another heavy burden which many of us will not be able to stand. Bond costs have become so excessive that only those with A-1 credit ratings have the opportunity of procuring them. In some States cash is required for the purchase of the alcoholic beverages. In these States the retailers will be snowed under and bankruptcies will result unless an exemption is granted.

This tax is undoubtedly an emergency tax, and taxation itself to be fair should be equal, to some extent with the ability to pay. The small package-store man or tavern owner who is just about making ends meet, should, in fair play, receive the opportunity to continue his business without being crippled, by exempting the 250 gallons of the merchandise on his floor from the tax until it actually goes into effect, so that the consumer will pay the tax and not leave the retailer carrying the burden which he can ill afford. When liquor carries too great a tax, it means that the Federal Government gets less revenue and the States likewise are deprived of income. Bootlegging results, with racketeering and illegal activity in its wake.

Many of us feel that liquor is being taxed too high, but for patriotic reasons we do not make this claim; but we urge you to see our position and to give us the helping hand which will permit us to continue in business. The average store carries about 600 gallons. When we ask for a 250-gallon exemption, we have gone to rock-bottom hoping that you will understand that we are trying to be fair in every way.

Some of the merchandise which we have on hand does not sell very often and with the increase of tax on that merchandise, the retailer will have to have real money to meet his obligations unless he gets the exemption. His outlook is indeed dark. We know that you do not want the retailers to go out of business with the loss to landlords, to municipalities, to the States and Federal Governments, the loss of employment and the loss of investments of the people whose few hundred or couple of thousand of dollars that they have worked their entire life for are at stake here.

The tax being trebled and then some, has placed us in a position where we must have some help. You are the gentlemen who can assist us, and we know that the American way of giving the little fellow a break will be considered by you to avoid our being pushed against the wall and being forced out of business.

A 250-gallon exemption was granted before on floor stock tax, and the history and experience of it, we believe, was favorable.

General liquor business throughout the country being as bad as it is, with merchandise being difficult to procure and cost prices to the retailer being high, without the opportunity of having the hours, the advertising advantages, and delivery advantages, we feel the pressure on all sides and we think that the Government should help us rather than injure us.

May we have your help?

National Retail Liquor Package Stores Association,
Joseph Regan, *President.*

Statement of the Distillery, Rectifying, and Wine Workers' International Union of America (American Federation of Labor)

The Distillery, Rectifying, and Wine Workers' International Union of America (American Federation of Labor) comprising workers engaged in both the production and distribution of distilled spirits, presents to the chairman and members of the Senate Finance Committee of the United States Senate this statement with respect to the proposed addition of $2 per proof-gallon in the Federal excise tax on distilled spirits incorporated in the pending revenue bill of 1942.

The distilling industry, in which the members of our Union make their livelihood, is the largest single industrial collector of revenue for the Federal Government. We are proud to be part of an industry whose products provide so substantial a contribution to the total national revenue, especially in times like these when our Government needs all the revenue it can obtain. The producing facilities of our industry have been all but completely converted to production for war purposes. Within the next few months these facilities will be devoted entirely to manufacturing alcohol exclusively for war use. Our industry will thenceforth be privileged to make a twofold contribution, since the sale of the products which it has in stock will continue to bring in much needed revenue to carry on the war.

Your committee is interested in deriving from the sale of these products the largest amount of revenue which can be obtained from this source, compatible with the public interest. It has been suggested that an additional tax of $2 per proof-gallon be imposed during the coming tax year. If the proposal contained in the revenue bill before you is adopted, the Federal excise tax will be $6 per proof-gallon.

Obviously, the ideal tax is one which produces the most revenue and yet stays within the limits which the traffic will bear. The limit of what the traffic will bear in this case is the capacity of the consuming public to absorb a new added tax on the tax-paid distilled spirits they purchase. Our only concern in offering this statement to your committee is to present the view of the thousands of workers in this industry as to the probable effect of an added $2 tax, as we see it.

In a word, our view is that the addition of a $2 tax at this time, first, would prove to be such a sudden and severe shock to the consuming public as to reduce the consumption of tax-paid spirits and drive the consumer to illicit non-tax-paid spirits, and, second, fail to produce the desired revenue.

This is the largest single tax increase which the consumer has been asked to absorb since repeal. At $2 per proof-gallon, it would represent an added cost to the consumer of 50 cents per quart.

People are going to have to pay greatly increased income taxes during the coming year. They are patriotically putting more and more of their income into purchases of War Savings stamps and bonds. Their Government is asking them not to buy unessential luxuries, and they are responding wholeheartedly to this appeal. Certainly the addition of a heavy tax on liquor—a nonessential luxury—is not going to encourage them to buy the products of our industry on the same scale they have in the past.

Furthermore, the people do not have to depend on legal liquor for their source of supply. The average quart of liquor costs the consumer $2.50. The bootlegger already has an advantage of $1 a quart in Federal taxes, 25 cents a quart in States taxes, and another 25 cents in various other taxes—a total of $1.50 a quart. If this proposed tax is now added, the price of this quart of liquor will inevitably go to at least $3, which will give the bootlegger a tax advantage of $2. The pressure on consumers to turn to the bootlegger cannot help but result in lower consumption of tax-paid liquor.

The people in our union, whose jobs in this industry are at stake, firmly believe thtat if the Government wishes to obtain more revenue from the consumption of distilled spirits, it would be safer and surer of getting such revenue if added taxes were imposed $1 at a time. This would cushion the shock to the consumer and would be less likely to affect consumption so seriously as a $2 tax imposed all at one time.

For these reasons, we respectfully urge the chairman and members of the Senate Finance Committee to give serious consideration to imposing no more than $1 per gallon in added excise taxes on distilled spirits in the present revenue bill.

DISTILLERY, RECTIFYING, AND WINE WORKERS' INTERNATIONAL UNION OF AMERICA (AMERICAN FEDERATION OF LABOR),
SOL CILENTO, *Secretary-Treasurer.*

AUGUST 6, 1942.

(The following statements were ordered inserted in the record at this point:)

STATEMENT BY EDWARD T. FLORE, NEW YORK, N. Y., GENERAL PRESIDENT, HOTEL AND RESTAURANT EMPLOYEES INTERNATIONAL ALLIANCE AND BARTENDERS INTERNATIONAL LEAGUE OF AMERICA (AMERICAN FEDERATION OF LABOR)

To the Chairman and Members of the Committee on Finance:

My name is Edward T. Flore. I reside in the city of Buffalo, N. Y., and am general president of the Hotel and Restaurant Employees International Alliance and Bartenders International League of America, an international union affiliated with the American Federation of Labor.

On behalf of the more than 250,000 members of our union, I respectfully beg leave to place before you our views and recommendations with respect to the proposal contained in the new Federal revenue bill that the present Federal excise tax on distilled spirits be increased $2 per proof-gallon.

First, we assume that the sole objective of your committee is to impose added taxes which will produce the greatest amount of additional revenue.

So far as liquor is concerned, we assume that you regard it as a luxury product upon which you are inclined to place the highest possible additional tax. At the same time, you undoubtedly appreciate that if taxes on any luxury become too high the public will be discouraged from buying it, especially in times like the present when our Government is asking the public to reduce purchases of luxuries.

Obviously, if consumption of liquor is cut down, the Federal Government will not obtain the revenue you aim to secure for it.

The present Federal excise tax on distilled spirits is $4 a proof-gallon. It has reached the present rate in comparatively easy stages. One tax raised amounted to 25 cents a gallon; another 75 cents a gallon. The highest tax increase you have ever attempted at one time has been $1 a gallon.

We believe that if you were to increase this tax by $2 a gallon at any time, you would run a grave risk of curtailing consumption of tax-paid liquor so that in the end the Government would not get the revenue you were seeking. We believe that this risk is doubly great now.

1. This added Federal tax alone would put the cost of tax-paid liquor at the highest peak since repeal. We believe that it would put the legal product beyond reach of the pocketbooks of a great proportion of those who are now liquor consumers.

2. All of the States of the Union are rapidly losing a substantial proportion of their revenue due to loss of gasoline taxes and automobiles taxes. If the States should seek to recover some of this revenue from liquor while you are imposing a new all-high Federal tax, the result will be to put the cost still higher and still further reduce the consumption.

3. It is a matter of common knowledge that bootleg (non-tax-paid) liquor already represents a substantial proportion of the total liquor consumption of the country. This is true, even under the present $4 Federal tax. If the taxes on legal liquor go much higher, people are likely to turn to bootleg sources for their supply.

Apart from the fact that this would reduce the Government's tax revenue from the sale of legal liquor, we do not believe that you wish to encourage an increase of bootlegging, especially at this time. The manpower and resources of our country should be devoted to winning the war rather than fighting a lawless, subversive bootleg army within our own borders.

We therefore respectfully urge your committee to consider holding any increase of excise taxes on distilled spirits at this time to $1 a gallon as the safest and surest rate most likely to provide maximum added revenue and, at the same time, to avoid recreating a widespread bootleg problem in this time of national stress.

EDWARD FLORE, *General President.*

MEMORANDUM SUBMITTED BY I. L. COLBORN, CASSOPOLIS, MICH., SECRETARY, MICHIGAN BEVERAGE RETAILERS ASSOCIATION

To the Senate Committee on Finance:

We will have to travel a long distance before it becomes clear what revenue results will be achieved in the adoption of a new tax bill under present wartime conditions.

It must be conceded that obligations of the Government must be met, it is part of the American spirit of justice. The strength of government is based upon the total tax available under conditions that in its application will achieve the results necessary to the end justified by the means, and still save a republic.

Corresponding rights of a war-torn government do not, in itself, sustain a tax that destroys the structure of true Americanism, a republic, not a democracy; democracy has a hollow sound; it is government of a single-track nature with no terminal facilities and no ultimate destination. A dual system of winning the war cannot exist. The Government should, as it is demanding of its citizens, in these times of total war, go all out for the suspension of, either by Congress or the Executive, any funds not in relation to an active war effort.

The Ways and Means Committee of the House has sent to your committee a measure that will no doubt require some considerable changes. Their work has been hampered by serious attempts of tax experts to influence their deliberations and findings in the effort to accomplish the impossible—eight billions.

It is obvious that with the continued unwarranted attack upon the Congress of the United States and the Senate, the inoculated European mind, self-dangerous, cancerous in growth, deadly in effect, destructive in its purpose, can now be seen breaking through the mist of deficit spending. The legislative bodies of our Government must break this deadly tax termite; no tax bill can support with any imaginary prediction a Treasury Department loaded with deficit obligations.

Nobody is complaining what the cost of the war will mean to our Nation. Our citizens know it will be high, and at the very moment their eyes are fixed upon our National Legislature, hoping that politics will be forgotten and that a tax bill will be reported that represents the combined intelligence of statesmen.

The small businessman wants to stay in business. He wants to do his share. He wants to pay taxes in an all-out effort, while labor, on the contrary, is striking at the heart of American institutions. Labor has gassed apprenticeship, gassed the open shop, and by false attacks of union leaders they are now trying to gas the consumer's tax. Should this tax be gassed by the united action of the Congress of Industrial Organizations and American Federation of Labor it is well to assume that those States that do not have a property limitation tax are in for a terrible time when the war comes to a conclusion.

To openly and defiantly oppose a consumer's tax of 10 percent, which is an all-out war effort tax, with no exceptions, one which will meet the requirements of the Government, is financial sabotage of national stability and should be so considered.

Class legislation in matters of taxation comes within the Himmler-Gestapo type of willful destruction. As for class legislation, note the Treasury ruling allowing the sellers of tangible personal property under the Federal sales tax with reference to charge accounts. You may pay the tax as installments are due. An administrative order of like nature is short-sighted and unwarranted. What class of business deserves this favor? It is hoped that when the present revised House bill is amended and sent in for final approval it will not contain any exemptions, and with the adoption of a consumer's tax, we will have a tax which, under our Constitution, if it has any meaning, is a tax combining the principles of justice and human concerns, and would not be challenged by the words "slacker," "coupon clipper," or "ability to pay."

During the 4½ years as a conferee in matters of taxation with the State of Michigan, the same copyrighted phrases then used are still employed when the question of taxation reaches those who are most willing to use any and all of them for the protection of self-interests. There is no tax that will be more successful in combating inflation than a tax on consumption; it will retard excessive and careless expenditures; the 10 percent proposed levy will go far in meeting this question.

The new tax bill is going to be drafted with the full knowledge of its effect and attending results. No tax bill should contain the "unwritten words of destruction." You can tax to destroy. During the past several months I had occasion to interview many small business men, the owners of large institutions, and their employees, with reference to a consumer's tax. This tax they agree will save the situation.

The New York Times, Saturday, July 4; I quote: "National income reaches new peak, $8,656,000,000, in May, 25 percent above year before, with index at 162.7 annual rate $109,000,000,000."

In the above you have a clear statement of facts. It is now possible to draw some conclusions with reference to the solving of the financial position of the Federal Treasury.

I now quote the Times further; in a recent issue the following information was given to the country, a report on Government maturities: "July, $450,056,000; August, $902,804,000; September, $1,496,066,300; October, none; November, $1,507,000,000; December, $232,370,200; January, none; February, $1.580,000,000; March, $65,963,700; April, none; May, none; June, $629,113,400"—or a total of $6,864,578,000.

Allowing the Times' figures of $109,000,000,000 to stand unquestioned, the following result would be obtainable. Let us consider a 25 percent deduction in total income to be exempt on account of Federal and State expenditures for the meeting of the war requirements, we can with reason assume the basic income of $70,000,000,000 is available for tax purposes.

A 10 percent tax on all tangible personal property bought for consumption and use with no further exemptions (except as stated above) would net our Government $7,000,000,000 per year. It must be fully understood that this tax must be paid by the purchaser. Under this application it would not conflict with many of the various State occupational taxes that are now being used under the name of sales taxes. This would not cause any undue burden on small business.

This figure would produce a monthly average of $583,333,333, and at the year's end our maturities would have been met. There would be an average of $135,401,000 of Treasury balance unexpended.

The May figure as given by the Times of $8,656,000,000 with the usual deductions will support the above averages. With the consumptive ability of the nation as averaged from statistics that have proven their worth by the various States in the careful determining the future revenues from occupational taxes, we would, as taxpayers under this plan, pay an average of $5.50 per month. This seems like a small tax for our stability in matters of finance in a world torn asunder.

The Senate Finance Committee, who will have the last fling at the present struggle for revenue, should at least take into consideration that certain corrections and adjustments should be made in the past Revenue Act for the benefit of all business. They must be saved. The present draft of the Ways and Means Committee is the death sentence of small business. When the execution will take place it is hard to determine; 100,000 are now tottering. Collapse of our Nation will come with the destruction of small business.

Senator HERRING. Mr. Cox, I want to ask you a question in regard to the O. P. A. or the W. P. B. order of conversion.

Is that being carried out uniformly on all of the distilleries? Are they all being put on a fair basis?

Mr. COX. Just as rapidly as possible, Senator. While there are a lot of problems, the W. P. B. in connection with the conversion of particularly the small plants, is going right ahead.

Senator HERRING. There is no preferential treatment of any one group?

Mr. COX. No, sir.

Senator HERRING. I am sure there is not.

Mr. COX. The order that came out just last week, I expect they all must be prepared to make alcohol by November 1 or go out of business.

Senator HERRING. I think that is right for the future. I was wondering if that was the case in the last 4 or 5 months.

Mr. COX. There has been some talk about some company having gotten the edge over the others. I am not sure about that, but I think the War Production Board is trying to do the thing equitably.

Senator GUFFEY. Would you furnish the committee with the tax rates with reference to Canada, England, Ireland, and Scotland?

Mr. COX. I do not have them with me.

Senator GUFFEY. I would like to see them.

Mr. COX. That is Great Britain and Canada?

Senator GUFFEY. And Ireland and Scotland.

The CHAIRMAN. Very well. Thank you, sir.

(Mr. Cox filed a statement on public revenues from alcoholic beverages (1941) with the committee.)

The CHAIRMAN. Mr. Law and Mr. Lourie, I understand you wish to file briefs on this question.

Mr. LOURIE. Yes, sir; I would like to file the brief.

Mr. LAW. Yes, sir.

The CHAIRMAN. Mr. Law, you are filing a brief as general counsel for the National Alcoholic Beverage Control Association?

Mr. LAW. That is right.

The CHAIRMAN. And Mr. Lourie, on behalf of the National Association of Alcoholic Beverage Importers, Inc.?

Mr. LOURIE. Yes, sir.

(The briefs referred to are as follows:)

BRIEF OF JOHN LAW, GENERAL COUNSEL, NATIONAL ALCOHOLIC BEVERAGE CONTROL ASSOCIATION, CHICAGO, ILL.

Mr. Chairman and gentlemen of the committee, I am here today representing the National Alcoholic Beverage Control Association of which I am executive secretary and general counsel. The association has its headquarters in Chicago and is composed of a group of States which operate under the so-called monopoly system of liquor control. Under this system the distribution and sale of alcoholic beverages in the different States are under the supervision and control of State agencies. The association is composed of the States of Maine, New Hampshire, Virginia, West Virginia, Alabama, Michigan, Idaho, Iowa, Wyoming, Utah, Montana, Oregon, and Washington. The monopoly system is in force in four other States that do not belong to our association.

The legislatures of the States that adopted the monopoly system, as distinguished from the private license system, did so after a great deal of study of the various forms of liquor control, and had two main purposes in mind in finally adopting the monopoly plan. The purposes were, first, the more effective control of the social problems arising from the distribution and sale of alcoholic beverages, and, second, to secure from the States the maximum amount of revenue consistent with the application of an adequate system of social control.

This committee has before it for consideration the revenue bill passed by the House in which is contained an increase of $2 per gallon in the excise tax on distilled spirits, changing the rate from $4 to $6 per gallon. If passed this will be the sharpest increase in the rate on distilled spirits since repeal became effective. We do not pretend to know to what point the rate on distilled spirits might eventually be raised without seriously curtailing consumption, if the upward moves were made gradually and in comparatively small amounts. We recognize that there has been a great increase in consumer purchasing power during the past year which enables the buying public to meet rising costs of all commodities. But we are deeply concerned lest the sharp increase proposed at this time, a jump of 50 percent in a tax which within less than a year received an increase of 33⅓ percent may not be so violent as to result in a radical decline in sales of legal tax-paid alcoholic beverages. If the increase were limited to a dollar a gallon at this time, we believe it could be absorbed by the purchasing public without too great difficulty, leaving open the possibility of such later gradual increases as might be found necessary and advisable.

It may well be that the social problems presented to the States by reason of the illicit production and sale of distilled spirits will not be a serious factor during the present era of high wages and maximum employment, but we must look forward to the day when employment will drop and facilities for illicit manufacture will be easier to acquire. But more important for the present is the question of State revenues. In many of our monopoly States the profits from liquor-store operations are definitely set aside to finance certain State functions. In some States a portion of the revenues are devoted to support of schools and universities, in others old-age assistance, hospitals, support of the blind, and in some the revenues go to the general funds of the State. While the financial conditions of our States is good at the moment due to the great stimulation in general business during the past year, I need not point out to you that there will be a sharp decrease in the near future in State revenues from many sources, such as gasoline, automobile licenses, sales taxes, and so forth. If at the same time there should be a precipitous drop in revenues from alcoholic beverages, there would be presented to the States a most serious situation that I think you gentlemen should bear in mind in approaching the difficult problem you have in securing the greatest possible amount of revenue for the Federal Government.

We are fully appreciative of the pressing need of the Federal Government for revenues at this time, and we are in complete sympathy with your desire to secure from alcoholic beverages the greatest possible amount of revenue, having in mind the various factors involved in the problem. However, I wish to point out that in imposing such a sharp increase in the excise rate, it might well produce additional revenue for the Federal Government and at the same time so reduce consumption of legal alcoholic beverages as to result in a drastic decline in State revenues. Should the States then feel compelled to increase the rate of their return in order to recover the loss in revenue, we would soon find the price of alocoholic beverages out of the reach of the average consumer, resulting in an unintended form of prohibition on the sale of alcoholic beverages.

More than 30 percent of the total amount of distilled spirits that are sold in this country are accounted for by the States operating under the monopoly system. The profits derived therefrom have a very important place in the financial picture of the States, and we ask that in determining the proper excise rate on distilled spirits the impact of the increase on the revenues of the States be given full consideration by this committee.

NATIONAL ASSOCIATION OF ALCOHOLIC BEVERAGE IMPORTERS, INC.,
Washington, D. C., August 11, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR MR. CHAIRMAN: The National Association of Alcoholic Beverage Importers, Inc., appeared at the public hearings held by the Committee on Ways and Means on the revenue revision of 1942 and presented oral testimony which appears on pages 2835 to 2837, inclusive, of the record of that hearing. The association, in order to conserve the time of the committee, respectfully requests that this communication be made part of the record of the hearing now being held by your committee.

The National Association of Alcoholic Beverage Importers, Inc., is a nonprofit membership association, incorporated under the laws of the State of New York. Its membership consists of persons engaged in importing alcoholic beverages into the United States, Puerto Rico, and Hawaii.

The importers of alcoholic beverages have made it clear to the Senate Finance Committee in a communication dated August 21, 1941, and to the Committee on Ways and Means, that they are anxious to aid the Federal Government in the obtaining of revenue necessary to win the war. The officers and members of this association have instructed me to inform your committee that there has been no change in the position we have taken ever since the present emergency arose.

At the time of the testimony offered before the Committee on Ways and Means, sufficient statistical information was not at hand to enable us to draw any valid conclusion as to the effect of the increased taxes imposed on alcoholic beverages by the Revenue Act of 1941. Under that act, the excise tax on distilled spirits was increased from $3 to $4 per proof gallon. The increased rates became effective on October 1, 1941.

The most important commodity handled by members of the import trade in the alcoholic beverage field is Scotch whisky. Ever since the war began in September 1939 our industry has been able to establish dollar credits for the British Government of approximately $40,000,000 annually. These credits represents the price paid for Scotch whisky in Scotland, and the costs of transportation, insurance, etc., to the United States.

Based on the statements issued by the Bureau of Internal Revenue of the Treasury Department with respect to internal-revenue receipts, there is definite indication that when the internal-revenue tax on distilled spirits was increased from $3 to $4 per proof gallon as of October 1, 1941, it resulted in a sharp decline in tax receipts from foreign-distilled spirits by our Government.

During the 9 months from October 1, 1940, to June 30, 1941, when the internal-revenue rate on distilled spirits was $3 per gallon, the total tax payments of foreign-distilled spirits amounted to 9,575,232 gallons. For the same period beginning with October 1, 1941, and ending June 30, 1942, when the internal-revenue rate on distilled spirits was $4 per proof gallon, the total quantity of foreign distilled spirits tax paid amounted to 6,523,303 gallons, or a decline for the 9-month period of 3,051,929 gallons. In other words, at the $4 excise rate, the United States Treasury obtained $26,093,212 as compared to a collection of $28,725,696 at the $3 per gallon rate. These figures would appear to indicate conclusively that when Congress increased the excise rate of distilled spirits to $4 per proof gallon, the point of diminishing returns was reached in the case of imported distilled spirits.

The decline in revenue caused by the increase in the internal-revenue tax is accentuated when you consider that there is a tariff collected on all imported distilled spirits. In general, the tariff amounts to $2.50 per gallon. We find, therefore, that for the 9 months from October 1940 to June 1941, inclusive, the tariff collected by the Government from imported distilled spirits amounted to $23,938,080. For the same 9 months, beginning with October 1, 1941, and ending with June 30, 1942, the tariff collected amounted to $16,308,257. Therefore, during 9 months in 1940 and 1941 when the internal revenue tax was $3, the total revenue received by the Government from imported distilled spirits amounted to $52,663,756 as against $42,401,469 collected for the period October 1, 1941, to June 30, 1942, the period during which the internal-revenue tax had been increased to $4 per gallon. Thus the tax increase from $3 to $4 per gallon resulted in a decline in revenue to our Government of over $10,000,000 in the 9 months from October 1, 1941, to June 30, 1942.

We feel that the foregoing figures are conclusive that the point of diminishing returns has been reached in the case of imported spirits. We are convinced that a further increase in the internal-revenue rate will result in a much greater loss of revenue to the Government and a further decline in the importation and consumption of foreign-distilled spirits than has occurred since the last increase in the excise tax.

The foreign-distilled spirits referred to above consist almost entirely of Scotch and Canadian whisky. The decline in consumption indicated by the foregoing statements has not been caused by a shortage of any of these particular spirits in the United States market. There have been no difficulties in transporting Canadian whisky to the United States. Furthermore, importers have been able to bring to the United States large quantities of Scotch whisky and at the present time we estimate that the stocks of Scotch and Canadian whisky in customs bond are probably about 7,000,000 gallons. Because of the longer time it takes to move Scotch whisky to the United States, it is our estimate that 75 percent of the stocks in customs bond are represented by Scotch whisky. We, therefore, are forced to conclude that the sharp drop in consumption indicated by the statistics issued by the Bureau of Internal Revenue has been caused by the increased prices brought about by the increased tax and not by any unavailability of the merchandise.

We have pointed out in previous oral statements as well as in briefs submitted to the Ways and Means Committee of the House of Representatives as well as to the Senate Finance Committee that the traditional practice followed by the Congress in raising revenue from the alcoholic beverage industry by the imposition of a tax at the point of manufacture is not the most efficient and effective way of obtaining the needed revenue.

Excise taxes which are paid by the producer become increasingly burdensome to the consuming public because the tax is included in prices charged by the manufacturer in sales to distributors and by distributors in sales to retailers and by retailers in sales to consumers. As a result, a certain amount of pyramiding occurs and the consumer pays in the final price an amount greatly in excess of the original tax.

We believe that the most efficient way of raising any additional revenue needed is by the imposition of an excise tax to be paid by the consumer at the point of sale. This tax, in the case of alcoholic beverages, could take the form of a percentage retail sales tax or could be collected through the use of a tax stamp to be affixed by the retailer at the time the sale is made.

The advantages of a direct tax on the consumer are obvious.

1. The consumer would pay the exact amount of the increased tax and would know that the amount in question was part of his contribution to the cost of winning the war.

2. The consumer would benefit because there would be eliminated the evils which might arise if the increased tax were imposed at the point of manufacture. A tax collected at the point of retail sale will tend to discourage bootlegging and illicit production.

3. This type of a tax would relieve the general alcoholic beverage industry, the largest single producer of direct Federal revenue, of the burden of additional financing at this particular time when it is difficult to raise additional capital.

We respectfully request that the committee consider the effect of adopting an excise tax payable at the source on the finances of the industry. It is estimated that not less than 45,000,000 gallons of tax-paid alcoholic beverages are in the possession of various distributors throughout our country. The proposed addition to the tax of $2 would mean that there would have to be raised $90,000,000 for the payment of the floor stock tax provided in the bill. However, when the war is over and the Congress is considering the reduction of taxes imposed during the emergency, an equivalent reduction in the internal-revenue tax of $2 per proof-gallon would mean that the trade would face a loss of $90,000,000 unless Congress provided for a refund from the United States Treasury of the amount of the tax reduction with respect to tax paid goods in the possession of the trade on the date when the tax is reduced.

The industry would face the impossible task of trying to liquidate these taxpaid stocks, regardless of cost immediately before the effective date of the lowered tax. Consumers waiting for lower prices would go on a buying strike. Substantial losses would be incurred and many in the trade would be forced into bankruptcy. In other words, if the trade will have to increase its capital investment to the extent of $90,000,000 because of an increased tax of $2 per proof-gallon on spirits, it will face a loss of $90,000,000 if the tax is reduced at a later date to the same extent.

These financial dangers are avoided if a consumer excise tax or a sales tax in the case of spirits and wines be adopted in lieu of increased excise taxes to be paid by the manufacturer at the time of tax payment of the articles. Furthermore, the type of tax we suggest offers two important advantages to the Government. The tax only is collected from the consumer and there is no pyramiding. At the same time the Government's tax position is flexible since the tax lends itself readily to increases or decreases as the Government's requirements vary.

Our Government now collects sales taxes on certain luxury items such as jewelry, perfume, furs, etc. It is our view that wines and liquors are definitely luxury items. We are unable to appreciate any reason for differentiating between luxury items with respect to the type of tax to be imposed. We, therefore, feel that a sales tax or a consumer's excise tax on alcoholic beverages is indicated at the present time. Such a tax has certain advantages since it is collected on the basis of the price. If, however, it is desired to use a stamp tax for proof that the appropriate amounts have been paid by the consumers, such a tax could be collected on a volume basis which would mean the tax would be paid by the consumer on a wine-gallon basis, thus avoiding all of the difficulties which arise when a tax is collected on a proof-gallon basis. The use of stamps is not novel in the case of the Federal Government.

We most respectfully direct the attention of the committee to the dual nature of the tax problem in the case of alcoholic beverages. Imported items pay a Federal tariff, a Federal excise gallonage tax, and a State gallonage tax. In other words, both Federal and State Governments are interested in the amount of revenue which may be obtained from the industry. The sharp decline in the tax payment of imported alcoholic beverages means, of course, that the States in which the articles were consumed also suffered a decline in revenue. There is, therefore, the danger that as Federal taxes increase and as consumption drops the various States whose revenues are being reduced because of the decline in other tax receipts, may also resort to increased gallonage taxes. We believe that this situation should be avoided and that it can be avoided by the imposition of a consumer excise tax or sales tax collected at the time of sale.

Respectfully submitted.

HARRY L. LOURIE,
Executive Vice President.

The CHAIRMAN. There is another witness who has not been scheduled for today, Mr. Botwinick.

STATEMENT OF BENJAMIN BOTWINICK, CHAIRMAN, BOARD OF DIRECTORS, METROPOLITAN PACKAGE STORE ASSOCIATION, INC., NEW YORK, N. Y.

Mr. BOTWINICK. My name is Benjamin Botwinick, representing the Metropolitan Package Store Association, Inc., and the Upstate New York Liquor Package Stores Associations, Inc. These are the trade associations for the retail package dealers in New York State. There are approximately 2,650 package stores in this State.

1. *Amount of tax increase.*—The liquor and wine package stores of New York State are of the opinion that the sole purpose of the increased gallonage taxes is to raise the maximum possible revenue for our war effort. They feel that the Treasury Department and the Congress are also of this opinion and are fully cognizant of the fact that the law of diminishing returns may take effect if taxes are too severely increased. We feel confident that if the presently considered tax increases result in disappointing returns, the Treasury Department and the Congress will make the necessary changes in rates. Since Federal and State gallonage taxes will constitute approximately 70 percent of the cost of the products we sell, we can truthfully be regarded as selling "flavored taxes" to the public as agents of the Government. We are partners whose goal, during this emergency, is to collect in an orderly and sedate manner as much taxes as we can, just as we do in the case of War bonds and War Savings stamps.

Any trace of bootlegging that may arise because of increased taxes should be treated just as seriously and severely as would the forging of fraudulent war bonds.

2. *Floor tax exemption.*—Another and equally important problem is that of liquor and wine floor taxes. These floor taxes should not be imposed in such a manner as to penalize the small retailer who is the backbone of this industry throughout the United States. Whenever a liquor tax increase goes into effect there is a transition period before the increased taxes are passed on to the consumer. In addition, every retailer has a certain amount of "dead" stock on which he has to pay a floor tax that he can never pass on to the consumer. Because of the hardship which this transition period causes the small retailer, it has been the custom prior to 1941 to grant a floor tax exemption of from 100 to 500 gallons. We feel that the retailer is entitled to at least a 250-gallon exemption, but in view of the Government's need for the maximum possible revenue we recommend a 100-gallon exemption.

3. *Method of payment of floor taxes.*—It has also been customary to set dates for payment of floor taxes that would cause a minimum of financial hardship and injustice. The bill that has passed the House of Representatives is similar in wording to the one that was enacted a year ago. It grants extensions in payment up to 7 months upon the filing of a bond for payment thereof.

It is this bond requirement upon which we particularly wish to comment. In practice we have found that the small retailer, regardless of his financial standing, very seldom can obtain a bond, whereas the large retailer has usually no difficulty in obtaining such bonds. As a result the smaller retailer has either had to sacrifice merchandise just prior to floor tax effective dates or to resort to borrowing from finance companies at enormous interest rates.

Since the Government permits quarterly payments of Federal income tax and of Federal unemployment insurance, without bond or interest requirements, there is no reason why a similar privilege should not be extended for liquor and wine floor taxes to reputable solvent merchants. If a liquor and wine package store has an inventory of $15,000, the floor tax, based on the proposed increased rates, will be approximately $3,000. We recommend that monthly payments be permitted, without bond requirements, for total floor taxes up to $3,000. We believe a bond should be required only where the total floor tax is in excess of $3,000. Such a provision would in no way jeopardize the Government, but would enable the small retailer to continue to function as a tax collecting agency. It would not affect the large retailers since their floor taxes will be in excess of $3,000, and therefore bonds would be required.

This closes our brief on liquor taxes. I am going to take this opportunity however to make some general comments on taxation.

I happen to be a C. P. A. and I want to state very briefly that I never thought I would find myself, at the age of 35, in agreement with men like Dr. Townsend. As an accountant, I want to say that the average taxpayer does not mind the amount of tax that he is going to pay today as much as the complications and involvements. I have never had a complaint in the last 2 years from a client of mine or other taxpayer as to the amount of his tax. It is rather the complications, the red tape he has to go through, and the complexities of the laws that he complains of. The laws have become so involved that there is no longer any tax expert in the country. If this committee would concentrate on simplification, the amount of tax that individuals or corporate taxpayers have to pay would not be objected to. I believe that most of the accountants do not relish the additional business that is thrown upon them through these complications; it takes them away from much more important and serious work that accountants should perform.

I wish this committee would consider favorably some sort of large revenue-producing simple tax, whether it is the Townsend type or any other type.

The CHAIRMAN. All right, sir, thank you.

Senator WALSH. Mr. Chairman, I submit for the record a suggested amendment to section 711 (a) (1) (B) relating to involuntary conversions and providing for the same status as sale or exchange. Accompanying the brief is an illustrative case. This matter has been submitted to Mr. Stam and he is familiar with it.

The CHAIRMAN. The suggested amendment and statement may be included in the record.

(The amendment and statement referred to are as follows:)

INCOME FROM INVOLUNTARY CONVERSIONS SHOULD HAVE SAME STATUS AS INCOME FROM VOLUNTARY SALE OR EXCHANGE, NOT SUBJECTED TO EXCESS-PROFITS TAX OR DECLARED VALUE EXCESS-PROFITS TAX, SUBMITTED BY HERBERT E. LOCKE, AUGUSTA, MAINE

Illustrative case.—In 1934, the owners of the taxpayer, a close corporation, had an involuntary investment in Corporation A of some $46,400. That is, they sold logs to Corporation A, delivered to A's sawmill, taking as pay A's trade acceptances which they discounted. A became insolvent, was wound up in receivership, paid no dividends to its general creditors. So taxpayer paid back to the banks the $46,395.79 received in discount of the trade acceptances (no account is taken of interest, damages for breach of contract, etc. The $46,400 is illustrative only). Thereupon, taxpayer purchased A's assets at receiver's sale for some $31,000, making some $74,500 total put into A's sawmill business. This is as of 1934.

Thereafter, until early in 1941, taxpayer operated the A sawmill business at a loss—always in the red. In June 1941, the plant burned just as it was starting to operate in the black. It had been acquired in 1934 at a bargain price as above indicated. Its depreciated basis at time of destruction was approximately $12,000. Fire insurance recovery was approximately $105,000.

Taxes were computed as follows: Income and surtax over $19,000; excess-profits tax (involuntary conversion not being sale or exchange) over $40,800; capital-stock tax over $1,200.

Points.—1. The hardship on the taxpayer in this particular instance.

2. Inequity of excess-profits tax on involuntary conversion by fire, a business misfortune, and at the same time exempting voluntary sale or exchange.

3. Interruption of productive effort which would otherwise be made by using the fire insurance proceeds promptly less the amount of income and surtax. A grave question arose whether the mill business taxpayer hoped to acquire with the proceeds, and thereby continue production sorely needed, would be considered "similar or related in service or use."

Unless and until involuntary conversions be given the same status as sale or exchange, every industry suffering involuntary conversion by fire, Government appropriation of its property, ex ships, incurs the same problem and suffers the same delay. Productive effort vital to the Nation as never before is considerably hampered.

RETROACTIVE PROVISIONS

The amendment to correct this condition was proposed by the taxpayer within 2 months of the fire which called to the taxpayer's attention the *Flacaus Oak Leather Co. case* and its effect upon the prior administration of the law. Taxpayer's counsel in August 1941 called this to the attention of Senator George, Mr. Tarleau, of the Treasury Department, and others. At that time it was expected that an amendment of this nature could be included in the administrative tax bill to be enacted following the completion of the general internal revenue bill.

Consequently, there has been no delay by the taxpayer in calling to the attention of the proper authorities the condition and the alleged necessity for its correction. It is not unreasonable that the amendment, if favorably considered, be made retroactive.

Retroactive provisions have repeatedly been enacted to correct similar situations.

Precedents on retroactive provisions.—Section 214 A of the Revenue Act of 1921 relating to involuntary conversion of property provides as follows in the last sentence:

"The provisions of this paragraph describing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits, and excess-profit tax acts."

Original proposal.—Add a section similar to section 112, subsection f, providing that "*For the purpose of this chapter, amounts received in connection with involuntary conversions shall be considered as amounts received in exchange for the property so converted.*

Reason.—Gives involuntary conversions (as by recovery of fire-insurance proceeds) same status as "sale" or "exchange": Nontaxability for excess-profits tax. Make retroactive as in previous similar cases.

House bill and its effect.—Evidently it was thought that we wanted all sales or exchanges of depreciable property treated as capital gains and that we wanted it made retroactive. This would make only a part of the gain on depreciable assets taxable for individuals under the provisions of section 117 (b) of the Code whereas 100 percent of the gain was included in the returns for 1941 as taxable income. As to corporations, it would change all of the short- and long-term gains and losses for 1940 and 1941. This would cause general confusion.

The House put additional provisions to that which we proposed into their amendment of section 117 relating to capital gains. Retroactivity of this section as amended would be burdensome on the administrators of the act.

New proposal.—Simply add a subsection to section 711 (a) (1) (B) and section 711 (a) (2) (D) as follows: "*There shall be excluded any net gain recognized on property involuntarily converted into other property or money as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof.*"

Our proposal is intended to touch just one thing—exemption from excess-profits tax of the net gains arising from involuntary conversions. We use "net" so that losses from involuntary conversions can be set off against gains. This gives gains from involuntary conversions of depreciable property the same tax status as gains arising from voluntary sales and exchanges.

Result.—This recognizes completely the very proper objection of the Treasury to retroactivity of the changes proposed by the House in section 117. At the same time, it recognizes the obvious equity of giving involuntary conversions the same status as sale or exchange.

Amendment.—Accordingly, as amended, section 711 would read as follows if this suggestion be adopted:

"SEC. 711. EXCESS-PROFITS NET INCOME.

(a) *Taxable Year Beginning after December 31, 1939.*—The excess-profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be made:

(1) *Excess-Profits Credit Computed under Income Credit.*—If the excess-profits credit is computed under section 713, the adjustments shall be as follows:

(B) Long-Term Gains and Losses, and Gains Recognized on Involuntary Conversions: There shall be excluded long-term capital gains and losses. There shall be excluded the excess of gains from the sale or exchange of property held for more than fifteen months which is of a character which is subject to the allowance for depreciation provided in section 23 (1) over the losses from the sale or exchange of such property. *There shall be excluded any net gain recognized on property involuntarily converted into other property or money as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof.*"

This uses 15 months just as the House Bill proposes. The present Code provides for 18 months. Exactly the same wording would then be enacted as Sec. 711 (a) (2) (D).

Respectfully submitted.

HERBERT E. LOCKE,
Attorney, Augusta, Maine.

AUGUST 10, 1942.

The CHAIRMAN. We will recess until 2 o'clock.

(Whereupon, at the hour of 12:40 p. m., a recess was taken 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. Ringer.

STATEMENT OF WALTER M. RINGER, PRESIDENT, FOLEY MANUFACTURING CO., MINNEAPOLIS, MINN.

Mr. RINGER. My name is Walter M. Ringer.

Mr. Chairman and members of the committee, I appreciate the opportunity of appearing before your committee in behalf of our own business and in behalf of small businesses throughout the country whose financial positions are bound to be affected adversely by the proposed tax legislation.

No small business can grow or even exist, while big business will stay big under this proposed tax legislation.

I know that the Government needs all possible funds for the conduct of this war. Our business and all small businesses are and should be willing to do their share in providing these funds. They must, however, under any tax program be given a chance to survive this war. They cannot be burdened or stifled under rates as outlined in the proposed tax legislation, the same legislation that enables big business to continue to stay big. Such a situation is manifestly unfair. This country needs small businesses. They must contribute their share to war production.

In normal years, in post-war years, and in these war years, small businesses have as definite a part to play as big businesses. If given a reasonable opportunity to expand, small businesses will make a valuable contribution to our war effort, and any tax program should bear this in mind.

Therefore, I urge that you give serious consideration to some practical plan or provision that will enable small businesses to accumulate some surplus to take care of limited expansion and to tide them over loss periods that are bound to follow this war. If this is not done, small businesses will be liquidated after the war, making large losses to creditors and much unemployment.

A large and important part of the war requirements produced in this country are and can be produced by comparatively small businesses. Much of this constitutes a definite increase in volume of business for these companies and if these companies are to meet the increased war production schedules, two things have been, and to some extent, will continue to be necessary: First, a much greater working capital and, second, an increased plant and equipment. This need is proportionately much greater in a small business than in a large, because total increase in production is proportionately larger.

These needs can be financed in two ways; namely, by borrowing and by accumulation of earnings. It has been our experience that the former method is difficult if not impossible and, furthermore, the incurrence of substantial debts is so risky for most small businesses as to be prohibitive. For practical purposes, this expansion can be had only through accumulation of earnings. Inasmuch as the proposed excess profit tax rates are practically confiscatory, a small business which for any reason has a small excess-profits tax credit is entirely prevented from making such an accumulation.

Our business, the Foley Manufacturing Co., a Minnesota corporation, established in 1926, of which I am president, is an example of the situation that confronts small businesses. We manufacture patented machinery and a line of patented kitchen utensils. We now employ 200 people. Our average yearly sales volume for the 10-year period ending 1939 was $184,257.

During the depression, our machinery business was very seriously affected. Our total yearly sales volume dropped from our peak of $369,000 in 1929 to $75,000 in 1933. Late in 1934 it was necessary that we reorganize and refinance our business, so we started from scratch again with very limited working capital. In an endeavor to keep our organization intact, we developed a line of patented kitchen utensils at considerable expense and loss to our company. By persistent effort over a period of years since 1934, our line of kitchen utensils has been expanded into a national distribution of corresponding growth in volume.

During that period from 1934 to 1936, inclusive, we lost money each year and it was not until 1937 that we showed a fairly good profit amounting to $24,359, resulting mainly from one good-sized order.

Senator DANAHER. On how much business, Mr. Ringer?

Mr. RINGER. In 1937?

Senator DANAHER. Yes.

Mr. RINGER. $225,000.

Senator DANAHER. Thank you.

Mr. RINGER. To be exact, $225,614.

Senator DANAHER. Thank you.

Mr. RINGER. In 1938 we lost money. In 1939 we made a profit of $3,429. The increased sales volume on our newer kitchen utensils began to attain a profitable volume in 1940 when we made a profit of

$26,000. In 1941 our sales volume doubled, due largely to one substantial order on a new patented kitchen utensil and our profit for that year was $79,000, on which we paid an income tax of $47,000, both Federal and State, this being 60.21 percent of our net income. In Minnesota, we carry the burden of an extremely heavy State tax.

As we added items to our line of kitchen utensils, we had to expand and invest in new equipment. Over the period of years from 1936 through 1941, this increased capital investment was approximately $80,000, half of which was borrowed from stockholders, thereby exhausting the ability of stockholders to provide additional funds for the business.

All this made it impossible for us to build up any liquid capital, yet, we have been growing and our business is recognized as an asset to the community, doing a national business on a product that affects economy in the home life of our people to the extent that it was declared a civilian essential.

Early in 1941 our company made a determined effort to get into war production. Inasmuch as we were manufacturing kitchen utensils out of steel and also supplying the Boy Scouts of America with their mess kits made of steel, we proposed to the War Department the adoption of steel mess kits in an effort to save aluminum, and we obtained a substantial contract in 1942 for steel mess kits for the quartermaster depot. We are also furnishing a weekly quota of machines of our manufacture to the Army Air Corps.

Our total sales volume this year, our first year in war production, will approximate $1,000,000, of which $500,000 will represent war contracts. This compares with $765,000 in 1941 and $339,000 in 1940.

However, to get into war production, we were required to make additional capital investment in machinery and equipment so far this year of $40,000, and to finance these war contracts we have had to resort to bank and Government loans. Of course, we must pay back these debts and to maintain a satisfactory financial position, we must be allowed to accumulate some earnings if we are to continue our business and the employment of 200 people.

An important factor in any business is that of inventory. Our own inventory is now five times greater than it was in 1940, though our sales volume is less than three times greater than our volume of 1940, from which you will appreciate we have a greater risk from inventory value shrinkages after the war.

With the renegotiation law standing as it is and business subject under its war contracts to renegotiation, business does not know at the end of the year what it has in the way of profits to devote to further production to further the war effort.

Many small businesses, including our own, have made commitments and plans for future expansion during 1942. While some of this expansion for war production can be amortized over a 5-year period, the need of small businesses is not for money over the 5-year period, but for money in 1943 to pay the 1942 tax bill.

We have yearly sales and profit figures on our business back to and including 1926, which I would be glad to submit to you, if you wish, to illustrate what happens to a small business, like ours, during 17 years of normal, depression, and pre-war periods.

The CHAIRMAN. You may put the figures in the record.

Mr. RINGER. I have it attached to my statement.

It indicates clearly the necessity of accumulating surplus to take care of depression years if small businesses are to be allowed to survive.

Since realizing the serious effect on business of the proposed tax legislation, I have talked with several hundred heads of other small businesses who all agree that some relief must be provided in this tax program if we are to have any development and expansion, at the same time sufficient margin for the continuance of solvent operation. There will be a need for a necessary reserve for inventory losses and post-war needs.

Early in June while in Washington, I personally discussed with Mr. Colin F. Stam the same situation which I now present to you.

Mr. Stam referred me to pamphlet C, Corporation Taxes, Exhibit 189, Relief from Excess Profits Taxes, and asked me to advise him if provisions therein offered the relief to our particular business and to small businesses generally that they had intended it should.

In analyzing the application of the proposed tax program as applied to our own business, and taking an estimated possible earnings of $100,000 on an anticipated sales volume of $1,000,000 for this year, which would be a fair rate of profit for normal operation and risk involved, our excess-profits tax credit would only amount to approximately $5,800 in excess-profits tax credit and would mean an excess-profits tax amounting to $89.200.

In respect to article II, "General relief," in all instances noted, computation of the credit for excess-profits tax computation based upon earnings does not include years beyond 1939, the last year of the base period. The relief provisions do not give any consideration to a recovery in 1940 and 1941 of a business depressed in the base years from ordinary operations other than those enumerated in section B, subsection (a), items (1) to (5), inclusive.

Even if the law would permit us to base the computation of the credit for excess-profits taxes upon a 6-year average, 1936 to 1941, inclusive, our credit would amount to only approximately $19,600. The excess-profits taxes thus computed upon a normal tax net income of $100,000 for 1942 would thus result in a tax amounting to $75,600.

The CHAIRMAN. You have the $10,000 flat exemption. You don't seem to have carried that in mind in figuring out your tax.

Mr. RINGER. No, Senator; I have only computed the application of the excess profits.

The CHAIRMAN. You have a $10,000 credit against excess profits.

Mr. RINGER. At the time I prepared this, the credit was five.

The CHAIRMAN. Yes. I can appreciate that. It doesn't make a lot of difference; it makes some.

Mr. RINGER. I can appreciate that, and that $10,000 does help.

The CHAIRMAN. Yes, sir.

Mr. RINGER. In general, the proposals do not appear definite enough, apparently leaving every case to stand on its own merits, to be considered first by the Commissioner, but subject to appeal from his action to a special relief division of the Board of Tax Appeals. This can lead only to compromise settlements with the Commissioner, which may be unfair to the taxpayer or to the Government, or may lead to costly proceedings in appealing his decisions, which smaller businesses, like ours, would be unable to stand, while big businesses, have enough involved to justify this expense and do not need the money realized by the tax saving at once, this is not true in the case of small businesses like ours.

Our problem is going to be where to get the cash with which to pay the taxes. We cannot collect receivables from the Government any faster than they are willing to pay them, and we shall only be entitled to retain the profits. Therefore, we have one of two courses open to us: Either obtain a loan from the Government or from a private institution with which to pay our taxes.

In view of the foregoing reasons, I make the following suggestions. The adoption of one or more of these suggestions would meet the foregoing objections at least in part. In every case the amendments suggested should be made applicable to corporations having net incomes of $100,000 or less before excess-profits taxes, provided that in no case should a corporation pay a tax in excess of that which it would pay if it had a net income of $100,000, plus an amount equal to the excess of its net income over $100,000. This "notch provision" is inserted to prevent an obvious injustice. It is possible that Treasury tax experts could provide a "notch provision" which would be more equitable. The suggested amendments to the excess-profits tax law are as follows:

1. An alternative credit in computing excess-profits taxes equal to 8 percent or 10 percent of sales, or cost of sales, should be permitted, provided that this credit should not exceed the sum of the credit to which the taxpayer would otherwise be entitled, and the amount of the taxpayer's additional net investment in plant and equipment during the taxable year.

2. An additional credit equal to 8 percent of earnings accumulated during the year, if the invested captal method of computing excess-profits tax credits is used.

3. An additional credit equal to 8 percent of the earnings accumulated during the period January 1, 1940, to the end of the taxable year, if the average earnings method is used for computing excess-profits tax credits.

4. In lieu of the present specific exemption of $10,000, an exemption of 25 percent of the excess-profits net income or $10,000, whichever is greater.

The adoption of these amendments would enable small businesses to accumulate approximately one-half of their net earnings within the limitation of $100,000. I have prepared an example which I am submitting with this statement.

I call your attention to a recent article, headed "Taxation" in the July 27 issue of Time magazine, page 72. This article points out that the British Government in their tax program are trying to preserve initiative in small business as evidenced by the fact that their rates are much lower on normal profits than those in our proposed legislation, and that one-fifth of their excess-profits taxes is to be refunded after the war. Also the British Government allows corporations to base their excess-profits tax credit on the most favorable pre-war year or on the most prosperous combination, while corporations in this country have to take the bad years with the good.

It is the small corporation and small business that will suffer most severely under the proposed tax legislation. Our company is and will continue to proceed with production at full speed. We hope that the tax bill, when finally passed, will give the relief necessary so that business may operate with maximum efficiency and contribute the greatest possible production in the best interest of our war effort.

The CHAIRMAN. Thank you very much, Mr. Ringer.

Mr. RINGER. Thank you very much.

(The tabulations submitted by Mr. Ringer are as follows:)

FOLEY MANUFACTURING CO., MINNEAPOLIS, MINN.

Gross sales, net profits, and income and excess-profits taxes, years ended Dec. 31, 1926, to Dec. 31, 1941, inclusive

Year ended—	Sales	Net profits or losses (−)	Income and excess-profits taxes	Percentage or taxes to net income
				Percent
Dec. 31, 1926	$92,267.57	$11,045.93	$1,839.10	11.77
Dec. 31, 1927	140,621.43	16,599.46	1,353.03	8.15
Dec. 31, 1928	271,368.62	35,666.63	4,380.00	12.28
Dec. 31, 1929	369,751.83	68,128.59	7,494.17	11.00
Dec. 31, 1930	333,033.02	30,991.45	3,718.97	12.00
Dec. 31, 1931	245,669.11	−7,701.62		
Dec. 31, 1932	134,487.22	−17,184.08		
Dec. 31, 1933	75,021.40	−8,361.63		
Dec. 31, 1934	103,363.05	−5,241.76		
Dec. 31, 1935	125,203.28	−3,959.55		
Dec. 31, 1936	153,959.80	−3,892.56		
Dec. 31, 1937	240,881.08	24,359.48	6,989.01	28.71
Dec. 31, 1938	205,345.79	−672.41		
Dec. 31, 1939	225,614.84	3,429.36	507.00	14.78
Dec. 31, 1940	339,285.35	25,689.88	8,068.82	31.41
Dec. 31, 1941	765,162.00	78,730.22	47,400.00	60.21

Effect of "notch provision" [1] *on incomes over $100,000; computation of income and excess-profits taxes on estimated taxable income of $125,000, assuming sales of $1,000,000*

Using income method:		
Normal tax net income		$125,000
Less credit:		
8 percent of sales	$80,000	
8 percent of accumulated earnings for 1940 and 1941	14,200	
Specific credit—25 percent of normal tax net income	31,250	
Total	125,450	
Deduct normal tax net income in excess of $100,000	25,000	
		100,450
Adjusted excess-profits net income		24,550
Excess-profits tax—90 percent of $24,550		22,095
Normal tax:		
Normal tax net income	$125,000	
Less excess-profits tax	22,095	
Net taxable income, at 40 percent	102,905	
		41,162
Total tax		63,257

[1] The principle underlying the computation under the "notch provision" proposal, irrespective of whether the excess-profits tax computation is made under the income or invested-capital method, is that the income in excess of $100,000 is deducted from the credit as computed in accordance with our proposed credits.

Computation of income and excess-profits taxes under proposed amendments for our business, assuming $1,000,000 in sales and net income of $100,000 for year ending Dec. 31, 1942

BASED ON EARNINGS METHOD

Computation of income and excess-profits taxes:			
(1) Excess-profits tax credit based on percentage of sales:			
Normal tax net income			$100,000.00
Less credit:			
8 percent of sales*		$80,000.00	
8 percent of accumulated earnings for 1940 and 1941:			
1940	$77,494.03		
1941	100,000.00		
	177,494.03	14,199.42	
Specific credit—25 percent of normal tax net income		25,000.00	
			119,199.42
Adjusted excess-profits net income			None
(2) Excess-profits tax credit based on our base-period earnings plus net investment in plant and equipment:			
Normal tax net income			100,000.00
Less credit:			
Base period earnings		$5,757.05	
8 percent of accumulated earnings 1940 and 1941		14,199.42	
Net investment in plant and equipment		40,000.00	
Specific credit—25 percent of normal tax net income		25,000.00	
			84,956.47
Adjusted excess-profits net income			15,043.53
Excess-profits tax, at 90 percent of $15,043.53			13,539.54
Normal taxes:			
Normal tax net income		$100,000.00	
Less excess-profits taxes		13,539.54	
		86,460.46	
Tax at 40 percent of $86,460.46			34,584.18
Total income and excess-profits taxes			48,123.72

BASED ON INVESTED CAPITAL METHOD

(3) Excess profits tax credit based on percentage of sales:			
Normal tax net income			$100,000.00
Less credit:			
8 percent of sales		$80,000.00	
8 percent of earnings for 1942		8,000.00	
Specific credit—25 percent of normal tax net income		25,000.00	
			113,000.00
Adjusted excess-profits net income			None
Excess-profits taxes			None

Computation of income and excess-profits taxes under proposed amendments for our business, assuming $1,000,000 in sales and net income of $1,000,000 for year ending Dec. 31, 1942—Continued

Computation of income and excess-profits taxes—Continued.		
(4) Excess-profits tax credit based on invested capital:		
Normal tax net income		100,000.00
Less credit:		
8 percent of invested capital and one-half of borrowed capital	$7,000.00	
8 percent of earnings for 1942	8,000.00	
Net investment in plant and equipment	40,000.00	
Specific credit—25 percent of normal tax net income	25,000.00	
		80,000.00
Adjusted excess-profits net income		20,000.00
Excess-profits tax, at 90 percent of $20,000		18,000.00
Normal taxes:		
Normal tax net income	$100,000.00	
Less excess-profits taxes	18,000.00	
	82,000.00	
Tax, at 40 percent of $82,000		32,800.00
Total income and excess-profits taxes		50,800.00

The CHAIRMAN. Mr. Glass.

STATEMENT OF I. R. GLASS, NEW YORK, N. Y., REPRESENTING TANNERS' COUNCIL OF AMERICA

Mr. GLASS. Senator George and gentlemen, my name is I. R. Glass, Tanners' Council of America.

On behalf of the tanning industry, I should like to refer very briefly to three matters in which the tanners are specifically interested.

I would very much appreciate your permission to file a detailed statement with you as soon as this can be prepared by the Tanners' Council.

The CHAIRMAN. You may do so.

Mr. GLASS. Two of the matters I want to refer to rather summarily because they have been dealt with by previous witnesses.

The first is the proposed change in the status of fiscal-year taxpayers. Tanners are specifically interested in that subject.

The CHAIRMAN. I think we all appreciate the fact that you have one of the most extreme cases in the case of that particular provision. We are not strangers to your business.

Go ahead with your statement.

Mr. GLASS. I wish to point out very briefly that the adoption of fiscal years by tanners was conditioned by the characteristics of the tanning industry and the seasonal characteristics of its principal customers. In addition to the awkwardness that would develop under the proposed change from an accounting and finance point of view, there would be a rather serious problem in raising the cash to pay taxes on a basis not heretofore anticipated.

Commitments in the tanning industry have to be made a great many months in advance due to the length of the processing period.

In some instances it takes a year or more to process and sell the finished product. For that reason tanners confronted by a retroactive change in their status as taxpayers would run into considerable difficulties in obtaining the cash with which to pay the taxes on the new basis.

I do not believe that exception can be taken by any tanners merely on the score of the proposed rates but rather on the retroactive effect of such rates resulting from the change in taxable status of fiscal-year taxpayers. May I emphasize that I am not here to discuss tax rates per se on these points in which tanners are interested vitally. Tanners feel that in the long run there is no possible benefit to the Treasury as far as revenue is concerned from the proposed changes. If the taxpayer were given opportunity or advance notice of the change in fiscal-year basis, the adjustment would be much more equitable both for the taxpayer and the Treasury.

The other matter to which reference has been previously made by other witnesses is the proposed change in the capital-loss provision, making it possible to offset capital losses only by capital gains in the year in which incurred or, if carried over, in the 5 subsequent years.

Tanners as a class do not have occasion to report capital gains. As a matter of fact I can safely say that species of gain is completely lacking in the tanning industry by virtue of the very highly specialized character of the capital investments tanners may make.

If a tanner invests in an allied or subsidiary company, for example to acquire barkland or timber property necessary for the conduct of his business, any liquidation of such a capital investment resulting in a capital loss could under almost no conceivable circumstances be offset by a capital gain. Inability, consequently, to take capital losses, long-term capital losses, into operating income would result in a hardship for an industry where there are no capital gains.

The other matter to which I should like to call the attention of your committee has not, I believe, been previously developed.

As a result of circumstances completely beyond the tanners' control it is becoming increasingly difficult for the producers of various types of leather to replace sales of finished leather by purchases of raw material, that is, hides and skins.

War Production Board restrictions—such as conservation and allocation orders, and import restrictions—as well as shipping difficulties, have created a situation whereby tanners' inventories are involuntarily being reduced. These factors cannot be offset by any means available to the tanners.

I emphasize that this condition is entirely beyond the control of the tanning industry. It is not a novel condition in many respects, but it has these novel consequences for the tanning industry, because forced liquidation of inventory will produce certain drastic results: Income during the current year will be inflated and exaggerated by the fact that tanners are forced to take into their income account for the current year the difference between the average value of inventories previously held and current sales prices.

In many instances the average value of tanners' inventories is considerably lower than the ceiling prices put into effect by the Office of Price Administration.

Such profits—that is to say, profits on inventory—are in no way indicative of true earnings from the conversion of raw material into finished leather. That principle has already been recognized, I believe, in the tax law, and it is one which is not unfamiliar to your committee.

As a matter of fact the inventory method followed by many firms in the tanning industry, in accordance with Treasury regulations, was adopted specifically for the purpose of minimizing the fluctuations in income resulting from fluctuations in commodity prices.

However, the combination of circumstances which has developed this year has created a very serious and unusual situation. On the one hand, leather is being shipped as fast as it can be produced. It is being shipped for military purposes to the Army and Navy and to military contractors. It is being shipped to plants producing essential civilian products.

On the other hand, tanners can't replace the sales they make with raw material by virtue of restrictions on purchases of hides and skins. What has happened, therefore, is an abnormal and fictitious inflation of income during the current year which, in view of proposed corporate-tax rates, is going to create an extremely difficult and serious hardship for the tanners concerned.

I should like to reiterate that there can be no possible exception taken to the effect, the incidence of tax rates, whatever they may be, upon liquidation of inventory under normal contracts.

Under normal contracts, if a corporation of the tanning business reduces its inventory, the presumption must be that it does so voluntarily, that it is free to replace that inventory if it so desires and, consequently, any of the profits accruing to the organization ought to be taxed at whatever the applicable rates may be. Today, because the existence and maintenance of those operating stocks in tanneries is conditioned by factors entirely beyond tanners' control, the abnormality of income which will result would seem to require some type of specific relief.

The Tanners' Council has compiled very ample statistics dealing with the inventory position of the industry. These statistics indicate that stocks today already show a decline of 15 to 20 percent from a year ago.

The Government is acquiring, for military purposes, sole leather and certain types of upper leather, to the extent of 30 to 35 percent of the total production. Civilian footwear requires the balance of the principal types of leather. To produce those leathers, and to make available the quantities needed by the Government, the tanners have cut ruthlessly into existing stocks.

I think a concrete example might illustrate the paradoxical situation in which a number of tanners are going to find themselves. I have a letter from a sole leather tanner who points out that—

> So far this year we have suffered a reduction in physical volume of our inventory of 25 percent, which will inflate our profits this year subject to excess-profits tax by the addition of an amount somewhere between $300,000 and $325,000.

The tanner then proceeds to point out that at some future date, perhaps next year or the subsequent year, it will become essential to replace the depleted inventory.

The Government may require production of additional quantities of sole leather. To produce those quantities, it is essential to have a minimum volume of inventory in the form of raw material and in processed stock.

The position of the tanner, however, is going to be as follows: Upon the exaggerated or inflated income of the current year he is paying 90 percent in the form of excess-profits tax. Consequently, if he has to replace the hide he has sold, he does not get back enough in the form of cash to buy an equivalent hide.

Let me put this paradox even more concretely. A tanner at the beginning of this year may have had 10 hides on hand, at an average inventory value of 10 cents per pound. His sales during the current year are based upon ceiling prices fixed by O. P. A., which are approximately 15 cents per pound. Under the tanners' inventory method, had he not been forced to liquidate part of his inventory, he would have been able to obtain sufficient funds from the proceeds of sales to buy back new hides at 15 cents per pound. But if he is forced to liquidate that original opening inventory of 10 hides, and he loses 5 or 10 hides, he can't replace; he has in cash, as an inventory profit, the difference between the opening inventory value and the level of sales prices. Consequently, all of that exaggerated profit becomes subject to excess-profits tax, and working capital available for the replacement of inventory is drastically curtailed.

In the following year the tanner is required to produce leather for Government or civilian use, and finds that he does not have the capital with which to build the necessary working inventory curtailed by circumstances beyond his control in the previous year.

I believe that this condition created by factors entirely beyond the scope of tanners' control requires some type of relief. It seems to me that in principle there is no substantial difference from the relief which might be extended by your committee in this instance and the procedure already recognized for involuntary conversions in existing law and regulations.

In other words, might it not be appropriate in such cases to set up the principle of a nondiscretionary reserve to be used within a limited period for the replacement of inventory?

If the reserve is not used for that purpose, if the taxpayer is content to remain in a partly liquidated state, then the reserve should be taxable at whatever rates are applicable; that is, the applicable rates for 1942.

Thank you, sir.

The CHAIRMAN. Thank you very much.

Mr. Robins.

STATEMENT OF JAMES ROBINS, MERION, PA., PRESIDENT, AMERICAN PULLEY CO.

The CHAIRMAN. All right, Mr. Robins.

Mr. ROBINS. Would 12 minutes be too much?

The CHAIRMAN. Well, sir, present your case as briefly as you can.

Mr. ROBINS. I will, sir.

Mr. Chairman, my name is James Robins. I am from Merion, Pa. I am president of the American Pulley Co., taking a day off to come here at my own expense, not at my company's special interest nor in my own, but in what I believe to be the public interest.

Nevertheless my comments will be based on my company's situation because it is typical of thousands of concerns that are up to their necks in war work entrusted to them by the War or Navy Departments.

Our contribution to the war effort, while very modest, has been such that it was one of the first four companies in the city of Philadelphia to receive the Navy "E" award, that it shipped as much in the second quarter of this year as the whole of 1938, and it is heading for an output of four times the normal rate.

Ours is a medium-sized company almost 50 years old. It makes power transmission equipment, material handling equipment, and pressed metal specialties for industry.

Its sales last year were about $3,000,000. It belongs to the capital-goods class. That is, when industry is busy, we are busy and progressing and when industry is inactive, we are pretty flat.

From 1930 to 1940, its stockholders got mighty little return for the loss of over a half million dollars at that time. Our buildings and equipment were not young even in 1929, and for 10 years thereafter we couldn't afford to spend money on them. We just concentrated on keeping our organization together.

Two years ago we concluded that a huge production for defense or war was inevitable, and that the company's part would be an active one. We realized that much of our equipment was not in shape to carry a heavier load, and that many of our facilities were not suitably located for the probable production requirement and in that 2 years we have spent about $36,000 for improvements, not one nickel of which has come from the United States Government. That is $55,000 more than the profit we made during that time, and we had to cut into our working capital and borrow heavily to make up the difference.

To handle this increased business, we have had to borrow heavily from the banks. The money is tied up in accounts receivable and in swollen inventories, in special tools, dies, and equipment. It is not available in cash.

True, we are allowing some money to go out to the stockholders in dividends, but it is only at a rate of 4 percent on their invested capital, and they waited a long time for that.

We want to go on producing at top speed for the war's duration and paying taxes to the utmost practical limit, but when the war is won, we want to keep from going down like a flat tire or maybe going out like a light.

To begin with, we ask you to do all these things. Companies like ours need your help on taxes.

To begin with, we ask you to tax a company like ours only on true profits. Book profits in our case are not true profits. For example, some of our presses and screw machines and lathes have run for 2 years without proper overhaul. They are taking an awful beating. We can't take the "stitch in time that is worth nine" to maintain these machines, so they will cost extra to fix up when the war is over.

Allow us the privilege of setting aside the money for this deferred maintenance tax-free.

Next, the life of these busy machines is being shortened by years through the beating they are taking. Please, in your tax bill, say that extra depreciation of such machines be charged off in line with recognized accounting principles.

Next, the company carries thousands of standard items in stock. For many of them the wartime demand is many times the peacetime norm. We have stocked up to give prompt service on such products. When the war ends, we may be stranded with several normal years supply on our hands made, I fear, at inflated cost. In your revenue law, give us the privilege of figuring our probable liability for loss on this dead stock and setting up a tax-free reserve for such inventory losses.

Last but not least, the company has the unknown factor of war-contract renegotiations to face. I hope that your tax bill will be framed to prevent the same dollar being taken by the Treasury twice, first as an excess-profits tax and later as a refund on a renegotiated contract.

If you do these things, our company can stand, during the war years, a terrifically high tax on true excess income, but it seems to me that Mr. Donald Nelson deserves from you the benefit of the powerful force that the profit motive still is in industrial production.

I hold no brief for profiteering. That is something as different from a seemly profit as a drunken spree is from a pause that refreshes.

In our company's case, for every million dollars of extra business done, the stockholders gain will only be $10,000, or 1 percent. If the excess-profits tax rate is 94 percent, I should think that sooner or later our company should clear at least 2½ cents or 3 cents on each dollar of sales that bring in excess profits.

Our company doesn't need all of this money now, but it does need it when the war is over, when the war contract cancelation comes in and business drops back to a normal level. It will need it for several things: First, we have been probably obliged to lay off a lot of men at least temporarily. We want to do something for them besides throwing them out on the street.

Seventy percent of our men are in the service. The law and our own inclination is to find jobs for them when they come back. We need the money to do it.

Third, we have a lot of full-time elderly employees, some of them in none too good physical shape. Those men may be pretty well worn out when this war strain ends and deserve honorable retirement. We want to be able to take care of them.

Fourth, we need to put our factory back on a peacetime basis and this will cost money. A powerful lot of modernization and renovation will then be needed.

Fifth, We have quite a program of product and market research and development that we want to put through to put us in a position to do justice to our organization after the war. One product in particular has great potentialities. If it is a success, it will fill our plant with peacetime work. I am referring to a form of steel window. But we shall need some cash to carry through to a successful conclusion, not a whole lot of cash, but it must be our company's own cash, or we may not be able to spend it for such development.

For these reasons, I commend to your attention the merits of the proposals for furnishing Government bonds in return for part of the excess-profits tax. In particular, I favor Mr. Clinton Davidson's post-war recovery plan as presented to your committee not long ago.

I think probably I have taken my time up, but there are a couple of comments I would like to make on that plan, if it is in order. It will take me a couple of minutes.

The CHAIRMAN. Yes, sir. We would appreciate your concluding as rapidly as you can.

Mr. ROBINS. Yes, sir.

The first point: Mr. Davidson, I believe, spoke along the lines that companies would die like flies after the war is over unless some such plan were in effect. I looked up our figures and I found that during the last war or after the last war we paid 23 percent of our income during the way in taxes, Federal taxes, leaving 77 percent. That was $880,000. But in 1921 we lost $330,000—3/8 of 4 years' earnings after taxes.

In this war and under these conditions, the figures are reversed. Instead of 77 percent staying with the company and 23 percent going out to Federal taxes, we are going to be paying more than 77 percent for taxes and less than 23 percent will stay with us.

If we have another post-war $330,000 loss like in 1921, either we will be crippled as a healthy going concern and as an employer of labor, or else we will fold up entirely like one of Mr. Davidson's flies.

The other comment I want to make is this: That it may seem that Mr. Davidson's post-war recovery plan doesn't set aside enough money to amount to anything. I mean by that I believe his proposal about setting aside about a billion dollars a year for post-war recovery refunds. That would appear to be only a drop in the bucket, but actually this money placed in industry's hands for venture capital at the right time will, in my opinion, if not too many strings are attached, accomplish miracles, for it will build up new production and fresh enterprise like snow rolled in a ball.

Thank you, sir.

The CHAIRMAN. Thank you very much.

Senator LA FOLLETTE. Mr. Chairman, I would like to insert in the record a letter which I think every member of the committee received from Mr. J. G. Luhrsen, executive secretary of the Railway Labor Executives' Association, dealing with the tax bill.

The CHAIRMAN. Very well, it may go in the record.

(The letter presented by Senator La Follette is as follows:)

RAILWAY LABOR EXECUTIVES' ASSOCIATION,
Washington, D. C., August 7, 1942.

DEAR SENATOR: I am writing to you on behalf of the members of the Railway Labor Executives' Association to set forth their views on taxation.

Arguments of the taxation proposals made to the Ways and Means Committee of the House of Representatives has revealed that the basic issue is quite simple. This is the issue: Shall the bulk of the billions needed to finance our war effort be contributed by corporations profiting from the enormous Federal expenditures and people with comfortable incomes, or shall that burden be thrown primarily on those who must spend all or almost all of their earnings on the necessities of life?

In answering this question, we feel it important, in wartime more than ever, to stick to the basic principle of levying taxes according to "ability to pay." The income tax is unquestionably the best means of putting this principle into effect. Through exemptions, credits, and deductions, it can be ascertained what money is available for paying taxes. A progressive rate structure, under which the tax rate rises as incomes rise, then distributes the load equitably.

A sales tax, on the other hand, is in inverse ratio to ability to pay. The tax rate decreases as incomes rise. For example: If Congress imposes a general sales tax on consumer purchases large enough to equal 10 percent of an income of $500, the tax would amount to only 6 percent of an income between $2,000 and $2,500 and 3 percent of an income above $10,000. If the Treasury Department were to recommend to Congress that it impose an income tax without exemption at the rate of 10 percent on an income of $500, at 6 percent of an income of $2,500, and 3 percent on an income above $10,000, Congress and the Nation would rightly conclude that the Treasury had forgotten every principle of tax justice. Yet that, in effect, is what the sales tax advocates are proposing.

In reference to the expressed desire of the Congress and the Administration to curb inflation through taxation, I should like to point out that available figures indicate that most of the current increase in national income as a result of the war is going to persons who are income taxpayers. The way to use taxes to curb inflation is to tap this new purchasing power. Income taxes reach that new money where it is, sales taxes where it isn't. Congress might try to drain off in taxes the entire amount of $17,000,000,000 in the so-called inflationary gap, but in doing so it would deal a crippling blow to large numbers of people who are not responsible for the rise in prices and at the same time fail to reach many whose incomes do provide a spur to inflation.

We believe that a third principle should be considered by Congress in acting on the tax bill—that is the removal of certain defects in the present law. These defects grant special privileges to favored taxpayers which permit them to escape their just share of taxes.

The most glaring examples of these special privileges are the privilege of husband and wife to file separate returns, the exemption of interest of State and local securities, and the special deduction known as "percentage depletion" available to those who derive their income from oil wells and certain kinds of mines.

Under present law, a family with one breadwinner who earns $5,000 a year pays a heavier tax than a family in which husband and wife earn $2,500 each. Also, under present law, a family in one of the so-called community-property States, pays less than a family in one of the other States, even though the family breadwinner earns exactly the same amount of income in each case. This happens because, under the community-property system, one-half of a husband's earnings becomes the income of his wife for tax purposes.

These inequities should be ended by requiring husband and wife to file a joint return of their income, so that each American family will pay taxes according to its real ability to pay.

Another special privilege which should be abolished is the exemption from tax of income from State and local securities. Under the present law, not a cent of Federal income tax is paid on interest from such bonds. I have heard it said that one rich man has $25,000,000 invested in these bonds and enjoys more than a million dollars in tax-free income. As Secretary Morgenthau said before the Ways and Means Committee on March 3: "The holders of tax-exempt securities are obtaining what are essentially windfall profits in a time of national sacrifice."

The third example of special privilege is the allowance of percentage depletion. The owner of an oil well is permitted to deduct 27½ percent of his gross income, but not more than 50 percent of the net income from the property. This deduction is permitted year after year, even after he has recovered 100 percent of the cost. Similar deductions, though not so large, are allowed in the case of coal and nonferrous metal mines and a few other mines. They result in tax advantages to a favored few which others do not enjoy.

This year's income taxes will not be easy to pay. But before any man complains that the burden is too much, let him ask himself whether he has really sloughed off the easy ways and pleasant trappings of prewar days. Let him also ask this question: Is it more fair for me to give up some of the luxuries I have grown accustomed to, or for someone further down the income scale to eat less food, buy less clothing, move to a cheaper room?

The lower income group must, because of their already meager returns, with constantly increasing prices in cost of living, yield to many restrictive ways of living, while those most able to pay go unscathed through loopholes which may well be called the "citadels of privileges" for escape.

The working classes and all of those in the low income brackets cannot and will not continue to tolerate the favoritism manifested in too many directions for those with greater ability to pay, while constantly sapping upon every ounce of these least able to pay.

The one glaring example of rank injustice is revealed on page 6886 of the Congressional Record of August 4, 1941, where the vote shows 242 yeas and 160 nays to strike out all of section 111 which thereby permitted the separate income returns to be made with the very definite warning and understanding that by so doing the base, or exemptions of those less able to pay would have to be lowered.

The loss of approximately $323,000,000 in taxes was shifted to the lower income brackets last year. This year, the continuing of separate income returns will show a loss of approximately $420,000,000. What was known to every legislator last year, should be even better known this year, is that this represents a most unfair and unjust principle of taxation, and that no discrimination of this, or any other kind, can be tolerated by the preponderant majority constituency, when facts are made available to them.

If these extraordinary, yet uncalled for burdens were necessary to truly represent the loyal and patriotic spirit of all out for the war effort, little complaint would come from those in the lower income brackets. But the rank and file is beginning to see and learn how the avenues of escape of a just taxation are made available to those with the greatest ability to pay.

There are, for example, the separate income-tax-return provision, the refusal of imposing higher taxes on corporations, the refusal of reducing excessive percentages of gross income for depletion of oil and mining companies, the refusal of taxing tax exempt State and local securities, the refusal to increase estate and gift taxes, etc., etc.

In other words, the big reserves for raising the proper taxation for defense and victory are dealt with with kid gloves while to the contrary, labor generally, including the white collar worker as well as those of medium incomes, are arbitrarily placed in the "must-pay" brackets regardless of how discriminatory the basis of taxation may be as between the two interests. The people of the United States are entitled to know the reasons for action taken by Congress with respect to every avenue of taxation, and therefore, debate and record votes should be had in order that every taxpayer may know where the responsibility rests as to the right or wrong, fair or unfair decision made.

Very sincerely yours,

J. G. Luhrsen,
Executive Secretary.

Senator Taft. Mr. Chairman, here is a brief by Mr. Harris.

The Chairman. Yes, I was going to call Mr. Harris. Mr. Harris.

STATEMENT OF SAMUEL K. HARRIS, LANSING, MICH.

Mr. Harris. Mr. Chairman, I believe you have the brief on hand which Senator Taft has handed you.

The Chairman. Yes, sir.

Mr. Harris. And I believe you have my remarks which I was expecting to make on the presentation of them.

The Chairman. We have them; yes, sir, Mr. Harris.

Mr. Harris. If you want me to read them again, I can, or you could leave them as is with the file.

The Chairman. We will be pleased to enter it in the record just as you have it here.

Mr. Harris. All right, sir. I was just wondering if there were any questions you might want to ask as to what this brief was about or why I am here.

The Chairman. Any questions?

Mr. Taft. Mr. Harris' brief is in connection with an amendment he thinks should be made to the estate tax law relating to the retaxation of profit twice in 5 years. He feels that the act should be amended to make clear certain cases in which they have actually taxed it twice although the deaths have been within 5 years.

Mr. HARRIS. Yes; that is correct.

Senator TAFT. It is a matter which I think we will be glad to consider and take up with the Treasury.

The CHAIRMAN. I notice you also deal with the disallowing of deductions on an income-tax return of office rent and so forth.

Mr. HARRIS. Yes, sir.

The CHAIRMAN. Which you covered in your statement to the House Ways and Means Committee.

Mr. HARRIS. Yes, that is correct. That is in a similar brief which I filed with the House Ways and Means Committee.

The CHAIRMAN. Yes, sir; you called attention to that here.

Mr. HARRIS. Yes, sir.

Senator TAFT. That has been taken care of.

The CHAIRMAN. We will be pleased to enter it in the record, Mr. Harris.

Mr. HARRIS. Thank you very much.

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

BRIEF SUBMITTED BY SAMUEL K. HARRIS, LANSING, MICH.

Mr. Chairman and members of the committee, the privilege you have extended me to appear before your honorable body at this time is greatly appreciated. And so, in coming here to-day, my purpose is to call to your attention certain inequalities and hardships which I do not believe the Congress intended to result from the operation of the present law, and to solicit your consideration of these matters in your deliberations of the new tax law now before you.

Knowing that your committee has on its hands a tremendous task, I will take only enough of your time to describe the two briefs which I have prepared and wish to present to you for your records.

On March 12 I was accorded the privilege of presenting similar briefs to the House Ways and Means Committee.

The first brief discusses the disallowing of deductions on an income-tax return of office rent, clerk hire, and other expenses incurred by an individual engaged entirely in dealing in securities and commodities. Particular emphasis is taken to show the similarity of intention of purpose, whether or not the individual buys and sells stocks and bonds, or shoes and clothes for the prime purpose of creating income and profit. It also brings out the fact that the income and profit from both kinds of enterprises are taxed, even though the expenses of only one of these methods of creating income and profit are deductible items on the individual's income-tax return.

Before describing my second brief I wish to state that I have read in a financial paper that the House Ways and Means Committee has written into the new law certain relief for individuals and estates from the condition described in the brief mentioned above. I am deeply gratified, and believe that the fairness of this change will encourage investors, such as I have described to produce both greater profits for themselves and aded taxes for the Government.

The second brief discusses what I consider to be an example of double taxation on part of an estate which was inherited from a prior decedent who died within the 5-year limit prescribed by article 41, Regulations 80, of the estate-tax law.

This situation was the result of the interpretation by the agent of the Bureau of Internal Revenue who ruled that the part of the estate in question could not be identified because the value was represented by funds that had been commingled with other funds belonging to the estate. Therefore this decision resulted in the payment of what I believe to have been a double tax on that part of the estate. If the law means what I understand it to mean, and what I believe the Congress intended it to mean, this tax would not have had to have been paid.

I realize very well that the purpose of this new tax law is to raise all the money possible to pay for the war, and it should do so by all means. I also believe that where injustices exist and are allowed to remain, the raising of taxes is ultimately reduced to the extent that these injustices tend to create in the mind of the taxpayer and antitax program or defense to offset what is considered unfair. However, I do believe that where these injustices or inequalities are found to exist, they are not intentional, and that the Congress desires to correct them if and when they are properly brought to it's attention.

I am therefore content to present these two briefs, trusting that in reading them you will find my reasoning correct and feel inclined to recommend that the new law will clarify and relieve these problems.

Respectfully yours,

SAMUEL K. HARRIS.

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MR. CHAIRMAN AND GENTLEMEN: This brief which I have the privilege of presenting to your honorable body discusses what I believe to be a case of double taxation levied on an estate which was inherited from a prior decedent whose death occurred within the 5-year period set up by law as a time during which estates which are so inherited are exempt from certain tax levies.

The estate in question was inherited by will, and only certain parts of it were accorded the benefit of exemption from the Federal estate tax, leaving other portions, still representing values received from the original estate, subject to what I believe was an example of double taxation.

This situation developed as a result of an interpretation of the law by representatives of the Department of Internal Revenue, who interpreted the term, "commingled funds," in the light of a recent Supreme Court decision. This decision seems, to the best of my belief, not to apply to the individual circumstances involved in the situation which I am discussing.

I will now attempt to show, first, that, due to a possible ambiguity in the wording of the law which gives an agent of the Revenue Department an opportunity for choosing an interpretation unfavorable to this estate, a part of the Federal estate tax paid in this instance was what amounts to a double tax on the value of certain property which was acquired in exchange for property inherited from the prior decedent; and, second, that this tax was paid contrary to the meaning and intent of the law as written by the Congress.

I now refer you to Regulations 80 (1937 edition of Estate Tax, sec. 303, p. 71,) under the heading "Deductions—Property Previously Taxed," in which the following is found, and from which I quote for your reference:

"For the purpose of the tax the value of the net estate shall be determined * * * by deducting from the value of the gross estate * * * an amount equal to the value of any property (A) * * * forming a part of the gross estate situated in the United States of any person who died within 5 years prior to the death of the decedent: (B) * * * or from such prior decedent by gift, bequest, devise, or inheritance or which can be identified as having been acquired in exchange for property so received. This deduction will be allowed—only to the extent that the value of such property is included in the decedents gross estate * * *. When the property referred to in this paragraph consists of two or more items the aggregate value of such items shall be used for the purpose of computing such deductions."

Also on page 72 under article 41, deductions of the value of (a) conditions (2), I quote;

"The property must be identified either as the same which the decedent so received or acquired in exchange therefor."

It is apparent from the section of the law quoted above that there is no definition of how or through what channel the property so received in exchange may be acquired.

Again on page 77 under article 43 entitled, "Property Acquired in Exchange," I quote, "the deduction for substituted property is not limited to property acquired by a single exchange of property received from the donor or prior decedent but extends to substituted property acquired by the process of exchange, whether through the medium of money or otherwise, irrespective of the number of conversions involved including the proceeds of the sale or other disposition of property so received or acquired as well as property acquired by purchase with the proceeds of the sale or other disposition of such property, so long as such proceeds can be conclusively identified as such and clearly traced to the property originally so received."

May I call your attention to the fact that the law here states that an amount equal to the value of the property so received from a prior decedent may be deducted. The words "amount" and "value" are used continually throughout this law with reference to money and property and dollars. We are therefore right, I believe, if we assume that amount, value, proceeds, and medium of money have a similar meaning and interpretation and are synonymous with the word dollars by which all intrinsic values are measured for the purpose of calculating the tax throughout the whole tax law. We must therefore conclude by this assumption that "dollars" constitute property for the purpose of taxation just as surely as do "things," the value of which are measured in terms of dollars and for which dollars are accepted in exchange.

The law states that a deduction shall be allowed, "only to the extent that the value of such property is included in the decedent's gross estate," which is as it should be. And here, too, we realize that value has to be measured in dollars in order to calculate the tax on the estate.

By pursuing this thought further we conclude that the law does not exclude the value of the original property received from a prior decedent, even though it may have increased in value, from being allowed as a deduction, and furthermore, even though prior to the decedent's death this property should have been exchanged or sold for dollars, and even though the number of dollars should be greater than the number of dollars which was considered as the value of the original property, this original value, "only to the extent that the value of such property is included in the decedent's gross estate," becomes the basis for calculating the tax.

Are we to assume then that a check given in payment for such "increased" value property and which represents, and is, property in exchange for the original property, plus its increased value, has commingled the funds, or value, to the extent that a proper entry of the value of this check in a proper account according to accepted bookkeeping practices prevents the original value from being ascertained and segregated or delivered for the purpose of the calculation of the tax?

Furthermore, there is nothing in the wording of this law that I have been able to find that prohibits the depositing of dollars received from the sale of property in the original estate as long as its origin is properly recorded for identification in a reliable set of books, and provided that at any time during or after the process of exchanges (and the number of exchanges is not limited, as recited in art. 43), an amount in dollars "the value of which is equal to the original value of the property sold or exchanged" can be accounted for and made available for delivery.

Since there can be no doubt in anyone's mind that dollars represent and constitute property, and that dollars take many forms in the course of modern transactions, it can be readily seen that here is where the possible ambiguity in the wording of the law comes into play, because for convenience, speed, and safety the transferring of property and values is mostly accomplished by means of checks and bookkeeping accounts. Thus it is that in the process of selling and exchanging the property of a prior decedent in which a number of exchanges are involved the medium of money or its recorded values are necessarily used.

Please note also that, if there are a number of separate items to be sold or exchanged for other items which it is desired to acquire, and the time for making each of these exchanges is different (as for example the shifting of a portfolio of stocks and bonds) the only possible way to accomplish these exchanges, which are permitted by law, is through the medium of money, which in turn if the amounts are large, is almost always transferred and accounted for by means of checks, deposits, bank balances, and bookkeeping entries.

I do not believe Congress intended to write this law in such a way that a citizen would be deprived of the clearly worded deductions in it because he made use of the accepted methods of transferring and accounting for money and values in making exchanges as described in the preceding paragraph, even though the funds involved should be technically commingled, because if the books were properly kept the funds representing the "original value" could be easily segregated and the tax calculated.

In concluding these remarks may I say that I trust you will find merit in my reasoning, and that you will feel inclined to correct and clarify this part of the new law now before you to the end that proper relief will be afforded citizens who have been adversely affected by the situation discussed in this brief.

In closing, please permit me to thank you for your attention and consideration.

Respectfully submitted.

SAMUEL K. HARRIS.

The CHAIRMAN. Senator Davis.

Senator DAVIS. I desire to present for the record for and on behalf of the Reading Co. of Pennsylvania, a brief statement that they desire to have go into the record.

The CHAIRMAN. Very well, it may go into the record, Senator.

(The document presented by Senator Davis is as follows:)

BRIEF ON BEHALF OF READING CO., PHILADELPHIA, PA., BY JOHN E. MCCLURE, COUNSEL FOR THE TAXPAYER

The committee is requested to amend section 150 (c) of H. R. 7378, so that the statute of limitations will be 7 years in fact in certain special cases referred to in the bill and not, as we respectfully point out, the promise of 7 years under section 150 (a) (5), cut short to 3 years by section 150 (c) which limits the retroactive amendment to taxable years beginning after December 31, 1938.

The amendment was deemed desirable by the Treasury Department, according to the statement by Mr. Randolph Paul before the Ways and Means Committee on March 3, 1942, as follows:

"(c) STATUTE OF LIMITATIONS ON BAD DEBTS AND WORTHLESS STOCK LOSSES.—The difficulties surrounding the deduction for bad debts and worthless stock losses have long been familiar sources of irritation to taxpayers and the Commissioner alike. It is far from easy to ascertain when a debt is bad or when a share of stock becomes worthless. At the same time, the taxpayer must select the proper year before the statute of limitations has run with respect to that year. Much litigation is occasioned by the artificial barrier thus thrown up by the statute of limitations, as a taxpayer who chose one year only to be met with the claim that an earlier but barred year was the correct year must battle to defend his choice or lose the deduction entirely. It is believed that this useless litigation and many of the difficulties in this field can be avoided by, first, eliminating the ascertainment of worthlessness and the charge-off requirement in the case of bad debts (including securities producing capital losses) and, second, allowing a 7-year statute of limitations with respect to refund claims relating to a deduction on account of these items. Interest should not be allowed for the interval between the expiration of the normal statute of limitations and 6 months after the claim was filed."

If it was intended that the amendment was to have future application of a 7-year period—that is, say in 1948 a taxpayer could file a claim for refund for 1940—we submit that there are as great if not greater reasons for giving taxpayers a 7-year statute of limitation today. We say this because the very confusion which Mr. Paul speaks of in his statement quoted above is less likely to exist in the future in that (a) section 115 removes the requirements that debts must be ascertained to be worthless and charged off during the taxable year, and (b) within another year, certainly 2 years at the most, the Supreme Court of the United States will have settled the question whether the Commissioner and the Board should substitute their judgment for that of the taxpayer, honestly made, in ascertaining debts to be worthless.

READING CO.'S SITUATION

A typical example of the hardship which would be caused by the application of section 150 (c) if not amended is brought to light in the recent case of *Reading Company* v. *Commissioner* (B. T. A. Memorandum Opinion July 14, 1921, par. 41, 344, 1941 Prentice-Hall B. T. A. Memo. Dec. Service). In this case the taxpayer made advances or loans to another railroad in the sum of $3,570,000 over the period 1933 to 1936, inclusive, of which $2,805,000 were made prior to 1936. The taxpayer in 1936 ascertained the $3,570,000 to be worthless and charged the amount off as uncollectible. The Board of Tax Appeals affirmed the action of the Commissioner in substituting his judgment for that of the taxpayer and held that the advances of $2,805,000 made from 1933 to 1935, inclusive, became worthless prior to 1936, thus denying the deduction in 1936. The result was that the railroad recently had to pay a deficiency of over $500,000 in taxes and interest without any remedy to secure a deduction in 1934 and 1935, as the bad debts were not charged off in those years. If section 150 is so drawn as to give taxpayers 7 years in fact in which to file claims, Reading Co. could protect itself in part.

Accordingly, it is suggested that section 150 (c) be amended so as to apply to taxable years beginning on or after January 1, 1934.

Respectfully submitted.

READING CO.,
By JOHN E. MCCLURE,
Counsel for the Taxpayer.

The CHAIRMAN. Mr. E. R. Bowen.

STATEMENT OF E. R. BOWEN, EXECUTIVE SECRETARY OF COOPERATIVE LEAGUE OF THE UNITED STATES OF AMERICA

The CHAIRMAN. Mr. Bowen, on what subject are you appearing?

Mr. BOWEN. I am appearing on behalf of the Cooperative League of the United States of America which is a national organization of the consumers cooperative movement.

The CHAIRMAN. Do you wish to read your brief?

Mr. BOWEN. I have a very short statement and I have cut out just about half of it, Senator.

The CHAIRMAN. All right, you may proceed.

Mr. BOWEN. My name is E. R. Bowen. I am executive secretary of the Cooperative League of the United States of America with offices in Chicago, New York, and Washington.

Some time ago, when an Assistant Secretary of the Treasury was asked in a public meeting in New York why the consumer, who pays the tax bills, is never effectively represented before congressional committees, the Assistant Treasurer, Mr. Gaston, declared that the Treasury would welcome a presentation by organized consumers. We are confident the committees of Congress also will welcome such a presentation.

We are here to represent the consumers and, therefore, to represent the public interest. We consumers are, economically, we the people. We have no class interest to represent, since we represent consumers, who are everybody.

The Cooperative League of the United States of America is the national voice of the consumers' cooperative movement in this country. And today, the consumers' cooperative movement is no small movement. There are today some 2,000,000 families who are members of the consumers' cooperatives. It is fair to say, therefore, that there are at least 8,000,000 persons associated with the consumers' cooperative movement.

In this year consumers' cooperatives will handle from $750,000,000 to $1,000,000,000 of goods and services. The point is not so far distant when consumers' cooperatives will relieve the Government of many of the burdens of attempting to control prices and prevent inflation. Consumers' cooperatives are already a yardstick for prices in fertilizer, in feed, in automobile insurance, and in other fields. With already the second largest distribution of oil and gas in some States, and with increasing production in refineries and wells, we can see the not distant day when consumers' cooperatives will perform the public service of becoming a public or consumer yardstick for oil and gasoline.

In the grocery field, we now have developed sufficiently to have compelled honest grade labeling, so the public can now know precisely what quality of goods it is getting inside the cans, bottles, and packages. Any consumer can have that protection now by purchasing from cooperative stores.

We recite these facts for the reason that the tax problem of today and of tomorrow is associated intimately with the problem of the cost of Government. We cooperators are beginning to solve the cost of Government in the only way it can be finally solved, by building a cooperative economy, an economy which permits and compels control of ourselves by ourselves, or economic control from within, and thus avoids the necessity of political regulation from without, at Government expense paid for through higher and higher taxation, as does monopoly business.

In dealing today with the present tax problem, we are only at this time endeavoring to present a general outline of the ultimate goal toward which we organized consumers are directing our efforts to prevent inflation and deflation.

We know that the effort we are now beginning is a long pull. It involves evolutionary educational work, but we are glad to tell you Members of Congress that consumers' cooperatives have organized for education. Today and tomorrow and next week and thereafter, this education will go forward. You Members of Congress can now be encouraged by the realization that consumer-citizens back home in your States, will begin to know why a general sales tax can never be defended as equitable, or in the public interest, and the basic reasons for an equitable and adequate personal income tax. We hope and believe that with this education they will be able to help you in deciding on these questions. We hope and believe they will endeavor to help you back home, as well as here in Washington.

As I have said, we are attempting here to establish the goal, and to lay the foundation cornerstones for preventing inflation and deflation.

We are presenting a taxation program in the interests of consumers which proposes, in general, three things:

First, to understand how to prevent inflation and deflation, we must change our thinking from a dollar or money economy to a goods or physical economy. Goods are what we fight a war with—goods are what civilians are fed, clothed, and housed with. The first necessity to prevent inflation is to think in terms of goods, rather than money.

Second, to prevent booms and busts, we must begin to realize that in terms of goods we always pay as we go, and that we can and should set as our goal to pay as we go in terms of money through taxation as well, rather than going into debt, which induces immediate and future inflation.

Third, for the preservation of democracy and economic stability, the people should be told the cold, hard facts—the truth about borrowing and taxation.

First, let us speak in general about the President's seven-point program and the general program of consumers' cooperative movement.

It has been truthfully said that the consumers' cooperative movement already functions in peactimes as the Government wants the people to do in wartimes.

> To keep the cost of living from spiraling upward—

the President said—

> we must:
> 1. Tax heavily.
> 2. Fix consumer price ceilings.
> 3. Stabilize the remuneration of individuals.
> 4. Stabilize prices to growers.
> 5. Purchase bonds with earnings.
> 6. Ration essential commodities.
> 7. Discourage credit and installment selling.

Consumers' cooperatives consistently advocate and put into practice the essential features of this seven-point program at all times and under all conditions.

The consumers' cooperative movement:

1. Supports adequate as well as equitable taxation.
2. Automatically fixes consumer price ceilings at cost of production and distribution without adding "profit on cost."
3. Stabilizes the remuneration of its employees in accordance with the cost of living.
4. Stabilizes prices to primary producers by eliminating waste in production and distribution and profiteering between producers and consumers.
5. Reinvests its savings in facilities for more economical production and distribution and other savings in Government securities.
6. Supports emergency rationing of commodities on which there is a shortage, and works toward their release from the scarcity restrictions of monopoly in peacetime.
7. Automatically discourages credit and installment selling by its own restrictions and by the education of its patron-members.

This discussion will have to do primarily with the first of these seven points—taxation.

We wish to present for your earnest consideration our recommendations as to the basic principles of an adequate and equitable policy of taxation from the standpoint of the consumer. We believe, as an economist has recently said:

> Anyone may detect notorious economic fallacies and thus see the dictates of sound policy, if he will look at every issue from the viewpoint of consumers * * *.

The voice of the organized cooperative consumer promises to be heard more often and more effectively in the halls of Congress, as well as in the channels of trade. We speak for approximately 6,000,000 consumers, federated through their local and regional cooperative associations in the Cooperative League. The effective force of this rapidly growing group of organized consumers is becoming increasingly recognized in America.

Before discussing the details of consumer tax program we stand for, we should first consider the objectives we wish to attain.

The goal we seek is the public welfare, since the consumer incarnates the public welfare in economic life. There are three general ways of expressing the ends which the consumers' cooperative movement seeks to achieve:

1. We seek to prevent inflation and deflation—or booms and busts.

The consumers' cooperative movement seeks to prevent such price and pay rises as will result in serious inflation and deflation, and at the same time to adjust gross inequalities between groups and individuals.

If booms develop, busts inevitably follow. "What goes up must always come down," as the President quoted.

Those who are old enough to have lived through the boom and bust of 1915–20, and who personally participated in the foreclosures of farms, the bankruptcies of businesses, and the tragedies of unemployment which followed, do not need to be warned of the dangers of another and still greater possible collapse.

We know it is not impossible that what happened in other countries might even happen here—that extreme deflation and bureaucratic dictatorship go hand in hand. We know that it is possible to build up an economic house of cards which might fall down upon our heads. We want to prevent any such possibility happening in America as a result of uncontrolled inflation and deflation. A widely distributed article entitled "Invincible Greenbacks" says that—

> The catastrophic German inflation of the twenties had its beginning in just such Government borrowing from banks.

The President said:

> You and I know the hardships and heartaches we all went through in the bad years after the last war when Americans were losing their homes and their farms and their savings and were looking in vain for jobs.
>
> We do not intend after this war to present the same disastrous situation to those brave men who today are fighting our battles in all parts of the world. Safeguarding our economy at home is the very least that our soldiers, sailors, and marines have a right to expect of us civilians, in Government, in industry, on the farm, and in all other walks of life.

2. We seek the goal of distributing oversavings and prevent underconsumption.

The consumers' cooperative movement seeks to solve the problem of inequitable distribution which has resulted from the present system.

"Underconsumption is the black plague of the twentieth century," as Milo Perkins has truly said. Underconsumption by the many is the direct and inevitable result of oversavings in the hands of the few. Both are the results of excess accumulation of profits, which is the inherent flaw in the present system and which cannot be corrected.

It should not be necessary to reiterate the statistical evidence which has now been presented. Every American should now be familiar with the fact that the primary cause of booms and busts is the lack of equitable distribution of the products we produce. There was presented before the temporary national economic committee evidence to the effect that we had saved 19 percent of our gross national income in 1929, and again began to do so in 1937.

The Brookings Institution report showed that 2 percent of the people accumulated two-thirds of all savings in 1929. The Government publication Consumer's Expenditures in the United States showed that the upper 7 percent of income receivers saved practically the total net amount which was saved during the year 1935–36; in other words, that 93 percent of all American consumers only broke even.

The statistical evidence is also presented that not one-third but two-thirds of the Nation are "ill-fed, ill-clothed, and ill-housed"; as could not be otherwise when the lower third only received incomes of $780 or less per year, and the middle third incomes from $780 to $1,450, and could not bread even when living under poverty conditions. This is surely not the ideal of the American way, and does not exemplify the principles of economic liberty and equality.

As has been said: "We cannot win the war at all without promoting justice within our Nation and giving freedom new meaning."

3. We seek to equalize total price and income levels—prevent the dangers of debt—balance the budget.

The consumers' cooperative movement seeks to solve the problem of excessive individual and national debt.

Some speak freely of a possible national debt of $250,000,000,000, and endeavor to rationalize such an amount. They say that a public debt is different from private debt. And it is. But not altogether in the way it is represented to be.

Both are assumed to be paid; but, if not, private debt can be liquidated by bankruptcy in an orderly way, but the public debt can be repudiated only with national disaster.

The dangers of debt are too little realized. Excessive debt spells disaster in the long run. The possible effect on the morale of the people is of even more consequence than the economic implications.

Even assuming that we can carry such a debt from a fiscal standpoint, considering the present and potential wealth of this country, the reactions of the people must be considered. If the people are to learn and practice the principles of thrift, of getting out of debt, of paying as they go individually, of balancing their family budgets, which are essential requirements in the stability of a people, then the Government must itself set the example for the people.

A Government cannot itself practice a permanent policy of going into debt and preach successfully to the people a policy of paying off their personal debts.

While it may be theoretically economically possible for a national debt to be increased to stratospheric proportions, the inevitable result will be an increasing lack of confidence by the people in the stability of the Government, and the generating of a dangerous and revolutionary spirit. Excessive debt has proven to be an active forerunner of dictatorship. The consumers' cooperative movement is in the process of building an economy free from excessive debt and is setting the example which the Government should follow.

We can equalize total price and income levels by:

1. Inflating prices to equal income, which would only mean paying through the nose by deflation afterward;

2. By borrowing excessive income or savings, which would only be deferring the "evil day" of taxation; or

3. By taxing away excess income or savings now, and thus permanently stabilizing our economy.

Paying as we go is the only true policy.

In terms of goods we always pay as we go. We cannot live or fight a war with anything but the goods which are produced as we consume them for civilian or military purposes.

In terms of a physical, or goods economy, we always balance the Budget. We could and should seek the goal of balancing our national Budget in terms of a finance or money economy. We do not do so at present for these three principal reasons:

First, because the balancing of the Budget would interfere with the normal or "business as usual" working of the present system. The other side of the coin of profit is debt. If all excess profits are taken by the Government in the form of taxes, it would mean that a constant brake would be applied on the making of profits, which would tend to hold them down to lower levels. So profit business is willing to loan rather than to pay taxes.

Second, because of the lack of economic education among the people. Generally speaking, the people have been so long taught the fallacies of a finance economy, that they do not fully recognize the truths of a physical economy. Yet a physical economy is basic and natural.

In earlier times, goods were always exchanged for goods between individuals. When our economy became more complicated by three-way-and-more exchanges, it was necessary to institute monetary measures to facilitate exchanges.

Unfortunately, in time, money instead of goods became the controlling element. We must get back to fundamentals where money will only be a medium of exchange and not a controller of exchange.

The tendency the world over is toward the adoption of the natural basis of exchange of goods for goods, with money only acting as a convenient lubricating medium. The function of finance in wartime, says the London Economist, is to get out of the way of the war effort. So should it also be in peacetime to get out of the way of unlimited production.

Third, because it is easier for a government to borrow than to tax. Doing things the easier way is, however, many times the more dangerous way. The people should be told the truth that, as a whole, all borrowing by the Government is only a deferment of taxation. That, as a whole, bonds are only a temporary substitute for taxation. That, as a whole, the cost of any Government expenditure cannot be passed on to succeeding generations. That, as a whole, whatever bonds are cashed in at some future time can only be paid for by the assessment of an equal amount of taxes. That, as a whole, whatever the Government puts into one pocket of the people, it must take out of the other pocket of the people at the same time.

I raise the question: Are we "fiddling while Rome burns"?

Instead of arguing here over whether the tax bill should be six or eight billion we should be considering the 42 billion it is proposed to borrow and how much of it the people could be educated to pay now in taxes instead of borrowing now and paying later in taxes. Why should we still hestitate to draft money when we accept that we must conscript men and businesses?

Secretary Morgenthau has said:

> 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.

Our appeal to you is: Then why not set as the goal to protect our economy and democracy to the full by all-out taxation? We must pay for all Government expenditures out of our current consumption of goods—why not also pay out of our current income in money?

The people can stand and should be told the whole truth. It is only a lack of faith in the patriotism of the people which causes the whole truth not to be told to them.

I appeal to Congress to have faith in us consumer-citizens. Instinctively the people understand, without scholastic economic education, that they pay as they go for all Government expenditures in terms of goods.

We will accept paying in terms of money, if and when we are faced with the whole truth. The situation ought not to be glossed over with the statement that we owe the money to ourselves and not to other countries, or that a public debt can be permanent.

The fact that what we are doing is deferring the decision as to who is to be taxed ought not to be minimized as not being a vital matter. It should be faced and decided now as to who is to pay, in order to prevent the future dangers of inflation and deflation, in order to distribute over-savings and prevent underconsumption now, and in order to forestall the possibility of an eventual collapse of democratic morale among the people.

Long-range political and economic wisdom always leads to telling the people the whole truth, and then acting legislatively and economically in accordance with it. Such is the primary basis of democratic faith. An informed citizenry is democracy's first line of defense.

Tax away whatever is needed. It goes without saying that the Consumers' Cooperative Movement supports every sound effort toward price and profit control, rationing, credit restriction, and so forth, which will help in any way to prevent the total price of the products we produce from increasing unnecessarily and at the same time will serve to equalize maladjustments.

On the other hand, it is far easier to establish effective control of the total income than of the total price level. Controlling the total income which the people can spend for the civilian goods which are available can be done effectively and equitably by means of taxing whatever amount of income is necessary to pay for Government expenditures out of the pockets of the people.

If the people have left in their pockets no more money than an amount equal to the normal price of the civilian goods that are available, then there will automatically be no inflation of prices. The total income which they can spend and the total price of the goods which they can purchase will balance. Prices of goods will not go up, since there will be no income with which to buy them at more than their normal prices.

Of course, credit will also have to be restricted, and rationing instituted on scarce commodities. Taxing the people adequately is the effective way to prevent future inflation and deflation. Taxing the people equitably, according to their ability to pay, will serve to prevent oversavings and underconsumption immediately. Taxing the people whatever amount is necessary to pay as we go will serve to prevent a break-down of morale and an economic collapse in the future.

We support graduated personal income taxes with minimum exemptions. This is the basic and equitable form of taxation.

The personal income which each of us receive should be the primary, and could be an adequate, method of raising whatever taxes are necessary. It can be readily collected by advance accumulations at each pay period. By establishing minimum exemptions, the Government can in part equalize the injustices of oversaving and underconsumption which the present system produces until a cooperative economy can be built which will automatically result in equitable incomes.

If we are ever to have justice among the people in the future, it is high time to begin right now. Only by putting justice into practice now, insofar as it can be done by the Government, will the people be thoroughly convinced that justice is intended in the end, after they have made the great sacrifices they are being called upon to make.

No would-be dictator can break down the morale of the people if they are told the whole truth by their democratically elected leaders, if they know they are being equitably treated, and if the Nation is following fiscal policies which make the future of the people economically secure.

We support other taxes as temporary alternatives.

The Consumers' Cooperative Movement, while a strong believer in democracy, is not naive enough to believe that the people can be educated overnight out of years of wrong practices and be willing to accept right ones. Although we believe that a graduated personal income tax with minimum consumption exemptions is the basic form of equitable and adequate taxation, we realize that other alternative forms of taxation must be continued until the people become economically educated and a new cooperative economy can be built.

In consequence, we support inheritance and gift taxes in order to assist, in part, in eliminating oversavings in the hands of the few; we support graduated corporation income and excess-profits taxes in order to offset, in part, the evils of profiteering and monopolization; we support excise taxes on so-called luxuries in order to equalize, in part, the distribution of consumption power among the people.

We oppose general Federal sales and pay roll taxes.

Taxing the poor on the basis of their pay checks or on their purchases, at the same rate as the rich, is the height of injustice. There can be no form of taxation more unjust and inequitable than taxation on necessary consumption. No form of verbal phraseology can change a leopard's spots—no more can the calling of a sales tax or pay roll tax by the name of "equality of sacrifice" make it any different in its fundamental and natural inequality. If the people are to become increasing believers in and supporters of political democracy, then the democratic principles of equality and justice must be applied to the economic sphere of their lives as well.

We speak on behalf of the consumers of America, who are becoming increasingly articulate and effectively organized to build a people's program of peace and plenty. Your acting on the basis of the principles enumerated above, we believe, will help to bring this to pass.

We will be back, we expect, in the future at each hearing on a tax bill, and in the meantime, we will be educating the people of America to understand better than they do now what is the basic form of equitable taxation and why we should and could pay as we go instead of building up a tremendous amount of Government borrowing and endangering, as Secretary Morgenthau says, our future and political economic stability.

The CHAIRMAN. Thank you very much, Mr. Bowen.

Mr. Kingsbury. Is Mr. Kingsbury in the room? I intended to call Mr. Kingsbury just after Mr. Robins concluded because he seems to be on the same subject.

STATEMENT OF F. B. KINGSBURY, NEW HAVEN, CONN., REPRESENTING THE AMERICAN TUBE BENDING CO., INC.

Mr. KINGSBURY. I have a statement which I would like to present which represents the thoughts of the president of our company.

Our company is a small corporation that has been engaged since it was formed in 1910 in the manufacture of parts from metal tubing, primarily for the automotive and aeronautical industries. All of our products are made to our customers' designs and specifications. At present, due to the demand for airplanes, we are engaged 100 percent in war work. We also subcontract as much as possible to other companies.

Due to war demand our business has increased over tenfold in the last 3 years. We have financed this increase ourselves and have added to our plant equipment, inventory, and pay roll by the aid of bank loans and a conservative dividend policy.

The tabulation below shows the trend of sales, profits, and debt from January 1, 1938, to July 1, 1942, with the tax computation for this year made in accordance with the tax bill recently passed by the House.

Year	Sales	Net profit before taxes	Percent profit on sales	Net profit after taxes	Debt to noteholders, etc.
			Percent		
1938	$249,119	$27,678	11.1	$22,803	$15,870
1939	275,968	1,573	.6	1,277	28,000
1940	665,929	70,436	10.6	46,809	80,831
1941	1,548,505	58,764	3.8	34,238	290,684
1942 (6 months)	1,286,950	218,689	17.0	39,561	157,833

Senator WALSH. How do you account for the tremendous increase in net profit for 6 months of 1942 compared with the whole year 1941?

Mr. KINGSBURY. Volume.

Senator WALSH. Volume?

Mr. KINGSBURY. Volume, purely and simply.

Senator WALSH. Your sales seem to be less.

The CHAIRMAN. One is a full year and the other is 6 months?

Mr. KINGSBURY. That is 6 months.

The CHAIRMAN. Very nearly double—very nearly doubling your sales.

Mr. KINGSBURY. Yes, sir. We have just received an emergency plant facilities contract from the Navy Department, and some provision will have to be made for meeting the cost of these buildings at a later date, and, in addition, we have contracted for other expansions which we will finance ourselves.

We feel that our pricing policy has been conservative, especially for highly specialized aircraft parts. We also feel that our dividend policy has been conservative, for in the period covered by the tabulation just given, only $27,600 has been paid out in dividends, while $106,602 has been put back into the business. At the present our capital stock and surplus amounts to $224,713, and our sales will exceed $3,000,000 this year. The effective tax rate for us under the House bill will be about 85 percent.

So much for background. What about the future? In the first place we want to go on record that we believe this war should be paid for out of current income just as far as possible. We do not oppose high taxes and are quite willing to pay them. Beyond that, however, there are two definite problems to be met. The most immediate one is how we are going to meet our indebtedness, contracted entirely to meet war demands, and at the same time pay our taxes. The other problem is the one of conversion after the war to peacetime production.

We estimate a profit before taxes for this year of about $460,000, and State and Federal taxes will take about $400,000 of it. How can we meet indebtedness of nearly $300,000 and set aside funds with which to pay our taxes out of the income on which they are assessed? We will have spent more on increased inventory this year than will be left after taxes, and taxes on 1942 income will have to be paid out of 1943 income or borrowings. What will happen the year the war ends? Taxes will have to be paid, but the income will not be there, and we will not have been able to provide the funds. We will be forced into bankruptcy either for taxes, or bank loans, or both. The only possible way out that we can see, is to be allowed a tax credit for all, or at least 80 percent of the money spent in paying off our indebtedness which was entirely due to war needs. We respectfully recommend the inclusion of such a credit in the new tax law.

If a credit such as this is part of the law, then by declaring dividends in conformity with previous policy, or not at all, we might be able to set up a cash reserve for taxes which would be wiped out at once after the war, and we would enter the period afterward with an expended plant capable of taking care of more than the entire peacetime requirements of the country in our particular line, with increased fixed charges of all kinds and a loyal group of employees we wish to keep employed.

The answer is new products and that takes money to develop. The only hitch is that there will be no money to do it with unless we can set up some sort of post-war reserve, for just this purpose. We have seen proposed a scheme to issue certain bonds for part of the taxes paid. We feel if normal and surtax rates are increased over 40 percent and excess profit rates are set at over 80 percent, that nonnegotiable and non-interest-bearing bonds should be issued to taxpayers for all taxes paid at higher rates than those just mentioned.

If these bonds become freely negotiable and interest-bearing after the war, their owners would have an immediate reserve that would enable them to rechannel their activities to peacetime needs, and what is more important still to keep up employment in what will be a very critical period in this country's history. For this reason we respectfully urge that these proposals also be written into the tax law now under consideration.

Thank you.

The CHAIRMAN. Thank you very much.

Any questions?

Senator TAFT. Mr. Kingsbury, I have one thing: Whether it would be possible to combine these two. That is, supposing we gave a post-war bond—whatever you might please to call it—due after the war for 10 percent of the net income or something of the sort, the excess, and then provided that if you needed that to pay your debts the R. F. C. could be directed to buy them immediately, or the Treasury could be directed to cash them immediately, in cases where the money was needed to pay debts. I see a great difficulty in putting any credit for paying off indebtedness. I can't see how that could be worked. It seems to me the moment you pay your taxes you go back and borrow it again, and I don't see how we can effectively work out a credit for payment of debts, but it occurred to me we might take this post-war credit and have the Government cash that in cases where they found it was absolutely necessary to enable you to pay debts or to expand the plant or do some other things.

Mr. KINGSBURY. That might be an idea. Of course, what we are going to need is funds to work with. That is, cash to continue on in business. That is, we are bound to take severe losses.

Senator TAFT. In the long run you would get it one way or the other, but I don't think you could get both, is what I was thinking about.

Mr. KINGSBURY. Well, I haven't any choice. Either one.

The CHAIRMAN. All right.

Mr. Cooper, how much time would you need?

Mr. COOPER. I should say about 20 minutes, Senator George. This really is a little bit longer, but I think I can cut it down as I go along.

The CHAIRMAN. All right. If you are not going to be able to finish in 20 minutes couldn't you condense your remarks?

Mr. COOPER. It really is about 30. I am condensing it to 20.

The CHAIRMAN. Can't you still reduce it?

Mr. COOPER. I will try as I go along.

The CHAIRMAN. I think if you state the points clearly and we get them——

Mr. COOPER. I have only five points.

The CHAIRMAN. You may proceed, but let's condense it as much as possible, sir.

Mr. COOPER. All right, sir.

The CHAIRMAN. We are very anxious not to run over today.

STATEMENT OF WALTER A. M. COOPER, WHITE PLAINS, N. Y., CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS

Mr. COOPER. My name is Walter A. M. Cooper, of White Plains, N. Y. I am appearing as chairman of the committee on Federal taxation of the American Institute of Accountants, the only national organization of certified public accountants. I shall not deal, however, with the personal-tax liabilities of our members.

Our country faces perilous and difficult times, financially as well as physically. We need money, more and more, despite the excellent progress made by Senator Byrd's committee in reducing nonessential expenditures. We hope that progress will continue. Our members are prepared to carry their share of the tax load, but we would like some relief from the work load, including that of holding our taxpayer clients who cry on our shoulders, justifiably, about their unfortunate situations which we shocked them with when we prepared their tax returns. Getting this broad picture from many, large and small, corporate and personal, we feel we can contribute some helpful thoughts.

1. An interrelated incentive saving and debt payment proposal.

Two situations are causing considerable concern, and we, in the accounting profession have all too frequently been confronted with them in our practice.

You have just heard some of it now. High rates of taxation are required in emergencies such as now exist. We believe all patriotic citizens, whether they be corporate officers or individual entrepreneurs, can and will endure them, provided something is done to protect those individuals and corporations who must endeavor to do the impossible by making debt repayments out of income which, under the proposed high rates, will no longer be available for that purpose or, if not faced with the debt repayment problem, should be accumulating reserves for the difficulties certain to be encountered in the post-war readjustment, but are unable to do so for the same reason.

I should like to lay before you a combination plan interrelating both problems which I believe will, without undue revenue loss and probably to the ultimate financial benefit of the Treasury, materially relieve both conditions.

Our plan first envisages the issuance of a new type of Treasury obligation, in the form of an incentive saving bond, which should be non-interest-bearing until after the cessation of hostilities, and nonnegotiable and nonassignable except that certain reservations will have to be made for cases of bankruptcy, death, or other situations where a transfer by law is involved. Such bonds should become negotiable a short time after the cessation of hostilities—say, 6 months after a declaration to that effect by the President or perhaps the declaration of the end of the emergency period which is required for amortization purposes—and at the same time should become interest-bearing at a low rate, say, 1½ percent to 2½ percent. The bonds should become payable in installments, commencing with the making of the proclamation previously referred to, over a period of from 5 to 10 years.

If they then become negotiable and assignable and are not payable over too long a period, the cash will become available either through payment by the Treasury or sale. It should also be provided that a certain minimum amount per person, say, $2,500 annually, be payable on the specified installment dates, this suggestion being made to cover the situation of wage earners to which I shall refer later.

The Internal Revenue Code should then be amended to permit all taxpayers, corporate and individual, to deduct amounts paid or commitments made within the taxable year or up to the ordinary due date of the return, for the purchase of the aforementioned bonds. The amount to be deductible should be limited to a stated maximum amount or a percentage of income, whichever is greater. We suggest, as a matter of discussion, a limitation of $2,500 per annum per person or corporation or 20 percent of the amount of income on which tax would otherwise be payable, whichever is greater.

The purpose of the percentage limitation is to prevent abuse and the purpose of the dollar limitation is to permit wage earners to purchase a larger amount of these bonds.

Behind this suggestion is the fact that many wage earners are today earning from $3,000 to $6,000 per annum whereas they used to earn half or less of their present earnings.

The greatest potential source of inflation lies in that extra income. If that can be siphoned off, one inflationary threat is removed, and if the individual is earning $5,000, the 20-percent limitation will permit the purchase of only $1,000 of bonds. Therefore, individuals in that category should be permitted to purchase a larger amount in order to make the plan effective.

Furthermore, in the post-war readjustment, many of these wage earners are likely to find themselves out of work. The higher wages are being paid in war industries to a very much greater extent than ordinary industries, and the war industries will be the first to suffer. Thus, by providing these wage earners with a back-log of savings bonds, which I previously suggested should be payable in the minimum amount of $2,500 per person per year, after cessation of hostilities, there will be less need for work or other forms of relief during the readjustment period and less demand therefor.

However, any provision permitting the purchase of bonds should also be tied in to any provision that is made for the relief of debt payments so that they do not overlap. With respect to the payment of debts, we urge that all taxpayers be permitted to deduct any reasonable amount used or set aside for the retirement of debts outstanding on the date of enactment of the law, if evidenced by notes, bonds, or other similar evidences of indebtedness, or for the acquisition of plant, equipment, and similar assets, even if not so evidenced.

Deduction should be allowed also for payment of commitments made prior to enactment, maturing into liabilities after enactment. I have in mind here such commitments as involve the acquisition of production facilities under contracts previously made but not resulting in a definite liability until the construction is completed after the enactment date.

This allowance should be subject to certain reductions and limitations. To begin with, we think that the amount of money used or set aside for that purpose, and which would otherwise be deductible, should first be reduced by any amount allowed as a deduction for amortization of war facilities or depletion, as these deductions will make available funds that can be used for debt retirement. I do not include the ordinary depreciation deduction because such deduction will not usually be applicable to war facilities and in connection with ordinary plant assets will normally be offset by expenditures for replacements.

To some extent the same thing might be true with respect to depletion of war facilities if it is necessary to add more war facilities or replace depletable assets.

Finally, there should be an over-all limit on the amount deductible for debt retirement, computed in the manner previously described, which we suggest be 20 percent of net income and that 20-percent limitation should cover not only the reduction for debt retirement, but also the purchase of bonds previously mentioned.

In other words, the taxpayer should not be permitted to deduct 20 which we suggest be 20 percent of net income and that 20-percent for bonds. Taxpayers who require deductions for debt retirement should not have free assets sufficient to purchase savings bonds or, to state it another way, if they have cash to buy the bonds, they should not require the debt-retirement deduction.

Thus the limitation and restriction would work this way:

1. Taxable net income		$1,000,000
2. Debt retirement	$200,000	
Minus amortization and/or depletion	100,000	
3. Balance deductible, but not in excess of 20 percent of item 1		100,000
4. Remainder		900,000
5. Bond purchase or commitment, $100,000, limited to 20 percent of item (1) minus item (3) or		100,000
Taxable net income		$800,000

Senator TAFT. Are you applying that to both individuals and corporations?

Mr. COOPER. Yes, sir.

Senator TAFT. Have you any idea as to how much it will take off the additional taxes we are raising?

Mr. COOPER. I am mentioning here later that I think it will get more cash into the Treasury.

Senator TAFT. It will take $2,300,000,000 off taxes alone on corporations, and it will take more than that off individuals.

Mr. COOPER. Which; the debt retirement?

Senator TAFT. The two together. It will take $2,300,000,000 off corporation tax and I think it will take more than that off individuals. I haven't figured that.

Mr. COOPER. And how much additional funds would the Treasury get? They would certainly get that $6,000,000.

Senator TAFT. Oh, yes; they would get it in the form of borrowing instead of in the form of taxes. I am afraid it is too much to be practicable. I am willing to do something reasonable, but I don't think you could do anything like that.

Mr. COOPER. Let me finish what I have here.

The CHAIRMAN. We will have to hurry along.

Mr. COOPER. There is precedent for such a debt-retirement deduction in the similar allowance to personal holding companies, because of the high tax rate to which they have been subjected for some time. However, this 20-percent limit on debt retirement should permit one exception, and that is with respect to the amounts that are required by contract to be used and set aside for the payment of debts.

In this connection, taxpayers have been under notice since October 8, 1940—enactment of the Second Revenue Act of 1940—that a substantial excess profits tax would be payable and they should not thereafter have entered into back-breaking borrowing arrangements.

Therefore, we suggest that all amounts required to be paid on similar obligations, under contracts existing on October 8, 1940, be deductible without limitation except that such amounts should also be reduced by the allowances for amortization and depletion.

A typical illustration of the type of case that would be covered is that of a company that issued bonds under an indenture, providing that all proceeds from the development of certain oil-bearing properties be paid into a sinking fund for the retirement of the bonds. Assuming this taxpayer receives a depletion deduction of 27½ percent of the income and is required to pay, as will be the case, 90 percent of the balance, its tax will amount to 56¼ percent of the gross income.

It, therefore, faces cash requirements of 156¼ percent of the amount of the income and unless adequate relief is included in the law, it will undoubtedly have to default, which will result in receivership.

Under this suggested provision, it would be entitled to a deduction of 62½ percent of its income and will pay no tax on the balance of 27½ percent, representing depletion.

However, the entire 100 percent must go to the bondholders, anyway. There is precedent for such an allowance in the deductions for or exemptions from the undistributed income tax when debt payment obligations existed.

All these restrictions with respect to the dates when the obligations were incurred or repayment contracts were made, should contain adequate protection to companies that are or have been reorganized and a successor assumes the same obligations subject to the same requirements.

Successors in such instances should be entitled to the same deductions as the predecessors would have received had they continued even though the obligations become such of the successors after the enactment of the law, or October 8, 1940, as the case may be.

In summary, I believe that if such an interrelated plan were adopted these would be the results:

First, the difficulties of debt retirement would be alleviated,

Second, the Treasury would receive, currently, much more cash, though not as much in the form of current revenue,

Third, considerable inflationary pressure would be removed,

Fourth, Government post-war expenditures would certainly be reduced as our people and business would be more self-sustaining,

Fifth, post-war revenue would be greater as there will then be more business activity to pay taxes, than if we so weaken our industrial structure that it cannot survive, and

Sixth, the two last mentioned results may more than offset the current revenue loss, though it won't happen for a couple of years. Meanwhile you will have more money.

We want private enterprise to live and we want our people to be on their own as far as possible, not on a dole. This plan will further both ideas.

2. The income credit should be 100 percent of the average of the best 3 years of the 4 years now recognized as the base period.

The greatest difficulty that we face in the development of a fair revenue law involving the imposition of a tax rate of 90 percent lies in the development of a proper, reasonable, and fair line of demarcation between what may be described as normal profits and excess profits.

No statutory formula can ever accomplish that result and hence the need arises for many relief provisions. However, the closer the statutory formula approaches a determination of normal profits, the better the ultimate results and the less we will need relief or special provisions.

It is proposed to reduce the exemption based on invested capital to as little as 5 percent on some capital and to 6 percent on a coniderable portion of it. The principal difficulty, however, lies in the fact that the statutory invested capital is an historical concept, based on what may have been paid in years and years ago and without regard to assets and capital developed from years of operation but not recognized for tax purposes.

The corporation is a shell existing in law but it really represents the combined capital of its shareholders. The existing shareholders in many, many cases, and almost certainly with respect to the majority of capital employed in corporate form, have an investment usually aggregating more than is recognized in statutory invested capital. Furthermore, the size of the corporation is no criterion of the wealth of its real owners.

Admittedly, it would be difficult to develop a formula that is reasonably administrable, to meet this situation, and the only excuse for not doing so lies in the application of the income formula. Whatever capital may not be recognizable under the statutory formula ought to have been productive of income during what might be called an immediate "pre-war" normal period, and, if it has, it receives its indirect recognition through the income-credit method, provided, however, that method be adequate. We do not believe the present formula is adequate. It will be considerably improved through an intelligent, sympathetic application of the new relief provisions, but those provisions will not cover the normal situation of fluctuating earnings, and the requirement that a fixed average be used when the tax is levied on the income of a single year.

Great Britain permits taxpayers, as I have told you, to use the best of the base period. It also permits a carry-back to prior years, as well as forward to future years, any unused credit. We, however, permit no carry-back and a carry-forward for only 2 years.

Furthermore, in determining the income credit, Great Britain permits the use of the 1 best single year out of a 3 base-year span, and does not require an average of the 3 years or even 2 of them.

In view of the revenue needs, it may be too much to suggest that our statute should be amended to base the credit on the best of the 4 base years, but at the very least, we ought to permit the use of the average of the best three out of the prescribed four and that 100 percent of that average ought to be allowed as the credit.

If we do that, we will eliminate many of our abnormal situations and the loss in revenue will not be as large as any estimates based on cold figures, which do not take into account the effect of not having to apply relief sections to a number of cases. That will also reduce administrative and taxpayer costs.

3. Section 129, relating to fiscal years should be eliminated, which you have heard a great deal about, except that I should like to add two thoughts. One is that we accountants don't relish the idea of having certified to thousands of financial statements which have gone to banks and other credit grantors, and on which purchasers of securities have relied, and all of them are going to be wrong if this provision is adopted. I can also testify to the fact that there are hundreds of companies concerned with that problem.

In fact, I, as chairman of that committee have received letters from over 60 accountants, each citing hardships of from 1 to more than 10 taxpayers.

One proposal in H. R. 7378 seems to us to be most unsound and inequitable. I refer to section 129 which proposes to add a new section to the Internal Revenue Code, requiring that the taxes of fiscal year taxpayers be computed under two laws and that the principal be retroactively applied to taxable years beginning in 1941.

The proposed retroactive application of this principle which was wisely eliminated from the revenue law in 1934, will create great difficulty in a number of cases. Fiscal year taxpayers have not had any intimation that their liabilities were not to be computed wholly under the 1941 Revenue Act, and, accordingly, many, many things that have been done, would not have been done, and cannot now be undone.

For example, some taxpayers who borrowed from the Reconstruction Finance Corporation on a contract requiring that a certain percentage of the net income be paid annually in retirement of the debt, have already made such payments.

If this provision is enacted into law, they will find that they have paid the Government too much but will have to pay the Government again in taxes.

Others have similar problems with respect to sinking-fund provisions under bond and preferred stock issues, and having already retired the securities in amounts based on earnings after taxes computed under the existing law, will find that they have paid out too much.

The same is applicable to many compensation plans involving the setting aside of a certain percentage of net income.

In other cases, dividends have been paid on the basis of what was throught to be a definitely known tax liability, and if that liability is unexpectedly increased, under a retroactive law, some companies will not have funds available to pay the added tax.

In at least one case that has come to my attention, the taxpayer corporation has liquidated, retaining sufficient funds to pay its present tax liability but if the law is amended, it will not have retained enough to pay all its debts, including taxes, and liquidating expenses.

Furthermore, many taxpayers have budgeted their expenditure requirements, plant extensions, and so forth, on the basis of what was thought to be a known liability, and will be seriously handicapped by this retroactive change.

I know you have heard a number of taxpayers present their own specific problems involving one or more of the points I have made.

I can testify to the fact that there are hundreds of companies in a similar position and have personally received communications from over 60 accountants, each citing the hardships of from one to more than 10 taxpayers. I have told them to write you and I am sure you will hear from many of them.

Furthermore, I should like to add that if there is any justice in the scheme it ought to be applied to fiscal year partnership whose members report on a calendar-year basis wherein it will have the opposite effect. If a partnership fiscal year began in 1941 and ended in 1942—there are many such cases—and the partners report on a calendar-year basis—most do—all the income is now taxable at 1942 rates even though partly earned in 1941. If it is right to retroactively change the law to tax the corporate fiscal-year income partly at 1941 rates and partly at 1942 rates, and you should decide to do that, justice requires that partnership income be similarly treated. That will materially reduce the revenue to be gained by the retroactive application of the idea. That is why I call it to your attention.

It has been suggested that during periods of increasing rates, fiscal year taxpayers have benefited from the lag in the application of higher rates, but it is equally true that when the rates recede, they will pay more tax because of the lag.

We do not believe that taxpayers have adopted fiscal years for tax reasons. The accounting profession has had much to say on the subject of the adoption of the natural business year and has been supported in its efforts by the Securities and Exchange Commission and business organizations generally. The elimination of this proposal from H. R. 7378, in its retroactive aspect will, no doubt, result in somewhat lesser revenue, during the taxable year, than the bill contemplates.

On the other hand, we believe that in the long run the revenue will gain appreciably if the existing law is left unchanged. We urge, therefore, that your committee eliminate section 129.

4. Extension of time for filing corporate tax returns. The accounting profession is urging that all corporate taxpayers be granted the privilege, under statutory amendment, of taking an automatic extension of 3 months for the filing of income- and excess-profits-tax returns.

While the statute now permits the Commissioner of Internal Revenue to grant extensions up to 6 months, and only a few years ago extensions were readily granted, in the past 2 years, particularly in 1942, it has been virtually impossible to obtain adequate extensions. Even to obtain the little extra time that has been granted has required considerable effort. Time that should have been devoted to the prosecution of the war effort has been devoted to getting time to prepare tax returns.

As an illustration, only last week an extension was denied to a taxpayer having 36 different offices in the United States and Canada, all operating independently and keeping their own accounts, but having much interoffice business which must be cleared when the accounts are closed at the year end, after which the results of all offices must be consolidated.

Many such situations can be cited. As a matter of fact, until the latter part of February 1942, and for some months prior thereto, the authority to grant extensions had been taken away from the collectors and centralized at Washington.

The authority was later returned to the collectors, but many of them, in view of previous Bureau policy, either refused to grant extensions, declined to do so unless the taxpayer made a personal visit, or so restricted the time granted or the circumstances under which extensions were granted that the authority now contained in the law was not really available to taxpayers.

This was particularly unfortunate in the light of the considerably increased demand on all accountants, whether in public or private practice, for statistics covering all types of data requested by various governmental authorities, the complications of the new tax laws, special accounting required for war production and costs thereof, and the great shortage of trained personnel.

This shortage has been recognized as being so severe that the Selective Service authorities have indicated that important accounting personnel should be granted deferment.

The difficulty will be further accentuated by the renegotiation of war contracts, which will require considerable study of accounting data, to say nothing of the preparation of that data. Hasty and not fully considered action can be particularly serious when so many binding tax elections are involved. Elections cannot safely be made without adequate data.

We see no relief available unless the statute is so amended as to either change to a much later time the filing date for all tax returns or permit business taxpayers, most of whom are corporate taxpayers, to take an automatic extension. We urge the latter, at least.

5. Personal exemptions should be eliminated. Information released with respect to the effect of H. R. 7378 indicates that it will fall short of realizing the required revenue by about $2,000,000,000. If that is not exactly correct, it is clear that the revenue will fall far short of what is necessary. In addition to that shortage, the proposed amendments will fail to tax, except to a very minor extent through excise taxes, a substantial portion of the national income which is likely to contribute materially to our inflation difficulties.

I understand from some statistics that have been developed, and these can be readily checked by the Treasury Department which has more data available to it, that the total personal funds of salaries, wages, interest, and dividends approximated, last year, $80,000,000,000, but that only $40,000,000,000 of that entered into tax returns, and not all of that produced revenue.

If we leave half, or anything like half, of what might be called personal income free of any tax, we fail to attack one of our principal difficulties—inflation—at its source, and lose much revenue in the process.

To gain the necessary revenue, either a sales tax or the elimination of all personal exemptions, for the purpose of income tax, and the withholding of that tax at the source is necessary. We urge that all exemptions be eliminated from the Internal Revenue Code in the determination of the income subject to income tax and thus directly impose some small measure of responsibility on every person in the United States.

Let those who claim that that will be a hardship or tend to reduce the standard of living of persons in the lower income brackets give some thought to the status of those in enemy-occupied territories, who, I am sure, wish now that they had paid a substantial tax to help avoid the conditions they now endure.

Reducing the exemption will increase the tax all along the line, including the tax of the wealthy—not necessarily percentagewise—but, more important, it will tap an available source that now suffers no direct tax burden.

The sales tax would, of course, accomplish a similar result, but the difficulties and complications entailed in the imposition of such a tax, and the collection of all of it, are far greater than the imposition of the direct income tax on every dollar of income without exemption, withheld at the source wherever possible.

As a matter of fact, with respect to payments of wages, interest, and dividends, it will be simpler for the Treasury to administer and for the payers to withhold, if no exemptions are deducted.

None of us is going to get through this war without giving up something, whether it be working more for the same real income or getting less for the same effort.

I have urged this proposition before, and I urge it again—no one can escape the responsibility of this conflict whether it be the men and women in the armed services or those who have to carry on at home. None should escape it.

Technical recommendations.—When hearings were held by the Ways and Means Committee of the House of Representatives our committee submitted a lengthy report suggesting numerous technical amendments. I shall not repeat them now. Many are included in H. R. 7378, but some still deserve your careful consideration and ought to be included in the bill now pending.

Copies of our committee's report were sent to each member of your committee, and I am filing, for the purpose of the record, an appendix to this statement directing attention to the particular items discussed fully in our previous report but not adopted.

We have also studied carefully the technicalities of the proposed amendments, and in a few days I shall submit for the record a supplemental report covering them.

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

APPENDIX

Attention is directed to the following technical suggestions in report of the committee on Federal taxation of the American Institute of Accountants dated April 13, 1942:

Regarding	*Recommendation No.*
Estate tax:	
Basis of property taxed	9
Credit for gift taxes	
Excessive depreciation in loss years	11
Basis of property acquired in transaction that was subject to section 24 (b), Internal Revenue Code	13
Effect of redemption of taxable stock dividends	14
Weekly closings of fiscal year accounts	15
War and inventory reserves	17
Two percent added tax on consolidated returns	20
Personal holding companies—several suggestions	22
Elimination of disclaimer, section 712 (c), Internal Revenue Code	24
Adjusting base period income for later year abnormal income applicable thereto	26

Regarding	*Recommendation No.*
Borrowed capital changes under income credit	28
Capital reductions under income credit method and adjustment for reduction of inadmissibles	31
Adjustment for predecessor's earnings under "Sansome" rule—clarification	33
Distributions in prior year—clarification	35
Reorganization of deficit companies	36
Consolidation of earnings and profits adjustments under section 718	38
New-capital provisions—corrections	39
Computation of current year abnormal income	40
Limitations on tax reduction under section 722	41
Section 734	42

Mr. COOPER. Thank you, sir.

(The following statement was submitted by Mr. Cooper on behalf of the American Institute of Accountants:)

AMERICAN INSTITUTE OF ACOONTANTS,
New York, N. Y., August 26, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

SIR: When the chairman of the committee on Federal taxation of the American Institute of Accountants testified at the hearings of your committee (Tuesday, August 11, 1942), it was arranged that certain technical recommendations dealing with H. R. 7378 would be submitted later. Our committee is now pleased to submit them herein.

COLLECTION OF TAX AT SOURCE—SUPPLEMENT U

Because of their work for clients, public accountants are necessarily familiar with various accounting records and methods and the office equipment used to record payments of dividends, bond interest, and wages. Our suggestions with respect to supplement U deal with the practical problems of carrying out the provisions of the proposed plan for collection of tax at source and for this purpose assume that the plan, generally laid down in H. R. 7378, will be retained.

We are in favor of the principle of the collection of tax at source, but any such plan will increase the burden on industry and on the Treasury Department and Bureau of Internal Revenue. It is therefore essential that such a radical change in income-tax practice be developed in a way that is as simple and practical as possible. It has been estimated that the present proposal will increase the cost of pay-roll departments by from 10 to 20 percent (more if it prevents using present mechanical equipment). Hence, anything that can be done to save any part of that labor effort leaves that much more effort for the prosecution of the war.

As a step in attaining that very desirable goal we offer seven suggestions which we summarize briefly as follows:

(1) Section 425 should be amended to exempt employers of less than eight from withholding.

(2) Section 426 (b) should be modified to provide a series of tables providing for income blocks on which specified amounts should be withheld.

(3) Section 427 (b) should be modified to base withholding on the status (as to exemption and dependents) at the beginning of the year.

(4) Section 430 should be amended to eliminate the requirement that a statement of tax withheld be furnished with final wage payments.

(5) Section 426 (a) should be modified to eliminate withholding on payments the partnerships or fiduciaries.

(6) Section 426 should be modified to exempt payments of interest and dividends of less than $50.

(7) Section 430 (b) should be modified to eliminate the requirement that a special statement of tax withheld be furnished with every interest or dividend payment.

(1) Employers of less than eight

Section 425 (h), defining "employer" and such other sections as are pertinent, should be amended to eliminate the requirement for withholding in the cases of employers of less than eight employees.

Based on information obtained from the Treasury Department, we understand that there are approximately 360,000 employers who have 8 or more employees and that there are something like 3,000,000 employers in all. If these numbers are substantially correct it means that the inclusion under the withholding plan of employers of less than 8 employees will require quarterly returns from an additional 2,640,000 employers, and yet it is estimated that these additional employers will account for not more than 15 or 20 percent of the total employees in the country or of the wages paid. Stated in another way, the 360,000 employers with 8 or more employees account for 80 to 85 percent of the total number of employees and of the total wages.

Therefore, the purposes of withholding income tax at the source would appear to be substantially secured if employers of less than eight employees were omitted from the requirement to withhold. We doubt whether the additional coverage will justify the extra millions of returns and the extra labor and expense placed upon the Bureau and small taxpayers. During these wartimes it would appear more important than ever to balance theoretical perfection against large additional requirements of the Bureau for employees, for space, for equipment, for printing, and other necessary expenses. We further suggest that any new plan will, especially in its first year, raise numerous administrative difficulties and, even if at a later date it is decided to include in the withholding plan employers of less than eight employees, that such should be omitted at this time during what might be called a test or trial period

(2) Special withholding tables on a block, rather than rate, basis

Section 426 (b) sets forth a tabulation of the amounts which shall be allowed as a deduction against wages paid for each pay-roll period and specified rates must be withheld on any payment in excess of such amounts. In place thereof we suggest that there be substituted tables such as the attached samples marked "Table 1" and "Table 2."

The method now provided in H. R. 7378 requires a calculation, for each employee, of the percentage (5 percent in 1943 and 10 percent in 1944) of the wages in excess of the minimum amounts stated in the table in order to determine the tax to be withheld. Accounting machinery as used in many payroll departments is not equipped to provide for the necessary multiplication and subtraction computations which would be required. It is suggested, therefore, that tables be included in the bill which will set forth the amount of tax to be withheld, based on the wages per week, etc., falling within each of several income blocks and for the different graduations of personal exemptions and dependents similar in principle to the simplified tax form and table for incomes up to $3,000, as illustrated by tables 1 and 2 heretofore referred to. These tables conform approximately to the present provisions in the act that the amount to be deducted or withheld in 1943 should be 5 percent after deducting exemptions plus an amount equivalent to 10 percent of the exemptions (being approximate amount of deductions usually claimed by taxpayers of this income group) based on the mean of the income block. The use of such tables would greatly simplify the withholding by employers as it will eliminate the need for exact computations, to the penny, in every case. Pay-roll clerks will soon memorize these tables, and will be able to reduce by 75 percent at least the time needed to determine the tax to be withheld.

Inasmuch as the withholding is not intended to represent the exact tax liability of the employee the amount which will be withheld on such a block basis will be close enough for practical purposes. The suggested spread in the income blocks ranges from $1 in the lower brackets to $5 in the higher brackets and the tax to be withheld is computed in even nickels. However, the spread between blocks may be such as the administrative officials may deem most suitable. The higher the income the wider can be the spread. The wider the spread between income blocks and the tax amounts (even dimes is better than even nickels, etc.), the better and simpler it will be for all concerned.

Separate tables can be provided for various numbers of dependents up to whatever number seems workable and necessary. The tables can be carried up to incomes equaling $10,000 per annum, with wider spreads between blocks as the income rises. These are details that administrative officials are in a better position to develop than are we. The principle is the important suggestion we urge upon you.

(3) Determination of exemption status

Section 427 (b) should be amended so that the personal exemption and credit for dependents will be based upon the status of the recipient at the beginning of the year (or of employment if after January 1).

The present proposal requiring a change in status to take effect on the first day of each pay-roll period places an undue, if not impossible, burden on the pay-roll department of any business with a large number of employees. We understand that, following the close of each year, an income-tax return will be required from most, if not all, employees, that there will be a difference between the tax for the full year as shown by such return and the tax withheld during the year, and that suitable provision is to be made for refunds and for specially prompt refunds of less than $50. Under the circumstances, we do not believe that the difference in amount withheld from any individual employee because of a change during a year in personal exemption or credit for dependents will justify the extra calculations required. To make it necessary to check back on exemptions at each pay-roll period will impose a heavy burden not justified by the results it will produce.

Similarly, section 431 should be amended so that a reasonable time will be given to the employer for preparing the necessary records and making the necessary calculations in the pay-roll department. We suggest that the status for the year be based upon the situation at the time the certificate is filed by the employee with the employer, which filing to be effective should be at least 7 days prior to the beginning of the year. In the case of employees hired during the year the certificate, to be effective to cover withholding by the employer, should be filed with the employer at least 7 days prior to the day when the first pay is to be received. The purpose of these suggestions is to give reasonable opportunity for the necessary clerical work in the pay-roll department for the protection of the employer, although each employer would have the option of making up the pay roll with a shorter period of advance notice as to status.

(4) Statements of tax withheld when employment is terminated

Section 430 (b) should be amended so that, within 30 days, or some other reasonable period, after the termination of employment a written statement shall be delivered to the employee or mailed by the employer to the employee at his last known address. In making this suggestion we realize that some employees, shifting from job to job, may not be reached by the forwarding of mail, but we believe that the failure of some employees to receive the statement during the year (they can always obtain duplicates by requesting them from the employer) is of less practical importance than the work involved in a requirement that all employers must complete a statement for the amount withheld up to the time the employment is terminated, and have such statement ready for delivery to the employee with his final pay. This requirement may in some cases extend unreasonably the time the employee is required to wait for such pay.

(5) Withholding from partnerships and fiduciaries

We question whether the proposed withholding of tax at source from payments to fiduciaries, as covered by section 173, and partnerships, by section 173 (g) and section 191, are of sufficient importance to justify the additional burden placed upon those making payments of interest and dividends and to the fiduciaries and partnerships themselves. Partnerships and fiduciaries are now required to file information returns showing the distribution to individual taxpayers, who in turn include such distributions in their personal returns. If partnerships and fiduciaries were omitted from withholding, as provided in the case of domestic corporations, there would be no loss of income but additional work would be saved those filing returns and the Bureau in handling such returns.

Hence, we suggest that section 426 (a) be amended to effectuate the above suggestion.

(6) Withholding from small payments of dividends and interest

Dividends and bond interest in many instances involve the payment of relatively small sums. To withhold tax on all such payments will involve the handling of many small items (in many instances less than $1) on the records of the withholding agent and the Bureau of Internal Revenue. The detail work would be reduced if no withholding were required except when the payment to the recipient of bond interest or dividends is $50 or more.

(7) Statements with payments of bond interest and dividends

Section 430 (b) provides for a statement to the person to whom dividends and bond interest are paid showing the amount of tax withheld. It should be made clear that this requirement can be satisfied by showing the proper deduction on the dividend check or interest check or by ownership certificates necessarily filed for bond coupons. To require the issuance of a special statement with each such payment will involve a heavy clerical task that will not be justified by the benefits to be obtained thereby. This will be particularly true if it be provided, and we suggest it be provided, that withholding on dividend and interest payments be on the gross amount without exemptions or deductions. There are not many people receiving investment income of this type who will have no tax to pay and most of these will probably receive their income without deduction if payments under $50 are exempted.

Summary

If these suggestions are adopted, the cost to, and burden on, business and the Treasury Department will be materially reduced without appreciably reducing the effectiveness of the withholding plan.

TAXATION OF INCOME OF DECEDENTS—SECTION 120

Section 120 of H. R. 7378 will grant relief and reduce the aggregate tax liability in some cases, but in the case of the larger estates it will increase the tax rather than decrease it, and in some estates will result in levying tax in excess of 100 percent of amount involved. This results from the specific provision which defines the deduction allowable for estate tax in the tax returns of the recipients of the accrued income and provides that (1) it be a portion of the total estate tax on an average basis, and (2) the credit for States taxes be first deducted so that in effect there is allowed as a deduction only 20 percent of the taxes actually paid on the income. The fact is, however, that the addition of the accrued income to the estate increases the tax in the highest bracket and by the full amount thereof as the credit is allowed for State taxes only if actually paid. Under the present law, whatever income tax may be chargeable against the deceased serves to reduce the estate tax in the highest bracket, and thus, under no circumstances, does the combined income and estate tax equal 100 percent of the total amount involved.

As an illustration of the effect of the proposed amendment, assume the case of a deceased having an estate of $5,000,000, including $100,000 of accrued income. Adding that to the taxable estate will increase the tax by 63 percent thereof, or $63,000. The recipients of the income ought to deduce that $63,000 in determining the amount subject to income tax.

However, the statute, as proposed in H. R. 7378, will permit a deduction of only the average tax (less credit for State taxes), which will be about $41,000, so that the recipients will be taxable on a net amount of $59,000. The tax payable by the recipient will depend on the total income, including the income derived through the estate, but it is to be noted that on incomes over $26,000 a rate of 61 percent begins to apply. It will be quite easy, therefore, for a tax of 61 percent or more to be levied on the $59,000 net income of the deceased, and even at the 60 percent rate it will amount to $36,000, making an aggregate estate and income tax of $99,000 on accrued income of $100.000. The total tax may easily exceed 100 percent of the amount involved and, in many cases, will considerably increase the tax over what is payable under the present law.

We urge, therefore, that this situation be taken care of by providing that the credit or deduction for the estate tax be determined by ascertaining the difference between what the estate tax would have been without the accrued income and what it was after including the income, and the credit for taxes paid to States be not considered in determining such amounts.

RE SECTION 218 OF REVENUE ACT OF 1942 ADDING SECTION 761 TO INTERNAL REVENUE CODE

A careful study of proposed section 761 indicates that it will not accomplish the purposes set forth in the report of the House Ways and Means Committee. We agree wholly with the principal proposed—namely, to approach as closely as possible the normal accounting procedure in connection with consolidations, as generally outlined in Consolidated Returns Regulations 110, so as to obtain the same net results whether subsidiaries remain in existence and are included in the consolidated return or were previously liquidated. However, it seems quite clear that if the language of the proposed amendment is followed, such result will not obtain for several reasons.

In the first place, section 761 (b) (1) provides that under certain circumstances the result should be to reflect in the invested capital of the transferee or parent company the equity invested capital, etc., of the transferor. However, it is stated that such result should obtain when the stock of the subsidiary was acquired by the parent by the issuance of its stock in transactions in which gain or loss in whole or in part was not recognized. However, the report of the committee indicates that such situation will generally occur where the stock of the subsidiary has been acquired with a substituted basis. The language of the committee report follows generally the consolidated returns regulations, the particular situation being covered by section 33.34 (b) (2) (IV) F. However, there may be many cases in which stock is acquired without recognition of gain or loss but which would still permit the parent company to include, in invested capital, its cost for the stock of the subsidiary. The obvious illustration is the case of a corporation acquiring all the shares of another corporation in exchange for its own stock where the stockholders of the subsidiary acquired less than a controlling interest in the parent corporation. Under section 718, the parent corporation, without liquidating the subsidiary, could include in its invested capital an amount equal to its cost for the stock of the subsidiary which would be the value of the shares issued. Though no gain or loss was recognized to the former shareholders of the subsidiary, no substitute basis in the hands of the parent corporation is involved. Under such circumstances, the consolidated returns regulations would require a consolidation of the two companies (if liquidation has not occurred) on the basis of including in the parent's invested capitol the amount ordinarily includible under section 718 and add to or deduct from the parent's accumulated earnings the accumulated earnings or deficit, as the case may be, of the subsidiary, accumulated after its acquisition.

While the report intimates that the rule of section 761 (b) (1) applies generally in cases involving a substituted basis and further intimates that the substantial equivalent of the consolidated returns regulations is included, it seems doubtful that the Commissioner of Internal Revenue has authority to issue a regulation that will accomplish the exact opposite of what the law specifically requires. This, of course, can be partly corrected, at least to relieve the situation previously described, by changing section 761 to apply only with respect to stock of the transferor (liquidator) which was acquired with a substituted basis, but even that will not go far enough. There are circumstances in which a substituted basis is involved, insofar as it relates to the owner of the stock at the date of liquidation under which section 761 will not result in a true consolidated picture even if amended as just suggested. An example is the case of a corporation that originally acquired all the shares of another corporation for cash or the equivalent but subsequently transferred that stock to another affiliate and, either because the transfer occurred in a consolidated return period or because the transfer to the affiliate in itself constituted a nontaxable reorganization, the holder of the stock at the time of liquidation would have had a substituted basis or would have acquired the shares in a transaction in which gain gain or loss was recognized. In all cases there would not have been involved the issuance of stock of the transferee but that has happened in many cases in which a parent of an affiliated group organized another corporation and transferred to it certain properties including stock of another affiliate, previously acquired for cash in exchange for stock of the new corporation.

Both of the difficulties previously mentioned can be substantially overcome only by including in the statute wording similar to that contained in subsections F and G of sections 33 34 (b) (2) (IV) of the consolidated returns regulations, including particularly the parenthetical clause. Even that clause will probably not cover every particular situation, including all very unusual situations, but it will lay down a sufficiently broad policy that will probably permit the issuance of regulations or rulings that will accomplish substantial justice. It seems doubtful that, despite the statement of policy set forth in the report of the House Ways and Means Committee, the restricted and specific wording of section 761 will accomplish the result ultimately desired. It is suggested, therefore, that the wording be changed to that contained in the aforementioned two subsections of the consolidated returns regulations.

A third feature that seems to require clarification relates to the method by which the invested capital of the subsidiary is to be reflected in the invested capital of the taxpayer. Section 761 (b) (1) states that there shall be included in invested capital of the taxpayer "the amount determined to be necessary to reflect the equity invested capital and the deficit in earnings and profits, if any, of the transferor with respect to such stock."

The above paragraph would seem to require that if there should be a deficit of the transferor, it must be reflected in the equity invested capital of the taxpayer which means that the latter's invested capital must be reduced. However, if the taxpayer itself has a deficit, there should be no reduction on account of the deficit of the subsidiary. To the extent that both corporations have earnings no problem arises. If the parent corporation has accumulated earnings in excess of the subsidiary's deficit, the deduction will be correct. Under the consolidated returns regulations, the subsidiary's deficit will not be deducted if the consolidated surplus otherwise is a deficit. It should not be required by section 761. While regulations might be issued to produce the correct result, here also it is doubtful that the regulations will be valid. In this connection, we suggest that the language of section 761 (b) (1) be modified to read, insofar as the last phase beginning "there shall be included", is concerned, as follows: "there shall be included, in lieu of the amounts determined to be otherwise includible in the equity invested capital of the taxpayer with respect to such stock, the amount determined to be necessary to reflect the equity invested capital of the transferor, with respect to such stock and in the event the transferor has an accumulated deficit in earnings and profits, the amount of such deficit shall be deducted from the accumulated earnings and profits of the taxpayer but not in an amount in excess of such accumulated earnings and profits."

A fourth feature which arises with respect to this proposed new section relates to transactions which occurred during the period when the provisions of section 718 (a) (5) and 718 (b) (4) were part of the revenue act. Transactions which may have been consummated before the enactment of the excess-profits-tax law containing the aforementioned provisions were not consummated in the light of the excess-profits-tax law. However, those that have been consummated since the law was first enacted have necessarily had to deal with and recognize the effect of the law. There have been cases in which subsidiaries were liquidated because under the terms of the law, then existing, the liquidation would not adversely affect invested capital. In cases where it would adversely affect invested capital, the transactions could not be consummated. A typical situation involves the case of a corporation (which we here call corporation A) owning all the shares of another corporation (which we here call corporation B), the latter having paid in and accumulated capital at the date of A's acquisition thereof in excess of the tax basis of its shares in the hands of the corporation that owned it. If the two corporations continue their separate existence, corporation A as a holding company only would not be concerned with excess-profits taxes or invested capital and corporation B would be entitled to its own invested capital. However, if corporation B were liquidated into corporation A, the latter succeeded to invested capital equal to that of corporation B. If such were the circumstances, corporation B could be liquidated. On the other hand, if the result would have been to reduce the aggregate invested capital, such a subsidiary was not liquidated.

Relying on the provisions of section 718, some such corporations were liquidated, without changing invested capital. The application of the proposed section 761, however, will result in reducing such invested capital. It is believed that taxpayers who relied on the existence of section 718, as it now stands, with respect to these liquidations, and accordingly liquidated subsidiaries, should not now be penalized by being required to reduce their invested capital. To meet this situation, therefore, we suggest that the amendment to eliminate sections 718 (a) (5) and 718 (b) (4) and to apply the provisions of section 761 should not be applicable to transactions consummated between the date of enactment of the first excess-profits-tax law (October 8, 1940) and the date of enactment of the pending law. If desired, the right to continue under the present provisions could be made elective, but this seems hardly worth while as taxpayers who found, under the existing law, that the liqudation of the subsidiary would reduce invested capital, did not liquidate their subsidiaries.

REGARDING BAD DEBTS

When deductible—Section 23 (k)

Section 119 of H. R. 7378 proposes to modify the requirements for the deduction of bad debts in two respects. One is to eliminate the write-off requirement, in which proposal we fully concur. The other change is to require that they be deducted in the year they become worthless rather than in the year ascertained worthless as provided by the existing law. We believe that this change is not desirable.

Most of the bad-debt deductions are sustained by business corporations. In the general operation of business, thousands of noncollectible accounts are charged off. In a great many such cases, it will be virtually impossible to prove the particular year in which the debts became worthless, particularly as to small accounts. As a matter of fact, many of them, particularly when individuals are the debtors, are worthless at the time the debt is created, but unfortunately the creditor does not learn that until sometime later.

In many other cases, where it might be possible, ultimately, after a great deal of work, to establish the year in which a particular debt became worthless, it will, nevertheless, be the cause of much dispute between the Treasury Department and taxpayers.

There is no advantage in making this change, nor is there any point in putting the bad-debt deduction on the same basis as worthless stock, because in the final analysis, bad debts are primarily the deductions of business corporations, while worthless stocks are primarily the deductions of individuals.

We suggest, therefore, that the present statute permitting the deduction in the year ascertained worthless be retained, but that the requirement regarding write-off be eliminated, as proposed in H. R. 7378.

Statute of limitations—Section 322

Section 150 of H. R. 7378 proposes to amend the statute of limitations with respect to worthless securities and bad debts to extend the same to a 7-year period. This is a very desirable change.

It is noted, however, that the application of this amendment is to be limited to taxable years beginning on or after December 31, 1938. We believe that this limitation is unsound and should be removed. The amendment should be made retroactive to all open cases.

To begin with, it may very well be that for the years 1941, 1942, 1943, or even 1944, there will be disallowances of either debts or securities alleged to have become worthless in prior years, including years prior to December 31, 1938. There is no reason why future disallowances should be outside the pale of the proposed amendment.

In the second place, there were many uncertainties in the years prior to 1938. In fact, there was more uncertaintly about the particular year in which securities or debts became worthless during that period than there is likely to occur in many future years. Taxpayers who have been whipsawed by actions on this most difficult problem should not be denied appropriate and proper relief merely because the alleged worthlessness occurred prior to December 31, 1938. Furthermore, this limitation will not completely relieve the situation because if disallowances should occur now, the proposed amendment merely extends the existing statutes by one year and possibly not even that in some cases. There will still be much dispute on the question of whether or not a particular debt or security became worthless before or after December 31, 1938.

We urge, therefore, that this limitation on the application of proposed section 322 (d) (5) be eliminated.

Taxpayers on the reserve basis

There is no provision proposed to make the changes with respect to bad debts, particularly the extension of the statute of limitations, applicable to taxpayers on the reserve basis. If our experience with the interpretations of the Bureau of Internal Revenue, with respect to section 711 (a) (2) (H), is any criterion, it will not be applicable to taxpayers on the reserve basis, although the net effect, whether the reserve or charge-off method be used, is always the same.

To develop this point it is first necessary to explain the operation of the reserve for bad debts. In determining what is a reasonable amount, the normal method is to estimate the probable future loss in the accounts receivable uncollected at the end of the year and add to the existing reserve for bad debts such amount as is necessary to increase the reserve to the required total. Such an ultimate check on the adequacy or inadequacy of the reserve is provided for in the applicable regulations. It is also required that any recovery be credited against the reserve, making it perfectly clear that any recovery of a bad debt serves to increase the balance before ascertaining the amount of the addition which may be deducted from income, and, in turn, serves to reduce the deduction allowable for the bad-debt reserve. The net effect, therefore, whether the bad-debt recovery be credited to the reserve or credited directly to gross income, is exactly the same, as will be observed from the following illustrative tabulation:

Balance of reserve at beginning of year	$50,000
Less: Charged off during year	30,000
Balance	20,000
Plus: Recoveries during year	5,000
Total	25,000
Reserve required at year end	45,000
Allowance for addition to reserve	20,000

If the recovery above had not been made or if it had been credited directly to taxable gross income, the allowable deduction would have been $25,000. The recovery has, therefore, effectively served to increase taxable income.

In applying section 711 (a) (2) (H), the Bureau of Internal Revenue has taken the position, by regulation, that taxpayers on the reserve basis are not entitled to any adjustment with respect to bad-debt recovery after January 1, 1940, which were written off prior to January 1, 1940, despite the fact that the recovery served to increase the net taxable income for the years after January 1, 1940.

If recoveries of bad debts, which affected the deduction for the reserve in a loss year, thus serving to increase the deduction without tax benefit, are to be similarly treated under this proposed amendment, the taxpayers using the reserve basis suffer discrimination.

The only difference between the application of the reserve method and the write-off method is in the effect it has on the year of the deduction. In the aggregate the total deductions must always be the same. There is no reason why a taxpayer using the reserve method should not obtain the benefit of the extended statute of limitations with respect to such items. Similarly, there is no reason why such taxpayer should not have the benefit of the provisions of section 711 (a) (2) (H). We, therefore, urge that the aforementioned section relating to excess-profits tax and the proposed provision relating to the statute of limitations be modified to make taxpayers, using the reserve method of treating bad debts, entitled to the benefits thereof.

DEDUCTIONS FOR TAXES

Some rather peculiar and anomalous situations are developing as a result of a strict application of the ordinary provisions of the Internal Revenue Code relating to the deduction for taxes. Some of these apply to taxpayers reporting on the accrual basis and some apply to taxpayers reporting on the cash receipt and disbursement basis. Three types of taxes create these situations, to wit: (1) Capital-stock taxes; (2) State income and franchise taxes; (3) Federal income and excess-profits taxes.

Capital-stock taxes

Rulings of the Treasury Department, fully supported by court decisions, now hold and maintain that capital-stock taxes being payable for the year beginning July 1 and ending the following June 30 accrue and become deductible as of July 1 or the later date when the corporation began business and first became subject to the tax if it did not begin business on or before July 1.

It is proposed to amend the law to permit an annual redeclaration of value for the purpose of capital-stock tax, which redeclaration will not be made until at least 14 months after the liability technically accrued and became deductible under established procedure. No calendar year corporation and many fiscal-year corporations can possibly file their returns correctly when they are required to deduct a tax liability, the amount of which will not be determined until they declare a value some months after the return is due to be filed. When it is realized that the amount which will be declared will be predicated on the estimate of the succeeding calendar year's taxable income, the propriety of permitting the deduction to fall in the year in which was earned the income for which the value was declared, becomes apparent. Of course, taxpayers who report on the cash basis do not face that problem. Therefore, we suggest that this situation be corrected or at least relieved by permitting taxpayers to deduct the capital-stock tax as of the date when accrued, as under the present procedure, or when paid according to whatever the taxpayer elects, such election to be binding as for future years' procedure. The amendment, of course, should obtain appropriate safeguards to prevent a double deduction and to assure a complete deduction for all such taxes.

State income and franchise tax

These tax deductions may cause trouble whether the taxpayer reports on the accrual basis or on the cash basis.

To consider the cash-basis taxpayer first, many of them are earning and receiving, before tax deductions, substantially increased incomes. They are permitted to use the cash basis for reporting only when that method clearly reflects income, and most items entering into the determination of income ordinarily overlap from year to year so that the use of the cash method does not materially distort the annual results. That is not so, however, with a State income-tax deduction, which is based on such income. If a taxpayer reports on a cash basis and his income increases materially for the year 1942, the tax payable thereon to the State will not become due until the following year, and will be paid in the following year. Following the cash-accounting method, that tax would not be deductible in determining the amount owing to the Federal Government on the enlarged income which is the basis for the State tax. It will be all right if the same taxpayer happens to have a large income for 1943 but then the same problem will arise with respect to 1944. Inasmuch as such State taxes are predicated on the income of the previous year and fluctuations in income will seriously distort the ultimate result if the State-tax deduction falls a year behind, we suggest that the law be amended to permit taxpayers on the cash basis to deduct income taxes or other taxes measured by income, whether called income taxes or not, in the year in which the liability accrued regardless of the method of accounting generally employed otherwise. Here, also, safeguards should prevent either a double deduction of the same tax or a loss of any deduction for taxes that will actually be paid.

On the other hand, in the case of the accrual-method taxpayers, certain State taxes, particularly New York State franchise tax, technically accrue in the year following the year in which the income is actually earned. Thus, if a corporation operating in New York earned a large income in 1942, the tax thereon which is payable to New York State as a franchise tax, but is nevertheless measured by the 1942 income, will accrue technically and become deductible as of November 1, following the end of the year 1942. Nevertheless, if the income is large in 1942, the tax will be proportionately increased, and the tax therefor relates directly to the 1942 income rather than 1943 income.

It is true, of course, that in such a case if the taxpayer corporation ceased to do business and liquidated, without passing its assets over to any successor, the tax would never be payable, but that seldom happens. If a particular taxpayer actually ceases to do business, it usually is the result of a transfer of a major portion of its assets to another corporation and the liability is technically passed over to the other corporation if the first corporation fails to pay the tax. In most cases, the first corporation is required to pay the tax as part of the transaction. However, the result is seriously distorted if the tax under such circumstances is not permitted to be deducted from the income which gives rise to it, as a matter of fact, if not as a matter of technical accrual. We urge, therefore, that the law be amended to permit taxpayers to deduct taxes which are measured by income from the income of the taxable period which serves as the yardstick regardless of the technicalities of accrual. The possibility of the tax not being paid by reason of liquidation or some unusual situation can be met by also providing that if in the subsequent period the tax is not paid, the reduction shall be disallowed.

Federal Income Tax

Finally with respect to Federal income taxes, the problem arises with respect to taxes on undistributed income whether they be under the provisions of section 102 or personal-holding company taxes. Where the accrual basis is used, no problem arises, but where the cash basis is used, the result may be so seriously distorted as to, in effect, require a corporation to pay out a dividend that it is legally unable to pay because, whether it uses the cash-basis accounting or otherwise, it cannot overlook a substantial Federal tax liability which must be paid out of the income of the year before anything is available for dividends. If such a corporation paid out all of its income without reserving enough to pay the tax liability, the Treasury Department would be the first to contend that the recipients are liable for tax as transferee in having received distributions that did not provide for the payment of Federal tax liabilities. We urge, therefore, that with respect to such taxes, as Federal income taxes, the taxpayer should be permitted to deduct the tax accrued during the year regardless of the method of accounting employed for tax purposes.

Respectfully submitted.

Walter A. M. Cooper, *Chairman.*
John A. Conlin
Scott H. Dunham
John D. Filson
William R. McNamara
Leslie Mills
George M. Thompson
Troy G. Thurston
Clarence L. Turner.

For the committee:

Walter A. M. Cooper, *Chairman.*

Table 1.—*Tax amounts to be withheld at each pay period for single persons with no dependents*

Line No.	If earnings are between—	Withhold following amounts if pay-roll period is— Weekly	Semi-monthly	Monthly
1	$11			
2	$11 and $11.99	$0.05		
3	$12 and $12.99	.10		
4	$13 and $13.99	.15		
5	$14 and $14.99	.20		
6	$15 and $15.99	.25		
7	$16 and $19.99	.35		
8	$20 and $24.99	.60		
9	$23 and $24.99		$0.05	
10	$25 and $29.99	.85	.25	
11	$30 and $34.99	1.10	.50	
12	$35 and $39.99	1.35	.75	
13	$40 and $44.99	1.60	1.00	
14	$45 and $49.99	1.85	1.25	
15	$46 and $49.99			$0.10
16	$50 and $54.99	2.10	1.50	.35
17	$55 and $59.99	2.35	1.75	.60

Complete tables will be furnished upon request.

TABLE 2.—*Tax amounts to be withheld at each pay period for married persons or heads of family with no dependents*

Line No.	If earnings are between—	Withhold following amounts if pay-roll period is—	
		Weekly	Semi-monthly
1	$26		
2	$26 and $26.99	$0.05	
3	$27 and $27.99	.10	
4	$28 and $28.99	.15	
5	$29 and $29.99	.20	
6	$30 and $30.99	.25	
7	$31 and $34.99	.35	
8	$35 and $39.99	.60	
9	$40 and $44.99	.85	
10	$45 and $49.99	1.10	
11	$50 and $54.99	1.35	
12	$55 and $59.99	1.60	$0.15
13	$60 and $64.99	1.85	.40
14	$65 and $69.99	2.10	.65
15	$70 and $74.99	2.35	.90
16	$75 and $79.99	2.60	1.15
17	$80 and $84.99	2.85	1.40
18	$85 and $89.99	3.10	1.65
19	$90 and $94.99	3.35	1.90
20	$95 and $99.99	3.60	2.15
21	$100 and $104.99	3.85	2.40
22	$105 and $109.99	4.10	2.65
23	$110 and $114.99	4.35	2.90
24	$115 and $119.99	4.60	3.15

Complete tables will be furnished upon request.

The CHAIRMAN. Mr. Snyder.

STATEMENT OF DANIEL W. SNYDER, JEFFERSON CITY, MO., PRESIDENT, MISSOURI POWER & LIGHT CO.

Mr. SNYDER. Senator George, I have reduced what I have to say here to writing, and I assure you that it won't take more than 10 minutes. I hope to read it sooner and quicker than that.

The CHAIRMAN. Do you represent all utilities, Mr. Snyder?

Mr. SNYDER. No, sir. I merely represent the company for which I work. I am president of the Missouri Power & Light Co., a Missouri corporation.

Senator George and gentlemen, the Missouri Power & Light Co. is a comparatively small company, although its operation covers a wide, if sparsely populated, territory. It serves no cities larger than cities of the third-class and only 8 of those, the balance of the 141 communities served being quite small, 99 of which are of less than 500 population.

Forty-two percent of all meters are in territory classed as rural as defined by the Bureau of the United States Census. Although this company is relatively small, its service is of great importance to its 59,000 customers in the 32 counties in which it operates. Therefore, it is essential for the protection of adequate service to these customers as well as for the welfare of its security holders that the credit and financial status of the company remain sound.

I have read statements attributed to Secretary Morgenthau to the effect that this new tax bill should leave "a sufficient margin of income for dividends and safety."

I have read a recently published article by the honorable chairman of this committee which gives assurance that it is not the intention to destroy any industry.

However, in including public utilities in the general class of corporations, this new tax bill does grave injury to an essential industry.

I understand the bill as passed by the House gives separate consideration to insurance and certain other types of companies. It would seem that public utilities, because of the nature of their business, should be given separate consideration because such corporations are quite unlike the ordinary corporation. Briefly the principal differences are as follows:

1. Utilities are regulated by governmental commissions as to their security issues, rates, and earnings.

2. Investment under the theory of regulation remains in the business and is not recoverable out of profits because the industry is operated on a service at cost basis.

3. Capital for needed expansion, which is a constant requirement in any growing territory, is not available from earnings.

4. The capital invested has a very slow turn-over. Usually it requires about 5 years to turn the capital once. Other types of business or industrial corporations are able to turn their capital one or more times each year.

5. The investor-owned electric utilities have to absorb a 3⅓-percent excise tax on certain classifications of gross earnings, which type of tax is not assessed against the ordinary corporation.

I do not presume to speak for the public-utility industry. My plea is for the Missouri Power & Light Co., which will face a most critical financial situation if this new tax bill is enacted in its present form.

This company has been, and is now, a subsidiary of the North American Light & Power Co. and has had advantage of a joint return.

This latter company is now in the process of dissolution under order of the Securities and Exchange Commission. In the near future the probability is that the small company will be "on its own." It will probably become an operating company without a parent company and also will be without any subsidiaries.

We believe the record of the company is a worthy one. From 1930 to 1941 the average price of electricity sold to its customers has been reduced from 4.59 cents per kilowatt-hour to 2.51 cents per kilowatt-hour, a reduction of approximately 45 percent.

During that period it has added $3,400,000 to its plant account, and is now engaged in a program of constructing additional facilities for restoring needed reserve capacity taken by factories working on war orders that requires nearly $2,000,000 additional expenditures.

This company does not object to paying a fair share of the tax burden. It believes it has paid a fair share and, perhaps, more than a fair share. From 1930 to 1941 Federal income taxes have increased $282,000 per year, an increase of 516 percent, and other taxes $169,000 per year, an increase of 130 percent.

This big increase in taxes over the last 10 years was absorbed only because of the successful promotion of additional kilowatt-hour sales and by the application of rigid economy and improved efficiency in the operation of the utility.

This new bill will add about $260,000 to the tax bill, and there is now no possible opportunity to offset this huge tax increase. No expansion in business, other than low-rate industrial war load, is possible because of W. P. B. restrictions necessary in the prosecution of the war.

The folowing comparison of the income account of the company shows the effect of this new bill compared with the actual results obtained in 1941.

Senator TAFT. Mr. Snyder, that increase in tax. Can you tell whether that is due to the normal rate or the excess-profits rate?

Mr. SNYDER. Well, it is due to both of them.

Senator TAFT. How far do you go into the excess-profits tax?

Mr. SNYDER. Rather heavily because of the fact that under a joint return we weren't heavily taxed for excess profits whereas under a separate return the excess-profits tax is large.

Senator TAFT. What do you use? Do you use the capital-investment basis?

Mr. SNYDER. No, sir. We use the average-earnings basis.

Senator TAFT. What is the matter with the capital-investment basis?

Mr. SNYDER. In the early years the depreciation allowable under the rules of the Bureau of Internal Revenue was heavy which reduces the base and also only half of bonded value is allowed. Therefore there is a slightly better result for the company by using the average earning basis rather than the capital investment basis.

Senator TAFT. How much——

Mr. SNYDER. There is very little difference.

Senator TAFT. How much excess income is there that falls in the excess-profits tax?

Mr. SNYDER. I couldn't tell you offhand, Senator. It is quite a substantial amount because the excess-profits tax is a substantial portion of this $260,000 increase.

Senator WALSH. What is your prefered-stock dividend?

Mr. SNYDER. What is it?

Senator WALSH. What is the rate?

Mr. SNYDER. It is $6 per share on a $100 value. In order to test that estimate we actually applied the new law to a 6 months' operation, and the amount available for the first 6 months, based on actual figures for common-stock dividends and surplus for 1942, is $1,949.

Senator CLARK. As against $322,000 last year?

Mr. SNYDER. Last year; yes, sir.

I am very nearly through.

	Actual, 1941	Based for separate returns on 1942 proposed revenue act	
		Estimated, 1942	Actual (6 months), 1942
Total operating revenues	$4,272,253.12	$4,569,981.68	$2,245,816.68
Operating expenses	2,026,486.00	2,305,992.64	1,128,642.64
Maintenance	165,658.59	192,488.31	94,838.31
Taxes other than income taxes	284,085.15	307,857.90	148,857.90
Provision for income taxes (State)	15,300.00	9,300.00	4,600.00
Provision for income taxes (Federal)	336,600.00	579,300.00	280,500.00
Appropriation for depreciation reserve	479,700.00	483,954.00	259,254.00
Total operating expenses, maintenance, taxes, and depreciation	3,307,829.74	3,878,892.85	1,916,692.85
Net operating revenues	964,423.38	690,923.83	329,123.83
Nonoperating revenues	39,408.42	16,535.30	5,285.30
Gross income	1,003,831.80	707,459.13	334,409.13
Total deductions (net)	381,057.20	368,223.88	182,463.88
Net income	622,774.60	339,235.25	151,945.25
Preferred dividend requirements	300,000.00	300,000.00	150,000.00
Available for common dividend and surplus	322,774.60	39,235.25	1,945.25

From the above it is readily noted that the earnings available for common-stock dividends are practically wiped out and the earnings for preferred are in serious jeopardy. The earning value of the common being thus destroyed its market value is likewise destroyed.

During the last 10 years this company has earned its preferred-stock dividends an average of 2.25 times. In recent years its preferred stock has had an open market value of about $100 a share. Subsequent to the introduction of this proposed tax bill this preferred stock suddenly dropped in price and has been quoted at about $85 per share.

I have no knowledge or experience in the formulation of tax laws. In conclusion, however, I wish to respectfully submit the following suggestions for the consideration of your committee:

First. That because of their unusual characteristics the public utilities be given a separate classification and treatment in the bill.

Second. That the 3⅓ percent excise tax absorbed by the electric utilities be allowed as a credit against normal income tax.

The CHAIRMAN. Isn't that collected from the customer?

Mr. SNYDER. No, sir; it is not. When the bill passed Congress in the first place, it was passed on to the customers, but in the subsequent bill it was changed so that now the utility absorbs that tax.

The CHAIRMAN. You are compelled then to absorb the tax?

Mr. SNYDER. Yes, sir.

The CHAIRMAN. All right.

Mr. SNYDER. Third. That the excess-profits tax be assessed on a formula that makes the tax an excess-profit tax in reality.

4. That cumulative preferred stock dividends be treated the same as bond interest because under regulation cumulative preferred stock has practically the same characteristics as a bond.

5. That the excess-profits tax be applied after the normal tax instead of prior to the normal tax. This latter arrangement being more logical.

I might add further that in case this tax has to be assessed in such quantities against the utilities, it would seem that a withholding tax could be arranged whereby the tax burden could be equally divided over all classes of securities rather than making the common stock take all of the loss, which practically prevents any surplus being built up for contingencies, and in making the statement, I am looking toward the management of these companies rather than the stockholders, because if we are to carry on and continue to give service to our customers there has got to be a little something over for surplus in those contingencies.

Senator RADCLIFFE. Just a moment ago you made some reference to the restrictions of the W. P. B. How far will these restrictions, so far as materials are concerned, interfere with the development of your plant or the maintenance as far as you can form any estimate at this time?

Mr. SNYDER. Aside from the work pertaining to the war—and I am not complaining at all about the restrictions—but aside from the work pertaining to the war, we are absolutely stopped. We can't sell any gas. We can't run any service unless the customer has his house wired and the foundation were in before March and, of course, they have all been taken care of. We are just stopped. We are in a straitjacket except for customers pertaining to the war.

Now, the only business I see in sight would be in case a camp would be located in our territory or they built some kind of war industry. Then we might get some business from that.

The CHAIRMAN. They take the lowest rates, of course?

Mr. SNYDER. Yes, sir; We are trading dollars very largely on that.

Senator RADCLIFFE. I suppose you are not able to form an estimate, even a very crude estimate as to what that might mean in dollars and cents?

Mr. SNYDER. You mean our increased business?

Senator RADCLIFE. No; I mean the restrictions of the W. P. B. Are you able to visualize what that means in the way of losses to you? I know that is a very general question and a highly speculative one.

Mr. SNYDER. I believe the best way I could answer that, Senator is this: That even during the depression years on the average we were able to reduce rates, in spite of rising labor costs, very nearly 5 percent a year and the only way we did that was by growth. Now, that growth at the present time is not possible under the war restrictions which I thoroughly agree are necessary. We have no objection whatsoever to those restrictions. We are cooperating just as fully as we know how.

Senator CLARK. You can't increase your income without expanding your facilities to any appreciable degree, and you can't extend your facilities under the present situation of the W. P. B. Order?

Mr. SNYDER. And in addition to that, Senator, as you well know, I think, in the towns that we serve we have had an exodus of population. We have had our reasonable and ordinary number of boys that have gone to the service. In addition to that, we have had many hundreds of men go from our towns, because there isn't much war work there, to the large industrial centers to get jobs.

Take the city of Moberly, which is an old railroad town and many former railroad shop men have gone into other lines of business and shops. These skilled men are now going to other cities. They have lost in Randolph County 1,800 heads of families.

Unless this section is given some war business I think the outlook is decidedly forlorn.

Unless business increases the next 2 years, I think the hope is a decidedly forlorn one.

Senator RADCLIFFE. If you raised your rates, that would only be a partial solution?

Mr. SNYDER. That would be no solution at all, if you will permit me to say that. If the excess-profits taxes continued at the rate of 90 or 94 percent in the aggregate, in order to get a dollar revenue, the ratepayer would have to pay 16 or 17 times that, and we just wouldn't have the courage to try to collect it.

I have just one concluding paragraph.

The CHAIRMAN. Yes, sir.

Mr. SNYDER. By utilizing these suggestions or a combination of them, a tax bill applicable to utilize could be devised that would result in an equitable and adequate taxation and also prevent the destruction of the utility's credit and its ability to serve the public.

I think I kept about within the 10 minutes including your questions.

The CHAIRMAN. Thank you very much, Mr. Snyder.

Are there any questions?

(No response.)

Mr. SNYDER. I want to thank you and the committee very much for permitting me to be present.

The CHAIRMAN. We were very glad to have you appear.

Mr. Hodes?

STATEMENT OF JAMES HODES, NEW YORK, N. Y.

Mr. HODES. My name is James Hodes of 20 Pine Street, New York.

I am here to voice opposition to the proposed section 121 of the revenue bill of 1942.

This is the section which would deny a deduction for interest on indebtedness incurred to purchase or carry fully paid-up life or endowment contracts.

I wish to state at the outset that I am not here as a representative of any insurance company or bank, or any organized group that may have a special interest in this legislation.

I have devoted many years to the study and analysis of matters relating to life insurance and one of my present connections is that of analyst and consultant on special life insurance problems to the firm of Pantaleoni & Silver, attorneys, who specialize in life-insurance matters.

However, I wish it to be clear that I am not here on behalf of that firm.

My appearance is dictated entirely by the fact that my studies reveal that the passage of this section would be detrimental to the interest of the United States Government and extremely unfair to that vast group of policyholders who are unorganized and therefore have no spokesman to present their point of view in respect to legislation affecting their interests.

There are many reasons why this section should be eliminated from the proposed bill.

The CHAIRMAN. You wouldn't put any limitation on single paid policies at all? You wouldn't limit it in any wise?

Mr. HODES. No, sir. I think I will develop the reason as I go along.

The CHAIRMAN. All right.

Mr. HODES. My first reason is most persuasive, because it does not involve any controversial issue as to the fairness or wisdom of this proposed amendment.

This amendment was recommended for the purpose of plugging up an alleged loophole and thereby creating additional revenue for the Treasury.

The simple fact is that adoption of this amendment will not result in any additional revenue to the Treasury, but it will actually result in a loss of revenue.

Apparently it was assumed that if the interest deduction were disallowed the Government's revenue from income taxes would be increased to the extent of the tax upon the amount disallowed.

That is not true. The gain in revenue derived from the disallowance of such interest payments must be measured against at least four different sources of revenue which the Government will lose by the passage of this amendment.

Now, I want to describe at this point a typical transaction, and I have an exhibit in support of this:

An individual, aged 40, goes to a life-insurance company and buys a $25,000 insurance policy for which he pays a single premium in cash.

By the way, I have selected the amount of $25,000 because the example is in the John Hancock Life Insurance Co., and their limit is $25,000. They won't sell any more than that.

At age 40 the company charges him for such a policy a premium of $12,711.75.

He makes a loan of $10,000 against the security of this policy from a bank—the policy has immediate cash value so he can make that loan—which sum represents almost the full immediate loan value of this policy.

The net result is that his total investment in the policy is $2,711.75.

Let us assume that he pays interest on the loan at the rate of 2½ percent per annum. That makes his interest charge $250 annually.

Under the present law this interest payment of $250 per annum is treated as an allowable deduction in reporting his income tax.

The proposed amendment seeks to eliminate this sum as a deduction with the idea in mind of yielding to the Government additional revenue to the extent of the tax rate applicable to this taxpayer on the sum of $250.

If the taxpayer is in the 51-percent bracket, the apparent increase in revenue to the Government would be $127.50.

Should the proposed amendment be adopted, its effect would be to eliminate this type of transaction. There is no question about that. People just wouldn't buy this form of insurance.

I will indicate to you now the revenue which the Treasury will lose if this kind of transaction is discontinued.

The large city banks, which are generally the lenders in these transactions, report as taxable income the interest income which they derive from this type of loan.

Now, these banks are subject to the same taxes as other corporations, the same normal tax, surtax, and excess-profits tax.

The income-tax returns of these city banks are available to this committee. They aren't available to me. I tried to get them, and the banks wouldn't let me know what they are, but I know that in almost every case the income tax that the bank pays at the top is much greater than the total of income tax that the individuals who make these loans would pay.

Senator TAFT. I think the rate is very much lower, however. In fact, many banks haven't paid any income tax, until recently, at all. I think the average rate would be much lower.

Mr. HODES. Are you talking of all banks or the large city banks?

Senator TAFT. Banks generally. Some banks pay big ones and some small ones.

Mr. HODES. I don't think that is true of the large city banks, sir. They are the ones that make most of these loans.

If as a result of the adoption of the proposed amendment this income were not received and reported in the bank's income, the amount so lost to the Treasury would be considerably greater than the hoped-for revenue, through disallowance of the interest deduction, but that is not the whole story.

The single premium paid to the insurance company in the illustration I have offered you was $12,711.75; of this, $11,475 represents reserve funds to the insurance company. The income derived from the investment of this reserve is subject to tax based on a formula which is now under consideration in the present revenue bill.

I have roughly computed the amount of income on this amount at $28.

If the tax bracket applicable to this income is only 51 percent—and it is much greater on the amount that is actually reported—the loss of revenue through the nonissuance of single premium insurance would be $14.28.

A third source of revenue in this bank-loan insurance transaction is derived from the income of the insurance agent who is involved at its inception.

He receives a commission on the sale of this policy amounting to $381.25, which is considerably more than the amount of interest paid—that is, $250.

Even if we assume that the average insurance agent is not in the same income-tax bracket as the purchaser of this type of insurance, nevertheless the agent reports as taxable income a sum much greater than the amount of interest deduction taken by the policyholder.

This alone in most cases would be sufficient to offset the revenue which the Government hopes to gain by the passage of this amendment.

There is a fourth source of offsetting revenue to the Government:

Under the agency system of selling insurance not only the soliciting agent but the general agent by whom he is employed derives a profit from the sale of the policy.

In the illustration given the general agent would receive $127.11.

Let us assume that he is in the 51-percent bracket. In that case the loss of the revenue would be $64.82.

These four sources of income now provide substantial revenue to the Treasury.

Under the proposed amendment these sources will be cut off.

The increased revenue which the Government would obtain because interest deductions would not be made would be far less than the revenue lost, but perhaps greater than all of these losses would be the future loss of revenue to the Government in the field of Federal estate taxes, if the insurance involved in these transactions is not purchased or is discontinued as a result of the adoption of the section under consideration.

I have exhibit B there. I show computations of typical cases which illustrate the potential losses to the Government in Federal estate taxes which would result from the passage of this amendment.

In the illustration we are considering an individual dies, leaving a general net estate, exclusive of life insurance, in the sum of $100,000.

If such an individual has purchased, by the bank loan method, $100,000 of fully paid insurance, which is subject to a $50,000 loan, the net amount which is includible in his estate is $50,000.

The estate tax on the net insurance involved would be computed at 40 percent of $50,000, so that the revenue through estate taxes to the Government would be $20,000.

It would take about 30 years to make up—30 years of income taxes—to make up this loss.

Similarly, in the case of a general net estate exclusive of life insurance in the sum of $500,000, where there is $200,000 of paid-up insurance in force, subject to a loan of $100,000, the estate tax would be computed at 60 percent of $100,000, or $60,000.

These are the amounts in revenue which would be lost if the type of transaction we are discussing were discontinued as a result of the passage of section 121.

It would be very shortsighted to make possible these substantial losses to the Treasury by the passage of the section under discussion.

When we compare the four sources of income-tax revenue together with the Federal estate-tax revenue, which the Government will lose by the passage of this amendment, with the insignificant gain in revenue which the Government expects to derive through the disallowance to the policyholder of interest deductions, the conclusion is inescapable that this amendment was proposed without any adequate study of its actual and potential effects upon the revenues to the United States.

It cannot be justified as a revenue-raising measure, because it must have the opposite effect.

PROPOSED AMENDMENT IS INEQUITABLE

I shall demonstrate that this amendment, besides failing of its purpose as a revenue measure, is inequitable.

People of wealth who own this kind of insurance subject to loan, or who might consider buying fully paid-up insurance, have available to them always other means of borrowing money. They could hypothecate securities; they could make loans on other stocks and bonds, and with the proceeds buy fully paid-up insurance which would not be subject to loan.

They could then make the deduction of the interest and they could escape the intent of this amendment.

Other wealthy individuals could also take ordinary life policies on which they pay annual premiums, which have developed a cash value, and make loans on those; with the proceeds they could then buy fully paid-up insurance. Again they would escape the intent of this amendment.

There is really no means of enforcing this—I mean, against people to whom this amendment is directed—because they would always have available to them means of making loans.

The proposed amendment is intended to deny to individuals who enter into bank loan transactions the right to reduce their insurance cost.

I have previously shown that these individuals can easily avoid the prohibition of this amendment by a number of methods.

Unfortunately, if this amendment is adopted, the only ones who will be affected adversely in the matter of tax relief are the ordinary individuals who own ordinary life policies. I will illustrate:

There are thousands of individuals who have purchased limited payment life policies—policies on which they pay annual premiums for a limited number of years: 10, 15, or 20 years.

Now, as an example, an individual who has purchased a 20-payment life policy in 1920 at the age of 35: This policy by its terms requires the payment of 20 annual premiums, after which it becomes fully paid up.

It then would fall into the category which is considered in this amendment.

Ten years pass, and in 1930 the policy has acquired a cash value which is more than 25 percent of its face value. The policyholder finds that he is unable to continue his insurance unless he makes a premium loan.

In passing, may I say that there are thousands and thousands of such loans on the books of the insurance companies.

Through the 30's he keeps his insurance in force by continually increasing the loan, and in 1940, when the policy by its terms becomes fully paid up, he finds himself with a policy subject to a maximum loan.

Although he is relieved of future premium payments he must continue to pay interest to his insurance company—and this interest is usually 6 percent—in order to keep the insurance in force.

It would be an obvious injustice to this class of policyholders—and there are thousands of them—to deny them a deduction for the interest which they pay on their loans in order to keep their policies alive.

This group of policyholders has no means of avoiding the effects of this amendment except to drop their insurance.

The CHAIRMAN. You mean this section applies to that sort of thing?

Mr. HODES. Yes, sir; it does.

The CHAIRMAN. Is that true? Is anybody here to speak for the Treasury?

Mr. HODES. I have it here.

The CHAIRMAN. Go ahead, and we will find out about it. If that is so, I didn't so interpret it. We will get into that.

Mr. HODES. Here it is. Here is 121. What they are adding to the section is:

Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium or fully paid up life insurance or endowment contract.

That is fully paid-up insurance.

The CHAIRMAN. You did construe the words "fully paid up" there as covering old policies on which the taxpayer has been paying for a number of years and finds himself owing a debt?

Mr. HODES. After the policy becomes fully paid up.

The CHAIRMAN. I don't think that is a correct construction of it.

Mr. HODES. Well, I won't dispute th , but I think if the term "fully paid up" is in the section, and if a person has a policy which on the face of it says "this policy becomes fully paid up"——

The CHAIRMAN (interposing). Are you talking about a single premium policy or an endowment policy fully paid up? I think you have got to construe all those words together.

Mr. HODES. It says, "single premium or fully paid up."

The CHAIRMAN. Yes; "or fully paid up."

Senator TAFT. I think the witness is right. It says, "carry a single premium or fully paid-up life insurance policy." It has been paid up.

The CHAIRMAN. If the witness is right, I would be very much against that.

Mr. HODES: I think also there are certain other technical things. An ingenious insurance man can think of a half dozen ways, if he were minded that way, of avoiding the intent of this, with a wealthy individual. All you have to do is to buy a five-payment life policy, and the wealthy man pays the five premiums in advance.

He then makes a loan against the receipt he gets from the company—or, I should say, he pays four premiums and leaves one, so it isn't fully paid up.

I can think of three or four other methods of avoiding the intent.

The CHAIRMAN. I don't want to find out any way of avoiding the intent. If that is what this section means I think it has got too much in it. I am not trying to avoid it.

Mr. HODES. No, sir. I say an insurance man can show a wealthy individual how to avoid the intent of this section.

The CHAIRMAN. I hardly think your interpretation is justified, although Senator Taft is a good authority on it.

Senator TAFT. It could be construed that way by the Treasury if they wanted to.

Mr. HODES. I think it would be construed that way by the Treasury.

Senator TAFT. That could be corrected very easily. I don't think they intended it.

The CHAIRMAN. I don't think so.

Mr. HODES. I don't want to take up very much more time.

I have thought of the fact that it might be corrected, but I know the technicalities of insurance.

The CHAIRMAN. I am glad you called our attention to it, if you are correct in your interpretation, because I can see some reason why the Treasury might desire to put an end to the single premium policies, taken in large amounts, interest paid on that policy.

There may be a great deal in what you have to say, but at the same time it affords someone who is able to do that an excellent opportunity to take a considerable deduction from his taxable income.

Mr. HODES. Yes, sir; but I think I have proven that by preventing activity you don't increase revenues. There is no question about it.

The CHAIRMAN. I understand your point—that your contention is that the Treasury is the loser in the long run.

Mr. HODES. That is right—by a great amount, too.

The CHAIRMAN. That doesn't keep the individual, though, from taking considerable advantage.

Mr. HODES. How about the individual—if we are talking about this philosophically—who purchases a home by a loan and deducts that interest from his income tax?

He, too, is buying some property, just as this individual is buying property. The profit motive exists in both.

The CHAIRMAN. I didn't mean to argue with you.

Mr. HODES. No, sir.

The CHAIRMAN. I was curious to know if your construction of the section was correct.

Go ahead.

Mr. HODES. Now there is another very large group of policyholders—particularly after this last depression—who, after maintaining their life insurance for many years, found it impossible to continue and were able to take advantage of the nonforfeiture privilege in their policies of surrendering their annual premium policies for a greatly reduced amount of fully paid-up insurance—as it is mentioned in this section.

That is, a person has a $5,000 policy he has carried for 15 years and then finds himself unable to continue to pay the premiums because of taxes or anything else. He is permitted to accept from the company a policy for, let's say, $1,200 or $1,500, fully paid up, and, if he needs money, if he is that hard up, he is going to make a loan and carry that policy subject to a loan.

It can be assumed that when indivduals are in such straits, that they must take advantage of the nonforfeiture privilege.

They are usually reduced to making loans from the insurance companies against the cash values of the fully paid-up insurance.

Now, sir, I have spoken to—I can't get the exact statistics—but I have spoken to insurance company officials, and I find that in these cases, in the many cases where policies were reduced in amount to fully paid-up insurance, usually they are carried for years with loans, because those people couldn't afford to pay the annual premium, and, as a matter of fact, welcome the relief through the fact that they could make loans against the policies.

Now, it may be stated that, in the report of the House Ways and Means Committee, the only justification for the introduction of this measure in the tax bill of 1942 was the express desire to treat interest deductions on loans made on fully paid-up insurance in the same manner as interest on loans made to purchase or carry tax-exempt securities. That is the only item in the report.

The analogy is completely fallacious and is based on a very superficial comparison of the nature of the collateral. In the case of tax-exempt securities there is immediate income accruing to the owner which is never reported to the Government.

In the case of the life-insurance policy—particularly the single premium policy—the cash value exceeds the premium consideration within a few years of its inception, and in the ordinary whole life policy in about 5 years the cash value may exceed the consideration paid for it.

So that if the policy is surrendered for any reason at all the excess of the cash surrender value over the consideration paid must be reported as income.

In the case of the single premium endowment policy—and the only ones that it pays anyone to buy and to handle in this way would be short-term endowments—there is no escaping the reporting of income at maturity represented by the difference between the maturity value and the dividends over the premium consideration.

Furthermore, in the case of tax-exempt securities there is no increase in revenue to the Government in the event of death of the owner of such securities which are subject to loan.

I have indicated previously the largely increased estate against which estate taxes will be levied in the case of fully paid-up life insurance policies which are carried by loan when the policyholder dies.

To digress for a moment, I wish to point out that individuals who purchase fully paid-up insurance and carry it with the aid of bank or insurance company loans, do not do so always with the idea of avoiding the payment of taxes.

In every case the cost to them is more than the amount of taxes they save.

It does enable individuals to carry larger insurance estates than if they bought it on an annual premium basis, but there is always a cost to them.

The transaction is the type, as a matter of fact, that should be encouraged as much as possible, because it takes money out of circulation and reduces spendable income, which at this moment is the primary purpose of all tax legislation.

Every time one of these single premium policies is sold about 20 percent of the cash that pays for it must come out of the policyholder's pocket.

This tying up of the policyholder's funds in insurance is anti-inflationary in effect.

Furthermore, the proceeds of a loan which is made are paid over to the bank by the insurance company.

Recent statements by all the large insurance companies indicate that the greatest proportion of their incoming funds are being invested in Government bonds.

In fact, in this morning's Baltimore Sun I noticed an item that several of the New York insurance companies have invested about a half billion dollars in Government bonds of the new "tap" issue within the last few days.

This, too, I maintain is anti-inflationary in effect.

In conclusion may I state that this proposed amendment is predicated upon two gross misconceptions:

The first is that it will raise additional revenue: it will not. The Government will in effect lose revenue at a time when it needs it most.

Secondly, the proposed amendment is based upon the misconception that it is plugging up a loophole in the tax law similar to the one which allows interest deductions on loans made upon tax-exempt securities.

As I have pointed out, the analogy is clearly fallacious.

Thus, upon examination, the whole structure upon which this proposed amendment was submitted falls of its own weight. When we add to that the inequity of the amendment against people of means, its discriminatory nature, and the injustice visited upon policyholders who have struggled for years to maintain their life-insurance policies, there can be no good reason for retaining the proposed section in the Revenue Act of 1942.

Thank you.

The CHAIRMAN. We thank you very much. Are there any questions?

(No response.)

The CHAIRMAN. Thank you.

(Exhibits A and B submitted by Mr. Hodes are as follows:)

EXHIBIT A.—*Age 40—Single premium whole life*[1]

Face amount	$25,000.00
Single premium	12,711.75
Loan for 1 year	10,000.00

(Collateral for loan is assigned cash value of policy at end of 1 year, $10,825.)

Payment by insured out of own funds	$2,711.75
Interest on $10,000 loan for 1 year at 2½ percent	250.00

[1] Illustration is based on a policy issued by the John Hancock Mutual Life Insurance Co.

EXHIBIT B.—*Illustration of income tax saved by insured* v. *Federal estate tax on insurance carried by bank loan method*

[Assuming the new 1942 tax law is passed by Congress]

General net estate, exclusive of life insurance	$100,000
Paid-up insurance	100,000
Less bank loan	50,000
Net insurance estate	50,000
Estate tax on net insurance 40 percent of $50,000	20,000

If the insurance is not purchased or is canceled because the deduction of interest is disallowed, the Government faces a potential loss of $20,000 Federal estate tax.

The CHAIRMAN. Mr. Langley.

STATEMENT OF WILLIAM C. LANGLEY, WESTBURY, N. Y.

Mr. LANGLEY. What I would like to do, Senator George, is to file with the committee this printed statement, which is only in proof form, because I came down here so hurriedly that I did not have a chance to have it finally bound up, and I would like to high-spot a few things that are in it. That will take me about 5 minutes.

The CHAIRMAN. You may do so, Mr. Langley.

Mr. LANGLEY. I wish to address myself, gentlemen, to the subject of the 90-percent excess-profits tax and the 45-percent income tax as affecting corporations.

It is my belief that a great number of corporations will omit preferred and/or common dividends; others will drastically reduce them, because of any, or all, of the following reasons:

Residue of earnings after taxes does not equal dividend requirements, or leaves too little margin over same.

Fear of impairing working capital or having to borrow working capital, or to borrow to pay taxes.

Fear of going into post-war period without strong cash reserves against decreased business, large inventory depreciation, and necessity for plant rehabilitation and installment of new machinery for reconversion purposes.

Inability to meet sinking-fund or debt maturities, thus causing defaults and receiverships.

Confirmation of the above: For the 6 months ended June 30 a total of 163 companies report net income of $398,523,000, which is 46.1 percent below the $583,213,000 reported for the corresponding period in 1941.

Corporations are already arranging post-war credits when possible against inventory shrinkage, plant conversion to peacetime activity, et cetera.

In addition, further confirmation is evidenced by the stock market. Since the 90-percent excess-profits and 45-percent normal tax was decided upon by the House committee, stocks have materially declin in market value.

In my opinion, the result of a 45-percent and 90-percent tax will be lower prices for equities of preferred and common stocks, and with nonpayment of dividends, these stocks will be discredited and investors will not buy or subscribe for them, just at the time when the country's business economy needs new equity money when the war is over.

Finally, the result will be that the Government will be the principal, the easy, and probably the only source for borrowing money, and then finally there will be Government management of plants and Government ownership of business and production.

A combination of normal taxes of 45 percent and excess-profit taxes does not properly distinguish between the normal earnings of established businesses and increased earnings due to the war. It does not properly recognize such realities as fixed interest and preferred dividend charges.

The individual stockholder should be taxed on his income, both earned and from dividends, in accordance with the principle of ability to pay. It is not equitable to impose on each stockholder, irrespective of his individual income, the same tax burden. To do so has the effect of taxing the individual stockholder upon his share of corporate earnings at rates in some cases 100 percent in excess of what he would ordinarily be obliged to pay if the principle of the ability to pay is to be recognized.

I have had prepared in my office a list of over 100 companies. We inducted into their last year's earnings the proposed taxes. Of course, it was impossible for us to be absolutely accurate about this, because we are not in possession of the Treasury reports, but we think that they are substantially correct. We have taken the actual normal and surtaxes paid last year and qualified them by the new tax.

A summary which I append to my statement, and which I understand will be printed in full in the record, shows that the preferred stocks of 42 utility companies and 23 industrial companies, and of the common stocks of 13 utility and 56 industrial companies, expose the following result:

Four utility companies, or 9 percent, will not earn their preferred dividends; 11 utility companies, or 26 percent, will not earn their preferred dividends and sinking funds; 13 utility companies, or 31 percent, will be border-line cases, earning their preferred dividends by a margin of less than 50 percent. Thirteen utility companies will have their average earnings per common share reduced 27 percent. Six industrial companies, or 26 percent, will be border-line cases, earning their preferred dividends less than twice. Fifty-six industrial companies will have their average earnings per common share reduced 39 percent.

Senator WALSH. You took the earnings of last year?

Mr. LANGLEY. Yes, sir.

Senator WALSH. And applied to those earnings the rates fixed in this law?

Mr. LANGLEY. Yes, sir; if preferred and common stocks of corporations like those listed above are harmed or discredited by nonpayment or reduction of dividends how will those companies be able to raise equity money in the future? One industry alone, the electric power and light, spent $654,000,000 in 1941 for property additions. Of this amount $279,000,000 was supplied by the depreciation account and $375,000,000 had to be financed by sales of securities, surplus earnings, and borrowings. For 1942 the budget for capital expenditures for the same industry is estimated to be $700,000,000.

It seems to me that it is evident from all of the above that the proper place to tax earnings is in the hands of the recipients instead of impairing or destroying the sources; that is to say, the corporations which generate these earnings and from which they flow. I therefore submit respectfully that the place to tax is the individual.

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

(No response.)

The CHAIRMAN. Thank you very much, Mr. Langley.

Mr. LANGLEY. Thank you very much for your time.

(The statement submitted by Mr. Langley is as follows:)

STATEMENT WITH RESPECT TO THE EFFECT OF THE HOUSE TAX BILL ON CORPORATIONS SUBMITTED BY WILLIAM O. LANGLEY, WESTBURY, N. Y.

I would like to show the effect of the proposed 90-percent excess-profits tax and 45-percent income tax.

1. A very great number of corporations will omit preferred and/or common dividends, others will drastically reduce them because of any or all of the following reasons:

Residue of earnings after taxes does not equal dividend requirements or leaves too little margin over same.

Fear of impairing working capital or having to borrow working capital, or to borrow to pay taxes.

Fear of going into post-war period without strong cash reserves against decreased business, large inventory depreciation, and necessity for plant rehabilitation and installment of new machinery for reconversion purposes.

Inability to meet sinking-fund or debt maturities, thus causing defaults and receiverships.

Confirmation of the above:

For the 6 months ended June 30 a total of 163 companies report net income of $398,523,000 which is 46.1 percent below the $583,213,000 reported for the corresponding period in 1941.

Corporations are already arranging post-war credits when possible against inventory shrinkage, plant conversion to peacetime activity, etc.

Lower prices for all stocks since tax bill with 90 percent excess profits and normal tax of 45 percent was introduced on July 11, 1942.

Department of Commerce figures indicate that the spectacular rise in national income paid out has benefited wages and salaries far more than any of the other distributive shares. In absolute amounts, the grand total of income payments increased by $21,300,000,000 from 1939 to 1941, and of this total, wages and salaries accounted for $16,700,000,000, or approximately 80 percent. The slight absolute gains in dividends and in net interest, and the more substantial gain in the net income of unincorporated business, become relative losses in terms of the over-all increase in income payments. Net business savings cannot be part of total income payments. Against the $3,900,000,000 of such savings in 1940 and 1941 must be set net business losses aggregating $4,500,000,000 for the years 1935 to 1938, inclusive.

RESULTS

Lower prices for equities, i. e., preferred and common stocks, nonpayment of dividends, stocks discredited with investors. Investors will not buy or subscribe to stocks just at the time when the country's business economy needs now equity money when the war is over.

Final result: Government, the principal, the easy, probably the only source for borrowing money—then, finally, Government managements of plants and Government ownership of business and production.

Colleges, charitable institutions, insurance companies are dependent on dividends to carry on and to pay fire and casualty losses. What will happen to them?

Sailors and soldiers want their old jobs back after the war, in motor companies, textile companies, etc. These have been converted to war work. Enormous expenditures must be made to reconvert to their former products. Do we want this to come from private capital or the Government?

There is constant reference to protection of small corporations and by intimation, at least, an invidous distinction is made as between big and small corporations. The analogy of a wealthy person against a poor person which is used in viewing big corporations and small corporations is utterly fallacious. Corporations are made up of groups of stockholders and the bigger the corporation is the larger the number of small stockholders and the smaller the unit holdings of stock per stockholder. This is illustrated by General Motors, 80 percent of whose 396,000 stockholders own less than 50 shares; American Telephone & Telegraph, 75 percent of whose nearly 750,000 stockholders own 25 shares or less.

To the contrary it is well known that most so-called small corporations are owned by a few individuals, and therefore the unit holders in many cases denote great individual wealth. To illustrate: If a corporation is capitalized at $1,000,000 it often belongs to two or three people with unit holdings worth perhaps $300,000 or $400,000 a piece. This is attested by many offerings of closely held stock of smaller companies to the public by families in anticipation of inheritance taxes. These stocks had no outside market so large blocks were sold through bankers in order to provide a liquid position for the holders.

This general close ownership of small corporations often means salaries to many members of the family, bonuses, etc., which diminish taxes paid. It is unquestionably true that generally speaking small investors of moderate wealth own the big corporations and people in affluent circumstances own the small.

REMEDIES

1. Deduct the corporation income tax before computing the excess-profits tax.
2. Allow credit to net income of preferred dividends paid in figuring surtax and excess-profits tax. This recognizes the fixed dividend feature of preferred stocks.
3. Allow credit for common dividends paid in figuring net income for surtax and excess-profits taxes. The Government benefits by higher surtaxes on individuals through larger common dividends which would result.
4. Deduct from net income for surtax and excess profits, payments reducing debt or for sinking fund purposes.
5. Allow post-war credits against taxes paid in the shape of Government obligations of suitable character.

6. Allow for excess profits tax purposes an appropriate reserve for inventory depreciation.

It seems to me that corporate life is like a tree, or rather a forest of trees. American business history is corporate forestation. We have built up in this country a great forest of business corporations. In the last 50 years, and even longer, the copartnership has been relegated to the rear, and the corporation has superseded it. This, I maintain, is and was a splendid, fruitful thing for the progress and people of America.

A copartnership is and was a small, selfish, and secluded affair, and generally resulted in a viewpoint consonant with narrow, selfish activities of a family who founded and perpetuated, or endeavored to perpetuate, the business for themselves and their descendants. They were afraid or jealous of outsiders and outside money. They did not relish nor would they brook outside interference. We have many instances of businesses which did not grow or flourish to an extent commensurate with the resources, intelligence, and enterprise of the American people because they were kept strictly family affairs. When the members of the family died or became slothful through affluence the business often decayed, withered, and died for there was no one to carry on.

If it had not been for the corporate form of development we would never have opened so soon and so magnificently the great West, through railroads, and because of transportation thus afforded, the mines and forests of our great country. Virtually all our major industries—steel, automotive, electrical, public utility, radio, airplane, and motion picture—have been developed and brought to their current high degree of efficiency by corporations, the great copartnerships of the American people. Shall we, should we, scrap and discard them and go back to the pioneer days of individualism, and the present so-called forward looking theories of socialization?

If, as it seems to me, the corporate business life of America is like a tree, I believe that we should nurture it at its roots and bring it to full fruition. Then, as is necessary, distribute the fruit and tax the recipient. Why and for what purpose and to what good should we destroy it? If you cut down the trees the value of the forest is destroyed. Reforestation, as well as the rebuilding of bankrupt and defunct corporations, is a long and expensive process.

Common sense dictates that such a destructive policy should not be attempted in the midst of our gigantic war effort and on the eve of a period of economic dislocation which inevitably will develop as the aftermath of the war. The law which requires corporations to reengage their employees after they have been discharged from military service is of no value if the corporations are destroyed and there are no jobs for them to go back to. A series of corporation failures during the post-war period would be a terrible blow to the morale of the men in the service who regard military service as a patriotic duty and not as a career.

If we are to avoid an unemployment problem and social unrest which will be infinitely greater, even under the most advantageous outcome of the war, than the one which followed the collapse of 1929, American corporations must be kept in a sound financial condition and permitted to build up a capital surplus which will carry them successfully through the transition period.

Congress must bear in mind that if national solvency is to be maintained, there is a point beyond which taxes cannot be raised at the risk of destroying the free enterprise system to which America owes its greatness. Taxpayers do not bear the burden alone and therein lies the fallacy that "high taxes fall on the rich and they can stand them." Taxes have a way of reaching down to everyone who buys anything or sells anything. They affect even the value of tax-exempt securities. Unfortunately, recurring periods of depression are, and probably always will be, features of our business life and are caused by various happenings which disturb the complex relationships of our economic system. At such a time every bankruptcy makes for others, and business management has an obligation to take precautions for limiting the scope and intensity of the storm.

Our American corporations are not owned by their management but by upwards of 20,000,000 investors who have invested their money in them. Why and for what purpose should we destroy them? If we do we have destroyed the thriftiness, the self-sacrifice, and the character, hopes, beliefs, and ambitions of not only these investors but of the countless other millions of savings-bank investors and life-insurance policyholders who have a vital though indirect stake in the preservation of our corporate enterprises. Where, when, and how long can we find them again, and how shall we reinspire them with hope and belief in the future when we have destroyed for them the foundations and fundament of their past?

A combination of normal taxes of 45 percent and excess-profits taxes of 90 percent does not properly distinguish between the normal earnings of established businesses and increased earnings due to the war. This does not properly recognize such realities as fixed interest and preferred dividend charges.

The individual stockholder should be taxed on his income, both earned and from dividends, in accordance with the principle of ability to pay. It is not equitable to impose on each stockholder, irrespective of his individual income, the same tax burden. To do so has the effect of taxing the individual stockholder's share of corporate earnings at rates in some cases 100 percent in excess of what he would ordinarily be obliged to pay if the principle of the ability to pay is to be recognized.

I have had prepared in my office a list of some companies showing their net income before Federal income and excess-profits taxes, the amount of Federal income and excess-profits taxes for the year 1941, and the amount available for preferred dividends or common dividends, as the case may be.

I have also inducted into these figures what the Federal income and excess-profits tax would have been for the year 1941 had the House bill been in effect in 1941.

The figures in most cases have been based upon the annual or other reports of the respective companies. I believe the figures are substantially correct; of course absolute accuracy cannot be obtained without going over the figures with officials of each company. There may be a few companies where there might be a question as to the effect on net income for future years due to possible non-recurrent items, such as certain reserves and extraordinary losses. These cases, however, are the exception rather than the rule.

The method we have used in determining the effect of the House bill on last year's earnings is as follows:

We have taken the actual normal and surtaxes paid last year and increased that amount by 45 percent, which is the increase from the present normal and surtaxes of 31 percent to the proposed 45 percent. We have increased the excess-profits tax paid last year by 50 percent, which is the increase from the present 60 percent to the proposed 90 percent rate. Appropriate adjustment has been made for the fact that the adjusted excess profits net income is deductible before the normal and surtax.

A summary of the preferred stocks of 42 utility companies and 23 industrial companies, and of the common stocks of 13 utility and 56 industrial companies, from the list I append herewith, shows the following result:

Four utility companies, or 9 percent will not earn their preferred dividends; 11 utility companies, or 26 percent will not earn their preferred dividends and sinking funds; 13 utility companies, or 31 percent will be border-line cases, earning their preferred dividends by a margin of less than 50 percent; 13 utility companies will have their average earnings per common share reduced 27 percent.

Six industrial companies, or 26 percent, will be borderline cases, earning their preferred dividends less than twice. Fifty-six industrial companies will have their average earnings per common share reduced 39 percent.

The summary also shows the following estimated effect of the proposed new Federal income taxes of 45 percent and the excess-profits taxes of 90 percent. The average coverage for preferred dividends of 42 public utility operating companies—I have not inducted this into a single holding company—shows that the average coverage for 1941—and this is not an over-all coverage; this is coverage after interest and amortization of debt discount, and after taxes—the average coverage will drop from 2.31 times on 42 public utility operating company preferred stocks to 1.75 times; on 23 industrial preferred stocks, it drops from 5.57 to 3.59 times.

The average earnings per share for 13 public utility operating company common stocks drops from $2.34 to $1.70, and on 56 industrial common stocks it drops from $4.31 to $2.62.

There has been a lot of talk about these corporations getting off just as well as they did in the period before 1939. I append herewith a tabulation showing a list of companies.

Out of 55 industrial companies their net income, after taxes and preferred dividends, was $542,000,000 last year. If you induct the proposed rates it drops to $343,000,000, and the average for 1936, 1937, 1938, and 1939 was $420,000,000 So, where the figure has been gotten showing that these companies are as well off, I do not know. The average was $420,000,000, and it drops to $343,000,000. In other words, the earnings adjusted to the proposed tax are 37 percent less than in 1941 and 18 percent less than the average for 1936, 1937, 1938, and 1939. Now, take the 49 utilities shown on the other table. The amount drops from $206,000,000 to $160,000,000, and the average earnings for the 1936, 1937, 1938, and 1939 period were $199,000,000, and the aggregate earnings adjusted to the proposed tax were 22 percent less than in 1941 and 20 percent less than in the period from 1936 to 1939.

If preferred and common stocks of corporations like those listed above are harmed or discredited by nonpayment or reduction in dividends, how will those companies be able to raise equity money in the future One industry alone—i. e., electric power and light—spent $654,000,000 in 1941 for property additions. Of this amount $279,000,000 was supplied by the depreciation account and $375,000,000 had to be financed by sales of securities, surplus earnings, and borrowings. For 1942 the budget for capital expenditures for the same industry is estimated to be $700,000,000.

It seems to me that it is evident from all of the above that the proper place to tax earnings is in the hands of the recipients instead of impairing or destroying the sources; that is to say, the corporations which generate these earnings and from which they flow.

AUGUST 6, 1942.

SUMMARY

A summary of the preferred stocks of 42 utility companies and 23 industrial companies, and of the common stocks of 13 utility and 56 industrial companies, from the list I append herewith, exposes the following results:

1. 4 utility companies or 9 percent will not earn their preferred dividends.
   11 utility companies or 26 percent will not earn their preferred dividends and sinking funds.
   13 utility companies or 31 percent will be border-line cases, earning their preferred dividends by a margin of less than 50 percent.
   13 utility companies will have their average earnings per common share reduced 27 percent.
2. 6 industrial companies or 26 percent will be border-line cases, earning their preferred dividends less than twice
   56 industrial companies will have their average earnings per common share reduced 39 percent.

Estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent

	1941 actual	1941 adjusted for new taxes
Average coverage for—		
42 public utility operating company preferred stocks	2.31	1.75
23 industrial preferred stocks	5.57	3.59
Average earnings per share for—		
13 public utility operating company common stocks	$2.34	$1.70
56 industrial common stocks	$4.31	$2.62

Estimated effect of proposed new taxes on certain public utility operating company preferred stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent. No provision made for possible further increase in taxes due to lowering of excess-profits exemption under invested-capital method]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends times earned	Annual sinking fund requirements
Alabama Power, $6 and $7	$5,718	$2,183	$3,536	$2,269	$1,207	1.55	$1,500
	5,718	3,002	2,716	2,269	447	1.20	1,500
Arkansas Power & Light, $6 and $7	3,153	*1,128	2,025	949	1,076	2.14	....
	3,153	*1,635	1,518	949	569	1.60	....
Birmingham Electric, $6 and $7	1,231	*322	909	429	480	2.12	....
	1,231	*467	764	429	335	1.78	....
California Oregon Power, $6 and $7	1,425	525	900	604	296	1.49	....
	1,425	728	697	604	93	1.15	....
Carolina Power & Light, $6 and $7	3,996	*995	3,001	1,255	1,746	2.39	230
	3,996	*1,443	2,553	1,255	1,298	2.03	230
Central Illinois Public Service, $6	3,858	[1] 1,853	2,005	1,708	297	1.17	600
	3,858	2,499	1,359	1,708	[2] 349	.80	600
Central Maine Power, $2½, $6, and $7	2,776	[3] 748	2,028	1,347	681	1.50	50
	2,776	1,083	1,693	1,347	346	1.25	50
Central Power & Light, $6 and $7	2,127	[4] 821	1,306	842	464	1.55	700
	2,127	1,128	999	842	157	1.18	700
Consolidated Edison of New York, $5	48,946	*15,025	33,921	10,922	22,999	3.11	....
	48,946	*21,786	27,160	10,922	16,238	2.48	....
Consumers Power, $4½ and $5	17,227	7,882	9,345	3,425	5,920	2.73	125
	17,227	10,407	6,820	3,425	3,395	1.99	125
Florida Power & Light, $7	3,695	*1,197	2,498	1,153	1,345	2.16	....
	3,695	*1,735	1,960	1,153	807	1.70	....
Georgia Power, $5, $6 and $7	7,604	[5] *2,238	5,366	2,676	2,690	2.00	1,687
	7,604	*3,245	4,359	2,676	1,683	1.62	1,687
Illinois Iowa Power, $2½	4,650	1,744	2,906	1,209	1,697	2.40	274
	4,650	2,472	2,178	1,209	969	1.80	274
Indianapolis Power & Light, $5¼	3,988	[6] 2,133	1,855	738	1,117	2.51	900
	3,988	2,858	1,130	738	392	1.52	900
Jersey Central Power & Light, $5½, $6, and $7	2,954	*820	2,134	1,346	788	1.58	530
	2,954	*1,189	1,765	1,346	419	1.31	530
Kansas Gas & Electric, $6 and $7	1,853	[7] 807	1,046	521	525	2.01	....
	1,853	*1,170	683	521	162	1.31	....
Kansas Power & Light, $4½	2,982	1,351	1,631	626	1,005	2.61	520
	2,982	1,839	1,143	626	517	1.83	520
Louisville Gas & Electric, Kentucky, 5 percent $25 par	4,895	2,142	2,753	1,076	1,677	2.56	....
	4,895	2,844	2,051	1,076	975	1.91	....
Minnesota Power & Light, $6 and $7	2,693	1,008	1,685	991	694	1.70	200
	2,693	1,394	1,299	991	308	1.31	200
Mississippi Power & Light, $6	719	*240	479	404	75	1.18	....
	719	*348	371	404	[2] 33	.92	....
Mississippi River Power, $6	2,322	809	1,513	494	1,019	3.06	156
	2,322	1,138	1,184	494	690	2.40	156
Montana Power $6	6,349	2,834	3,515	957	2,558	3.67	480
	6,349	3,758	2,591	957	1,634	2.70	480
New York Power & Light, $6 and $7	3,655	[8] *1,071	2,584	1,589	995	1.63	....
	3,655	*1,553	2,102	1,589	513	1.32	....
Northern Indiana Public Service, $5½, $6, and $7	4,653	[9] 1,886	2,767	1,377	1,390	2.01	1,000
	4,653	2,625	2,028	1,377	651	1.47	1,000
Ohio Edison, $6, $6.60, and $7	7,547	3,649	3,898	1,867	2,031	2.08	....
	7,547	4,838	2,709	1,867	842	1.45	....
Ohio Public Service, $5, $5½, $6, and $7	4,336	2,065	2,271	960	1,311	2.37	160
	4,336	2,773	1,573	960	613	1.63	160
Oklahoma Gas & Electric, $6 and $7	3,857	1,468	2,389	1,159	1,230	2.06	475
	3,857	2,025	1,832	1,159	673	1.58	475
Pennsylvania Edison, $2.80 and $5	1,562	*471	1,091	852	239	1.28	....
	1,562	*683	879	852	27	1.03	....
Pennsylvania Power & Light, $5, $6, and $7	10,349	3,300	7,049	3,846	3,203	1.83	850
	10,349	4,680	5,669	3,846	1,823	1.47	850
Public Service of Indiana, $5	4,941	[10] *1,782	3,159	741	2,418	4.26	1,242
	4,941	*2,584	2,357	741	1,616	3.18	1,242
Public Service of Oklahoma, $5	2,598	[11] 855	1,743	440	1,303	3.96	200
	2,598	1,190	1,408	440	968	3.20	200
Rochester Gas & Electric, $5 and $6	3,306	*1,028	2,278	1,393	885	1.63	....
	3,306	*1,490	1,816	1,393	423	1.30	....

See footnotes at end of table.

Estimated effect of proposed new taxes on certain public utility operating company preferred stocks—Continued

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent. No provision made for possible further increase in taxes due to lowering of excess-profits exemption under invested capital method]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends times earned	Annual sinking fund requirements
San Antonio Public Service, $6	$2,126	[11] $1,078	$1,048	$270	$778	$3.88	$270
	2,126	1,421	705	270	435	2.61	270
Texas Power & Light, $6 and $7	2,560	855	1,705	865	840	1.97	....
	2,560	1,158	1,402	865	537	1.62	....
Toledo Edison, $5, $6, and $7	3,519	1,320	2,199	945	1,254	2.33	302
	3,519	1,820	1,699	945	754	1.80	302
Utah Power & Light, $6 and $7	2,778	*811	1,967	1,705	262	1.15	....
	2,778	*1,176	1,602	1,705	[2] 103	.94	....
Virginia Electric & Power, $6	7,091	3,260	3,831	1,172	2,659	3.27	670
	7,091	4,351	2,740	1,172	1,568	2.34	670
Washington Water Power, $6	2,657	*743	1,914	622	1,292	3.08	....
	2,657	*1,078	1,579	622	957	2.53	....
West Penn Power, $4½	9,543	3,792	5,751	1,337	4,414	4.30	320
	9,543	5,148	4,395	1,337	3,058	3.28	320
West Texas Utilities, $6	1,595	[13] 385	1,210	431	779	2.81	452
	1,595	558	1,037	431	636	2.40	452
Wisconsin Electric Power, $4½ and $6	7,233	3,332	3,901	1,512	2,389	2.58	....
	7,233	4,522	2,711	1,512	1,199	1.79	....
Wisconsin Power & Light, $6 and $7	2,852	[14] 1,313	1,539	1,116	423	1.38	370
	2,852	1,816	1,036	1,116	[2] 80	.93	370

*Income taxes only (no excess profits taxes).
[1] Includes $1,570,000 payable except for refunding.
[2] Deficit.
[3] Includes $34,000 payable except for refunding.
[4] Includes $250,000 payable except for refunding.
[5] Includes $2,132,000 payable except for refunding.
[6] Includes $650,000 payable except for refunding.
[7] Includes $358,000 payable except for refunding.
[8] Includes $186,000 payalbe except for refunding (estimated).
[9] Includes $433,000 payable except for refunding.
[10] Includes $520,000 payable except for refunding.
[11] Includes $410,000 payable except for refunding.
[12] Includes $434,000 payable except for refunding.
[13] Includes $215,000 payable except for refunding.
[14] Includes $1,135,000 payable except for refunding.

Estimated effect of proposed new taxes on certain industrial preferred stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent. No provision made for possible further increase in taxes due to lowering of excess-profits exemption under invested capital method]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends, times earned	Earned per common share	Annual sinking fund requirements
American Bank Note, $6	$2,135	$1,098	$1,037	$270	$767	3.84	$1.17	....
	2,135	1,518	617	270	347	2.28	0.53	....
American Can Co., $7	37,545	18,700	18,846	2,886	15,960	6.53	6.45	....
	37,545	24,482	13,063	2,886	10,177	4.52	4.11	....
American Rolling Mill, $4.50	24,143	12,915	11,228	2,025	9,203	5.54	3.21	$1,500
	24,143	16,953	7,190	2,025	5,165	3.55	1.80	1,500

Estimated effect of proposed new taxes on certain industrial preferred stocks—Continued

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Preferred dividends, times earned	Earned per common share	Annual sinking fund requirements
American Tobacco, $6	$43,543	$19,659	$23,884	$3,162	$20,722	$7.54	$4.58	$5,849
	43,543	26,270	17,273	3,162	14,111	5.46	3.11	5,849
American Woolen, $7	19,144	12,200	6,944	2,450	4,494	2.83	11.23	....
	19,144	15,690	3,454	2,450	1,004	1.41	2.51	....
Bethlehem Steel, $7	116,958	82,500	34,458	6,537	27,921	5.27	9.35	4,960
	116,958	105,125	11,833	6,537	5,296	1.81	1.71	4,960
Celanese Corporation, $7, $5, $7 2d	13,972	6,866	7,106	2,656	4,450	2.68	8.23	1,200
	13,972	9,107	4,865	2,656	2,209	1.75	1.60	1,200
Crucible Steel, $5	22,237	14,798	7,439	1,672	5,767	4.44	12.95	250
	22,237	18,676	3,561	1,672	1,889	2.13	4.24	250
B. F. Goodrich, $5	19,418	10,810	8,608	2,060	6,548	4.17	5.02	1,875
	19,418	13,856	5,562	2,060	3,502	2.70	2.70	1,875
Hershey Chocolate, $4+$1	9,162	3,218	3,944	1,269	4,675	4.68	6.82	....
	9,162	4,457	4,705	1,269	3,436	3.70	5.01	....
Marshall Field & Co., $6	10,076	5,390	4,686	900	3,786	5.20	1.95	....
	10,076	7,051	3,025	900	2,125	3.36	1.09	....
Maytag, $6, $3, 2d	2,705	1,080	1,625	1,017	608	1.60	0.38	....
	2,075	1,478	1,227	1,017	210	1.20	0.13	....
National Biscuit, $7	17,057	6,325	10,732	1,736	8,996	6.19	1.43	....
	17,057	8,721	8,336	1,736	6,600	4.80	1.05	....
National Gypsum, $4.50	3,399	1,865	1,534	288	1,246	5.32	0.94	253
	3,399	2,400	999	288	711	3.47	0.54	253
Pure Oil, $5, $6	19,281	3,996	15,285	3,909	11,376	3.90	2.86	....
	19,281	5,735	13,546	3,909	9,637	3.46	2.42	....
Radio Corporation, $3.50 1st, $5 B	26,565	16,373	10,192	3,219	6,973	3.16	0.50	....
	26,566	21,151	5,415	3,219	2,196	1.68	0.16	....
Republic Steel, $6PP, $6P	70,288	46,250	24,038	2,037	22,001	11.81	3.87	4,428
	70,288	58,838	11,450	2,037	9,413	5.62	1.65	4,428
Schenley Distillers, $5.50	9,965	*2,487	7,478	926	6,552	8.08	5.20	1,200
	9,965	*3,606	6,359	926	5,432	6.85	4.31	1,200
Sharon Steel, $5	4,233	2,600	1,633	298	1,335	5.47	8.40	400
	204,233	3,301	932	298	634	3.12	1.62	400
United States Rubber, $8	29,776	16,113	13,663	5,209	8,454	2.62	4.80	2,000
	23,776	20,924	8,852	5,209	3,643	1.70	2.09	2,000
United States Steel, $7	234,871	118,700	116,171	25,220	90,051	4.60	10.45	11,973
	4,871	160,727	74,144	25,220	48,924	2.94	5.64	11,973
Wilson & Co., $6	9,178	*2,131	7,047	1,910	5,098	3.62	2.56	1,415
	9,178	*3,089	6,089	1,949	4,140	3.13	2.08	1,415
Youngstown Sheet & Tube, $5.50	37,624	21,500	16,124	825	15,299	19.55	9.13	3,960
	37,624	27,832	9,792	825	8,967	11.87	5.35	3,960

*Income taxes only (no excess-profits taxes).

Estimated effect of proposed new taxes on certain public utility operating company common stocks

[First line shows 1941 actual results; second line shows estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent. No provision made for possible further increase in taxes due to lowering of excess-profits exemption under invested capital method]

[000 omitted]

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Earned per common share	Annual sinking fund requirements
Central Hudson Gas & Electric	$1,604	[1] $480	$1,124	$316	$808	$0.54	....
	1,604	*696	908	316	592	.40	....
Cleveland Electric Illuminating	11,549	4,492	7,057	1,148	5,909	2.54	....
	11,549	6,108	5,441	1,148	4,293	1.84	....
Commonwealth Edison	44,566	17,818	26,748	....	26,748	2.10	....
	44,566	24,438	20,128	....	20,128	1.58	....

See footnotes at end of table.

Estimated effect of proposed new taxes on certain public utility operating company common stocks—Continued

	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for preferred dividends	Annual preferred dividends	Balance for common	Earned per common share	Annual sinking fund requirements
Connecticut Light & Power	$5,753	$2,001	$3,752	$374	$3,378	$2.94	$200
	5,753	2,322	3,431	374	3,057	2.67	200
Consolidated Edison of New York	48,946	*15,025	33,921	10,922	22,999	2.00	----------
	48,946	*21,786	27,100	10,922	16,238	1.41	----------
Houston Lighting & Power	4,727	1,805	2,922	315	2,607	5.21	----------
	4,727	2,456	2,271	315	1,956	3.91	----------
Indianapolis Power & Light	3,988	[2] 2,133	1,855	738	1,117	1.56	900
	3,988	2,858	1,130	738	392	.55	900
Louisville Gas & Electric, Kentucky	4,895	2,142	2,753	1,076	1,677	1.85	----------
	4,895	2,844	2,051	1,076	975	1.07	----------
Oklahoma Natural Gas	3,246	*748	2,498	592	1,906	3.47	475
	3,246	*1,084	2,162	592	1,570	2.85	475
Pacific Gas & Electric	33,255	10,792	22,463	7,970	14,493	2.31	1,303
	33,255	15,175	18,080	7,970	10,110	1.61	1,303
Public Service of Indiana	4,941	[3] *1,782	3,159	741	2,418	2.18	1,242
	4,941	*2,584	2,357	741	1,616	1.46	1,242
Washington Gas Light	1,715	[4] 508	1,207	270	937	2.20	160
	1,715	722	993	270	723	1.70	160
West Penn Power	9,543	3,792	5,751	1,337	4,414	1.50	320
	9,543	5,148	4,595	1,337	3,058	1.04	320

*Income taxes only (no excess profits taxes).
[1] Includes $340,000 payable except for refunding.
[2] Includes $650,000 payable except for refunding.
[3] Indludes $520,000 payable except for refunding.
[4] Excludes $16,000 credit applicable to 1940.

Estimated effect of proposed new taxes on certain industrial common stocks

[First line shows 1941 actual results, second line shows estimated effect of proposed new Federal income taxes of 45 percent and excess-profits taxes of 90 percent. No provision made for possible further increase in taxes due to lowering of excess-profits exemption under invested capital method]

[000 omitted]

	Net income for common before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for common	Earned per share, common	Annual sinking-fund requirements
Adams-Millis Corporation	$1,046	$422	$624	$4.00	----------
	1,046	575	471	3.02	----------
Air Reduction Co	14,741	7,625	7,116	2.62	----------
	14,741	9,921	4,820	1.77	----------
Allen Industries, Inc	861	425	436	1.66	----------
	861	568	293	1.11	----------
American Brake Shoe & Foundry	6,078	3,300	2,778	3.56	----------
	6,078	4,298	1,780	2.32	----------
American Home Products Corporation	6,900	2,535	4,365	5.12	$240
	6,900	3,508	3,392	3.98	240
American Laundry Machine Co	3,666	1,500	2,166	3.96	----------
	3,666	2,041	1,625	2.98	----------
Armstrong Cork Co	7,556	3,526	4,029	2.86	----------
	7,556	4,646	2,910	2.06	----------
Atlantic Refining Co	*20,178	6,424	13,754	5.16	----------
	*20,178	9,315	10,863	4.07	----------
Autocar Co	3,174	1,709	1,465	7.27	----------
	3,174	2,348	826	4.16	----------
Bath Iron Works Corporation	3,327	1,931	1,396	3.33	----------
	3,327	2,637	690	1.65	----------
Babcock & Wilcox Co	15,732	11,480	4,252	6.33	----------
	15,732	14,418	1,314	1.95	----------
Beech-Nut Packing Co	5,861	3,152	2,709	6.19	----------
	5,861	4,108	1,753	4.03	----------

See footnotes at end of table.

Estimated effect of proposed new taxes on certain industrial common stocks—Continued

	Net income for common before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for common	Earned per share, common	Annual sinking-fund requirements
Bendix Aviation Corporation	$36,714	$23,446	$13,207	$6.30	
	36,714	30,711	6,003	2.84	
Borden Co	11,157	*2,887	8,270	1.88	
	11,157	*4,185	6,972	1.58	
Bridgeport Brass Co	6,716	4,805	1,911	2.03	
	6,716	6,037	679	.72	
Budd Wheel Co	5,704	3,950	1,754	1.82	
	5,704	4,977	727	.75	
Bullard Co	6,381	4,404	1,977	7.16	
	6,381	5,513	868	3.12	
Butler Bros	3,773	1,700	2,073	1.85	
	3,773	2,403	1,370	1.22	
Carnation Co	4,776	2,359	2,417	3.97	
	4,776	3,144	1,632	2.67	
Chicago Pneumatic Tool Co	8,021	5,960	2,061	6.15	
	8,021	7,454	567	1.69	
Chrysler Corporation	68,771	28,660	40,114	9.22	
	68,774	38,806	29,968	6.89	
Clark Equipment Co	7,236	5,150	2,086	8.67	
	7,236	6,480	756	3.19	
Commercial Solvents Corporation	5,343	2,728	2,615	.99	
	5,343	3,507	1,336	.69	
Congoleum-Nairn, Inc	4,242	2,225	2,017	1.62	
	4,242	2,928	1,314	1.06	
Container Corporation of America	6,742	4,415	2,327	2.98	$600
	6,742	5,597	1,145	1.46	600
Continental Can Co., Inc	11,869	4,400	7,469	2.62	
	11,869	5,955	5,914	2.07	(1)
Corn Products Refining Co	17,599	9,054	8,545	3.37	
	17,599	12,073	5,526	2.19	
Eastman Kodak Co	48,452	27,233	21,219	8.57	
	48,452	35,614	12,838	5.19	
Eaton Manufacturing Co	11,864	7,500	4,364	6.20	
	11,864	9,500	2,364	3.30	
Electric Auto-Lite Co	13,621	7,735	5,886	4.90	400
	13,621	9,920	3,701	3.08	400
Fairbanks, Morse & Co	8,620	5,699	2,920	4.87	
	8,620	7,228	1,392	2.32	
Flintkote Co	3,278	1,720	1,558	2.34	225
	3,278	2,236	1,042	1.50	225
General Foods Corporation	25,215	11,737	13,478	2.56	
	25,215	15,704	9,511	1.81	
General Motors Corporation	480,564	287,992	192,572	4.42	
	480,564	374,606	105,958	2.43	
Hazel-Atlas Glass Co	5,744	2,863	2,881	6.63	
	5,744	3,776	1,968	4.53	
Johns Manville Corporation	14,379	8,718	5,661	6.66	
	14,379	11,189	3,190	3.75	
Jones & Laughlin Steel Corporation	27,952	14,342	13,610	10.85	
	27,952	18,921	9,031	7.20	
Kennecott Copper Corporation	83,519	34,268	49,251	4.55	
	83,519	45,287	38,232	3.54	
Kresge (S. S.) Corporation	17,223	7,775	9,448	1.72	
	17,223	10,478	6,745	1.23	
Lambert Co	2,075	*725	1,350	1.81	
	2,075	*1,051	1,024	1.37	
Lehigh Portland Cement Co	4,728	2,710	2,018	2.78	
	4,728	3,547	1,181	1.62	
Lerner Stores Corporation	2,673	1,285	1,388	3.47	
	2,673	1,770	903	2.26	
Loew's Inc	13,895	3,747	10,148	6.09	
	13,895	5,427	8,468	5.08	
Loose-Wiles Biscuit Co	1,844	734	1,110	2.15	
	1,844	1,029	815	1.60	
McCrory Stores Corporation	4,099	1,877	2,222	2.24	
	4,099	2,452	1,647	1.66	
Mesta Machine Co	7,009	3,402	3,607	3.60	
	7,009	4,503	2,506	2.51	
Minneapolis-Honeywell Regulator Co	6,513	3,899	2,614	4.20	
	6,513	5,011	1,502	2.41	

See footnotes at end of table.

Estimated effect of proposed new taxes on certain industrial common stocks—Continued

	Net income for common before Federal income and excess-profits taxes	Federal income and excess-profits taxes	Net income for common	Earned per share, common	Annual sinking-fund requirements
Monsanto Chemical Co.	$15,941	$9,609	$6,332	$4.90	----------
	15,941	12,304	3,637	2.93	----------
National Acme Co.	9,770	6,625	3,145	6.29	----------
	9,770	8,350	1,420	2.84	----------
Newport News Shipbuilding & Drydock Co.	13,814	8,923	4,891	6.11	----------
	13,814	11,455	2,359	2.95	----------
Otis Steel Co.	3,815	2,400	1,415	1.54	----------
	3,815	3,125	690	.75	----------
J. C. Penny Co.	33,739	16,611	17,128	6.24	----------
	33,739	21,923	11,816	4.31	----------
Pullman Inc.	16,087	*5,168	10,919	3.31	----------
	16,087	*7,494	8,593	2.60	----------
Simmons Co.	7,227	3,716	3,511	3.03	----------
	7,227	4,870	2,057	2.04	----------
United States Gypsum Co.	13,667	7,181	6,486	5.42	----------
	13,667	9,423	4,244	3.55	----------
United States Tobacco Co.	4,097	*1,210	2,887	1.58	----------
	4,097	*1,754	2,343	1.28	----------

*Income taxes only (no excess-profits taxes).
[1] Company has $6,000,000 bank loans.

Net income for dividends (after taxes)—Public utility operating companies

[000 omitted]

	1936	1937	1938	1939	1940	1941	1941 adjusted for proposed new taxes [1]	1936-39 average
Alabama Power	$3,634	$3,888	$3,363	$4,110	$3,017	$3,636	$2,716	$3,749
Arkansas Power & Light	1,099	1,422	1,317	1,265	1,154	2,025	1,518	1,276
Birmingham Electric	621	756	565	624	475	909	764	641
California-Oregon Power	1,098	928	896	905	948	900	697	957
Carolina Power & Light	2,115	2,565	2,504	2,224	3,099	3,001	2,553	2,352
Central Hudson Gas & Electric	1,858	1,740	1,595	1,634	1,625	1,124	908	1,707
Central Illinois Public Service	1,543	1,519	1,662	1,912	2,301	2,005	1,359	1,659
Central Maine Power	1,650	1,730	1,793	2,047	2,124	2,028	1,693	1,805
Central Power & Light	918	1,442	1,395	1,431	1,514	1,306	999	1,296
Cleveland Electric Illuminating	6,920	7,102	6,826	7,332	8,316	7,057	5,441	7,045
Commonwealth Edison	14,745	19,049	19,897	25,414	29,170	26,748	20,128	19,776
Connecticut Light & Power	4,531	4,174	3,854	4,169	4,064	3,752	3,431	4,182
Consolidated Edison of New York	37,200	35,574	34,893	36,428	36,455	33,921	27,160	36,048
Consumers Power	9,036	10,026	8,801	9,675	10,966	9,345	6,820	9,384
Florida Power & Light	1,456	1,926	2,040	1,429	2,286	2,498	1,960	1,713
Georgia Power	5,051	4,978	4,542	4,974	4,564	5,366	4,359	4,886
Houston Light & Power	2,392	2,784	2,977	2,786	2,928	2,922	2,271	2,735
Illinois-Iowa Power	1,982	2,477	2,114	2,431	2,274	2,906	2,178	2,251
Indianapolis Power & Light	1,598	1,852	1,935	2,184	3,205	1,855	1,130	1,892
Jersey Central Power & Light	1,774	1,983	2,016	2,235	2,624	2,134	1,765	2,002
Kansas Gas & Electric	1,258	1,295	1,255	1,191	1,587	1,046	683	1,250
Kansas Power & Light	2,081	2,112	1,887	2,501	1,985	1,631	1,143	2,145
Louisville Gas & Electric, Kentucky	3,382	2,556	2,577	2,789	2,804	2,753	2,051	2,826
Minnesota Power & Light	1,274	1,492	1,112	1,374	1,340	1,685	1,299	1,313
Mississippi Power & Light	559	701	649	446	416	479	371	589
Mississippi River Power	1,214	1,235	1,736	1,443	1,177	1,513	1,184	1,407
Montana Power	3,606	3,612	2,547	3,250	3,924	3,515	2,591	3,254
New York Power & Light	2,946	3,213	2,749	2,621	3,686	2,584	2,102	2,882
Northern Indiana Public Service	1,603	2,187	1,873	2,366	2,926	2,767	2,028	2,007
Ohio Edison	4,186	4,733	3,702	4,172	4,146	3,898	2,709	4,198
Ohio Public Service	2,297	2,908	2,392	2,968	2,700	2,271	1,573	2,641
Oklahoma Gas & Electric	2,424	2,580	2,345	2,779	2,540	2,389	1,832	2,532
Oklahoma Natural Gas	850	1,440	1,486	1,555	2,613	2,498	2,162	1,333
Pacific Gas & Electric	24,968	24,911	23,430	25,678	24,673	[illegible]	16,080	24,747

[1] 45 percent income taxes and 90 percent excess-profits taxes.

Net income for dividends (after taxes)—Public utility operating companies—
Continued

	1936	1937	1938	1939	1940	1941	1941 adjusted for proposed new taxes	1936-39 average
Panhandle Eastern Pipe Line	$1,711	$3,760	$3,059	$4,363	$4,548	$4,804	$3,864	$3,223
Pennsylvania Edison	1,105	984	967	1,109	1,198	1,091	879	1,041
Pennsylvania Power & Light	7,914	8,229	7,980	8,776	8,532	7,049	5,669	8,225
Public Service of Oklahoma	1,384	1,377	1,597	1,856	1,951	1,743	1,408	1,553
Rochester Gas & Electric	2,872	3,055	2,171	2,511	2,789	2,278	1,816	2,652
San Antonio Public Service	849	858	841	887	1,091	1,048	705	859
Texas Power & Light	2,254	2,125	1,971	2,273	1,979	1,705	1,402	2,156
Toledo Edison	1,852	2,165	2,299	2,768	2,549	2,199	1,690	2,271
Utah Power & Light	1,357	1,689	1,302	1,402	2,022	1,967	1,602	1,437
Virginia Electric & Power	3,153	3,394	3,484	3,833	4,128	3,831	2,740	3,466
Washington Gas Light	676	760	1,006	1,232	1,314	1,207	993	918
Washington Water Power	2,555	2,752	2,489	3,042	2,819	1,914	1,579	2,709
West Penn Power	7,414	6,941	5,512	6,045	6,377	5,751	4,395	6,478
West Texas Utilities	621	809	810	927	1,002	1,210	1,037	792
Wisconsin Power & Light	1,243	1,061	1,337	1,593	1,608	1,539	1,036	1,308
Total	190,928	202,849	191,550	212,959	224,433	206,166	160,482	199,568

Net income for dividends (after taxes and preferred dividends)—Industrial companies

[000 omitted]

	1936	1937	1938	1939	1940	1941	1941 adjusted for proposed new taxes [1]	1936-39 average
Adams Millis	$398	$432	$500	$553	$472	$624	$471	$471
Air Reduction	7,065	7,327	3,769	5,077	6,446	7,116	4,820	5,809
Allen Industries	730	362	84	459	59[illegible]	436	293	409
American Brake Shoe	1,803	3,081	794	1,834	2,682	2,778	1,780	1,878
American Home Products	2,825	2,875	3,026	4,207	4,290	4,365	3,392	3,233
American Laundry Machine	728	972	16	816	905	2,166	1,625	508
Armstrong Cork	5,278	5,158	1,082	4,273	3,942	4,029	2,910	3,948
Atlantic Refining	6,905	9,350	3,725	4,436	5,625	13,754	10,863	6,104
Autocar	155	40	*471*	312	393	1,465	826	9
Bath Iron Works	228	20	130	661	2,052	1,396	690	260
Babcock & Wilcox	1,212	1,805	*3,089*	1,169	3,588	4,252	1,314	274
Beech-Nut Packing	2,709	2,741	2,527	2,473	2,890	2,709	1,753	2,612
Bendix Aviation	3,025	2,255	156	4,486	7,861	13,267	6,003	2,480
Borden Co	7,921	6,291	6,641	7,980	7,583	8,270	6,972	7,208
Bridgeport Brass	1,070	733	*252*	459	1,259	1,911	679	504
Budd Wheel	744	578	*498*	634	975	1,754	727	364
Bullard	692	879	*22*	280	1,697	1,977	368	459
Butler Bros	1,908	1,261	813	941	659	2,073	1,370	1,106
Carnation	1,725	1,616	1,775	2,836	2,172	2,417	1,633	1,863
Chicago Pneumatic Tool	516	912	54	111	1,009	2,061	567	398
Chrysler	62,110	50,729	18,798	36,880	37,802	40,114	29,968	42,129
Clark Equipment	432	1,084	153	1,053	1,405	2,086	756	680
Commercial Solvents	2,232	1,587	*294*	1,600	2,387	2,615	1,836	1,281
Congoleum Nairn	2,548	2,525	1,265	2,111	1,617	2,017	1,314	1,112
Container Corporation	1,287	1,784	29	1,449	2,227	2,827	1,145	1,137
Continental Can	9,039	8,721	6,202	7,736	8,053	7,469	5,914	7,924
Corn Products Refining	9,770	6,880	8,033	8,400	7,861	8,545	5,526	8,146
Eastman Kodak	18,537	21,978	16,970	21,168	19,707	21,219	12,838	19,663
Eaton Manufacturing	2,390	2,569	23	2,707	2,994	4,364	2,364	1,922
Fairbanks Morse	1,871	2,064	496	2,470	2,749	2,920	1,392	1,725
Flintkote	1,171	1,005	812	1,432	1,436	1,558	1,042	1,105
General Foods	14,360	9,087	13,086	14,443	14,569	13,478	9,511	12,744
General Motors	229,527	187,524	93,132	178,460	186,537	192,572	105,958	170,911
Hazel Atlas Glass	2,848	2,807	2,158	2,884	2,598	2,881	1,968	2,697
Johns Manville	3,849	4,927	930	3,640	5,396	5,661	3,190	3,336
Jones & Laughlin	19	679	*9,990*	*981*	6,167	13,610	9,031	*2,553*
Kennecott Copper	25,491	49,822	22,689	33,947	43,837	4[illegible],251	38,232	32,987
S. S. Kresge	11,042	10,712	8,997	10,450	10,070	[illegible],448	6,745	10,300
Lambert	1,272	1,152	1,278	1,262	1,173	1,360	1,024	1,241

See footnotes at end of table.

Net income for dividends (after taxes and preferred dividends)—Industrial companies—Continued

	1936	1937	1938	1939	1940	1941	1941 adjusted for proposed new taxes [1]	1936-39 average
Lehigh Portland Cement	$1,827	$1,005	$477	$2,030	$1,804	$2,018	$1,181	$1,335
Lerner Stores	2,073	1,860	1,155	1,391	1,272	1,388	903	1,620
Loew's Inc	9,695	13,445	9,029	8,650	8,021	10,148	8,468	10,205
Loose-Wiles Biscuit	1,127	525	784	881	987	1,110	815	829
McCrory Stores	1,988	1,869	1,465	1,931	1,982	2,222	1,647	1,813
Mesta Machine	4,341	4,656	2,910	2,715	3,083	3,607	2,506	3,655
Minneapolis Honeywell	2,954	2,837	880	2,036	2,406	2,614	1,502	2,177
Monsanto Chemical	4,469	4,0805	,821	4,979	5,288	6,332	3,637	4,268
National Acme	688	1,426	183	578	2,199	3,145	1,420	719
Newport News Shipbuild	445	1,330	1,162	2,481	4,186	4,891	2,359	1,354
Otis Steel	1,274	1,537	*1,967*	*541*	*37*	1,415	690	56
J. C. Penney	18,712	16,575	13,739	16,481	16,231	17,128	11,816	16,377
Pullman, Inc.	6,347	12,276	2,296	4,009	7,484	10,919	8,593	6,232
Simmons	4,011	3,314	1,645	2,447	2,702	3,511	2,357	2,857
United States Gypsum	4,781	4,873	4,178	6,818	6,505	6,486	4,244	5,162
United States Tobacco	4,073	3,299	3,195	3,233	3,814	2,887	2,343	3,450
Total	516,223	491,546	248,959	429,293	483,603	542,126	343,793	420,498

[1] 45 percent income taxes and 90 percent excess-profits taxes.

Italic indicates a deficit.

The CHAIRMAN. Mr. Harold V. Bozell.

STATEMENT OF HAROLD V. BOZELL, PRESIDENT, GENERAL TELEPHONE CORPORATION, NEW YORK, N. Y.

Mr. BOZELL. My name is Harold V. Bozell. I am president of the General Telephone Corporation of 80 Broad Street, New York. I speak on behalf of the independent telephone companies of the United States, as a member of the tax committee of the United States Independent Telephone Association. Your list today credits me to Washington, but actually I am a Kansan and Missourian and transplanted to New York.

You, Mr. Chairman, I believe, are the only one of the members of the committee that has the advantage of being served by an independent telephone company. I think the other gentlemen all receive their service from the Bell System, but the independent telephones in these United States serve one out of every five telephones in the country. In other words, of the 23,450,000 telephones in the United States at the end of 1941, about 4,609,000 were operated by independently owned companies and by rural or farmer lines and systems. These independent companies thus serve more telephones than there are in all of Greater Germany, including Austria and Czechoslovakia, and almost as many as in all Great Britain and France, combined. The independent companies number some 6,350 and they operate about 12,000 telephone exchanges as shown on the accompanying map to which is attached a list of some well-known places served by them.

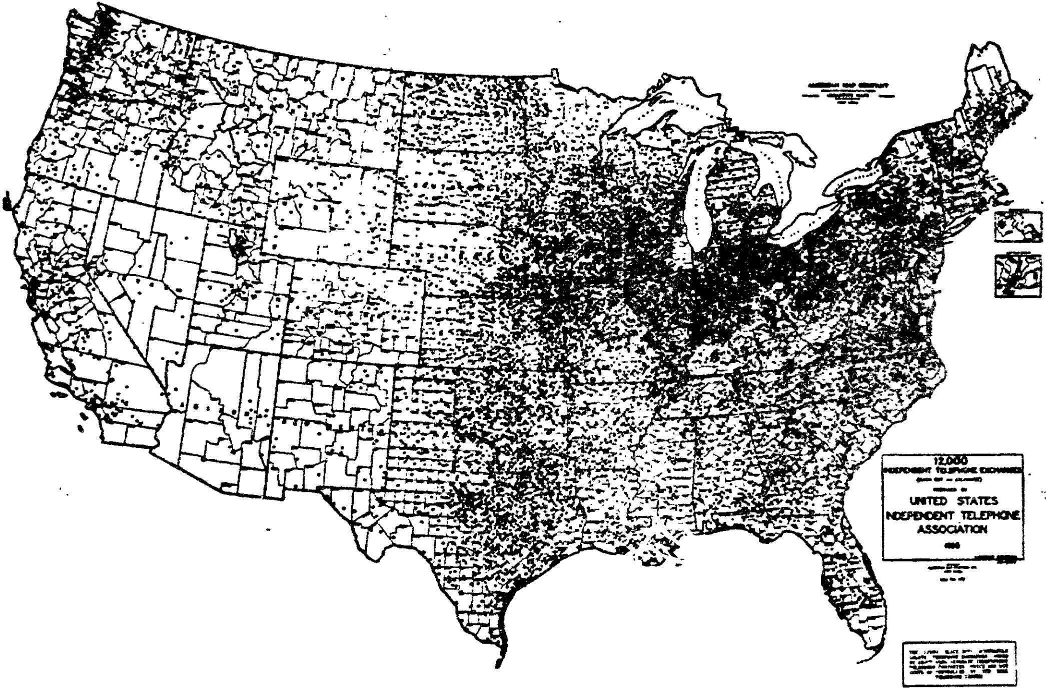
(The list and map (p. 1645) referred to are as follows:)

SOME WELL-KNOWN CITIES AND TOWNS SERVED BY INDEPENDENT TELEPHONE COMPANIES—TO ACCOMPANY MAP SUBMITTED WITH STATEMENT ON BEHALF OF THE INDEPENDENT TELEPHONE COMPANIES OF THE UNITED STATES TO COMMITTEE ON FINANCE, UNITED STATES SENATE, AUGUST 11, 1942

Long Beach, Calif.
Palm Springs, Calif.
Redlands, Calif.
San Bernardino, Calif.
Santa Barabara, Calif.
Santa Monica, Calif.
St. Petersburg, Fla.
Tallahassee, Fla.
Tampa, Fla.
Honolulu, Hawaii
Bloomington, Ill.
Kewanee, Ill.
Mattoon, Ill.
Connersville, Ind.
Elkhart, Ind.
Fort Wayne, Ind.
Lafayette, Ind.
La Porte, Ind.
Logansport, Ind.
Richmond, Ind.
Terre Haute, Ind.
Valparaiso, Ind.
Fort Dodge, Iowa
Newton, Iowa
Ashland, Ky.
Lexington, Ky.
Muskegon, Mich.
Owosso, Mich.
Mankato, Minn.
Jefferson City, Mo.
Lincoln, Nebr.
Carlsbad, N. Mex.
Gloversville, N. Y.
Jamestown, N. Y.
Johnstown, N. Y.
Middletown, N. Y.
Rochester, N. Y.
Durham, N. C.
High Point, N. C.
Pinehurst, N. C.
Southern Pines, N. C.
Ashland, Ohio
Ashtabula, Ohio
Bellevue, Ohio
Chillicothe, Ohio
Elyria, Ohio
Lima, Ohio
Lorain, Ohio
Mansfield, Ohio
Marion, Ohio
Mount Vernon, Ohio
Newark, Ohio
New Philadelphia, Ohio
Portsmouth, Ohio
Warren, Ohio
Wooster, Ohio
Butler, Pa.
Erie, Pa.
Johnstown, Pa.
Meadville, Pa.
York, Pa.
Sumter, S. C.
Johnson City, Tenn.
Brownwood, Tex.
Gonzales, Tex.
San Angelo, Tex.
Texarkana, Tex.-Ark.
Bristol, Va.-Tenn.
Charlottesville, Va.
Lexington, Va.
Everett, Wash.
Wenatchee, Wash.
Bluefield, W. Va.
LaCrosse, Wis.
Wausau, Wis.
Wisconsin Rapids, Wis.

Mr. BOZELL. The independent companies actually serve almost twice as many communities in the United States as do the Bell companies, but the Bell companies are in all the largest cities and therefore serve a larger number of telephones. It is estimated that about two-thirds of the area of the United States is served by independent companies. Long distance service is freely interchanged between independent companies and the Bell System. The gross revenues of these independent companies for 1941 totaled $164,000,000.

The independent telephone companies confront in the next few years the very difficult problems that face all businesses in the United States, and in addition the problems peculiar to a closely regulated business with a public interest. Our rates and hence our income are determined by regulatory bodies. We cannot readily increase rates even when costs of material, wages, and taxes are steadily rising. We cannot negotiate rates as manufacturers negotiate prices in connection with their contracts. As a matter of fact, increases in rates high enough to compensate for the proposed additional Federal taxes as set forth in the revenue bill recently passed by the House of Representatives are entirely impracticable, since the greater part of any increases would go right back into additional taxes; and even if such increases were authorized they could not as a practical matter be imposed on the average telephone subscriber. One of our companies has recently reviewed this situation with its State regulatory commission, which found that taxes at the levels proposed would prove an insurmountable barrier; the commission would have to authorize an increase in rates of about $10 to provide each $1 of desired increase in net income.


12,000
INDEPENDENT TELEPHONE EXCHANGES
UNITED STATES
INDEPENDENT TELEPHONE
ASSOCIATION

Furthermore, were such a move deemed possible and were it to be attempted, increases could not be obtained without lengthy hearings and proceedings before State regulatory bodies, which could hardly be concluded before the companies suffered serious damage from the impact of the taxes. Hence, one characteristic of this business is a comparatively steady, moderate rate of return on its investment, one that is never allowed to be excessive. Last year the average rate of return for independent class A companies—that is, those with annual revenues of $100,000 or more—as a whole was 4.8 percent on their plant investment. An estimate, necessarily rough, would indicate that if the rates set forth in the House bill had been in effect in 1941 this rate of return would have been about 4 percent. Our junior securities possess virtually no speculative possibilities. They are typically held by small investors in communities all over the country who want a regular and secure income from them.

The second notable characteristic of this business is the necessity for additions to plant and equipment year after year. The requirement of new investment in connection with war activities, including service to the armed forces, is particularly pressing at the present time. Most of the larger and many of the smaller independent telephone companies are located near and render telephone service to one or more Army camps, naval establishments, or war industries. Some examples are Carolina Telephone & Telegraph Co., Inc., Tarboro, N. C.; Illinois Commercial Telephone Co., serving many Illinois areas; Virginia Telephone & Telegraph Co., Charlottesville, Va.; Southwestern Associated Telephone Co., operating in various areas in Oklahoma, Texas, and New Mexico; Eastern Illinois Telephone Co., Rantoul, Ill.; The Home Telephone & Telegraph Co., Fort Wayne, Ind.; San Angelo Telephone Co., San Angelo, Tex.; Pike-Crenshaw Telephone Exchange, Gosher, Ala.; Florida Telephone Corporation, Ocala, Fla.; Peninsular Telephone Co., Tampa, Fla.; the United Telephone Co., Rolla, Mo.; Durham Telephone Co., Durham, N. C.; West Coast Telephone Co., Everett, Wash.; South Carolina Continental Telephone Co., Sumter, S. C.; Southeastern Telephone Co., Tallahassee, Fla.; Southwest Telephone Co., Brownwood, Tex.; and Indiana Associated Telephone Corporation, Lafayette, Ind. We could go on indefinitely as to the extent of what independent telephone companies are having to do in connection with war activities. Some independent company is being called upon almost every day to furnish immediate telephone service to an additional camp, airport, or war industry to be located in its territory—sometimes three or four new ones in 1 day.

The demand for additional service, both for official and essential business calls and for calls from men in service to their families at home is tremendous. The peak loud of long-distance calls in the case of the Carolina company, for example, is Sunday night, normally a dull period. Even purely rural lines are being taxed as never before by calls necessitated by the emergency, such as calls relative to troop movements and air operations. Materials are hard to get, and the industry is operating in full cooperation with the War Production Board in its orders restricting growth to essential purposes as defined by the Board, but it is still true that most companies will be called upon to spend substantial additional sums on capital outlays, often ranging up to 10 or 20 percent, and sometimes to 50 percent or more, of the existing investment, to supply essential service.

Thus two related problems confront nearly every independent telephone company: How to raise the funds required for needed service; and how to offer a good enough and safe enough return on the new securities to obtain the money. If the company cannot pay common dividends, or if it is likely to default on its preferred dividends, the raising of new capital will be almost impossible. It should be emphasized that the money this industry must obtain constitutes permanent capital and is invested in telephone plant. The problem is different from that of the industry which obtains money for inventory and liquidates through sales.

The proposed increases in corporation taxes, particularly the increase in the surtax to 21 percent, are a crushing blow to corporations which cannot possibly increase their incomes to match the taxes. Large industrial corporations whose gross incomes have been greatly enlarged by a greater volume of business, whether in war materials or other goods, can possibly meet the the new imposts without too much difficulty. Smaller corporations, such as most of those for whom we speak, with level or declining incomes, will be very hard hit. Indeed, a few computations will show that the proposed tax system conforms to ability to pay only in reverse. The more corporate income increases (as was illustrated in many cases in 1941), the less burdensome the corporate taxes will prove to be on the owners of the corporation—its stockholders. The more stable income a corporation has, the less likely it is to be able to meet its interest and dividend requirements. A tax system that operates in this way demands revision.

In the second place, the proposed taxes will hit hardest those corporations with the soundest financial structures. During the past decade there has been a strong drive, fostered by Congress and such administrative agencies as the Securities and Exchange Commission, and some of the State regulatory commissions, and either anticipated or participated in by progressive managements, to scale down corporate overcapitalization and to replace bonds with stock. One of our members, Lexington Telephone Co., in Kentucky, went through a voluntary financial reorganization during that period, and as a result almost half of its debt was replaced with stock. The reorganization was a success; under good management the new stockholders have received a regular return on their investment. Yet, so far as Federal taxes are concerned, the corporation would be much better off if it still had all of its debt outstanding.

Everyone would agree that a corporation with moderate or with no bonded indebtedness is in sounder condition to meet financial shocks and emergencies than one heavily indebted. But Federal taxes on corporations have placed a heavy and probably unintended premium on debt financing. It is not impossible for bankers to show a company that a good part of proposed financing can be paid off out of the saving in Federal taxes, if bonds or notes are used instead of common or preferred stock. If normal tax and surtax rates aggregate 45 percent, as now set forth in the House bill, a company must earn over $9 per share of preferred stock in order to meet a dividend rate of $5 per share. On the other hand, to meet a $5 interest coupon on debentures, the company need earn only a like amount. The higher the Federal tax rates, the greater the encouragement to and even necessity for corporations to increase their debt, not their stock issues.

The individual security holder finds no great difference between bonds and preferred stock. In either case, he is seeking a safe, regular income. Moreover, in either case, that income is subjected both to normal taxes and to surtaxes in his hands, so, from the tax point of view, there is no advantage to him in one type of security over the other. Yet in fact, if he receives dividends on preferred or common stock, the corporation has already paid a tax on the money as its income, so that the same income is taxed twice On the other hand, if he receives interest on bonds or notes, the income is only taxed once—as income to the bondholder.

It would seem to be imperative that this discrimination in favor of unduly heavy debt should be corrected. Independent telephone companies like other industries will be faced with an extremely trying period of adjustment after the war. A considerable amount of the plant expansion which is now necessary to take care of direct and indirect war requirements will have to be abandoned because there will no longer be any need for this excess plant. Thus the telephone companies will be faced with sizeable losses since the only value for this excess plant will be whatever salvage can be recovered. It would appear to be elementary that this more or less temporary plant should not be financed by debt securities and that if it is the companies will not be in a position to survive the losses of the post-war period. The present 5-year amortization provisions are of very little help to us since the same facilities are necessarily used by Army privates calling their mothers as well as by officers calling Washington; by war industries and by civilian industries. Thus in most cases it is not possible to segregate property used exclusively in the war effort, as the present amortization section requires.

That the situation as it now stands is prejudicial to corporations which have sought to keep their financial structures sound by avoiding too much debt can be shown by many examples in the telephone business.

Associated Telephone Co., Ltd., which is the largest of the independent telephone companies in point of telephones served and which operates in southern California, in Long Beach, Santa Monica, Santa Barbara, West Los Angeles, and in a number of other towns in this area along the Pacific coast, furnishes a typical example. This company has a total capitalization of $23,281,683 of which $11,668,000, or 50 percent, is in first-mortgage bonds, $5,636,608, or 24 percent, is in preferred stock represented by 288,000 shares of no-par value which carry a dividend rate of $1.25 (approximately 5 percent), and $5,977,075, or 26 percent, is in common stock represented by 240,000 shares of no-par value. The effect of the tax rates in the House bill on the operations of this company are set forth below. The net income and construction figures used are 1941 figures. However, the results shown are a fair picture of what the company will be faced with during 1942 and succeeding years if the new tax rates should be put into effect.

Net income available for interest, preferred Federal income and excess-profits taxes		$1,612,400
Less Federal income and excess-profits taxes, 1941 rates	$550,500	
Increase, based on House bill	221,800	
		772,300
Balance available for interest and preferred dividends		840,100

Interest and amortization	$427,300	
Preferred dividends	253,800	
		$681,100
Balance		159,000
Add back provision for depreciation		1,114,400
Money available from operations for construction, working capital, and common dividends		1,273,400
Construction requirements (exclusive of reusable salvaged material)		2,650,000
Deficiency in cash from operations before payment of any common dividends		*1,376,600*

As indicated in the above table, the company would have only $159,000 left out of its net income after paying the increased taxes, its interest and amortization charges and its preferred stock dividends. This amounts to 2.65 percent of its average common stock and surplus invested in the business during the year. This sum, together with the depreciation provision for the year of $1,114,400 would give the company cash from operations for the year of $1,273,400 as against construction requirements of $2,650,000. This would leave a deficiency in cash from operations of $1,376,600 which would have to be raised through financing of one kind or another. But the company would be in a serious dilemma. It would probably be impossible to finance these requirements with common stock since it is obvious that the company could pay little or no common dividends on its presently outstanding common stock to say nothing of paying anything on an increased amount. As to preferred-stock financing, the over-all interest and preferred dividend requirements amounting to $681,100 would barely be earned, so that further preferred-stock financing would doubtless be out of the question.

The sale of short-term notes by the company also would be impracticable because the company would have no means of paying such notes at maturity. Furthermore, it appears very doubtful whether the company would be able to sell any first-mortgage bonds since the interest, as indicated in the preceding table, would be earned only about 1.97 times and since there are definite limitations in the company's bond indenture on the issuance of additional bonds. Even if this could be done, it would increase the debt of the company to a point where it would be extremely burdensome and it would place the whole financial position of the company in danger. Thus, the company would find itself in an impossible position. It operates in a territory in which the Army and Navy activities are extremely large and also where there are a great number of war industries. It is essential that the company make the necessary additions to its plant to furnish adequate service for this war activity but because its net income would be reduced to practically nothing no sources of cash with which to do this construction work would be available.

Other typical examples of the effect of the tax rates set forth in the House bill on independent telephone companies are set forth in schedule 1 attached.

(The schedule referred to is as follows:)

SCHEDULE 1.—*Statement showing the effect of the proposed Federal income and excess-profits tax rates of the 1942 revenue bill as passed by the House of Representatives on the net income and the cash from operations available for construction and other corporate purposes of the independent telephone companies listed therein*

[Based on operations for the year ended Dec. 31, 1941]

Name of company	Headquarters	Net income before Federal income and excess-profits taxes and preferred dividends	Federal income and excess-profits taxes			Balance	Less preferred-stock dividends	Balance	Add back depreciation provision	Money available from operations for construction, working capital, and common dividends	Construction requirements (exclusive of reusable salvaged material)	Deficiency[1] in cash from operations before common dividends
			At 1941 rates	Increase under 1942 revenue bill as passed by the House	Total							
American Telephone Co.	Abilene, Kans.	$99,163	$29,870	$13,490	$43,360	$55,803	$13,810	$41,993	$66,947	108,940	$94,396	$14,544
Ashtabula Telephone Co.	Ashtabula, Ohio	85,081	33,696	16,585	50,281	34,800	----------	34,800	33,130	67,930	39,972	27,958
Associated Telephone Co., Ltd.	Santa Monica, Calif.	1,185,085	550,500	221,817	772,317	412,768	253,750	159,018	1,114,421	1,273,439	2,650,000	*1,376,561*
Carolina Telephone & Telegraph Co.	Tarboro, N. C.	653,962	253,007	112,571	365,578	288,384	----------	288,384	301,035	589,419	960,793	*371,374*
Central Electric & Telephone Co.	Sioux Falls, S. Dak.	524,878	173,600	78,400	252,000	272,878	196,770	76,108	282,462	358,570	342,134	16,436
Citizens Independent Telephone Co.	Terre Haute, Ind.	137,189	52,508	23,713	76,221	60,968	23,333	37,635	149,350	186,985	220,976	*33,991*
Home Telephone & Telegraph Co.	Fort Wayne, Ind.	389,342	133,184	60,147	193,331	196,011	130,666	65,345	334,036	399,381	773,081	*373,700*
Illinois Consolidated Telephone Co.	Mattoon, Ill.	126,235	49,329	22,278	71,607	54,628	----------	54,628	100,325	154,953	96,953	58,000
Illinois Telephone Co.	Jacksonville, Ill.	36,408	9,830	4,439	14,269	22,139	12,950	9,189	62,000	71,189	52,976	18,213
LaCrosse Telephone Co.	LaCrosse, Wis.	83,667	38,670	17,464	56,134	27,533	15,900	11,633	52,587	64,220	90,037	*25,817*
Lincoln Telephone & Telegraph Co.	Lincoln, Nebr.	533,572	123,684	55,857	179,541	354,031	225,000	129,031	410,502	539,533	773,276	*232,743*
Lorain Telephone Co.	Lorain, Ohio	131,424	41,600	18,787	60,387	71,037	69,000	2,037	61,803	63,840	113,695	*49,855*
Michigan Associated Telephone Co.	Muskegon, Mich.	455,252	148,008	66,842	214,850	240,402	88,488	151,914	246,899	398,813	585,031	*186,218*
Middle States Telephone Co. of Illinois.	Pekin, Ill.	117,496	60,000	27,097	87,097	30,399	5,205	25,194	71,653	96,847	119,739	*22,892*
New Jersey Telephone Co.	Flemington, N. J.	58,129	23,987	10,833	34,820	23,309	----------	23,309	25,617	48,926	98,270	*49,344*
Northern Ohio Telephone Co.	Bellevue, Ohio	352,051	140,649	63,519	204,168	147,883	79,450	68,433	225,498	293,931	415,572	*121,641*
Ohio Telephone Service Co.	Greenville, Ohio	79,168	26,118	11,795	37,913	41,255	11,375	29,880	54,227	84,107	349,628	*265,521*
Peninsular Telephone Co.	Tampa, Fla.	1,062,728	435,233	188,966	624,199	438,529	140,000	298,529	418,184	716,713	954,830	*238,117*
Pennsylvania Telephone Corporation.	Erie, Pa.	844,484	289,218	130,614	419,832	424,652	175,730	248,922	534,549	783,471	1,359,333	*575,862*

Southeast Missouri Telephone Co.	Cape Girardeau, Mo.	244, 784	93, 942	45, 876	139, 818	104, 966	60, 500	44, 466	120, 415	164, 881	275, 795	*110, 914*
Southeastern Telephone Co.	Tallahassee, Fla.	97, 125	25, 120	11, 344	36, 464	60, 661	15, 401	45, 260	55, 009	100, 269	268, 089	*167, 820*
Southwestern Associated Telephone Co.	Lubbock, Tex.	444, 227	152, 600	68, 916	221, 516	222, 711	91, 542	131, 169	295, 416	426, 585	557, 789	*131, 204*
Star Telephone Co.	Ashland, Ohio	107, 314	29, 908	13, 461	43, 237	64, 047	6, 042	58, 005	29, 187	87, 192	38, 925	48, 267
United Telephone Co., Inc.	Warsaw, Ind.	171, 736	55, 099	24, 883	79, 982	91, 754	62, 420	29, 334	163, 418	192, 752	222, 750	*29, 998*
United Telephone Co.	Clinton, Mo.	59, 951	13, 760	6, 214	19, 974	39, 977		39, 977	70, 667	110, 644	202, 709	*92, 065*
United Telephone Co. of Pennsylvania.	Harrisburg, Pa.	234, 107	102, 473	46, 278	148, 751	85, 356		85, 356	162, 877	248, 233	438, 770	*190, 537*
Virginia Telephone & Telegraph Co.	Charlottesville, Va.	73, 510	36, 000	16, 258	52, 258	21, 252		21, 252	83, 560	104, 812	162, 011	*57, 199*
Total		8, 388, 068	3, 121, 491	1, 378, 444	4, 499, 935	3, 888, 133	1, 677, 332	2, 210, 801	5, 525, 774	7, 736, 575	12, 256, 530	*4, 519, 955*

[1] Italic indicates deficiencies.

We have shown what the corporate tax pattern and related schedules of the House bill will do to this particular essential industry—the impulse is to suggest a modification which would fairly solve this industry's problems. But that is only patching the structure at best, and there have been dozens of patchings suggested to meet the special problems of other businesses.

The weaknesses of, or inequities in, the present tax structure itself are being forcefully brought to attention as the attempt is made to have that structure carry the extremely heavy tax load which must necessarily be carried. This emphasizes the point that Secretary Morgenthau made when he first presented his proposed plan for this revenue act to the Ways and Means Committee of the House when he said that it would be necessary to examine the structure carefully to see that substantial inequities were not experienced; and your own chairman, Senator George, has been publicly quoted as saying that he felt that the revenue act to be drawn at this time should be so fundamentally sound and equitable that it could stand through the war period in form, with rates changing as necessity demanded.

Therefore, rather than suggest a modification of the present structure, may we suggest a redesign or a revision of the basic tax structure itself as it applies to corporations?

The basic idea is one not new to you—namely, tax the corporation as a vehicle to reach the owners, the people who are doing business through the corporate form, but do not tax the corporation as an entity. To accomplish this, we suggest:

1. An income tax on corporations set at a level judged to give the average return that would result if all the earnings of the corporation were distributed to its stockholders and such distributed earnings taxed as a part of their individual incomes—then apply the British system of giving credit to each stockholder for the tax paid on his behalf by the corporation.

Naturally the advantage of using the corporate machinery to collect the tax on business done through corporations should be used, and it would have to be used to be sure to get the tax on earnings not distributed to security holders.

The present system of taxing people who are doing business through the corporate form results in unjust discrimination against these people as compared with those who do business through partnerships, individual enterprises, and other forms. This discrimination may even go so far as to take from these people 100 percent of their income from such business if the tax burden on corporations is so high that such corporations are forced to discontinue paying any dividends to their stockholders. Such discriminations should be eliminated by creating a different tax structure.

2. An excess-profits tax on all business whether corporate, partnership, or individual, on profits resulting from the war effort. In devising this tax it is extremely important there be a true measure of what really constitutes excess profits. We believe that such excess profits are not real excess profits until after the deduction of all expenses, including normal income taxes and surtaxes.

If it is not feasible at the present time to make this or some equivalent fundamental change in the tax structure itself, then we believe that at least so far as regulated public service corporations are concerned—certainly we know this to be true with respect to the independent telephone companies—the present bill should be changed to make the following provisions:

1. Allow a corporation a credit against net income, for purposes of normal income taxes and surtaxes, for all dividends distributed.

By far the largest number of stockholders of independent telephone companies consist of individuals who have invested their savings in these stocks and the dividends received represent an important part of their income upon which they depend for living expenses. This double tax works a severe hardship on these small stockholders and is not consistent with the "ability to pay" theory of taxation. It is grossly unfair to subject stockholders with small incomes to a tax of 45 percent and upwards, deducted by the corporation from dividends which would otherwise be payable to them, and then compel them to pay in addition their own normal tax and surtaxes on the very same income.

We believe that no one will seriously contend that it is desirable to use our tax laws to encourage corporations to get into debt and stay there. Moreover there is obvious inequity in a double tax on dividends, particularly when the two surtax scales, individual and corporate, are as high as at present. The defect we have discussed is basic and its correction is important to the survival of corporate enterprise. Second, even in these times, there are other better ways of raising the amounts involved, which do not discriminate severely against small stockholders, and seriously prejudice telephone corporations in expanding as they must. Third, the actual loss of revenue would not as great as it might seem at first blush, for dividends would be paid subject to taxes in the hands of the stockholders, if our proposal were in effect, which would not be paid at all under the tax structure and rates set forth in the House bill. Many independent telephone companies will be very unlikely to pay any common dividends under the House bill provisions, and some may find it impossible to pay their preferred dividends. They can pay them under our proposal. Certainly the real differences between preferred stock and debentures are not so great as to justify the tremendous premium the tax law puts on debentures.

2. Restore the original and correct deduction of the normal tax and the surtax from income subject to excess profits tax in place of the present deduction of excess profits tax in computing the normal tax. The normal tax as its name implies is the basic and fundamental tax to which corporations are subject. It must be paid out of income. There simply are no "excess profits" until a corporation meets the charges to which it is subject. The normal tax is obviously a preferred charge among these. To subject a corporation to an excess profits tax upon an amount of income with no allowance for the normal tax is to tax it upon hypothetical, not real, net income. The amount of income being used as a base is not even existent as net income to the corporation, much less as excess profits net income, because the normal tax must be met out of it. The reversal of the original deduction may have produced addi-

tional revenue to the Treasury, but it is unfair and unsound. The present arrangement is chiefly objectionable for indicating that excess profits exist where they do not, and exaggerating their amount. Surely a corporation should not be subject to an excess profits tax if, for example, its net income, minus the normal tax and surtax, does not exceed its base period earnings.

3. Allow a flat credit of 8 percent on all invested capital, irrespective of amount, in computing income subject to excess profits taxes. The present schedule discriminates against the small stockholder as compared with the large. Huge corporations like United States Steel, General Motors, American Telephone & Telegraph Co., the large railroads, etc., have hundreds of thousands of stockholders holding very small investments. This we know to be true of the larger independent telephone companies. These stockholders will be allowed a credit of only 5 percent or 6 percent on the major portion of their investment; whereas many, if not most, corporations of $5,000,000 or less invested capital are closely held—in this group we find the family corporations, etc.—and their stockholders will have maximum credit. An equitable structure should allow the same percentage credit to all invested capital irrespective of what size of investment may be necessary in a particular business.

The independent telephone companies do not wish to avoid their fair share of the cost of the war based on equitable principles of taxation. However, they are gravely concerned over the possible effect of the taxes imposed by the House bill on their ability to continue to provide the telephone facilities necessary to the prosecution of the war. It is hoped, therefore, that some way can be found to remove the inequities contained in the House bill.

The CHAIRMAN. Thank you very much, Mr. Bozell.

Senator BAILEY. I would like to ask a question there. I have looked at your tables. Schedule 1 shows net income before Federal income and excess profits taxes and preferred dividends of $8,388,068 here. Then you have a charge for construction requirements in the next to the last column in that same schedule. If you deduct the construction requirement figure in that schedule of $12,256,530, you would have a deficit of nearly $4,000,000 on those two statements anyway, wouldn't you?

Mr. BOZELL. It is not quite so direct a calculation as that. We have to subtract certain items from net income and then there is a depreciation provision taken out of income. But that is a noncash income, and we add it back, but still we are actually $4,500,000 shy.

Senator BAILEY. You would be that much shy anyway, wouldn't you? At least you would be shy $3,000,000 anyway?

Mr. BOZELL. The taxes under the new bill are practically $4,500,000. That leaves $3,800,000 of the $8,300,000. Then subtract preferred dividends and add back depreciation and we have available only $7,736,575 toward construction requirements of $12,256,530.

Senator BAILEY. What interested me was this charge for construction requirements. I would like to have you explain just why that is necessary.

Mr. BOZELL. It primarily is necessary due to the war activities in that these companies occupy so much of the territory of the United States. For instance, up in Senator La Follette's territory near Madison, Wis., there is a big powder works where the telephone company must spend large sums to supply service. And in your own State, Senator Bailey, the Carolina Telephone and Telegraph Co. of Tarboro, N. C., has increased its investment over 50 percent to supply Fort Bragg and three or four other large war establishments down there.

Senator BAILEY. Do you consider that as capital investment?

Mr. BOZELL. Yes, sir.

Senator BAILEY. It is not lost.

Mr. BOZELL. It will be when Fort Bragg is evacuated at the end of the war.

Senator BAILEY. Fort Bragg won't be evacuated this side of the day of judgment, in my judgment.

Mr. BOZELL. Maybe that is true.

Senator BAILEY. That is a purely military establishment.

Mr. BOZELL. Yes, but my point is that we have to make these capital additions as permanent financing. They are not a type of borrowings that you can borrow against inventories and later liquidate. We have to secure the money as a part of our permanent capital structure. Earning 2 percent on your common stock, you cannot go out and sell additional common stock on any fair basis to your present stockholders.

Senator BAILEY. You are arguing that you cannot get the capital?

Mr. BOZELL. That is correct. If we can pay dividends to the security holders, the record of the company will then be such that those security holders or others will buy new securities for these capital additions. But otherwise we cannot. If you talk to John Porter, of Tarboro, N. C., you will find——

Senator BAILEY (interposing). I hope you don't tell him to talk to me, because I want to get these facts from you.

Mr. BOZELL. His company has nothing but common stock——

Senator BAILEY (interposing). I know something about the company. It has always been a very prosperous company.

Mr. BOZELL. Seventy percent of the stock is owned by the customers who live there, but if John Porter has to show the effect of these tax provisions on his company, that he cannot earn enough to induce those people to buy some more common stock, he is going to have a hard time financing the necessary additions that the Government is calling on him for. There come across my desk every day requirements for $150,000, $80,000, $50,000, et cetera, for additions, all called for by the Government, necessary capital additions to plant.

Someone asked here about the War Production Board restrictions. Under these we can provide only essential telephone services, but those essential services are so heavy in their development at the present time that——

Senator BAILEY (interposing). You run to Fort Butler and Fort Bragg, too. Then there are other establishments down there. Do you run into all of those?

Mr. BOZELL. They have 5 large ones in their 21 counties. I don't know the names of all of them.

Senator BAILEY. So they are running these new lines?

Mr. BOZELL. Yes, sir. And John Porter's total investment over the past 2 years has increased 50 percent, due entirely to war activities.

Senator BAILEY. Has he already run the lines?

Mr. BOZELL. Yes, sir; and he is adding all the time. The companies with which I am connected have run lines to the Badger ordnance plant, which is just north of Senator La Follette's home, but we are going to have to put $90,000 more in there to provide the necessary telephone distribution system as they build the additional powder houses.

Senator BAILEY. Have you made any estimate of the revenues to be derived from these new lines?

Mr. BOZELL. Yes, sir.

Senator BAILEY. Is that in this statement here, or is this the old income statement? (Referring to the Associated Telephone Co., Ltd., statement.)

Mr. BOZELL. This is 1941, but this is as good a picture as we can give you for 1942. The income that the Army and the Navy and war plants give us is a perfectly fair income and we are not objecting to that. We think their contracts are fair, but what we say is that this particular tax structure so taxes these corporations that you cannot pay enough out to our security holders to get more money to supply the construction that the Government establishments and the war industries demand of us. Our dealings with the Government are satisfactory, the limitations upon telephone growth put out by the War Production Board are enlightened and intelligent; the problems we have result almost entirely from the way the tax structure happens to meet this particular kind of an industry.

Senator BAILEY. Are the Bell people confronted by the same thing?

Mr. BOZELL. Yes, sir. I cannot speak for them, but if you would refer to an article by Mr. G. H. Semler in the New York Journal of Commerce on July 29, copies of which, I am told, were sent to all Senators, dealing with this situation, you will note that it was estimated that the Bell companies were about $108,000,000 shy before paying common dividends, in cash available for construction—I mean that is a figure corresponding to the $4,519,955 red figure in my schedule 1.

Senator BAILEY. You make a fair return on what you put in?

Mr. BOZELL. Yes, sir; but we have to get the money to put in, and under this tax structure, our normal channels are cut off.

The CHAIRMAN. Mr. C. D. Laylin, Columbus, Ohio.

STATEMENT OF CLARENCE D. LAYLIN, COLUMBUS, OHIO, GENERAL COUNSEL AND TAX ADVISER OF THE OHIO CHAMBER OF COMMERCE

Mr. LAYLIN. Mr. Chairman, and gentlemen of the committee, I have a prepared statement and a supplement to it that I had not intended to comment upon orally but merely to file as an exhibit. I would like to file them all for the record if I may and high-spot my statement in a few minutes, but have my full statement in the record.

The CHAIRMAN. Yes, sir; we will be glad to have you do so.

Mr. LAYLIN. My name is Clarence D. Laylin. I live in Columbus, Ohio, and represent the Ohio Chamber of Commerce. The views which I shall try to present are those of the committee on taxation and public expenditures and the board of directors of the Ohio Chamber of Commerce. Each of these is a rather numerous and representative group of businessmen of our State who are trying to think for our business community as a whole, and not for manufacturers or retailers or operators of mines or farms, or public utilities, as such.

One thing these men deplore is the frequency with which the Federal tax laws have been changed in recent years. They feel that, within certain certain limits, to which I shall allude in a moment, business corporations can adjust themselves to a given tax program and live under it; but it is most disturbing to have the program modified as often as it has been. It is bad enough to have to guess in making tax accruals when a revenue bill is pending that will, when enacted, be retroactive to the beginning of current taxable years; but this bill makes its principal features partially applicable to fiscal taxable years which have already closed or will have closed before the bill becomes a law. We have had many complaints against this injustice from Ohio corporations having fiscal taxable years.

Those for whom I am speaking recognize that the times and cumstances call for extreme measures. They recognize that corpo- tions and individuals must both be subjected to very high taxes—the highest possible taxes, in fact. They believe therefore that Congress should immediately set its stakes for an all-out program of taxation, and, having put that program into effect, abide by it for the duration of the war.

They also believe that an all-out program of taxation and internal borrowing calls for an all-out program of economy in nonessential appropriations and expenditures. The recent statement of Senator Byrd, chairman of the Joint Committee on Economy in Nonessential Expenditures, to the effect that the appropriations for such objects have already been trimmed to the extent of $1,300,000,000, pleases us; but the accompanying comment that these economies have done little more than scratch the surface, confirms our own impresisons and impels us to urge again, as we did before the Ways and Means Committee of the House of Representatives, that the good work thus begun should continue. We have no bill of particulars; but the joint committee has pointed the way and will, we trust, continue to do so.

We are disappointed that the revenue bill as it passed the House of Representatives did not follow the recommendations of the Treasury by an outright repeal of the capital-stock tax and the declared value excess-profits tax. We regard these taxes as mere nuisances, even after their wholly speculative character has been ameliorated to some extent by according the privilege of annual declarations.

I have said that we recognize that heavy business taxes are a necessary part of a war-taxation program. But there is a limit somewhere; and we firmly believe that the increase in the surtax on normal corporation net incomes which is proposed in the bill before you passes that limit. Our study had convinced us that the combined maximum rate of 31 percent for the corporation normal tax and surtax, carried by the present law, goes to the verge of economic safety. The bill as passed by the House permits the deduction of the entire excess-profits tax net income, instead of the tax itself, in determining the income subject to the normal tax and the surtax. This change, together with certain administrative changes which are carried by the bill, might justify an increase of the combined rate to 35 percent.

If the capital-stock tax and declared-value excess-profits tax were repealed instead of amended, a slight further adjustment in the combined rate could be justified; but it should still be on the order of 35 percent instead of 45 percent as carried by the bill.

Our reasons for believing that the present combined rate, adjusted to other changes as indicated, represents the maximum of taxation on normal net earnings of corporations have been so fully stated by others this afternoon, and I presume at previous hearings, that I need not repeat them.

You have heard references to the need for cash working capital for betterments and additions, to debt retirements, preferred-stock dividends, and the like, so I will not go over that again.

Again, you have heard reference to the theoretical objection to a high rate of taxation on the normal income of a corporation because it is a double tax. The earnings when distributed are taxed again to the stockholder, and it would be better to tax the earnings to the stockholder rather than to impose a high rate on the corporate earnings, which is higher than many individual stockholders would have to bear if they were subjected to the tax on their share of the corporate earnings.

Quite naturally the war has dislocated business conditions. Some corporations and individuals are profiting or stand to profit by it. A large number, however, are harmed rather than helped by the war. Among these are many which are subjected to demands which are not now and thus far have never been recognized as deductions or credits in determining the taxable net income of a corporation. There are varying requirements for cash working capital. There are corporations operating on borrowed capital and which are required by contract to pay their debts in specified installments. There are corporations which must put a goodly share of their earnings back into the business in order to keep going because if they cannot grow, they must die. If such circumstances were recognized in the basis of determining normal taxable net income or surtax net income, such companies might be able to stand a tax on the order of that proposed by the bill. So long, however, as the tax law treats as taxable net income that which the necessities of business require to be withheld from distribution, the rate of the tax must kept within bounds, else the tax burden, added to these others, will result in an impairment of the credit of such corporations and very quickly put them out of business, or make them dependent upon Government financing, which is an equally disastrous alternative. This prediction is not a figment of the imagination.

Actual cases have been reported to us in which the combined requirements of the corporation for cash working capital and debt retirement, for example, are in excess of 55 percent of the normal net income. There are also the numerous cases of corporations with preferred stock dividend requirements which they will be unable to meet under any such heavy normal and surtax rates as are proposed. Regardless of legal distinctions, and particularly where the preferred stock dividends are cumulative, such a situation is bound to impair the credit of such corporations.

Again, the rate of taxation on the normal income of a corporation should in theory be relatively small because the actual corporate gains belong to the stockholders and to the extent that they are distributed are taxed again. Of course, a fair tax should be laid on the privilege or advantage of doing business under corporate forms; but when the rate of corporate taxation is raised above the level of a reasonable excise, the result is a species of double taxation which is objectionable and very inequitable in its application to the stockholders, on whom the real burden ultimately falls. A 35 percent rate, for example, is rather high in comparison with the combined normal and surtax rates applicable to individuals, even under the very drastic individual schedules carried in the present bill. An individual's net income would have to be between $8,000 and $10,000 before he would be subjected to such a rate. Yet to the extent that the corporation tax results in a diminution of dividends it amounts to a 35 percent tax on the many stockholders having incomes far below that level.

The bill before the committee continues the policy of the present law in its recognition of a distinction between excess profits and normal profits. With that policy all are in accord. When we ask that the rates on normal corporation income or profits be increased no more than might be justified because of other changes in the law, we mean that the actual experience of companies of the kind I have described under the law as it stands convinces us that the extreme of economic safety has already been reached.

The excess-profits tax is another story. Once the basis of determining excess-profits tax credit is fairly and justly fixed, the only limit on the rate of the tax on excess profits is the law of diminishing returns. Even under the comparatively low excess-profits rates that have been heretofore in effect, we have seen instances of the operation of this law. Specifically, when the combined effective rate of taxation of a corporation gets too high, the management of the corporation loses most of its incentive toward efficiency and economy of operation and expenditure. Indeed the temptation arises to spend money in almost any way that is recognized for income and excess-profits tax purposes as a deduction from or credit against corporate income. The result, so far as the excess-profits tax is concerned, is that the revenue yield under extremely high rates is likely to be little if any more than it would be if the rates were not so high. Another result is a marked inflationary effect.

The problem of the excess-profits tax, then, divides itself into two parts: First, the fixing of a sound basis, or a fair measure of normal profits; and second, the devising of some means to overcome or obviate the law of diminishing returns and the tendency toward inflation.

As to the first of these, we think the House bill is deficient. We see no reason for limiting excess-profits tax credit on the average-earnings basis to 95 percent. The average-earnings basis has proved itself and is now firmly established in our law. It should be recognized to the extent of a full 100 percent.

We believe that the average-earnings basis should be the average of the best 3 out of the 4 years in the base period. This of itself will go far toward minimizing the necessity for resort to the special relief procedure.

We see no reason for creating the two additional brackets of invested capital percentages which the House bill proposes. We think the 6-percent and the 5-percent brackets should be omitted.

We believe that if these three very simple changes are made in the bill as it passed the House, we will have a much fairer measure of normal profits and a much more equitable basis of determining excess profits. Other technical changes in the same direction by way of liberalization of carry-over provisions should also be considered, but we have no specific recommendations as to such matters.

I should like to be able to say that when and if such changes are made, the rate of the excess-profits tax would become immaterial. However, the law of diminishing returns and the tendency toward inflation to which I have alluded forbid any such sweeping statement. The people whom I am representing feel very strongly that unless a way can be found to overcome these effects, any excess-profits tax rate in excess of 75 percent will fail of its objective both from a revenue and from an anti-inflationary point of view. When the bill was under consideration in the Ways and Means Committee of the House, there was a proposal that some part of the high rate on excess profits be represented by a form of post-war credit. Our people had thought that if the rate should exceed 75 percent a workable scheme of post-war credit might to a large degree neutralize what would otherwise be the undesirable effects of such an excessive rate.

I have heard this afternoon two specific types of proposals for post-war credit. I shall not deal with them in detail, but will say in general that if any such plan of post-war credit were incorporated in the bill, the objections which I have voiced to an excess-profits tax rate in excess of 75 percent would be very largely overcome.

Furthermore, if such plan of post-war credit should be made available to corporations having only normal profits to be taxed as well as those which would be subject to the excess-profits tax, a slightly higher combined rate on normal profits could be tolerated, but the Ohio Chamber of Commerce is unalterably opposed to the precollection of income taxes on wages, bond interest, and dividends at the source as proposed in the bill as it passed the House. I need not give my reasons for opposition to these proposals. I believe they have been given in the previous hearings before the committee.

I might add, however, that we are also opposed to any withholding tax whatsoever in the nature of a pay-roll deduction. We believe that any substantial tax of this character, no matter how it may be simplified, will have a definite inflationary tendency, unless wages and salaries are frozen. The experience of employers in our group under the social-security taxes and similar pay-roll deduction measures convinces us that demands for higher wages would inevitably follow the imposition of a withholding tax.

Furthermore we think that the individual surtax rates in the first four brackets are too high as they stand in this bill and that any form of withholding tax would exaggerate the effects of excessive taxation in the medium and lower income brackets which are, of course, surrender of life-insurance policies, defaults under land contracts and home construction mortgages, and other similar disastrous consequences. We believe that the surtax in the first bracket should not exceed 10 percent, that in the second 13 percent, that in the third bracket 16 percent, and that in the fourth bracket 22 percent.

We remember that under the social-security tax law as it now stands, sections 1400 and 1410 of the Internal Revenue Code, the rate of the tax on both employers and employees will automatically double in 1943. Our view is that this revenue bill should contain amendments of these sections in effect holding these rates level. This view is based on the fact that the balance of the Federal old-age and survivors insurance trust fund as of June 30 of this year was over three and a quarter billion dollars. Furthermore, by June 30, 1946, this trust fund will increase, according to the report filed this year by the board of trustees of the old-age-trust fund, to the unprecedented total of $10,813,000,000. This reserve will exceed by 6,800,000,000 the "three times test" for adequacy which was advocated by the Treasury Department in 1939 and which was made a part of the Social Security Act at that time on recommendation of this committee (sec. 201 (b) (3)). If this rate is frozen at its present level, our estimates show that there will still be an excess of $2,200,000,000 above the "three times test" at the end of the same period.

I should like to submit for the record a more detailed statement which clearly indicates that there is no justification for increasing the rates of these social-security taxes at this time.

The CHAIRMAN. You may do so.

Mr. LAYLIN. The changes in the House bill which we advocate represent our ideas of the full length to which taxation of business corporations on the so-called principle of ability to pay can go. We are aware that in so doing we raise the question of revenue, for most if not all of our recommendations seem superficially to involve a loss of estimated revenue. Without stopping to discuss the question as to whether this apparent loss is real, may I say that when we have gone to the limit of taxation of incomes as such, any additional revenue that may be required—and we think additional revenue is required—must be obtained through some other method. Inevitably our own thinking brings us to a general sales tax as the only alternative. Such a sales tax should reach, and reach in the most equitable way, the vast enhancement of spending power which is accruing to employees who are enjoying very high wages and salaries under present conditions. It is that increased spending power, immune in large part from the impact of the income tax, that constitutes one of the chief threats of inflation.

Our group has arrived at this conclusion with reluctance. Heretofore the Ohio Chamber of Commerce has always opposed a sales tax—particularly a retail sales tax—as a Federal measure. As Senator Taft knows, we have in Ohio a very successful consumers' retail sales tax. It is relatively expensive to administer because of the rebates given to retailers as compensation for collecting the tax from the consumers and because of the inherent cost of administering a tax of this character. Nevertheless we like our Ohio tax and because of certain constitutional limitations on other forms of taxation have come to regard it as indispensable in our system. Accordingly we are opposed in principle to the invasion of this field by the Federal Government. In this dilemma we have turned to a manufacturers' sales tax on the Canadian model as the best solution of the problem in our opinion. We recognize the difficulties involved in adjusting the price-control system to such a tax but we think they are not insuperable. The manufacturers' excise or sales tax field is one which the States in the very nature of the case cannot enter and one which the Federal Government has heretofore entered through selective taxes. The manufacturers' sales tax is relatively simple of administration, especially when general in application, and involves a minimum of administrative expense, and, what may be equally as important in these times, a minimum of administrative personnel.

The yield of such a tax depends, of course, upon the rate at which it is imposed and upon the exemptions which are made. In Canada the manufacturers' tax is in addition to special excise taxes on particular commodities. But, on the other hand, some of the bare necessities of life, such as unprocessed foods, are exempted. Problems of this sort are no different under a manufacturers' sales tax than they would be if we were considering a consumers' retail sales tax. We have seriously considered the repeated assertions of the Secretary of the Treasury to the effect that a manufacturers' sales tax is inflationary. We have concluded that on the whole the Secretary is mistaken in that a general manufacturers' sales tax need not have a net inflationary effect. The rate of the Canadian tax, for example, has fluctuated greatly during the many years of its existence, yet statistics of the Dominion seem to indicate that these changes have not had any appreciable effect upon the cost-of-living index. Therefore, though certain features of the manufacturers' sales tax might seem to indicate a theoretical inflationary tendency, we believe that, if properly drawn, the over-all effect of such a tax would be the same as that of any other form of sales tax, namely, anti-inflationary.

I should also like to submit for the record a number of estimated statements, showing how the corporation taxes carried by the House bill would affect certain Ohio corporations. Each statement represents an actual company and has been made by a responsible executive. They were furnished in compliance with a random request without suggestion as to what they ought to show and without foreknowledge of what the returns would be. In these statements you will find concrete evidence in support of the faith that is in us.

The CHAIRMAN. You may file them.

Mr. LAYLIN. Thank you very much.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you very much for your appearance.

(Statements submitted by Mr. Laylin, entitled "Supplementary statement of the Ohio Chamber of Commerce" and "Estimated effect of proposed taxes upon certain Ohio corporations," are as follows:)

SUPPLEMENTARY STATEMENT OF THE OHIO CHAMBER OF COMMERCE URGING THE FREEZING OF SOCIAL SECURITY TAXES AT THE PRESENT RATE OF 1 PERCENT ON THE EMPLOYER AND 1 PERCENT ON THE EMPLOYEE, AS A PART OF THE REVENUE ACT OF 1943, SUBMITTED BY CLARENCE D. LAYLIN, GENERAL COUNSEL AND TAX ADVISER, AND PREPARED BY THE SOCIAL SECURITY DEPARTMENT OF THE OHIO CHAMBER OF COMMERCE

In considering the question of a pay-roll withholding tax and proposed increases in the individual income tax there is another pay-roll tax which is of vital importance to all taxpayers, both employers and employees, that, in our opinion, has not been given the attention it deserves. We are referring here to the automatic increase in the employment taxes under chapter 9, subchapter A, sections 1400 and 1410 of the Internal Revenue Code (Federal old-age and survivors insurance taxes). Effective January 1, 1943, these rates will be doubled—from the present schedule of 2 percent to a total of 4 percent—and will remain at this rate until 1946, when they will again be increased. These taxes are divided equally between employers and employees.

Based on the analysis which follows, we are convinced that there is no justification for this tax increase at this time. These taxes already constitute a heavy burden on both employers and employees. We are of the opinion that critical examination of this automatic increase may be considered properly by this committee at this time.

PRESENT RATE YIELDS HUGE SURPLUS

Under present conditions, with the current rate of 1 percent on both employers and employees, the balance in the old-age and survivors insurance trust fund as of June 30 of this year was over $3,250,000,000. During the fiscal year just completed tax collections and interest payments amounted to $972,000,000, whereas total disbursements amounted to only $141,000,000. Excess collections amounted to $831,000,000. If the law is not changed and the scheduled increase of rates is permitted to take effect on January 1, 1943, the fund balance at the close of the current fiscal year will be slightly over 4½ billion dollars.

FULL RESERVE FUND ABANDONED IN 1939, REVISED ESTIMATES SHOW FAVORABLE EXPERIENCE

When the Congress studied the taxing provisions of the Social Security Act in 1939 the principle of building up the so-called full reserve fund was abandoned. In accordance with this decision, this committee recommended, and the Congress approved, a freezing of the tax rate at the 1-percent level for the years 1940, 1941, and 1942 instead of the 1½-percent rate which was contained in the original Social Security Act.

Since the law was last amended significant changes have been made in the estimated operations for the next several years. This can be clearly demonstrated by comparing the estimates which were made in 1939 when the tax was frozen at present levels with the revised estimates for the same period which were submitted to Congress this year by the board of trustees of the old-age and survivors insurance trust fund.

As an indication of the anticipated trend for the next several years we have compared in the following table the 1939 and the 1942 estimates. Revised estimates of receipts show substantial increases in the tax yield. Anticipated benefits are now much lower, and as a result the trust fund will be much larger than it was expected to be when the rates were frozen at the 1-percent level.

TABLE I.—*Comparison of estimates of operations of the old-age and survivors trust fund prepared in 1939 and 1942 for fiscal years 1941–45*

[In millions of dollars]

Items estimated	Year of estimate	1941	1942	1943	1944	1945	Total	Increase or decrease, 1942 estimate over 1939
Net tax receipts [1]	1939	505	504	919	1,067	1,078	4,073	
Net tax receipts [1]	1942	[2] 663	872	1,365	2,170	2,169	7,239	+3,166
Benefit payments	1939	298	431	583	667	776	2,755	
Benefit payments	1942	[2] 64	113	166	225	290	858	−1,897
Interest	1939	49	54	61	71	82	317	
Interest	1942	[2] 56	72	92	127	174	521	+204
Trust fund, end year	1939	2,127	2,254	2,651	3,122	3,506		
Trust fund, end year	1942	[2] 2,397	3,229	4,520	6,592	8,645		+5,139

[1] Administrative expenses deducted from 1942 estimated receipts in order to make them comparable to 1939 estimates.
[2] Actual expenditures.

Source: 1939 estimates, U. S. Senate Report No. 793, 76th Cong., p. 17; 1942 estimates, Second Annual Report of Board of Trustees of the Old-Age Trust Fund, 1942, Doc. No. 694, p. 6.

SECRETARY OF TREASURY RECOMMENDS CONTINGENT RESERVE

The Secretary of the Treasury, in testifying before the Committee on Ways and Means of the Seventy-sixth Congress, said:

"We should not accumulate a reserve fund any larger than is necessary to protect the system against unforeseen declines in revenues or increases in the volume of benefit payments. Specifically, I would suggest to Congress that it plan the financing of the old age-insurance system with a view to maintaining for use in contingencies an eventual reserve amounting to *not more than three times the highest prospective annual benefits in the ensuing 5 years.*

"* * * I think that it is most important that prior to 1943 Congress again comprehensively reexamine the financial provisions of the act. Pending that reexamination, however, I believe that the tax rates for 1943 and thereafter which are now in the act should be retained so that there shall continue to be a definite program for financing old-age insurance on the statute books." [Italics ours.] (Source: Hearings Relative to the Social Security Act Amendments of 1939, vol. 3, pp. 2113–2114.)

SOCIAL SECURITY ACT AMENDED TO INCLUDE "THREE TIMES TEST"

Acting upon the above suggestion of the Secretary of the Treasury, a specific amendment was added in 1939 to title II of the Social Security Act, which established a body to be known as the Board of Trustees of the Federal Old-Age and Survivors Trust Fund. Section 201 (b) of the Social Security Act reads as follows:

"* * * It shall be the duty of the Board of Trustees to—

"(1) Hold the trust fund;

"(2) Report to the Congress on the first day of each regular session of the Congress on the operation and status of the trust fund during the preceding fiscal year and on its expected operation and status during the next ensuing 5 fiscal years;

"(3) *Report immediately to the Congress whenever the Board of Trustees is of the opinion that during the ensuing 5 fiscal years the trust fund will exceed three times the highest annual expenditures anticipated during that 5-fiscal-year period,* and whenever the Board of Trustees is of the opinion that the amount of the trust fund is unduly small." [Italics ours.]

TRUSTEES' REPORT FOR 1942 PREDICTS OVER $10,000,000,000 IN RESERVE FUND IN 1946

The second annual report of the board of trustees (H. Doc. No. 694, p. 6) furnishes the estimates of operations of the Federal old-age and survivors insurance trust fund which appear in the following table:

TABLE II.—*Financial statement of old-age and survivors insurance trust fund—Second annual report of the board of trustees, 1942*

(P. 6, H. Doc. 694, 77th Cong., 2d sess.)

The board of trustees reports the following estimated operations:

[In millions of dollars]

Trust fund balance June 30, 1941					$2,398
Income by years:	*Taxes*	*Interest*	*Total*		
1942	$900	$72	$972		
1943	[1] 1,394	92	1,486		
1944	[1] 2,200	127	2,327		
1945	[1] 2,200	174	2,374		
1946	[1] 2,338	222	2,560		
Total	9,032	687		$9,719	
Expenditures by years:	*Benefits*	*Administrative expenses*	*Total*		
1942	$113	$28	$141		
1943	[1] 166	29	195		
1944	[1] 225	30	255		
1945	[1] 290	31	321		
1946	[1] 360	32	392		
Total	1,154	150		1,304	
Net increase in fund 1942–46					8,415
Trust fund balance June 30, 1946					10,813
Three times test—average benefits 1951–55 estimated by trustees at $1,500,000,000 ($1,500,000,000×3)					4,500
Excess over "three times requirement"					6,313

[1] Estimated.

The above table shows that by June 30, 1946, the balance in this trust fund will be $10,813,000,000. In this same report it is estimated that for the fiscal year period 1951–55 the average annual benefit payments will be $1,500,000,000. (The actual estimate for the year 1951 will be much lower than the average for 1951–55 which is used here. Therefore, the $1,500,000,000 probably is an over-this table as well as in table II.

If we apply the "three times test" to this trust fund balance as of 1946, we find that the normal contingent reserve need only be $4,500,000,000. This will produce an excess reserve above normal of $6,313,000,000. It logically follows, therefore, that the contemplated tax increase is not justified by the existing conditions and the rate might well be kept at existing levels.

IF RATES ARE FROZEN AT PRESENT LEVEL, RESERVE FUND BALANCE STILL MORE THAN ADEQUATE

In the following table, the estimates of the board of trustees with respect to income have been adjusted on the assumption that the rates would remain at present levels—1 percent on employer and 1 percent on employee. (The same official estimated expenditures given by the board of trustees have been used in this table as well as in table II.)

TABLE III.—*Estimated operations 1943–46 if taxes remain at present rates (1 percent on employer and 1 percent on employee)*

[In millions of dollars]

Trust fund balance, June 30, 1941					$2,398
Income by years:	*Taxes*	*Interest*	*Total*		
1942	$900	$72	$972		
1943	[1] 934	92	1,026		
1944	[1] 1,100	113	1,213		
1945	[1] 1,100	127	1,227		
1946	[1] 1,039	142	1,181		
Total	5,073	546		$5,619	
Expenditures by years:	*Benefits*	*Administrative expenses*	*Total*		
1942	$113	$28	$141		
1943	[1] 166	29	195		
1944	[1] 225	30	255		
1945	[1] 290	31	321		
1946	[1] 360	32	392		
Total	1,154	150		1,304	
Net increase in fund 1942–46					4,315
Trust fund balance June 30, 1946					6,713
3 times test—Average benefits 1951–55 estimated by trustees at $1,500,000,000 ($1,500,000,000×3)					4,500
Excess over "Three times requirement"					2,213

[1] Estimated.

It will be seen from this table that even if the rates are frozen, the "three times test" of the reserve fund will be exceeded by over $2,213,000,000.

FURTHER TESTS OF ADEQUACY OF RESERVE

The board of trustees of the old-age trust fund has expressed some concern over the adjustment which may be necessary at the termination of the war, when it is reasonable to expect there may be increased retirements of aged workers and a possible reduction in revenues. Nevertheless, we do not believe that concern over these possibilities will justify a reserve fund which has been shown above to exceed the "three times test" of adequacy by a sum of over $6,000,000,000.

If we were to assume that the $1,154,000,000 of benefits estimated by the board of trustees for the period 1942–46 were to be doubled, it is obvious that the already existing trust fund of 3¼ billion dollars would be more than enough to pay these benefits if not another penny of taxes were to be received during this period. Even if this remote condition should occur, it will not come about overnight, and we sincerely believe that any reversals in the presently anticipated program can be reported to Congress whenever such circumstances arise and adequate measures taken to anticipate them.

OLD-AGE INSURANCE COLLECTIONS IN OHIO

As an illustration of the size of these taxes and the impact of the proposed automatic doubling of these rates, it should be noted that in the State of Ohio during 1941, Treasury reports indicate that the tax yield will be slightly in excess of $60,000,000—$30,000,000 being deducted from the wages of the workers and another $30,000,000 being paid by the employers.

In view of the fact that current receipts are already running far ahead of all reasonable anticipated expenditures, it is quite difficult to explain to taxpayers in the State of Ohio why this tax yield should next year be increased from

$60,000,000 to approximately $120,000,000. Other States will encounter the same problem.

BURDEN ON INDIVIDUAL WORKERS

The social-security tax is now being paid by specifically designated groups of our earning population. To say that we are justified in taxing this group of individuals more than is needed for social-security purposes, and thereby aid in financing ordinary or extraordinary governmental costs, is to ignore the plain equities of the situation. In effect, such unjustified tax increases will mean that certain portions of the taxpaying public will be called upon for more than their share in the over-all tax burden.

PRICE CONTROL—ANOTHER HANDICAP IN EFFECTIVE ENFORCEMENT OF DOUBLED TAX

Employers as well as employees throughout the country will encounter grave problems in handling this doubled social-security tax. Most, if not all, employers are faced with the problems of price freezing. No detailed explanation is necessary here to point out the difficulty which would be encountered by all employers, both large and small, in assimilating under existing price schedules a pay-roll tax which will be doubled during the ensuing year. The social-security pay-roll tax has a pyramiding effect, being paid by every employer in the long channel of production, from the extractive industries to the ultimate consumer. The cumulative effect of this tax will make the adjustment of existing price ceilings extremely troublesome.

This situation is particularly true of those business enterprises which have not been able to take part in the war effort. They are already faced with increasing costs on a diminishing volume of business.

The effect of this doubled tax on those business enterprises which are engaged in the war effort will be to establish higher operating costs by whatever portion of their total cost is represented by pay-roll items. Furthermore, if this tax is doubled, this item will reduce the amount of profits which will be subject to the schedule of the excess-profits taxes which are now contemplated. Instead, the money will go into the old-age and survivors insurance reserve fund, creating an obligation on the part of the Government to expend future tax money and to pay substantial amounts of interest thereon for many years in the future.

PROPOSED TAXES ON INDIVIDUALS

In order to test the over-all burden of the social-security tax, withholding tax, and increased income tax during the year 1943, the following table has been prepared showing the total proposed Federal-tax burden on low-income industrial workers. This table shows, for example, that a single man earning $30 per week would, under the House proposals, pay a total of $4.93 per week in direct taxes. This same man, if married, would pay $1.61 a week. A married man earning $50 per week with no dependents would pay $6.51 per week. If he had one dependent, he would pay $4.59 per week, and if he had two dependents, he would pay $2.66 per week.

TABLE IV.—*Weekly taxes of selected wage earners under House revenue bill 7378 and 2 percent social-security pay-roll tax in 1943*

SINGLE PERSON

Weekly earnings	Social security [1]	Income tax [2]	5 percent withheld [3]	Total	No dependents			
					Social security	Income tax	5 percent withheld	Total
$15	$0.30	$0.79	$0.20	$1.29	$0.30			$0.30
$25	.50	2.54	.70	3.74	.50	$0.08		.58
$30	.60	3.33	.95	4.93	.60	.81	$0.20	1.61
$40	.80	5.12	1.45	7.37	.80	2.56	.70	4.06
$50	1.00	6.87	1.95	9.82	1.00	4.31	1.20	6.51
$55	1.10	7.81	2.20	11.11	1.10	5.13	1.45	7.68

[1] First $3,000 of wages subject to 2 percent tax for social security in 1943.
[2] Income tax—rates and exemptions in House bill 7378 have been used.
[3] Withholding tax—weekly exemption schedule in House bill has been taken into account.

TABLE IV.—*Weekly taxes of selected wage earners under House revenue bill 7378 and 2 percent social-security pay-roll tax in 1943*—Continued

MARRIED PERSON

Weekly earnings	1 dependent				2 dependents			
	Social security	Income tax	5 percent withheld	Total	Social security	Income tax	5 percent withheld	Total
$15	$0.30			$0.30	$0.30			$0.30
$25	.50			.50	.50			.50
$30	.60			.60	.60			.60
$40	.80	$1.08	$0.28	2.16	.80			.80
$50	1.00	2.81	.78	4.59	1.00	$1.31	$0.35	2.66
$55	1.10	3.73	1.03	5.86	1.10	2.23	.60	3.93

It would seem to be clear from the above table that consideration of the broad economic effect of the general burden which must be borne by all taxpayers, without taking into account the effect of doubled social-security taxes, will result in serious problems for the many millions of persons who are subject to this special pay-roll tax.

CONCLUSIONS

The intention of Congress in 1939 was clear to abandon the fallacious concept of a full reserve fund for old-age and survivors' insurance. It has been demonstrated that the revised estimates based on the most recent calculations of the board of trustees indicate that far more money will be collected under the increased rates than will be needed for many years to come. Considering the fact that the so-called three-times test contemplates a trebling of the highest anticipated expenditures in the ensuing 5 years, there will always be adequate time for Congress to adjust the rates when they are needed. The law already provides for the filing of such a report with the Congress.

We earnestly recommend that this committee in its deliberations fully and carefully consider the adoption of an amendment to sections 1400 and 1410 of the Internal Revenue Code to the end that the existing 1-percent rates on employers and employees be reduced or maintained at the existing level until such time as the estimates of the board of trustees indicate the necessity of resuming the scheduled increase.

ESTIMATED EFFECT OF PROPOSED TAXES UPON CERTAIN OHIO CORPORATIONS

In response to a general inquiry, the Ohio Chamber of Commerce has received from the executives of certain Ohio corporations the within estimates as to the effect upon their respective companies of the 1942 revenue bill as it passed the House in the light of operations during the first 6 months of the calendar year 1942. The great majority of the companies circularized had not had opportunity to study the bill. Of the replies received, many contained general comments and criticisms but omitted any figures. The attached statements, however, seem to be fairly representative of different types of business corporations, as indicated by the descriptions; the Ohio Chamber of Commerce has not been authorized to divulge the names of the companies submitting the attached statements.

PAPER BOX MANUFACTURER

We are unable at this time, to give actual figures, but by projecting our present figures for the year on the basis of current operations we arrive at the following:

Sales	$2,500,000	Normal and surtax	$53,820
Net profit	250,000	Net income after tax	55,780
Excess-profits credit	94,000	Investment	+800,000
Excess-profits tax	140,000	Percentage on investment	+6.96

Since 1937 we have expended for fixed assets approximately $700,000, and, at present, have "borrowed money" to the extent of $555,000, part of which was borrowed on the basis of a time loan, payable $100,000 per year, starting 1943.

It appears that the members of the Ways and Means Committee of the House have no conception of business practices in setting up their proposed tax, since no provisions were made to allow any credit for retirement of obligations contracted before 1941, which must, of necessity, be retired during the present period.

CHAIN STORE

	1941 rates	1942 proposed rates	Increase, decrease
1941 TAXABLE INCOME			
(Sales, $16,000,000)			
Normal and surtax	$78,861.95	$69,251.85	−$9,610.10
Excess-profits tax	89,647.56	171,858.60	+82,211.04
Total	168,509.51	241,110.45	+72,600.94
Net profit after tax	$152,847.05	$80,246.11	
Net profit percentage after tax	0.96	.50	
Net profit before tax	$321,356.56	$321,356.56	
Net profit percentage before tax	2.01	2.01	
ESTIMATED 1942 TAXABLE INCOME OF $600,000			
(Sales, $22,000,000)			
Normal and surtax	$115,663.67	$70,063.20	−$45,600.47
Excess-profits tax	226,117.20	398,873.60	+173,756.40
Total	341,703.87	469,936.80	128,155.93
Estimated net profit after tax	$258,219.13	$130,063.20	
Estimated net profit percentage after tax	1.17	.59	
Estimated net profit before tax	$600,000.00	$600,000.00	
Estimated net profit percentage before tax	2.73	2.73	

Our 1941 profit after tax was only ninety-six one-hundredths of 1 percent of our sales. On the basis of the present proposed revenue bill, our net profit would have been fifty one-hundredths of 1 percent or $80,246.11, and our tax would be $241,110.45 or 75 percent of our earnings.

On the basis of our 1942 anticipated sales and income, our taxes will be $469,936.80, leaving a net profit of $130,063.20 or fifty-nine one-hundredths of 1 percent on our anticipated sales of $22,000,000.

To pay 78 percent of our profits in taxes, leaving only $130,063 net profit to operate a business doing $22,000,000 worth of business is simply, impossible.

PUBLIC UTILITY

Estimated 1942 Federal income taxes computed at rates carried in bill as passed by the House:

Excess-profits tax	$2,503,960
Normal tax	791,202
Surtax	692,302
Total excess profits, normal, and surtax	3,987,464
Taxable net income before Federal income taxes	6,158,345
Book net income before Federal taxes	5,026,300
The reason for the difference between the taxable net income and the book net income is primarily due to the fact that we are booking a larger amount for reserve for retirements than is allowed as a deduction for Federal income and excess-profits taxes. There are also numerous items which are not allowable deductions for income-tax purposes which are expensed on our books.	
Net income after Federal taxes, per books	1,038,835
Preferred dividends	450,000
Balance available for common stockholders and for surplus	588,835
Rate of return on book property values percent	.96
Amount of excess-profits credit	$3,280,740

I am listing below a number of comparisons for the years 1939 to 1942, which are most interesting and which readily disclose the disastrous effect which this war revenue bill will have upon our company.

Amount of net earnings available for common stockholders and for surplus:

1939	$2,626,195	1941	$2,222,498
1940	2,924,263	1942	588,835

Ratio of net earnings available for common stockholders and surplus to book property values:

	Percent		Percent
1939	5.15	1941	3.87
1940	5.45	1942	.96

Total Federal income and excess-profits taxes:

1939	$661,309	1941	$2,114,834
1940	681,638	1942	3,987,464

Ratio of Federal income and excess-profits taxes to book net income before Federal taxes and before any dividends:

	Percent		Percent
1939	17.69	1941	44.18
1940	16.81	1942	79.33

Ratio of Federal income and excess-profits taxes to book net income after Federal taxes and before any dividends:

	Percent		Percent
1939	21.50	1941	79.13
1940	20.20	1942	383.84

MACHINE TOOL MANUFACTURER

Tax estimate, based on bill which passed the House July 21, 1942 (excluding possible sliding scale for surtax on first $50,000

Excess-profits tax:			
Estimated income—excess-profits net income		$10,000,000.00	
Less: Specific exemption	$10,000.00		
Excess-profits tax credit as shown on 1941 return	555,502.50		
		565,502.50	
Adjusted excess-profits net incofe		9,434,497.50	
Excess-profits tax, at 90 percent			$8,491,047.75
Normal tax:			
Estimated income		$10,000,000.00	
Adjusted excess-profits net income		9,434,497.50	
Normal tax base		565,502.50	
Normal and surtax, at 45 percent			254,476.13
Total tax			8,745,523.88

Tax percentage, 87.46.

METAL PRODUCTS COMPANY

The following figures are estimates but not impossible in light of our present volume:

Should our operating profit amount to	$200,000
Total tax would be	150,156
Leaving a net profit of	49,844

In other words a 75 percent tax on profits.

Should our operating profit amount to	300,000
Total tax would be	244,657
Leaving a net profit of	55,343

The above figures indicate a tax of 81½ percent on profits.

The amazing point revealed by the above figure, is that on the last $100,000 of earnings, the tax collector would get a slice of $94,501, or 94½ percent, and the company could retain $5,499 for expansion of the business or for the proverbial rainy day.

Should we be required to compute our excess-profits tax on the invested capital base, the following picture would result:

Gross earnings	$200,000	$300,000
Resulting tax	176,468	270,968
Resulting net profit	23,532	29,032
Tax percentage	88.23	90.32

PUBLIC UTILITY

	Present law, 1941	Proposed law, 1942
Excess-profits credit	No material change	
Excess-profits tax	$1,586,884.28	$4,727,698.61
Normal and surtax	$1,425,316.97	$1,565,051.12
Remaining return on investment:		
After taxes:		
Amount	$3,193,322.42	$2,473,331.27
Percent [1]	2.91	2.14

[1] Computed on total of property, plant, and equipment as of June 30 of 1941 and 1942.

PAPER MANUFACTURER

Based on tax bill passed by House of Representatives

Tax rates		*Invested capital credit*	
Excess-profits tax (90 percent)	$5,000,000	at 8 percent	$400,000
Normal tax (24 percent)	5,000,000	at 7 percent	350,000
Surtax (21 percent)	15,000,000	at 6 percent	900,000
	25,000,000		1,650,000
Total income, before tax	3,300,000		
Less excess-profits credit	1,650,000		
	1,650,000		

SUMMARY

Total income, before tax		$3,300,000
Less:		
Normal and surtax (45 percent on $1,650,000)	$742,500	
Excess-profits tax (90 percent on $1,650,000)	1,485,000	
		2,227,500
		1,072,500

Return on $25,000,000 invested capital, 4.29 percent.

The rate of 4.29 percent on invested capital is approximately equivalent to $1 per share of common stock of our company, as against about $3.56 per share in Federal income and excess-profits tax.

STEEL COMPANY

The statutory invested capital of this corporation and subsidiaries for the year 1942 has been estimated, under existing laws, to be approximately $102,000,000, which would afford an excess-profits-tax credit of $6,270,000. The net taxable earnings of this corporation and subsidiary companies for the first 6 months of 1942 were approximately $7,500,000, and, applying the rates and provisions of the revenue bill of 1942 as passed by the House of Representatives, the provision for

Federal income and excess-profits taxes for the period would approximate $5,400,-000, which would leave a balance of profits of $2,100,000, which would be equivalent to a return of approximately 4.1 percent upon statutory invested capital. Preferred-dividend requirements for the 6-month period are approximately $900,000, which would leave a balance of $1,200,000 available for the payment of debts and disbursements to common stockholders. The corporation is required to pay off long-term debt to the extent of $1,200,000 per year and, deducting one-half of this amount from the earnings of the first 6 months, would leave only $600,000 for distribution to common stockholders and to provide a cushion for years to follow when earnings may be at a very unsatisfactry level. Needless to say, under the tremendous taxes as recommended in the House bill, this corporation would be in no position to pay any dividends to its common stockholders and, if its previous conservative policy were to be continued, even the payments to preferred stockholders would necessarily have to be reduced.

POTTERY COMPANY

Assuming we will earn $150,000 for 1942, our picture will shape up as follows:

Estimated earnings of corporation	$150,000
Excess-profits credit, including specific exemption	66,000
Balance of income subject to excess profits tax at 90 percent	84,000
Portion of income subject to normal tax and surtax (represents the amount of income not subject to the excess tax), at 24 and 21 percent, or a total of 45 percent	66,000
Excess tax ($84,000 at 90 percent)	75,600
Normal tax ($66,000 at 24 percent)	15,840
Surtax ($66,000 at 21 percent)	13,860
Total taxes	105,300
Total income	150,000
Less: Total taxes	105,300
Leaves available for payment of mortgage and dividends	44,700

Out of $44,700, that we would have left from our net earnings of $150,000, we are obligated to pay $30,000 on our mortgage together with preferred-stock dividend of $1,900. This, you will note, leaves us $12,800 to run a $2,000,000 business.

STEEL COMPANY

Consolidated earnings for first 6 months of 1942 before income and profits taxes		$10,465,782.18
Less:		
Provision for State and foreign income taxes	$131,459.76	
Provision for Federal income and profits taxes	7,000,000.00	
		7,131,459.76
Net income for 6 months		3,334,322.42

Based on more detailed estimates made since the above earnings statement was released, it appears that the provision for Federal taxes should have been $7,272,000, thus reducing the earnings for the period to $3,062,322.42. The taxes so estimated are composed of:

Excess-profits tax	$4,937,000
Income and surtaxes	2,335,000
Total	$7,272,000

Total excess-profits credits effectively used in making the computation were $10,460,000 out of total estimated credits available of $10,608,000.

Assuming that our earnings before taxes can be maintained at the same rate during the second half of the year as for the first half, it is clear that our net earnings for 1942 will be approximately $6,000,000. Study of the figures convinces us that this will be the approximate ceiling. If it were possible to earn as much as $30,000,000 before taxes instead of at the rate of

$20,000,000, such increased earnings would add only $1,000,000 to the $6,000,000 now estimated as the probable ceiling for net earnings.

On June 30, 1942, our funded debt stood at $28,000,000, whereas at the close of 1939 we had funded debt and bank loans of $3,550,000. Admittedly, a very considerable part of the borrowed money is represented in facilities subject to amortization over a period of 5 years and, so long as our earnings before taxes are above the excess-profits-credit level, our taxes would be reduced by about 90 percent of the amounts amortized. However, it is not at all certain that we can effectively use all of the amortization to which we are entitled.

It seems reasonably clear that when the war is over we will have a very sizable funded debt which was created largely for war purposes. The restrictions placed by the 1942 bill, not only on true excess profits but on normal profits as well by the excessive taxes on normal profits, can have no other result.

As we see the situation, we see no objection to a high level of tax on true excess profits. Such profits, however, should not be drawn off entirely in view of capital outlays for war purposes which must be compensated for, at least in part, out of such excess profits. The proposed tax on normal incomes is entirely too high, will immediately create serious difficulty for many corporations and make our problems more serious during the post-war period.

OFFICE EQUIPMENT MANUFACTURER

Our excess-profits credit is $210,000. Let's assume we will have a net income before taxes of $1,000,000 for the calendar year 1942. We then would have a normal tax based on the present bill approved by the House of $94,500. Our excess-profits tax would amount to $702,000, making a total Federal income tax of $796,500.

This would leave $203,500 balance available for sinking fund, capital expenditures, working capital, and accumulating preferred dividends. We have a bond indebtedness which calls for a sinking fund. With this estimated profit we would be required to set aside $72,550 for the sinking fund and the accumulating dividend referred to above, and which was part of the agreement in plans to retire the indebtedness of this company, would amount to $66,000 which would leave us a net of $64,950.

This would mean that in order to do the job in the war program which we have obligated ourselves to do it would be necessary for us to take money out of our earned surplus.

ELECTRICAL-EQUIPMENT MANUFACTURER

We have been in business since 1902 and at present we are employing 85 people. So far this year about 80 percent of our production has been for war purposes, consisting of electrical switches, relays, and contactors, which are used in connection with battery-charging apparatus for planes, tanks, and ships, and also by the United States, British, and Russian Signal Corps.

The demand for these devices has expanded very rapidly in the past 2 years and has resulted in a very large increase in sales over previous years. Judging from results for the first 6 months, our profits, before taxes, will be about $200,000. We are compelled to use the average-earnings method in figuring our excess-profits tax, and the results would be as follows, if we understand the provisions of the House bill correctly:

Earnings for base years:	
1936	$3,495.36
1937	14,860.68
1938	15,253.28
1939	4,638.89
Total	38,247.61
Average	9,561.90
95 percent of average	9,083.00
Plus specific exemption	10,000.00
Total credit	19,083.00

Income	$200, 000. 00
Credit	19, 083. 00
Excess-profits base	180, 917. 00
Excess-profits tax, 90 percent of above	162, 825. 30
Normal and surtax	7, 151. 54
Capital-stock tax	2, 500. 00
Total taxes	172, 476. 84

From the above figures you will note that the House bill would leave us about $27,524 from earnings of $200,000 and that approximately 86 percent of our earnings would be absorbed by Federal taxes.

Our earnings for 1941 were $47,629.98, and we paid taxes on same as follows:

Excess-profits tax	$11, 422. 83
Normal and surtax	10, 778. 35
Capital-stock tax	562. 50
Total	22, 763. 68

Unquestionably our large prospective gross profits for the present year are due primarily to vastly increased sales attributable to the war effort. Therefore, these profits should be taxed heavily, but the taxation should not proceed beyond the point where it would inevitably have the effect of putting us out of business for lack of adequate working capital. I am sure that it will have this effect if we continue to take approximately 85 percent of our current earnings and invest the same in tax-anticipation notes. We have an indebtedness of about $37,000, and if we have to pay the taxes provided by the House bill we can see no way of paying anything on this indebtedness during the present year.

PUBLIC UTILITY

Income account—year 1942 (6 months actual and 6 months estimated) compared with year 1941

	Year 1942	Year 1941	Increase-decrease	
			Amount	Percent
Gross revenue	$26, 240, 248. 44	$24, 717, 696. 41	+$1, 522, 552. 03	+6. 16
Deductions:				
Operating expenses	8, 971, 180. 42	8, 379, 771. 21	+591, 409. 21	+7 8
Taxes (exclusive of Federal income taxes)	2, 456, 145. 32	2, 336, 868. 22	+119, 277. 10	+5. 10
Depreciation and amortization of plant adjustments	3, 345, 684. 00	3, 000, 000. 00	+345, 684. 00	+11. 50
Income deductions (fixed charges)	3, 443, 212. 48	3, 454, 014. 49	−10, 802. 01	−. 31
Total deductions	18, 215, 622. 22	17, 170, 653. 92	+1, 044, 968. 30	+6. 09
Net income before Federal income taxes	8, 024, 626. 22	7, 547, 042. 49	+477, 583. 73	+6. 33
Federal income taxes:				
Federal excess-profits tax	3, 708, 790. 00	1, 810, 000. 00	+1, 898, 790. 00	+104. 91
Federal income and surtax	2, 252, 438. 00	1, 838, 600. 00	+413, 838. 00	+22. 51
Total Federal income taxes	5, 961, 228. 00	3, 648, 600. 00	+2, 312, 628. 00	+63. 38
Net income	2, 063, 398. 22	3, 898, 442. 49	−1, 835, 044. 27	−47. 07
Preferred stock dividends	1, 866, 923. 00	1, 866, 923. 00		
Balance to surplus	196, 475. 22	2, 031, 519. 49	−1, 835, 044. 27	−90. 33

NOTE.—You will note that our gross revenue shows an increase of 6.16 percent, gross income before deduction shows a decrease of 0.31 percent, Federal income taxes, etc., show an increase of 63.38 percent, while the net income shows a decrease of $1,835,000, or 47.07 percent, which gives us a very scant margin over our preferred dividend required.

The CHAIRMAN. Mr. Rowland Jones.

STATEMENT OF ROWLAND JONES, JR., WASHINGTON, D. C., REPRESENTING THE NATIONAL ASSOCIATION OF RETAIL DRUGGISTS

Mr. JONES. My name is Rowland Jones, Jr., and I represent the National Association of Retail Druggists, an organization of 28,000 independent retail druggists. My remarks will be very brief, because they have been made before this committee before.

One point that we wish to bring before the committee is the need for the establishment of a differential tax for pure ethyl alcohol used for medicinal purposes. The House bill taxes ethyl alcohol to a point that brings it to $11.40 a proof-gallon. That compares with about 40 cents a gallon cost of the raw material.

The CHAIRMAN. Mr. Jones, we took your view of it last year, but we did not have any luck in conference.

Mr. JONES. I know that. I appreciate what the Senate did last year, and we hope the Senate will do it again and perhaps this year the conference will not discard it. But as the distilled-spirits tax goes up, the problem grows progressively worse. I understand that a proposal will be made to this committee to establish such a differential but to tie to it a $100 occupational tax in exchange for the privilege of withdrawing pure alcohol at a lower tax rate. We hope the committee will not approve of any such arrangement as that, because it would deny automatically the privilege of a lower taxed alcohol to the 58,000 retail druggists of this country who are compelled to use the pure product.

Senator BAILEY. Is it restricted to medicinal uses?

Mr. JONES. Yes, sir. But naturally, the attaching of a $100 occupational tax to the privilege to make the withdrawals will make the privilege available only to the very large users eliminating the average retail pharmacist.

Senator TAFT. Is this alcohol to be denatured?

Mr. JONES. No, sir; our alcohol is pure ethyl alcohol. We have another strange situation here for the pure ethyl alcohol which must be used. We have hundreds and hundreds of millions of dollars of the same alcohol, denatured of course, withdrawn without any taxation of any kind.

Senator HERRING. Was it not the mechanics of operating under that procedure, the difficulty of administration, which was the reason for the objection by the Treasury Department?

Mr. JONES. The Treasury Department takes the position that the administrative problem involved in having a lower taxed alcohol for this use is responsible for their very vigorous opposition to a tax differential, but we take the position that the Treasury says now there is a 10 percent bootlegging element in the consumption of distilled spirits, and with that picture and with that enforcement problem, the very small enforcement problem involved in this proposition would not be important at all.

Mr. Chairman, the only other statement I wish to make is to file with the committee a statement in support of the principle advanced by the Treasury to the House committee involving the establishment of an income-tax deduction for a part at least of the costs of medical care. We believe that as the income tax dips lower and lower into the small-income groups, that the need for some allowable deduction of at least a part of the expenses of medical care should be allowed. I would like to offer a brief on that.

The CHAIRMAN. You may do so.

Mr. JONES. One more thing: Dr. E. F. Kelly, secretary of the American Pharmaceutical Association, concurs in the remarks that I have made, and I ask leave on behalf of Dr. Kelly and myself to file an additional brief if this other $100 occupational tax in connection with an alcohol differential is seriously considered.

The CHAIRMAN. You will be given that privilege.

(The statement submitted by Mr. Jones is as follows:)

STATEMENT OF ROWLAND JONES, JR., WASHINGTON REPRESENTATIVE OF THE NATIONAL ASSOCIATION OF RETAIL DRUGGISTS, ON THE 1942 REVENUE BILL

We would urgently recommend that expenditures for medical care be made deductible in determining net income of individuals for income-tax purposes. In making this recommendation we are not proposing something new and untried. Since the beginning of income taxes in that State Minnesota has exempted for income-tax purposes, I quote, "Payments for expenses for hospital, nursing, medical, surgical, dental, and other healing services, and for drugs and medical supplies incurred by the taxpayer on account of sickness of, or personal injury to himself or his dependents."

We would suggest that the language be made more restrictive and that the exemption of "drugs and medical supplies" be limited to those prescribed by a licensed physician or dentist. If drugs and supplies used in self-medication are included there might be an opportunity for tax evasion, and, further, the purpose of the exemption, which is to safeguard public health, might be defeated to some extent.

Let it be noted, however, that even without this safeguard the exemption has worked so well in Minnesota that there has never been any attempt made to remove it from the income-tax law. It should be noted, also, that the exemption is in addition to the regular deduction for dependents and not in lieu of any part thereof.

May I offer for the record at this point a copy of a communication from the Department of Taxation of the State of Minnesota which states in brief that under the language of the exemption in the Minnesota statute, in the year ending June 30, 1941, the average deduction from gross income taken on the returns was $82.33.

There are sound reasons for writing such an exemption into the Federal income tax at this time:

(1) Lowering the personal exemption of a married person to $1,500 and of a single person to $750, has deprived taxpayers in the lower brackets of exemption amounting to several times the amount which would normally be spent for medical care. Thus a married person without children formerly enjoyed an exemption of $2,400 which, it might be assumed, would cover rent, food, clothing, and other necessities, including medical care. With a reduction to $1,500, coupled with a substantial increase in the cost of living, the exemption is not sufficient to cover essential expenses exclusive of those for medical care.

(2) The lower exception has not only placed a heavier burden on those who have paid income taxes heretofore, but it has brought into income-tax brackets many who formerly paid no income tax. These people will face the necessity of sharply revising their family budgets. It is a normal human trait to eliminate or postpone provisions for health; to delay going to the doctor, to resort to self-medication instead of seeking the more expensive professional treatment, or even to trust to luck that an ailment will cure itself. I submit that at this time, when the maintenance of the health of the people is so important, and their morale so essential to the war effort, that anything that tends to discourage prompt and effective health measures should be avoided.

(3) The increase in rates proposed at this time, by lowering the spendable incomes of persons in the middle brackets, will actually bring an increasing number of these people into the low-income group and thereby make them subject to the same temptation to neglect health. In fact, their temptation to do so may become even stronger; for it is harder for those who have enjoyed

a higher standard of living to adjust to a lower, and many of them have incurred indebtedness and fixed charges which must be met. For instance, many of them have recently built homes on which they are obligated to make Federal Housing Administration payments. In many instances they budgeted their incomes so closely in making their plans for repaying the mortgages as to leave a minimum for current expenses. Those plans were made on the basis of income-tax payments at the former lower rates, and did not contemplate taxes which would sharply reduce their spendable income. They will have to revise their budgets, and the revisions may include no provision for medical care.

(4) The allowance of the proposed deduction would not only prevent failure to seek medical attention, but it would tend to encourage people to devote to that purpose income which otherwise would be used for luxuries—expenditures which the Government is trying to prevent at the present time. We will assume that a taxpayer is subject to an income tax amounting to 20 percent of his income, and that he is tempted to purchase a rug worth $100. Inasmuch as the part of his income devoted to the purchase of the rug is taxed $20, the rug will actually cost him $120. If he knew that $100 spent for medical care would not be taxed—in other words, that it would cost him just $100—he would be likely to give the $100 to his doctor instead of to a rug dealer. This would not only promote health but it would actually help to realize the Government's purpose to discourage the purchase of things made from critical materials. It would tend to postpone the purchase of the rug to the post-war period, when it may be desirable to stimulate buying and not to discourage it. Further, expenditures for medical care do not contribute to inflation.

I understand that objection to allowance of a deduction for medical expenses has been made, based on the claim that the exemption might be used for tax evasion. I trust that the committee will not take that objection seriously.

Let us consider the matter. Would the hypothetical income-tax payer be likely to seek medical attention he did not need, in order to lower his income tax? He would save $20 on his income tax, but he would have to pay the doctor $100 in order to save it. I submit that that would be a bad bargain, and one which no man who measures his financial advantage closely enough to think of it would ever undertake.

But, it might be suggested, there could be collusion between the doctor and the taxpayer. An unscrupulous doctor might submit a bill for $100 and accept $50 in payment. That would be even more absurd. For the doctor would have to enter $100 on his books and pay an income tax on it. Doctors are generally philanthropic, but their philanthropy does not extend that far.

It may be urged that the proposed deduction would reduce the revenues collectible under the income-tax law. That, also, is questionable. Sick men, as a rule, are not good income-tax payers themselves; and being unable to work they do not add to the taxable earnings of employers. Not only the success of the effort in the production of armaments, but also the ability of the Government to finance that effort, requires that every man and woman in the Nation be physically able to make his contribution. Statistics are available to you, which show how enormous are the economic losses, even in times of peace, due to sickness and other physical incapacity. Those losses are likely to be even greater at a time when war adds to the strain, and especially if unwise taxation causes thousands of people to reduce the expenditures they normally make for the protection of their health.

Lest it be thought that the National Association of Retail Druggists has a selfish purpose to serve in making this plea, let me call your attention to the fact that prescription medicines account for a very small amount in the health budget of the Nation. Prescriptions average only 10 percent of the business of a drug store, and the profits on prescriptions only a fraction of that. The druggist might conceivably gain in net profit, from the increase of business in proprietary preparations if the public, as a result of an unwise tax policy, went to self-medication.

The association which I represent in September of last year decided to make an effort to establish the principle of limited deduction for income-tax purposes for costs of medical care. Therefore, it was with a great deal of interest and pleasure that we learned of Mr. Paul's suggestion last week to this committee, which admits the justice of this contention. But we submit that the suggested exemption for health expenditures limited to that part of such expenditure which is in excess of 5 percent of the taxpayer's income cannot be defended.

The Treasury suggestion of the exemption of even that part admits the principle of health expenditure deduction. The principle being admitted, there can be no justification for limitation which would defeat completely the chief purpose to be accomplished. Superficially the proposal may seem fair for the reason that, being based on a fixed percentage of income, the portion of income devoted to medical expenditures, on which the taxpayer would continue to be taxed, would vary in direct ratio to the income.

It is proper to place a maximum on deductible medical expenditures but it should not be based on a fixed percentage having no relation to the size of the income. The more equitable method would be to allow deductions for medical care in full where the taxpayer's income is under a certain determined figure, and then to apply the 5 percent method on incomes exceeding such determined figure.

We would suggest a figure of $5,000 and the allowance of a complete exemption of the costs of medical care for incomes below that figure. That would provide an incentive to adequate medical care for the great proportion of those making income-tax returns and includes those forced to operate on the tightest budgets. We believe that it is probable that such an exemption would not cost the Government a great deal of revenue for the reason that a healthy taxpayer will continue to earn income from which the Government will derive revenue, while a taxpayer unable to work is a total loss, not only from the standpoint of revenue but from that of production of things needed to sustain the war effort.

An alternative proposal would be to allow a certain fixed maximum deduction based on the size of the family.

The Treasury proposal is further defective for the reason that the lower income groups in our present situation cannot afford the 5 percent medical care expenditure which the Treasury would set as the figure which must be expended before a medical care exemption would come into effect.

STATE OF MINNESOTA,
DEPARTMENT OF TAXATION, INCOME TAX DIVISION,
St. Paul, February 13, 1942.

The NATIONAL ASSOCIATION OF RETAIL DRUGGISTS,
St. Paul, Minn.

(Attention of Mr. Frank W. Moudry.)

GENTLEMEN: Reference is made to your letter of February 2, 1942, in which you request information relative to the deduction for payments made for sickness and personal injury expenses under the Minnesota income tax law.

The total of State income and franchise tax payments made for the fiscal year ended June 30, 1941, was $12,757,788.58. The total deductions taken on returns for this period on account of necessary payments of sickness and personal injury is approximately $9,500,000. Based on 115,540 returns filed during this period, the average deductions from gross income taken on each return for this item would be $82.23.

We trust this is the information you desire.

Very truly yours,

G. HOWARD SPAETH,
Commissioner of Taxation.
By WM. G. BURKMAN,
Director, Income Tax Division.

The CHAIRMAN. Mr. Spitzer.

STATEMENT OF A. LEWIS SPITZER, NEW YORK, N. Y.

Mr. SPITZER. My name is A. Lewis Spitzer. My address is 120 Broadway, New York City.

This is a proposal to amend section 107 of the Internal Revenue Code which the House has revised and is section 128 of the House bill.

Section 107, Internal Revenue Code, enacted in 1939, relating to the taxation of compensation received for personal services rendered over a period of 5 calendar years or more, now reads as follows:

> In the case of compensation (a) received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services, (b) paid (or not less than 95 per centum of which is paid) only on completion of such services, and (c) required to be included in gross income of such individual for any taxable year beginning after December 31, 1938, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the years included in such period.

The House bill, section 128, reduces the minimum period from 5 calendar years to 36 months and the requirement of 95 percent to 80 percent, to be effective for taxable years beginning after December 31, 1941. This is a necessary and salutary change and will meet with general approval.

However, for a taxable year beginning after December 31, 1940, and not after December 31, 1941 (hereinafter simply referred to as "1941"), the bill changes the 5 calendar years to 60 calendar months, which we submit is inadequate, and the 95 percent to 75 percent. This distinction is made in the last paragraph of section 128 of the House bill by making the amendment "applicable to taxable years beginning after December 31, 1940, but with respect to a taxable year beginning after December 31, 1940, and not beginning after December 31, 1941, the period specified in such subsection (a) shall be 60 months in lieu of 36 months." Thus the bill takes the year 1941 out of the general reduction made by the section for all taxable years beginning after December 31, 1940.

The minimum period for a taxable year beginning in 1941 should be 36 months, the same as for taxable years commencing after December 31, 1941. There is no reason, and none is stated, for the distinction made by the House. Every consideration which requires the reduction to 36 months for taxable years beginning after December 31, 1941, similarly requires that reduction for taxable years beginning in 1941. The reduction to 36 months has been urged by the New York and Illinois State and Chicago Bar Associations.

The purpose in enacting section 107, as stated by the late Senator Harrison in Senate Committee Report No. 648, was to relieve the "hardship" of taxing fully in 1 year—

> the compensation of writers, inventors, and others who work for long periods of time without pay and then receive their full compensation upon the completion of their undertaking—

which—

> under existing law * * * results in two inequities: First, only the deductions, expenses, and credits of the final year are chargeable against the compensation for the full period; second, under our graduated surtax, the taxpayer is subjected to a considerably greater burden because of the aggregation of his compensation—

which is, of course, increased as tax rates are increased.

In presenting the section to the House in 1939, Representative Jere Cooper similarly stated that its purpose was to relieve this "hardship," and very frankly said that the period of 5 years was—

> to some extent arbitrary, for some period of time had to be fixed * * * (and) is entirely experimental.

The House has very wisely seen fit to make a change in the minimum period of 5 calendar years not only for 1942 and thereafter, but for taxable years beginning in 1941, undoubtedly for the additional reasons (1) that a steep increase in income tax rates was made in the 1941 act and thus further aggravated the "inequities" and "hardship," and (2) that administrative features were not considered in 1941, although many were then urged, including the reduction of the period in section 107 to 36 months. These considerations warrant the same treatment for compensation received in 1941 as thereafter.

If the provision for the 60-month period is not changed, compensation received in 1941 is subjected to the sharp increase in rates made in 1941, although it is for services performed in part as far back as 1936. To invoke the section if the 36-month period applied in 1941, instead of 60 months, the individual who received his compensation in 1941 would still have had to commence his services at the latest some time in 1938, long before the emergency arose. The tax on such compensation should not be greater than if it had been received in equal portions in each of those 3 or more peace years. Such earnings should not be subjected to the high "emergency" rates of tax now in effect any more than earnings received in 1942.

No conscientious objection can be made to applying emergency rates to current earnings, but not to compensation actually earned during years before the emergency, but not received until thereafter. There is as little, if not less, justification for applying the high 1941 rates to compensation received in 1941 for services rendered from January 1, 1938, or before, as for applying wartime rates to such compensation received in 1942, for none of such compensation received in 1941 was earned during the emergency. The result of the distinction made in the House bill between taxation of compensation received in a taxable year beginning in 1941 and that received in a subsequent taxable year is that it does not at all relieve the further hardship caused by the sharp increase in 1941 rates on individuals who received their compensation in 1941 for personal services rendered during the 3 or 4 prior peacetime years.

Criticism had been directed at the provision for a minimum period of 5 full calendar years not only because the period was too long but also because persons working more than 60 months but not 5 full calendar years could not invoke the section, while others who worked fewer months but for 5 full calendar years could. The real purpose of the amendment to 60 months for 1941 could not have been to correct this defect and put all persons rendering personal services for 60 months on the same basis whether or not that period covered 5 full calendar years, for if that were the reason, the change from 5 calendar years to 60 calendar months would not have been made effective for just 1 year, 1941, but for the years from 1939 when the section was enacted, and the percentage requirement would not have been reduced from 95 percent to 75 percent for 1941 as against 80 percent for 1942 and thereafter, for which distinction also no reason appears. The changes are discussed in section 12 of the Summary of Technical and Administrative Amendments and under section 128 of the detailed discussion of the technical provisions of the bill in the report of the House Committee on Ways and Means.

The need for high taxes is fully recognized, and no objection is made to paying higher rates on current earnings. That is what others are called on to do. It is not fair, however, as Congress has recognized in principle, first, to superimpose past years' earnings on 1941 income and project the aggregate into the very much higher surtax brackets, and, second, thus to subject money earned over the last 3 or 4 years to the high 1941 rates. This others are not compelled to do.

As long as it is recognized that the section should be revised as to compensation received in a tax year beginning after January 1, 1941, and very properly so, the general reduction to 36 months should apply to 1941 as well as to 1942. The year 1941 was the first year of high emergency rates on individual incomes. The higher rates should admittedly not discriminate against any class of taxpayers. The greater the increase in rates, the more harmful is discrimination, and the more zealously should Congress guard against it. The increase in taxes in 1941 imposes a far greater burden on individuals rendering personal services over a period of years than on corporations or persons engaged in business, who may accrue income, as well as expenses, which such individuals cannot do. In fact, Congress, as well as the Treasury in its regulations under section 42, Internal Revenue Code, has already afforded relief to taxpayers in the case of construction contracts performed over a period in excess of only 12 months. But such relief is not available to an individual in 1941 unless he has worked himself for at least 60 months. He must pay income tax on the entire amount in 1 year subject not only to the graduated surtax rates but also to the increase in rates enacted in 1941.

In the intervening years he had to meet his overhead and expenses, even if he had to borrow the funds. He does not even get the benefit of these deductible items from his taxable compensation. Merely because he happens to be compensated in that one year he is subjected to the high surtax rates and to the much higher 1941 rates of income tax. He should not have to pay out an unduly high proportion of his earnings, and thus be penalized and discriminated against, as the late Senator Harrison said, because he cannot accrue his compensation or expenses, especially when every other class of taxpayers may by use of the accrual method spread out income.

If the general reduction to 36 months were also to apply to 1941, it would not only put both groups of taxpayers on a more equal basis and thus be more equitable, but it would simplify the bill and not increase administrative difficulties. Returns for 1941 would have to be amended in one case or the other, but under the House bill the added hardship caused by the increase in rates in 1941 is not alleviated.

It is respectfully submitted that the Senate strike out the special provision in the last paragraph of section 128 of the House bill that—

with respect to a taxable year beginning after December 31, 1940, and not beginning after December 31, 1941, the period specified in such subsection shall be sixty months in lieu of thirty-six months.

The general reduction in the minimum required length of services to 36 months should be made effective for any taxable year beginning on or after January 1, 1941.

To individual taxpayers the reduction to 36 months for 1941 will mean much in greatly relieving the additional hardship due to the higher 1941 rates. From the standpoint of the Treasury, however, there will be no material decrease in revenue. Even as to this, Mr. Paul frankly said, in discussing gains accruing over a period of years:

> We want to be fair even if we do not get the top revenue.

As Secretary Morgenthau pointed out in the Treasury's recommendations, in referring to the "inequities of our tax laws" which "result in unfair burdens upon certain taxpayers":

> With rates at wartime levels it becomes urgent to correct all such defects. I therefore propose that we make every effort in this session of Congress to eliminate all hardships of this character so that our tax laws will cast their burden equitably upon all taxpayers.

Here is an opportunity for Congress to correct an inequity to individual taxpayers, without even affecting revenue materially.

The CHAIRMAN. Thank you, Mr. Spitzer.

Mr. A. F. Matthisen, Chicago, Ill.

STATEMENT OF A. F. MATTHISEN, REPRESENTING THE SELF-LOCKING CARTON CO., CHICAGO, ILL.

Mr. MATTHISEN. My name is Andrew F. Matthisen, and I am secretary of the Self-Locking Carton Co., of Chicago, Ill.

We are manufacturers of folding paper boxes and under the rates recommended by the House Ways and Means Committee, our taxes for 1942 will amount to about 60 percent of our total net income.

We have no defense work except a small order for dried-egg boxes, but our volume of business represents an increase over the prior years period 1936 to 1939 of approximately 30 percent with a corresponding increase in earnings.

We realize that most everyone who appears before your committee makes a point of assuring you that they do not complain about high taxes—so much so that you are probably tired of hearing it repeated—nevertheless, I believe it is absolutely true that everyone, from the richest to the poorest, is only too glad to do his share in winning the war. I believe that very few people are interested in making profits during these times if they can feel assured that their businesses will be solvent and ready to proceed in a normal way after the war is over. This thought is our only excuse for taking the time of your committee. We want to go on record in our small way regarding what we believe to be a most serious and dangerous problem that will confront us.

We all agree that winning the war is the first and foremost undertaking, and it goes without saying that funds must and will be found to pay the war bill.

At the same time, wisdom demands that every consideration be given to devise ways and means to carry us through the reconstruction period with the least possible unemployment.

This can only be done by helping industry in every way possible to make the shift from war to peacetime production.

The American people are buying War stamps and bonds actuated unquestionably by a sincere desire to help win the war, but behind the urge to help there is the thought that every dollar invested in War bonds will be a cushion against bad times that everyone expects after the war is over.

I understand that even the boys in service are investing part of their small pay checks for bonds, no doubt looking forward to the day when they will return from the battlefield to meet the new danger of being unable to get a job.

This is the great responsibility of those who cannot carry a gun; this is the problem that Congress must solve if the boys who return are to have a chance to get jobs, to marry, and lead normal lives again.

It is the responsibility of Congress and everyone connected with industry to work and plan so that the boys who have gone to the front for us will not judge and find us wanting when they return.

While tremendous war contracts are in process of construction, and money is circulating freely, the tendency is to feel secure. However, among the more thoughtful in the rank and file and management of industrial companies, we hear the question, "What will happen when war production stops?"

Will industry be stymied for lack of funds to make a quick change from war to peacetime activity? No plan has been adopted that will help industry as a whole in getting back to peacetime production.

We realize that in the face of the tremendous job that has been accomplished in gearing our plants to war production, that it is not fair to demand that all the post-war economic problems also be solved at the same time.

However, it seems to us that in considering the 1942 tax bill, special consideration should be given to the possibility of providing reserve funds as a cushion against post-war needs for reconstruction and any other contingencies such as inventory inflation and payment of indebtedness.

The corporation rates passed by the House—excess profits of 90 percent and normal and surtax of 45 percent—are high enough to permit in our humble opinion a refund credit of some sort. In fact, we believe that no matter what rates are finally agreed upon, that it is of vital importance to industry and the workers of the land that reserves be built up beginning at once.

The credit refund plan which provides special nonnegotiable, noninterest-bearing bonds payable during 5 consecutive years beginning 6 months after the armistice is signed, as already considered by the House Ways and Means Committee, in our opinion is sound and practical and worthy of consideration by this committee.

I believe the post-war credit plans so far considered provide for a credit of that part of the excess-profits tax which is in excess of 80 percent.

If the rates passed by the House of 90 percent and 45 percent are accepted by this committee and become law, it would be our recommendation that a post-war credit be provided based on a flat 10 percent of the total excess profits, normal and surtax.

We present in the attached an illustration of the calculation of the 1942 tax for a company whose net income is $3,000,000, and whose excess-profits credit is $950,000.

A summary of the tax as calculated in the illustration is given below:

Net income, 100 percent, $3,000,000.
Excess-profits tax, 60.7 percent, $1,822,500.
Normal and surtax, 17.6 percent, $529,875.
Total tax, 78.3 percent, $2,352,375.

A refund credit payable in nonnegotiable, non-interest-bearing bonds maturing 6 months after the armistice is signed, in five equal annual installments, and based on a flat 10 percent of the total tax, would be 10 percent of the $2,352,375, or $235,237.50. In other words, such a company would pay $2,352,375 and would have a post-war credit of $235,237.50, leaving $2,117,137.50 that would go toward the payment of the war bill unconditionally.

We feel that the 1942 tax bill should provide the total funds that the Treasury Department report are needed at this time and feel absolutely certain that the taxpayers, both large and small, will not complain, but will pay with a smile.

We cannot say that a corporation doing defense work such as the one assumed in the illustration would suffer any great hardship under the tax rates recommended by the House Ways and Means Committee, since it will earn and be permitted to retain over and above taxes, an amount which is approximately 68 percent of the average earnings of the company during the period 1936 to 1939 as shown below:

Net income, $3,000,000.
Tax payable, $2,352,375.
Net balance, 68 percent, $647,625.
Average earnings, 1936–39, 100 percent, $950,000.

It is almost certain that each year from now on will see higher taxes, reduced earnings which such a company would be permitted to retain, making such funds available for payments of bonded indebtedness and distribution to stockholders.

In the case of a company with a large bonded indebtedness, we can easily imagine financial difficulties even while the war is in progress. To provide cash reserves for post-war contingencies under such circumstances and yet pay some dividends to stockholders, becomes problematical.

This means that when war work ceases, large sums will be needed to change over from war production to peacetime production, and if funds are not available, thousands of men and women may be unemployed.

All this, in our opinion, shows the need for post-war reserves.

I firmly believe that any provision in the tax law for post-war relief will have the effect of inspiring greater confidence by the people in the value of United States bonds and the value of the dollar.

Confidence will facilitate the flow of capital into necessary industries and the sale of Government bonds.

Therefore, anything that Congress may do to assure the people that steps are being taken to cushion the after effects of the war, will help the battle against inflation and the deflation that will inevitably follow, in short, buck up the morale of the Nation as a whole.

The CHAIRMAN. Thank you, Mr. Matthisen.

Mr. Gretz, representing the American Telephone & Telegraph Co.

STATEMENT OF HARRY C. GRETZ, ASSISTANT COMPTROLLER, AMERICAN TELEPHONE & TELEGRAPH CO., NEW YORK, N. Y.

Mr. GRETZ. Mr. Chairman and members of the Senate Finance Committee. My name is Harry C. Gretz; I am an assistant comptroller of the American Telephone & Telegraph Co. and represent also the Associated Telephone Companies, commonly referred to collectively as the Bell Telephone System.

My purpose of appearing here is twofold: First, to acquaint the committee with the burden placed on our companies and employers generally by the withholding provisions in the bill passed by the House which as far as the withholding from wages is concerned is the most complex pay-roll deduction employers have so far encountered, and, second, to propose a simplified plan of fixing the amount of withholding tax which will place this type of pay-roll deduction more in line with other pay-roll deductions.

This withholding will not be the employer's first experience in acting as a tax collector for the Government. Employers have for some years been deducting old-age insurance taxes from employees, keeping the required records and paying the taxes collected to the Government and filing information returns by employees of the amounts deducted each quarter.

More recently many employers, and I am informed most of the larger employers, are assisting in the war financing through the adoption of pay-roll savings plans for the purchase of War bonds by employees. Many of these employers have also become the agents for the Government in the issuance of the bonds. Our companies were among the first to adopt such plans and also among the first to be designated by the Treasury Department as issuing agents. As of June 30, 1942, 382,420 regular employees out of a total of 394,298 have authorized deductions from their wages at the rate of approximately $50,000,000 a year.

Provisions of the bill.—Section 153, collection of the tax at the source, insofar as it relates to wages, is new because of its applicability to the individual's Federal income tax and is different from, and more complex than, the above-mentioned pay-roll deductions in that the determination of the amount to be deducted involves the subtraction of a "withholding deduction" from the gross wage to obtain the base to which the rate is applicable.

This withholding deduction is not a fixed amount for all employees but will vary according to the individual's family status. It may be subject to change within the year. The gross wage, for large numbers of employees, will vary from pay period to pay period. The resulting net wage and the amount to be withheld will vary with any change in the gross pay.

The attached statement, marked "Table 1," outlines the several operations that an employer must add to his ordinary pay-roll operations in order to comply with the provisions of the bill. The table also shows the frequency of each operation, that is, whether it is performed annually, quarterly, or at each pay period. This list is tentative until the regulations are issued and assumes a minimum of record keeping and reporting.

As indicated previously and as table 1 brings out, the complications in this type of pay-roll deduction grow out of the determination of the amount to be withheld. They are covered by items 4, 5, and 6, and as shown in the column headed "Frequency" must be performed for each employee for each pay period. These operations can be more readily visualized in the following:

(*a*) Name of employee, John Smith.
(*b*) Gross pay, $40.
(*c*) Withholding deduction, $34.50.
(*d*) Net pay taxable, $5.50.
(*e*) Amount to be withheld (5 percent of (*d*)), $0.28.

There are, of course, other items on the pay roll, but items (*c*), (*d*), and (*e*) are the minimum additional items necessary to the determination of the amount of the withholding tax. There are other operations necessary to the requirements, as shown on table 1, some of which must be done for each pay period and others which are required quarterly or annually.

While it is true that the withholding will not apply to large numbers of employees because their exemption exceeds the pay, it should be borne in mind that employers will be required to perform certain operations (items 1, 2, 3, 4, and 5 (*a*) on table 1) in order to determine that such employees are not subject to the withholding.

On the other hand, where the employee is on a salary basis which does not fluctuate, some of the operations may be omitted each pay period by predetermining the amount to be withheld, which amount will remain constant until there is a change in the family status of the individual or a change in his rate of pay. The number of such employees in our companies will be a small minority.

Employers of large groups of employees have found out by experience that savings can be made and errors reduced by predetermining certain computations and showing the results on tables. The clerks refer to the tables for the result rather than make the detailed entries and computations. The most desirable table for this purpose is one in which the amount of the withholding tax is shown for each possible amount of gross pay and each possible family status. An illustration of such a table is appended and marked "Table 2."

This table 2 is based on the provisions of the bill as it now stands and illustrates the amount of withholding for a married person whose weekly pay is in the range of $50 to $50.99. It picks up each 1-cent change in the amount of the withholding tax as the bill requires. There is shown a tabulation on the bottom of table 2 of the number of such tables that are required to cover a possible wage range up to $119.99 weekly, for each of the marital status groups and for each of the common pay-roll periods; 436 such tables are required for weekly paid employees and a total of 1,744 for all pay periods.

Proposal for simplification.—The greater the number of tables, the longer it takes to locate the amount of gross wage and the appropriate family status, in order to determine the amount to be withheld. The way to simplification is to increase the range in the wage band to which stated amounts, based on the average for the wage band, would apply. By using $10 wage bands, instead of the 10-cent wage bands required by the bill as it now stands, a complete table applicable to married persons with varying numbers of dependents, and with weekly wages up to $119.99 can be shown in the same space as required for a range of only $1 of gross weekly wage.

Such a table is shown on the appended table 3. May I suggest that you refer to that exhibit? It covers the withholding from married persons for weekly wages up to $119.99, with provision for extending the table beyond that amount. Amounts are shown for zero to 10 dependents with provision for extending the table to take care of dependents over 10. The amounts of the withholding are averages for the wage bands, adjusted to the nearest 10 cents. For pay rolls other than weekly for which I used a $10 wage band, I would recommend a $20 wage band for biweekly pay rolls, a $25 wage band for semimonthly pay rolls, and a $50 wage band for monthly pay rolls.

Table 3 also shows a comparison of the average withholdings and the minimum and maximum withholdings for each wage band. The deviation in any one wage band will range from 20 to 30 cents. This means that a married person receiving a gross weekly wage at the lowest point of the wage band will have a withholding of from 20 to 30 cents greater, while the married individual receiving a gross weekly wage at the highest point of the wage band will have a withholding of from 20 to 30 cents less than if calculated on the precise requirements of the bill.

At the bottom of table 3 there is shown a comparison of the number of tables required under the bill as drawn and under the proposed simplified plan. For each type of pay period the proposed simplified plan requires 4 tables as against 436 under the bill. For the 4 commonly used pay-roll periods a total of 16 under the simplified plan against 1,744 under the bill. The number of such tables could be cut in half if, for the purposes of the withholding, husbands and wives, when both are employed, are considered as single persons and the head of a family considered as a married person.

The use of an average amount of withholding tax (adjusted to round off the amounts) for each wage range, appears justified from the standpoint of administrative simplification. True, it does introduce an element of discrimination but the extent of the discrimination does not appear unreasonable when it is considered that we are concerned only with a partial prepayment of the tax and not the tax itself. The bill introduces the same principle in the table of optional tax on individuals with gross income from certain sources of $3,000 or less (sec. 104).

Withholdings from dividends and interest.—The additional clerical and machine operations involved in the withholding at the source from dividends and interest are different than those involved in the withholding from wages but no less serious. Without describing these operations in detail, it might be said that serious problems grow out of the exemptions allowed nontaxpayers and the receipts that are required for each withholding from the individual stockholders and bondholders.

The fact that one group is exempt from the withholding while another group is not exempt requires a separation of stockholder ledger records, thus complicating the maintenance of those records as well as adding new operations. As to the withholding from interest, it should be noted that a large majority of interest coupons are deposited in the banks for collection. This requires special records to follow the coupons from the initial depository to the issuing corporation and special records where the corporation cashes the coupons direct.

The issuance of receipts involves a tremendous amount of clerical work in order that a relatively few stockholders and bondholders who are not clearly exempt, but who will have withholdings in excess of their taxes, may support their claim for refunds so that refunds may be made promptly by the Bureau. By broadening the use of Form 1099 to include all dividend payments, the Bureau should be able to check the claims for refunds without the necessity of requiring such claims to be supported by receipts.

Personnel and office-machine problem.—Under ordinary circumstances industry would take care of the additional work proposed by the bill by employing additional clerical forces, making necessary changes in existing office machines, and purchasing additional machines as might be required, but under war conditions employers are finding it difficult to maintain adequate clerical forces because of the demands of the armed services and of the war industries.

Obviously, in a system employing 400,000 persons and with 640,000 stockholders, the operations leading up to the issuance of pay checks and dividend checks are done largely by office machines. A withholding requirement will require additional parts and replacements of parts of certain machines and, because of additional operations, will also require some additional machines.

The manufacturers of office machines have converted a large portion of their plants to war work and there is a serious priority problem that must be met if changes in existing machines and additional machines are necessary. To illustrate the seriousness of the office-machine problem, the War Production Board sent out letters under date of July 6, 1942, regarding the need by the armed forces of at least 500,000 additional typewriters, only half of which are in the hands of manufacturers and dealers. American business is being asked to supply the remainder and at the request of the W. P. B. they are now engaged in inventorying their typewriters and the use made of them in an effort to meet this pressing problem.

A subsequent order issued by the W. P. B. on August 3 requires the manufacture of typewriters to be completely stopped on October 31, 1942, except for one manufacturer who will be allowed to manufacture not more than 1,600 typewriters a month, all of which are to be reserved for the Army, Navy, and Maritime Commission.

Conclusion.—For the reasons given, it is earnestly requested that Congress give very serious consideration to simplifying the requirements of section 153, "Collection of tax at source." Even with these simplifications there still remains a considerable burden on both industry and the Bureau of Internal Revenue to balance off against the objectives of controlling inflation and better collections of income taxes.

(The tables submitted by Mr. Gretz are as follows:)

TABLE 1.—*Additional operations required in connection with the withholding tax on wages (as provided in H. R. 7378 as passed by the House)*

Operations	Frequency
1. Obtain a withholding deduction certificate from each employee on or before the close of the first pay period in 1943 and sort by pay roll and pay-roll-order sequence.	Annually.
2. Obtain withholding deduction certificates covering changes in the employee's family status during the year.	Irregularly.
3. Indicate family status by symbol or otherwise and record the appropriate exemption on employee's service record.	Initially and as changes are received.
4. (a) If pay rolls are prepared manually: Enter the amount of exemption on the pay roll for each employee.	Each pay period.
(b) If addressing equipment is used: Enter the symbol for family status and the amount of exemption on addressing plate or stencil for each employee.	Initially and as changes are received.
5. (a) Compare exemption with gross wage for each employee; and (b) Where the gross wage exceeds the exemption, determine the net wage subject to withholding by subtracting the exemption from the gross wage.	Each pay period.
6. (a) Compute the amount to be withheld on the net wage for those employees whose gross wage exceeds the exemption; and.	Do.
(b) Enter these amounts on the pay roll	
7. Tabulate the amounts deducted from each employee and credit the aggregate amount to accounts payable in favor of the Government.	Do.
8. If employers furnish the employees with a statement of gross pay and deductions, post the amount withheld to the statement of deduction.	Do.
9. Post the amount deducted from each employee to a record for accumulating such amounts during the year.	Do.
10. Total the postings to employee's record of withholdings, tabulate the totals for all employees and reconcile with item 7.	Quarterly.
11. Prepare tax return, voucher and check for payment of the aggregate tax withheld to the Government.	Do.
12. (a) Prepare annual statement for each employee showing (1) total wages paid and (2) amount of tax withheld, one copy to be furnished to the employee and another copy to be transmitted to the Government.	Annually.
(b) In case employees are separated from the service before the close of the year, a similar statement must be prepared and furnished to the employee with his last payment of wages.	Irregularly.
13. Tabulate the annual statements of taxes withheld from each employee (item 12) and reconcile aggregate with the sum of the quarterly tax payments to the Government (item 11).	Annually.

NOTE.—Items, 4, 5, and 6 may be greatly simplified by the use of tables which show the amount of the tax appropriate to the gross wage, provided the number of such tables is kept within reasonable limits by the use of an average tax for stated wage groups or brackets.

With the use of certain types of office machines, some of the above operations may be combined under a single machine operation.

Where the term "each pay period" appears in the column headed "Frequency," it means that the operation must be repeated 52 times for employees paid weekly, 26 times for employees paid biweekly, 24 times for employees paid semimonthly, and 12 times for employees paid monthly.

TABLE 2.—*Illustrating predetermined amounts of withholding (at 5 percent) applicable to gross wage (based on provisions of H. R. 7378 as passed by the House)*

[For married persons whose weekly pay is in the range of $50 to $59.99]

Classification	M-0	M-1	M-2	M-3	M-4	M-5	M-6
Weekly deduction	$26.00	$34.50	$43.00	$51.50	$60.00	$68.50	$77.00
Gross weekly wage:							
$50.00 to $50.09	$1.20	$0.78	$0.35	$0.00	$0.00	$0.00	$0.00
$50.10 to $50.19	1.21	.78	.36				
$50.20 to $50.29	1.21	.79	.36				
$50.30 to $50.39	1.22	.79	.37				
$50.40 to $50.49	1.22	.80	.37				
$50.50 to $50.59	1.23	.80	.38				
$50.60 to $50.69	1.23	.81	.38				
$50.70 to $50.79	1.24	.81	.39				
$50.80 to $50.89	1.24	.82	.39				
$50.90 to $50.99	1.25	.82	.40				

Total number of such tables required by H. R. 7378

For the range of wages from $11 to $119.99 weekly for married persons	109
For the 3 other marital status groups	327
Total for weekly paid employees	436
For the 3 other common pay periods	1,308
Total for all classes of marital status and pay periods	1,744

TABLE 3.—*Illustrating predetermined amounts of withholding (at 5 percent) applicable to gross wage (based on the proposed simplified plan of average withholding by wage bands but retaining the varying amounts of withholding deductions by family status)* [1]

[For married persons with weekly pay up to $119.99]

Classification	M-0	M-1	M-2	M-3	M-4	M-5	M-6	M-7	M-8	M-9	M-10
Weekly deduction	$26.00	$34.50	$43.00	$51.50	$60.00	$68.50	$77.00	$85.50	$94.00	$102.50	$111.00
Gross weekly wage:											
$11.01 to $19.99											
$20.00 to $29.99											
$30.00 to $39.99	.40										
$40.00 to $49.99	.90	.50	.10								
$50.00 to $59.99	1.40	1.00	.60	.20							
$60.00 to $69.99	1.90	1.50	1.10	.70	.20						
$70.00 to $79.99	2.40	2.00	1.60	1.20	.70	.30					
$80.00 to $89.99	2.90	2.50	2.10	1.70	1.20	.80	.40				
$90.00 to $99.99	3.40	3.00	2.60	2.20	1.70	1.30	.90	.50			
$100.00 to $109.99	3.90	3.50	3.10	2.70	2.20	1.80	1.40	1.00	.50	.10	
$110.00 to $119.99	4.40	4.00	3.60	3.20	2.70	2.30	1.90	1.50	1.00	.60	.20
For each $10 or fraction thereof over $119.99 add	.50	.50	.50	.50	.50	.50	.50	.50	.50	.50	.50

[1] For each dependent over 10 deduct $0.40 from previous column.

NOTE.—The figures shown in the classification symbol are the numbers of dependents.
The amount shown as the withholding tax is determined by applying the 5-percent rate to the midpoint of the wage group and adjusting the result to the nearest multiple of 10 cents.

Comparison of the adjusted average withholding in the above with minimum and maximum withholding in the wage band

	Married person no dependents ($26)			Married person, 2 dependents ($43)		
	Minimum	Maximum	Adjusted average	Minimum	Maximum	Adjusted average
Gross weekly wage:						
$11.01 to $19.99	0	0	0	0	0	0
$20.00 to $29.99	0	$0.20	0	0	0	0
$30.00 to $39.99	$0.20	.70	$0.40	0	0	0
$40.00 to $49.99	.70	1.20	.90	0	$0.35	$0.10
$50.00 to $59.99	1.20	1.70	1.40	$0.35	.85	.60
$60.00 to $69.99	1.70	2.20	1.90	.85	1.35	1.10
$70.00 to $79.99	2.20	2.70	2.40	1.35	1.85	1.60
$80.00 to $89.99	2.70	3.20	2.90	1.85	2.35	2.10
$90.00 to $99.99	3.20	3.70	3.40	2.35	2.85	2.60
$100.00 to $109.99	3.70	4.20	3.90	2.85	3.35	3.10
$110.00 to $119.99	4.20	4.70	4.40	3.35	3.85	3.60

Comparison of number of tables required

	Under H. R. 7378	Proposed plan
For married persons paid weekly	109	1
For the 3 other marital status groups	327	3
Total for weekly paid employees	436	4
For the 3 other common pay periods	1,308	12
Total for all classes of marital status and pay periods	1,744	16

The CHAIRMAN. Thank you very much, Mr. Gretz.

Before we proceed further, I think we have one difficulty coming up on mutual insurance matters and, Senator Byrd, I will ask you and Senator Herring, Senator La Follette, and Senator Taft to act as a subcommittee to look into that matter. It will be up in the morning.

On this question of withholding, Mr. Clerk, I wish you would notify Senator Clark and Senator Gerry that I have asked them to serve with Senator Danaher to see if they can work out something; because those are two problems which are going to be quite troublesome when we get into executive session.

Now, Mr. Brenckman, I believe we will have time to hear you now if you wish to proceed.

STATEMENT OF FRED BRENCKMAN, WASHINGTON REPRESENTATIVE, THE NATIONAL GRANGE

Mr. BRENCKMAN. Mr. Chairman and gentlemen of the committee, the National Grange has serious doubts regarding the wisdom of section 621 of the revenue bill which has passed the House and which is now before this committee. With certain exceptions this section proposes a 5 percent tax on the transportation of property within the United States. It is stipulated that the Government itself shall be exempt from this charge, while the tax on coal is fixed at 5 cents a long ton.

The proposed tax is unsound and objectionable for several reasons. In the first place it would be inflationary, and it would infallibly increase the cost of living. The battle against inflation is one of the most important that we have to fight on the home front, and any move that tends toward inflation should be avoided if possible. In the next place the tax would be pyramided, and the ultimate consumer would have to pay more than the Government would receive. Furthermore, such a tax would be discriminatory because it would rest more heavily on those sections of the country that are farthest removed from market than would be the case of other sections within easy reach of their markets.

We hold that the distance a man lives from market is not a just measure of the tax he should pay to support our war effort. War taxes should bear equally on all parts of the country and, so far as possible, every element of discrimination should be eliminated.

It is true that during World War I a tax was laid on transportation charges, but it is important to remember that there were no general price ceilings at that time. Manifestly, there would be no gain in collecting a tax of, say $250,000,000 a year, on transportation charges, and then appropriating an equal or perhaps a greater sum from the Public Treasury to subsidize business so that it could function under the ceilings that have been established by the Office of Price Administration.

As we see it, such a policy, so far from being an aid in winning the war, would prove a distinct hindrance. If, however, Congress should see fit to impose such a tax, notwithstanding its many objectionable features, the National Grange would be in favor of segregating agricultural products as coal has already been segregated, together with livestock and animal products, and imposing a flat rate of a given amount per 100 pounds; such a rate should be the same throughout the country, regardless of the distance the freight might be carried.

In making this proposal we want to have it clearly understood that, if the tax is to be imposed, we want agriculture to pay its fair and proportionate share, but we would like to see the tax levied on a more fair and equitable basis than would be the case under the plan mapped out in section 621.

The records of the Interstate Commerce Commission show that during the year of 1941 the class I railroads of the United States transported 106,832,113 tons of agricultural and livestock products in carlots. The total revenue accruing to the roads from this traffic was $641,693,751. A 5-percent tax on this sum would call for $32,084,688. A careful analysis shows that a flat rate of 1½ cents per 100 pounds on all agricultural and livestock products carried by the railroads would net substantially the same sum as a 5-percent tax.

We have worked out some detailed figures and comparisons in this connection, and I should like to have permission to file this matter as a part of my statement.

The CHAIRMAN. You may file it.

(The matter referred to is as follows:)

Agricultural products and livestock carried by class I steam railways, calendar year 1941

[Compiled from Freight Commodity Statistics issued by Bureau of Transport Economics and Statistics, Interstate Commerce Commission]

No.	Commodity group or class	Revenue freight originated—Number of tons (2,000 pounds)	Freight revenue		5 percent of freight revenue	Number of hundredweight in column (2)	Cents per hundredweight required to produce 5 percent of revenue
			Total	Per ton			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	GROUP I. PRODUCTS OF AGRICULTURE (CARLOTS)						
10	Wheat	23,409,757	$88,324,216	$3.76	$4,416,211	469,395,140	0.941
20	Corn	12,147,597	43,714,656	3.60	2,185,733	242,951,940	.900
30	Oats	2,848,655	10,991,895	3.86	549,595	56,973,100	.965
40	Barley and rye	4,683,641	17,248,762	3.68	862,438	93,672,820	.921
41	Rice	819,031	3,796,527	4.64	189,826	16,380,620	1.159
42	Grain, n. o. s	94,100	478,240	5.08	23,912	1,882,000	1.271
50	Flour, wheat	8,708,210	35,785,224	4.11	1,789,261	174,164,200	1.027
51	Meal, corn	188,441	654,164	3.47	32,708	3,768,820	.868
52	Flour and meal, edible, n. o. s	459,172	2,352,652	5.12	117,633	9,183,440	1,281
60	Cereal-food preparations, n. o. s	892,066	5,492,916	6.16	274,646	17,841,320	1.539
61	Mill products, n. o. s	8,653,249	26,885,237	3.11	1,344,262	173,064,980	.777
70	Hay and alfalfa	545,847	3,301,786	6.05	165,089	10,916,940	1.512
71	Straw	200,498	1,495,532	5.15	74,777	5,809,960	1.287
80	Tobacco, leaf	733,284	6,220,896	8.48	311,045	14,665,680	2.121
90	Cotton in bales	3,864,471	36,665,296	9.49	1,833,265	77,289,420	2.372
91	Cotton linters, noils, and regins	707,107	5,070,011	7.17	253,500	14,142,140	1.793
100	Cottonseed	548,425	1,122,563	2.05	56,128	10,968,500	.512
101	Cottonseed meal and cake	980,374	3,416,639	3.76	170,832	18,167,480	.940
110	Oranges and grapefruit	2,335,607	53,376,241	22.85	2,668,812	46,712,140	5.718
111	Lemons, limes, and citrus fruits, n. o. s	332,532	8,920,699	26.83	446,035	6,650,640	6.707

Agricultural products and livestock carried by class I steam railways, calendar year 1941—Continued

[Compiled from Freight Commodity Statistics issued by Bureau of Transport Economics and Statistics, Interstate Commerce Commission]

No.	Commodity group or class	Revenue freight originated—Number of tons (2,000 pounds)	Freight revenue		5 percent of freight revenue	Number of hundredweight in column (2)	Cents per hundredweight required to produce 5 percent of revenue
			Total	Per ton			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	GROUP I. PRODUCTS OF AGRICULTURE (CARLOTS)—continued						
120	Apples, fresh	872,871	$12,474,832	14.29	$623,717	17,457,420	3.573
121	Bananas	820,614	12,402,984	15.11	620,149	16,412,280	3.779
122	Berries, fresh	31,158	1,081,843	34.72	54,092	623,160	8.680
123	Cantaloupes and melons, n. o. s	211,597	7,277,545	34.39	363,877	4,231,940	8.598
124	Grapes, fresh	486,326	15,438,873	31.75	771,944	9,726,520	7.936
125	Peaches, fresh	264,863	4,112,551	15.53	205,628	5,297,260	3.882
126	Watermelons	198,243	3,125,937	15.77	156,297	3,964,860	3.942
127	Fruits, fresh, domestic, n. o. s	462,333	9,458,930	20.46	472,946	9,246,660	5.115
128	Fruits, fresh, tropical, n. o. s	38,012	806,440	21.22	40,322	760,240	5.304
130	Potatoes, other than sweet	3,294,600	35,394,574	10.74	1,769,729	65,892,000	2.686
140	Cabbage	230,659	3,558,494	15.43	177,925	4,613,180	3.857
141	Onions	370,032	4,534,926	12.26	226,746	7,400,640	3.064
142	Tomatoes	240,613	6,222,338	25.86	311,117	4,812,260	6.465
143	Vegetables, fresh, n. o. s	1,687,211	48,078,743	28.50	2,403,937	33,744,220	7.124
150	Beans and peas, dried	1,050,608	10,208,848	9.72	510,442	21,012,160	2.429
151	Fruits, dried or evaporated	569,365	8,255,628	14.50	412,781	11,387,300	3.625
152	Vegetables, dry, n. o. s	115,227	1,539,396	13.36	76,970	2,304,540	3.340
160	Vegetable-oil cake and meal, except cottonseed	1,795,230	6,406,354	3.57	320,318	35,904,600	.892
161	Peanuts	233,980	2,251,102	9.62	112,555	4,679,600	2.405
162	Flaxseed	799,201	2,970,243	3.72	148,512	15,984,020	.929
163	Sugar beets	6,195,707	3,843,516	.62	192,176	123,915,340	.155
164	Products of agriculture, n. o. s	6,974,092	32,013,365	4.59	1,600,668	139,481,840	1.148
(800)	Total products of agriculture	100,172,666	586,771,120	5.86	29,338,556	2,003,453,320	1.464
	GROUP II. ANIMALS AND PRODUCTS (CARLOTS)						
170	Horses, mules, ponies, and asses	128,539	1,779,374	13.84	88,969	2,570,780	3.461
180	Cattle and calves, single-deck	3,442,846	28,050,513	8.15	1,402,526	68,856,920	2.037
181	Calves, double-deck	86,189	902,576	10.47	45,129	1,723,780	2.618
190	Sheep and goats, single-deck	139,853	1,229,559	8.79	61,478	2,797,060	2.198
191	Sheep and goats, double-deck	807,472	8,060,652	9.98	403,033	16,149,440	2.496
200	Hogs, single-deck	549,128	3,018,390	5.50	150,919	10,982,560	1.374
201	Hogs, double-deck	1,505,420	11,881,567	7.89	594,078	30,108,400	1.973
	Total livestock	6,659,447	54,922,631	8.25	2,746,132	133,188,940	2.062
	Total products of agriculture and livestock	106,832,113	641,693,751	6.01	32,084,688	2,136,642,260	1.502

EXPLANATORY NOTES

The variation in the average revenue per ton shown for the various classes of commodities is the result in part of the variation in rates and in part of the variation in the length of haul. The average length of haul is not reported separately by commodities.

The tons reported as "originated" are based on waybills. Tons of commodities rebilled from transit points are counted a second time. Hence the number of tons shown as originated for such a commodity as wheat contains duplications and the average revenue per ton based thereon is less than the average freight payment from farm to market. The revenue shown for flour reflects the fact that when grain is milled in transit, the product is charged with the remainder of the through grain rate after deducting the in-bound grain rate.

Interstate carload rates (in cents per 100 pounds, except as noted) on various commodities moved all-rail and in force Mar. 17, 1942

Commodity	From—	To—	Distance	Rate	Minimum weight	Tariff I. C. C. No.
Cotton (other than absorbent, carded, or dyed).	Durant, Okla	Boston Mass	1,740	[1] 89	80,000	Peel's 3370.
	...do	McKinney, Tex	61	[2] 14	50,000	Peel's 3370.
Beans, green	Harlingen, Tex	New York, N. Y	1,995	184	20,000	Peel's 3450.
	Suisun-Fairfield, Calif	San Francisco, Calif.	52	9	21,000	Haynes' 1393.
Oranges and grapefruit.	Oleander, Calif	Portland, Maine	3,270	142	36,000	Kipp's 1478.
	San Jose, Calif	San Francisco, Calif.	47	7½	20,700	Haynes' 1393.
Sugar beets	Ardmore, S. Dak	Mitchell, Nebr	158	[3] 134	[4]	C. B. & Q. 10580.
	Torrington, Wyo	Scottsbluff, Nebr	31	[3] 65		
Potatoes (other than sweet).	Preston, Idaho	Washington, D. C	2,338	104	[5] 30,000	Kipp's A-3117.
	Janesville, Minn	New Ulm, Minn	45	7½	[6] 30,000	Kipp's A-3207.
Fat cattle	Kansas City, Mo	New York, N. Y	1,270	[7] 85	22,000	A. T. & S. F.-14226; Jones' 3132.
	Abilene, Kans	Kansas City, Mo	164	23	22,000	U. P.-4783.
Grain	Grand Forks, N. Dak	New York, N. Y	1,625	[8] 60	[9]	G. N. A-7607; Kipp's A-2042; Jones' 3350.
	Cokato, Minn	Minneapolis, Minn.	48	10	[9]	G. N. A-7067.
Apples	Wenatchee, Wash	Washington, D. C.	2,923	[10] 110	39,900	Kipp's 1466.
	...do	Hugo, Wash	44	12	20,000	Bohon's 595.

[1] Higher rates on lower carload minima.
[2] Higher rates on other carload minima.
[3] In cents per ton, 2,000 pounds.
[4] Marked capacity of car.
[5] Minimum 30,000 pounds Oct. 1 to May 1, inclusive.
[6] Minimum 36,000 pounds during September to May, inclusive.
[7] Combination, 25 cents to East Fort Madison, Ill.; 60 cents beyond.
[8] Combination, 20 cents to Minneapolis, Minn.; 13 cents to Manitowoc, Wis.; 26 cents beyond.
[9] Minimum weight marked capacity of car used, except oats, 80 percent marked capacity of car used.
[10] Higher rates on lower minima.

The CHAIRMAN. Thank you, Mr. Brenckman.

The hour is late, and there are only two other witnesses remaining on this list, for today, Mr. Cranch and Mr. Compton, both of whom live here in Washington and who I understand will be here anyway. We will be able to reach you tomorrow.

Some one or two witnesses whom I called this morning did not appear. If they have come in and desire to file a brief, I will be glad to have the brief received.

STATEMENT OF N. C. HELMAN, MADISON, WIS., GENERAL COUNSEL, CREDIT UNION NATIONAL ASSOCIATION

Mr. HELMAN. My name is N. C. Helman. I am general counsel of the Credit Union National Association of Madison, Wis., appearing for Mr. William Reid, president of the association, but who, because of official business as the city tax collector of the city of New York, was prevented from coming here. Our statement is contained in this memorandum which I will file with your committee, and I would like to add this one point in connection with this memorandum, which is that the credit unions are concerned with but one phase of the tax bill, that is purely a mechanical portion of section 425 and section 426, which relate to the withholding provisions of dividends paid by credit unions and other similar institutions. On August 5 there appeared before your committee Mr. Morton Bodfish, of the United States Savings and Loan League, and in his statement he suggested an amendment to these two sections which would remedy the condition that we are complaining of and which seriously affects us unless amended.

The CHAIRMAN. You pay very small dividends?

Mr. HELMAN. Our dividends are so fractional that the average person does not receive more than $5 per annum, and in some instances if we were to be required to make the deductions under the provisions of sections 425 and 426, we would have to account for as little as 10 cents and 15 cents.

The CHAIRMAN. Much the same as Mr. Bodfish's organization?

Mr. HELMAN. Our situation is even more aggravated.

The CHAIRMAN. I believe that was referred to.

You may file your statement, and the committee will be very glad to take it under consideration.

(The statement filed by Mr. Helman is as follows:)

To: The Committee on Finance, United States Senate, Hon. Walter F. George, chairman.

From: Credit Union National Association, Madison, Wis., William Reid, president; Roy F. Bergengren, managing director; N. C. Helman, general counsel.

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.

This statement is submitted in the interest of credit unions of which there are over 10,000 chartered under the Federal Credit Union Act and under various State laws. The aggregate membership of the credit unions now operating throughout the continental United States and in the Hawaiian Islands comprises over 3,000,000 persons—who are, in the main, of the low-income or small-salaried groups.

We deem it most urgent that your committee give consideration to amending sections 425 and 426 of H. R. 7378, so as to provide appropriate exemption from the withholding requirement provisions in relation to dividends paid by credit unions in other similar institutions.

While credit unions are not titled "banks" and their earnings are not distributed under the label of "interest": they are in fact mutual savings institutions or cooperative banks and their distributed earnings are the equivalent of interest paid on the savings of their members.

In applying the provisions of section 101 of the United States Internal Revenue Act the Treasury Department has held credit unions to be "cooperative banks."

Credit unions should, therefore, be placed in the same category, for the purposes of the proposed legislation, as other banking institutions and the dividends declared on shares and deposits be made exempt from the withholding requirements of the act.

The savings investments of credit unions are accumulated over a period of time, principally from the regular weekly deductions made out of the earnings of the individual members. These accumulations constitute the capital of the credit union and are used to make loans exclusively to its own members for remedial or provident purposes only. The interest rate charged for these loans is maintained at the very lowest rate possible. Any surplus capital not so utilized is invested in legally restricted securities; and in most instances in governmental issues. At the present time practically all of such surplus funds are invested in defense bond issues. At the last annual national convention of credit unions held in May of this year they adopted as a matter of policy that credit unions invest as much of their funds as is possible in the purchase of Defense bonds and, in keeping with this objective, maintain the dividend rate at a level not exceeding 3 percent.

The management of credit unions is vested in a board of directors selected from its membership. This board and other management committees all serve without pay. In all other respects the operations of credit unions are designed by law to be conducted at the very minimum of overhead cost.

The bookkeeping operations which the deductions contemplated under the proposed law will entail considerable expense to credit unions and in many, if not in most, instances this cost will actually exceed the amount the credit union will be required to turn over to the Government. In most instances, the holdings of the individual members in the credit unions are so small that the annual deductions that will be required to be made as to each individual member under the present provisions of H. R. 7378 will not exceed 50 cents, and in a great many instances as little as 10 or 15 cents per member.

The present income yield of credit unions has been substantially reduced by two factors: (1) The curtailment of credit extension imposed by regulation W, issued by the Federal Reserve bank, and (2) the substantial participation of credit union funds in defense bond purchases.

The imposition upon credit unions of any additional management or operating expenses, at this time will be extremely onerous, and because of the small-profit margin may seriously jeopardize continued operation of many small credit unions.

Aside from this very practical phase, we are concerned with the discrimination which may result as against investment in credit unions. While other savings institutions will not be required to make withholdings on interest paid to their depositors, credit unions will be subjected to this requirement. Although the credit union is a comparatively new institution in the United States (the Federal Credit Union Act having been adopted in 1933) these organizations are already rendering a very substantial social service in our national economic life. They are educating the millions of wage earners that comprise its membership to systematically allocate a portion of their income toward building up a thrift fund and in sensibly budgeting their monetary requirements. Every encouragement should be lent these organizations, particularly at this time when so much of their accumulated savings is diverted into the purchase of defense bonds.

There is still another factor which should not be overlooked in connection with this matter and that is the unwholesome psychological effect that this particular withholding feature of the act will have on the millions of people from whom these very fractional amounts will be withheld, or who (if tax exempt) in order to obtain these few pennies will be called upon to execute official documents and be subjected to other official red tape. This phase merits serious consideration.

We have examined the memorandum submitted by the United States Savings and Loan League in connection with this same problem, and we whole-heartedly affirm the contentions they have there made.[1] The language of the suggested amendment to section 425 (c) as contained in their memorandum is agreeable to us and will, in our opinion, remedy the phase of the legislation complained of.

This amendment, we are convinced, will avoid the resulting discrimination as against credit unions, savings and loan associations, and other such institutions; and will also obviate the unreasonable amount of bookkeeping and accounting work and the attendant costs to such institutions. This is especially to be avoided since there is very small benefit to be derived by the Government from the deductions.

Mr. Compton. Mr. Chairman, may I ask whether I can be assured of being heard tomorrow morning, for the reason that I have to be away tomorrow afternoon?

The Chairman. I am not sure. If you would like to make a brief statement this afternoon, while there are only a few members of the committee present, we will be glad to have you do so.

STATEMENT OF WILSON COMPTON, WASHINGTON, D. C., REPRESENTING THE LUMBER AND TIMBER PRODUCTS WAR COMMITTEE

Mr. Compton. At this hour, I think that I will ask that this statement may be included in full in the record, and I will skip as much of it as I can, although it is a very short statement.

The Chairman. Yes; you may do so.

[1] Testimony of Mr. Morton Bodfish, of United States Savings and Loan League, before U. S. Senate Finance Committee on August 5, 1942, vol. 1, pp. 907–968.

Mr. COMPTON. I represent the Lumber and Timber Products War Committee, which is a voluntary committee of the Advisory Commission of the Council of National Defense organized in 1940. It is a voluntary group representing the lumber and timber products industries, the backbone of which are the loggers and the manufacturers of lumber, and of which I am the executive officer.

I have submitted one matter, which is section 213 (e) of the House bill, and a collateral matter on section 114 of the Internal Revenue Code.

The revenue bill of 1942, in section 213 (e) under the title "Bonus Income of Industries With Depletable Reserves" contains a special wartime provision intended to encourage additional production of war materials by industries using "depletable resources."

In substance this provision would limit the taxation of so-called "bonus" income, from the production of certain metals, to the normal taxes and surtaxes and would exempt such income from the excess-profits taxes. This is an important provision. In principle it applies to natural resources industries generally. In fact at present it applies only to copper and to a few other nonferrous metals as to which "bonus" payments have been provided for additional production from marginal mines and from marginal producers.

We urge that this provision be so amplified as to provide similar encouragement to the production of lumber and timber products. The specific language for which we ask your consideration is this:

To amend section 213 (e) amending proposed section 711 (a) (1) (H) to read as follows:

BONUS INCOME.—There shall be excluded income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of a product the exhaustion of which gives rise to an allowance for depletion under section 23 (m), and unless taxpayer has computed his allowance for depletion of timber under the provisions of paragraph (5) of subsection (b) of section 114, income derived from timber products, (1) produced from timber owned by taxpayer, in excess of his average annual production of the same or similar products produced during the years 1936 to 1939, or during 1940, or during 1941, from timber owned by him; or (2) produced by taxpayer and sold, if so authorized by the Office of Price Administration on recommendation of the War Production Board or other agency of the United States, at prices higher, and to the extent only that such prices are higher, than the applicable general maximum prices prescribed from time to time by the Office of Price Administration.

The proposed addition frankly would exempt from the excess-profits tax that portion of income derived from logs or lumber produced in excess of the stated quota; or income derived from increases in prices of specified timber products purchased by or for the United States Government, if such increases, for the purpose of stimulating production of such war products, were recommended by the War Production Board and authorized by the Office of Price Administration. No such recommendation has been made and no such authorization given. So far as we know none is in contemplation now. But the authority exists to do both. We think that eventually the authority will be exercised as among the practical steps necessary to maintain the needed production of timber products.

In Canada the Canadian Government has had the same problem of helping the logging and lumber companies to maintain production in the face of acute labor shortages, scarcity of equipment and maintenance materials, difficulty in securing timber and high war taxes. They have attempted to meet it by providing in their tax system for a special additional timber-depletion allowance applicable to the volume of logs or lumber now produced in excess of the "average cut in the period 1936 to 1939."

Following the Canadian precedent, we ask your consideration of a second and optional provision which would permit loggers and lumber manufacturers to deduct from their income an additional depletion allowance in consideration of production in excess of a stated quota or in consideration of production of specified products determined by the war agencies to be necessary for war needs. The suggested specific language is this:

To amend section 114 of the Internal Revenue Code by adding at the end of the section the following:

(5) EXTRAORDINARY DEPLETION OF TIMBER FOR WAR USE.—A special allowance for depletion in the case of logs produced by the taxpayer from timber acquired prior to 1940 shall be added to the depletion otherwise allowable under the provisions of section 23 (m) and this section, as follows:

(a) On production in excess of average annual production during the years 1926 to 1939, or during 1940, or during 1941, 50 percent or $5 a thousand feet whichever is the lesser amount; or

(b) On production of particular species, type, grade, or other specification with respect to which any agency of the United States Government shall certify to the Secretary of the Treasury (1) that continuous and increased production of logs of such species, type, grade, or other specification is necessary to supply needed war materials, and (2) that on account of increased and abnormal cost of producing such timber an incentive to such production is necessary, 100 percent or $8 a thousand feet, whichever is the lesser amount;

but this subparagraph shall not apply to any taxpayer in any year in which he has computed his war excess-profits income under the provisions of section 711 (a) (1), subparagraph (H).

Senator DANAHER. Is the present depletion allowance under existing law computed in the same terms as is suggested?

Mr. COMPTON. Yes. It would be merely a percentage addition to that.

Of these two proposed options the first would offer partial exemption from excess-profits taxes in return for increased production. It would apply principally to producers with incomes subject to the excess-profits tax brackets who are reluctant to liquidate their reserves of good timber at 10 cents or 20 cents on the dollar of its present value.

The second in return for increased production of needed war materials would apply to all producers but principally to the marginal producers or marginal operations which have limited timber reserves for which the present timber-depletion allowances are now usually much less than replacement costs. The two provisions should go together. Together they will, we believe, provide in many cases an effective inducement to extraordinary production of needed logs and lumber which otherwise will not occur. This view is widely confirmed by the judgment of representative men in these industries.

Yesterday I talked with the Canadian timber controller, who is confronted with the same problems of increasing demand for timber products and gradually declining production. The Canadian plan contemplates (1) increased ceiling prices for manufacturers but not extending to consumers, fortified with bonus payments where necessary; (2) tax provisions which will compensate timber owners for excess cutting of their timber reserves. We think similar principles are applicable here.

The Chairman of the War Production Board and his associates in recent weeks have repeatedly, earnestly, and urgently asked for more production of lumber. Strange as it seems to us in the timber industries, and no doubt to you, lumber, because of the gigantic magnitude of the war needs has become a critical material, comparable to the scarce metals, even to copper. Temporarily it is a "bottleneck." Yet while the war defense and essential civilian requirements for lumber have been increasing, the national production of lumber has been gradually declining. In many important regions today it is still declining at a time of the year when log and lumber production ordinarily is at its peak.

Senator La Follette. Do you attribute that to the tax situation?

Mr. Compton. No; very little.

The Chairman. Largely to lack of labor?

Mr. Compton. Lack of labor and material.

Senator La Follette. To what extent do you think the tax provisions would tend to remedy this?

Mr. Compton. I will come to that in a moment, if I may.

On June 18 the Chairman of the War Production Board in an open appeal to the lumber and timber products industries made this significant statement:

> I ask that all individual operators in the lumber industry, including loggers, lumber manufacturers, and plywood plants in all parts of the country, do everything within their power to maintain maximum production of lumber and lumber products. At no time since the last World War has there been greater need for individual and collective effort toward that objective and in my opinion that need will exist for the duration of the present war.
>
> I well realize that members of your industries are facing difficulties which must be overcome if maximum output of lumber and lumber products is to result. I know, too, that all of these problems are not of your own making. I do feel, however, that some of them can be effectively met by action on your part and with the assistance of the War Production Board.

The national production of lumber last year was about 35,000,000,000 feet, the national consumption about 36,000,000,000 feet. The estimate furnished us in May by the war agencies, of the 1942 requirements of lumber for war, defense, and essential civilian needs is 38,700,000,000 feet. Later unpublished estimates are even somewhat higher. Meantime, the national production is running at about 33,000,000,000 feet and the national trend on the whole continues downward. Lumber inventories are the lowest of record. Meantime, the war agencies have told us that the national requirements next year, also, will be at least 35,000,000,000 feet.

For the record may I file six tables showing the recent course of lumber production and lumber inventories under wartime conditions?

(The tables referred to are as follows:)

STATISTICAL DIVISION, NATIONAL LUMBER MANUFACTURERS ASSOCIATION

TABLE 1.—*Lumber production*

[Comparison by years, 1936-41; 1939=100]

	Total softwoods		Total hardwoods		Total lumber	
	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.
1936	20,242	95	4,113	110	24,355	98
1937	21,589	102	4,408	118	25,997	104
1938	18,293	86	3,353	90	21,646	87
1939	21,242	[1] 100	3,733	[1] 100	24,975	[1] 100
1940	24,903	117	4,031	108	28,934	116
1941	28,444	134	4,521	121	32,965	132
1942 (6 months)	12,903	....	2,249	....	15,152	....

[1] Percent.

Source: Estimated industry totals adjusted to latest census information.

TABLE 2.—*Softwood lumber production in principal regions*

[Comparison by quarters and index numbers, using 1939 quarters, respectively, as 100]

	Southern pine		Western pine		West coast		Northern hemlock		Southern hardwoods	
	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.
First quarter:										
1936	1,535	85	539	95	1,610	106	68	106	437	98
1937	1,944	107	631	111	1,588	104	84	131	503	113
1938	1,718	95	414	73	1,216	80	53	83	451	101
1939	1,816	[1] 100	570	[1] 100	1,525	[1] 100	64	[1] 100	447	[1] 100
1940	2,184	120	706	124	1,737	114	73	114	508	114
1941	2,757	152	883	155	2,141	140	111	173	502	112
1942	2,350	129	900	158	1,977	130	63	98	546	122
Second quarter:										
1936	1,731	88	1,237	90	1,824	107	64	80	555	128
1937	2,082	106	1,604	110	2,163	127	103	129	666	153
1938	1,669	85	1,083	79	1,264	74	79	99	342	79
1939	1,972	[1] 100	1,373	100	1,704	[1] 100	80	[1] 100	434	[1] 100
1940	2,445	124	1,457	106	1,898	111	73	91	488	112
1941	2,768	140	1,677	122	2,147	126	98	123	570	131
1942	2,370	120	1,634	119	2,287	134	85	106	619	143
Third quarter:										
1936	1,874	94	1,517	98	1,705	96	87	143	626	112
1937	1,940	98	1,788	116	1,887	107	85	139	714	128
1938	1,949	98	1,448	94	1,454	82	70	115	488	87
1939	1,986	[1] 100	1,544	[1] 100	1,771	[1] 100	61	[1] 100	559	[1] 100
1940	2,644	133	1,743	113	1,890	107	94	154	497	89
1941	2,778	140	2,048	133	2,286	129	95	156	660	118
1942	....	......	....	......	....	......	....	......	....	......
Fourth quarter:										
1936	1,973	100	1,103	91	1,531	86	74	132	577	99
1937	1,726	87	920	75	1,243	70	49	87	534	91
1938	1,860	94	966	79	1,458	82	51	91	515	88
1939	1,975	[1] 100	1,218	[1] 100	1,787	[1] 100	56	[1] 100	584	[1] 100
1940	2,890	146	1,305	107	1,872	105	87	155	648	111
1941	2,529	128	1,451	119	2,236	125	62	111	644	110
1942	....	......	....	......	....	......	....	......	....	......

[1] Percent.

Source: Regional association estimated industry totals adjusted to latest census information.

TABLE 8.—*Lumber production, by months, 1939–42*

[Million board feet]

	Southern pine	Western pine	West coast woods	Northern hemlock	Southern hard-woods
1939:					
January	605	182	531	19	145
February	551	154	458	20	147
March	660	234	536	25	155
April	623	351	552	23	128
May	697	500	556	28	153
June	652	522	596	29	153
July	641	487	547	22	158
August	705	554	612	19	199
September	640	503	612	20	202
October	686	494	632	19	206
November	663	432	610	19	197
December	626	292	545	18	181
	7,749	4,705	6,787	261	2,024
1940:					
January	669	215	581	31	171
February	708	212	530	21	178
March	807	279	626	21	159
April	826	390	639	25	166
May	856	524	621	23	170
June	763	543	638	25	152
July	793	572	573	33	182
August	914	620	684	33	164
September	937	551	633	28	201
October	1,049	546	653	29	249
November	951	415	608	25	214
December	910	344	611	33	185
	10,163	5,211	7,397	327	2,141
1941:					
January	968	266	690	31	185
February	858	209	683	42	164
March	931	348	768	38	153
April	956	475	758	30	189
May	962	579	678	38	186
June	850	623	711	30	195
July	931	682	707	35	212
August	949	695	830	36	219
September	898	671	740	24	229
October	896	646	850	24	245
November	824	443	738	18	205
December	809	362	642	20	194
	10,832	6,059	8,810	366	2,376
1942:					
January	825	263	637	25	185
February	738	278	658	19	183
March	787	359	682	19	178
April	797	470	746	31	201
May	782	487	780	33	209
June	791	676	761	21	209

Source: Regional associations' estimated industry totals adjusted to latest census information.

TABLE 4.—*Lumber stocks*

[Stocks end of each 6 months period and index numbers based on end of 1938 as 100]

	Total softwoods		Total hardwoods		Total lumber	
	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.
1938:						
End of first 6 months	6,390	101	2,360	110	8,750	103
End of second 6 months	6,331	[1] 100	2,138	[1] 100	8,469	[1] 100
1939:						
End of first 6 months	6,110	97	1,984	93	8,094	96
End of second 6 months	5,826	92	1,807	85	7,633	90
1940:						
End of first 6 months	5,859	93	1,807	85	7,666	91
End of second 6 months	5,123	81	1,630	76	6,753	80
1941:						
End of first 6 months	5,162	82	1,488	70	6,650	79
End of second 6 months	4,993	79	1,355	63	6,348	75
1942: End of first 6 months	3,575	56	1,268	59	4,843	57

[1] Percent.

Source: National Lumber Manufacturers' Asosciation and regional associations reports.

TABLE 5.—*Lumber stocks*

[Stocks, end of each quarter, and index numbers, based on end of 1938 as 100]

	Southern pine		Western pine		West coast		Northern hemlock		Southern hardwoods	
	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.	Million board feet	Index No.
		Pct.		*Pct.*		*Pct.*		*Pct.*		*Pct.*
1938: Dec. 31	2,094	100	2,014	100	988	100	303	100	1,106	100
1939:										
Mar. 31	2,092	100	1,697	84	982	99	312	103	1,041	94
June 30	2,056	98	1,883	93	950	96	290	96	977	88
Sept. 30	1,907	91	1,977	98	843	85	228	75	967	87
Dec. 31	1,919	92	1,923	95	930	94	175	58	958	87
1940:										
Mar. 31	2,037	97	1,672	83	970	99	193	64	933	84
June 30	1,996	95	1,861	92	920	93	182	60	905	82
Sept. 30	1,681	80	2,051	102	865	88	173	57	820	74
Dec. 31	1,503	72	1,812	90	851	86	158	52	829	75
1941:										
Mar. 31	1,642	78	1,479	73	885	90	211	70	755	65
June 30	1,747	83	1,593	79	838	85	219	72	687	62
Sept. 30	1,422	68	1,775	88	821	83	190	63	676	61
Dec. 31	1,425	68	1,721	85	971	98	172	57	709	64
1942:										
Mar. 31	1,202	57	1,334	66	929	94	162	53	665	60
June 30	881	42	1,293	64	756	77	123	41	613	55

Source: Regional associations' estimated industry totals.

TABLE 6.—*Unfilled orders*

[Million board feet]

	Southern pine	Western pine	West coast	Northern hemlock	Southern hardwoods
Jan. 1, 1939	307	259	362	22	243
Jan. 1, 1940	306	261	452	31	208
Jan. 1, 1941	498	380	693	33	258
Jan. 1, 1942	621	421	827	33	268
July 1, 1942	871	665	1,067	91	388

Source: Regional associations estimated totals.

Mr. COMPTON. The principal factors behind the lagging production, frankly, are not Federal taxes. Labor shortages especially of skilled workers and especially of woods workers, are the chief factor. Difficulty of securing needed equipment and needed materials for maintenance and repairs is another. An increasing number of logging and lumber operations, large and small alike, are being caught in the squeeze between fixed and sometimes arbitrary "ceiling" prices on the one hand and increasing costs of labor, stumpage, and materials on the other hand.

Some timber owners, logging and lumber manufacturing operations—and this, Senator La Follette will, I hope at least in part, answer your question—which right now are in high surtax or excess-profits tax brackets are in fact, in the longer view, operating at a loss; many others on a thin and dubious margin of profit. The experts may say this is absurd. But let me ask you how you would appraise, for example, a timber company in Texas now cutting timber for which its depletion allowance is 10 cents a thousand feet, timber which cannot be replaced, if it can be replaced at all, for less than $12, impairing its future by cutting its timber reserves in excess of their sustained yield capacity in order to supply urgent war needs and now as a result in the high excess-profits tax brackets? Or a Virginia company cutting timber which it could sell for $10 a thousand feet on the stump but for which it has now no tax depletion allowance? Or a Washington manufacturer with a $3 tax depletion allowance who is now selecting from his woods the biggest and best fir trees worth many times $3 a thousand feet to make long timbers required by the Navy? Or an Oregon timber company with a tax depletion allowance of $1.25 on timber which it has held for over 40 years and which cannot be replaced for less than $5 a thousand feet? All this, paradoxical as it may seem, is in accordance with the present tax law.

These companies all are on a sustained yield operating basis, or were before the war. They are among the hundreds and the thousands of operations, large and small, upon which the war agencies must depend for their crucial requirements of lumber and timber products if they are going to get them.

For the record I would like to file a brief digest of the effects of present taxes on production in principal timber regions.

(The digest referred to is as follows:)

ILLUSTRATIVE EFFECTS OF FEDERAL TAXATION POLICIES ON PRESENT TIMBER AND LUMBER PRODUCTION; IN WEST COAST, WESTERN PINE, AND SOUTHERN PINE REGIONS

1. From a small manufacturer of west coast woods (July 23): "We have had a tremendous call for the launching ways. We have a bunch on our books now which are 20 by 24 inches—70 feet. We have got out so many of these that we have exhausted our supply for this kind of timber and have gone way back in the timber with 'cats' and have cleaned out the woods a year or more ahead of us. In order to take care of floating drydocks, barge, and ship lumber, we have skipped our poor stands and have gone into the best timber, and I hate to think of what we are going to be up against in the future. I think by all means we are entitled to some sort of relief. I was in hopes that the bill would give us the relief along the lines of copper or in a percentage of our excess-profits tax. I understand there was some talk about it.

"What I am afraid of under the present set-up in small concerns like ours is that by the time we use our share of our profits for our additional capital investments, such as equipment, that we will be worse off from the cash standpoint at the end of this spree than we were when we started, and we will find ourselves with an inferior lot of timber and expensive logging ahead of us. If we should go into a depression it would be very serious."

2. From Douglas fir plywood producers (August 4): "Loggers are being asked to accelerate way beyond normal production of irreplaceable crop in period of highest taxation. If Government can issue certificates of necessity to encourage new plants it should be possible to grant the loggers relief from tax situation now confronting them."

3. From a west coast logging and timber company (June 19): "Timber owners cutting their timber under present conditions and paying the high tax rate will have nothing left with which to acquire more timber. Just to illustrate * * * have a $1.25 depletion rate on timber that they have carried for lord knows how long, maybe 40 or 50 years, and everything above that is considered profit and subject to high taxes, which leaves very little; on the other hand, timber transactions of comparable timber indicate values of $4 to as high as $11 per thousand feet. As a matter of fact, the Government sold a small piece of timber through the Forest Service up in Washington the other day for $11."

4. From a west coast logging and manufacturing concern (August 8): "In a nutshell, a fellow may be depleting at $3 per M and having to pay $5 to $7 per M to replace the cut stumpage. Unless some relief is given, it is just going to be impossible. I have a State section up now that is thousands of dollars above what the price was a year or two ago. I have complained and they come back with a statment as follows: 'Did it ever occur to you, you might just as well pay a little more for State timber which goes into the State irreducible school fund, as to pay so much to the Federal Government?' I only mention this to show the trend of thought of these different people. What they don't realize is that this stumpage we buy now possibly won't be cut on this market, and if we only retrieve $1 or $2 per M net profit after paying all taxes, how are we going to buy timber at the present price?

"If we should buy timber now and have it on our hands after the war is over, and there should be a resumption of normal prices, we would be out of luck. On the other hand, if we are going to stay in business we must continue to purchase timber, and I am frank to say we are afraid to.

* * * * * * *

"It is a heavy strain on a fellow's patriotism to overcut at the present time, knowing he won't have a net return after the taxes are paid, sufficient to replace his timber."

5. From a western pine and west coast logging and manufacturing company (August 3): "We ourselves plan to operate at the fullest possible capacity. This may not be true of a good many other lumbermen. It seems to me that the provision as it is used in Canada whereby the allowance by depletion is raised by one-third on that portion which is cut in excess of a base period of 1936 to 1939 is the most practicable approach."

6. From a Mississippi manufacturer of southern pine (July 23): "We have in recent weeks paid as high as $15 per tree for some 800 to 1,100 feet in order to get a large timber from the said tree. The average cost of cutting, loading, and hauling logs to our mill is around $8 per M. You can readily see that every piece of lumber coming out of logs that cost this price, other than the special timber from the inside, must be sold at a considerable loss in view of the ceiling on 1-inch and 2-inch lumber, as the lumber cannot be handled through the mill, kiln, yard and planing mill under $8 or $9 per M these days and times. Many owners of timber around here do not hesitate to ask an average price of $12 and up for ordinary timber that would make only ordinary lumber, say 10-inch and under sizes. In order to get the special logs hauled from these special trees we are frequently obliged to pay a premium of around $2 per M."

7. From a group of Texas, Arkansas, and Louisiana manufacturers of southern pine (August 8): "It must be conceded that lumber operators who have held timber for a long number of years and realize upon it in a few years, in which the tax rates are exceptionally high are subjected to an excessive tax on profits which were in fact earned over a long number of years, and that if such operators would deplete their timber over a longer period the resultant excess-profits tax would be substantially reduced. The situation in the lumber industry in that respect, is, of course, different from that of industries which are not required to provide for an expensive raw material supply long years in advance of its actual consumption. Many mills operating on a reforestry plan obtain virtually no depletion allowance at all, and in their case the proposed tax of 90 percent is so excessive that it cannot but tend to reduce rather than increase production."

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"This situation was recognized by the House committee (see p. 149 of the official report) which explains the insertion of subsections H and K in section 711 (a) (1) and (2), respectively, exempting from excess-profits tax bonus income of industries with depletable resources. The situation has also been recognized in past and present tax laws by giving tax relief to individuals receiving in 1 year compensation for services rendered over a period of over 60 months (new law 36 months). (See p. 90 of report of House committee and sec. 128 of the 1942 law.) It is further recognized in the present excess-profits tax law by permitting exclusion from income subject to excess-profits tax of abnormal income earned in prior years, but realized in the current year."

* * * * * * *

"Congress has recognized the fact that it is not equitable or reasonable to tax at present high tax rates income which in fact accrued over a long period of years but is realized in 1 year. It is for that reason that the new bill provides in section 136, amending section 117 of the Internal Revenue Code, that the maximum tax on the profits from the sale of capital assets by corporations shall be taxed at only 25 percent. Therefore if a timber owner sells his timber he is taxed on the profits at only 25 percent, but if he utilizes it himself or sells logs he is subject to tax up to 90 percent."

* * * * * * *

"Generally the situation in the case of a timber owner who acquired timber over a long period of years is one wherein his depletion allowance plus the profit retained after paying taxes is in many instances insufficient to defray the cost of replacing the timber cut. Thus at the end of the year, even after a successful operation, the taxpayer may in fact be poorer than he was at the beginning of the period, although he operated at a profit, reduced the possibility of future profits by cutting his best timber now and hastened the time when he will be completely out of business because there is no further timber available to him."

Mr. COMPTON. We are not asking for tax reform. You will come to that sometime later. We are seeking more production of war materials and are asking for simple war tax limitations which we believe, if applied, will substantially encourage additional production. If they do they will likely result in no loss of total tax revenue. Your experts can perhaps better estimate that likelihood.

The war agencies have asked our help in meeting the urgent national needs for more lumber. We in turn ask your help. Tax limitation itself will not solve the problem of war production of timber products. But it will help. In many situations it is likely the only condition on which adequate log supply will be available.

May I add, Mr. Chairman, in answer to Senator La Follette's question, the principal reliance for getting more has been frankly an exploitation appeal. That has done a lot of good. We are contributing to it all we can, and it should be continued, and it is nation-wide, and it goes to operators both large and small, but we think that that should be supplemented by an incentive appeal.

Frankly, under the existing tax law, to which we are not raising any question, there are a lot of timber companies and logging companies, if they produce more, they will be doing it at a very severe sacrifice of their future ability to operate at all. It involves the question of replacement of timber, and you are familiar with some of the intricacies of that. We are not wishing to raise that issue now. That would be fundamental—that would be tax reform, and we do not raise that now, but we think if in addition to this exploitation appeal there could be some inducement appeal which could be provided along the one pattern which is in the House bill, the depletable resources provision, and the plan which is now applied in Canada and around which they are building the dual plan which I mentioned, that in all likelihood a great number of timber companies will scratch and scramble the means even with their inadequate labor, even with their inadequate facilities to get out more logs. That is the only way to get more lumber. It means a sacrifice and a very definite sacrifice because they cannot deplete now, hundreds of them cannot deplete now, for tax purposes at anything apprcaching the price that they would have to pay for the restoration of their timber. It is true in your State and in many others.

The CHAIRMAN. Thank you.

I will ask to have inserted in the record at this point the statement of Messrs. Brewster and Steiwer regarding additional time for credit against Federal unemployment taxes.

(The statement referred to is as follows:)

MEMORANDUM BY BREWSTER & STEIWER, ATTORNEYS, WASHINGTON, D. C., FOR PROPOSED AMENDMENT TO THE PENDING REVENUE BILL OF 1942, PERMITTING ADDITIONAL TIME FOR CREDIT AGAINST FEDERAL UNEMPLOYMENT TAXES

(1) *Nature of the amendment.*—The proposed amendment is similar to title VII of the Revenue Act of 1941. That title extended the time within which taxpayers might pay contributions into State unemployment funds and still obtain credit therefor against the Federal unemployment tax for the years 1936 to 1940, inclusive. This amendment makes like provision for the year 1941, but does not again extend the time with respect to the earlier years. The new amendment, like title VII of the 1941 act, would limit the credit under the proposed extension to 90 percent of the amount which would have been allowable as credit if the contributions to the State fund had been paid before the due date of the Federal return.

(2) *Reasons for the proposal.*—The amendment is believed meritorious and necessary due to the severe hardships presently confronting certain industries, in particular the anthracite coal mines. The undersigned represent two anthracite coal operators in particular: Delano Anthracite Collieries Co. of Ashland, Pa., and Williamstown Collieries Co. of Dauphin County, Pa. These and other anthracite coal operators are faced with bankruptcy unless they can obtain the tax relief which this amendment would provide. Approval of the amendment would also afford much needed relief to many taxpayers in addition to the anthracite coal operators.

The companies in question have recently suffered from widespread floods and landslides which have put their mines, as well as those of other operators, currently out of operation. However, they are actively repairing the properties, which, it is expected, can be reopened shortly. In that event, the companies will be in better position to maintain their pay rolls, thus avoiding a serious dislocation of labor; and to carry on production of anthracite coal essential to prosecution of the war. Their output of coal is being used under contract for essential war industries.

Prior to the disasters above-mentioned, the companies had only recently entered a period of operation at a small profit, after long-continued losses. They will be unable to complete their repair work, maintain their pay rolls and resume operations if they must pay both the prescribed contributions into the State unemployment fund and the enlarged Federal unemployment tax for 1941. They cannot, without this legislation, obtain the usual credit against the latter tax due to their financial inability to pay the State contributions prior to June 30, 1942. Without this credit, their Federal tax would be approximately five times that otherwise due and their total State and Federal tax practically double.

Unless the proposed amendment is inserted in the pending revenue bill, it is therefore clear that the Government will be harmed by the probability of receiving no further taxes, essential war industries will not receive the coal which the companies could otherwise produce, labor in the affected locality will not be employed and the anthracite companies, from all indications, will be ruined.

(3) *Not an extension of prior relief legislation.*—This amendment is not a further extension of the additional time which has been granted taxpayers by the parallel legislation contained in the Revenue Act of 1941, the Second Revenue Act of 1940, the Social Security Act amendments of 1939, and the Revenue Act of 1938. It is not contended that taxpayers should have still further time to familiarize themselves with the time limitation provided in the Federal Unemployment Tax Act or to take advantage of prior relief legislation. This pro-

posal is intended rather to relieve a current situation of unusual hardship which is in no degree the fault of the taxpayers concerned. It will in effect relieve them from a penalty, but will not deprive the Federal Government of normally expected revenue.

(4) *Permanent law provides relief for bankrupt companies, but no assistance in avoiding bankruptcy.*—The permanent social security tax provisions of the Internal Revenue Code, of course, give a measure of relief to companies in bankruptcy, but afford no help to those desiring to avoid bankruptcy. In the case of these coal operators their leases are forfeited if they enter bankruptcy, in which event they could not continue operation. They, accordingly, are effectively barred from using that method of relief.

(5) *Conclusion.*—It is earnestly hoped that the Finance Committee will approve this amendment and incorporate it in the pending revenue bill when reported to the Senate.

Respectfully submitted.

BREWSTER & STEIWER,
Washington, D. C

PROPOSED AMENDMENT SUBMITTED BY BREWSTER & STEIWER, ATTORNEYS, WASHINGTON, D. C.

TITLE ——. CREDIT AGAINST FEDERAL UNEMPLOYMENT TAXES

SEC. ———. CREDIT AGAINST FEDERAL UNEMPLOYMENT TAXES.—

(a) Allowance of Credit.—Against the tax imposed by the Federal Unemployment Tax Act for the calendar year 1941, any taxpayer shall be allowed credit (if credit is not allowable under section 1601 of such Act) for the amount of contributions paid by him into an unemployment fund under a State law—

(1) Before the sixtieth day after the date of enactment of this Act, if such credit is claimed before the expiration of six months after such date of enactment;

(2) Without regard to the date of payment, if the assets of the taxpayer are, at any time during the fifty-nine-day period following such date of enactment, or were at any time during the period from the last day upon which the taxpayer was required under section 1604 of the Federal Unemployment Tax Act to file a return of the tax against which credit is claimed to June 30 next following such last day, inclusive, in the custody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of a court of competent jurisdiction.

The provisions of the Federal Unemployment Tax Act (except section 1601 (a) (3)), including such provisions as modified by section 902 (e) of the Social Security Act Amendments of 1939, shall apply to allowance of credit under this subsection. The amount of such credit against the tax for the calendar year 1941, in the case of contributions paid after the last day upon which the taxpayer was required under section 1604 of the Federal Unemployment Tax Act to file a return for such year, shall not (unless the credit is allowable on account of paragraph (2)) exceed 90 per centum of the amount which would have been allowable as credit on account of such contributions had they been paid on or before such last day. The terms used in this subsection shall have the same meaning as when used in the Federal Unemployment Tax Act. The total credit allowable against the tax imposed by such Act for the calendar year 1941 shall not exceed 90 per centum of such tax.

(b) Refund.—Refund, credit, or abatement of the tax (including penalty and interest assessed or collected with respect thereto, if any), based on any credit allowable under subsection (a), may be made in accordance with the provisions of law applicable in the case of erroneous or illegal assessment or collection of the tax (including statutes of limitations). No interest shall be allowed or paid on the amount of any such credit or refund.

The CHAIRMAN. The committee will recess until 10 o'clock tomorrow morning.

(Whereupon, at 6:10 p. m., a recess was taken until 10 a. m., Wednesday, August 12, 1942.)

REVENUE ACT OF 1942

WEDNESDAY, AUGUST 12, 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.

We have one witness who was brought over from yesterday. Is Mr. Cranch in the room? Will you please come around, Mr. Cranch, and we will see what length of statement you have. You were the only witness brought over from yesterday. How much time will you require this morning?

Mr. CRANCH. I think I can do it in 15 minutes.

The CHAIRMAN. We will appreciate your making progress. I am taking you first because you were left over from yesterday.

STATEMENT OF RAYMOND G. CRANCH, WASHINGTON, D. C., ECONOMIST, REPRESENTING THE AMERICAN FEDERATION OF LABOR

Mr. CRANCH. My name is Raymond G. Cranch, address Washington, D. C. I am economist on the Washington research staff of the American Federation of Labor.

The American Federation of Labor is chiefly concerned with securing a fair distribution of the total tax burden. Our organization favors taxation fully adequate to meet the war emergency.

Such taxation should be so designed that it will not—

(1) Deprive workers of the wages necessary to maintain health and efficiency or,

(2) Limit war production by depriving industry of necessary working capital, or

(3) Interfere with post-war readjustment to peace-time conditions.

THE GENERAL SALES TAX

The American Federation of Labor opposes a general sales tax because of its unfair burden on workers. Such a tax bears more heavily on persons in low income groups than on those in high income groups for the reason that most of the income of those in low income groups is spent on food and clothing which would be subject to a general sales tax, while the percentage of the income of those in the high brackets which is expended on such purchases is much smaller. A sales tax deprives the worker with a low income of food and clothing actually needed for the support of his family.

If the urgency for Federal tax revenue should later compel the levying of any sales tax, we feel that all food should be excluded from such a tax, and also the cheaper grades of clothing. If it is necessary to have some form of sales tax, the American Federation of Labor hopes it will be possible to confine such a tax to luxury products so that the worker with an inadequate income is not penalized.

Senator VANDENBERG. May I ask you one question just at this point?

Mr. CRANCH. Certainly.

Senator VANDENBERG. Suppose that it became inevitably necessary that we had to choose between the retail sales tax and a pay roll withholding tax; would you still oppose the sales tax?

Mr. CRANCH. Only insofar as it concerned food and cheap clothing. In fact, in our work with Mr. Disney of the House on that, we took the 1918 figures and we took the present situation, and we found that a very large return could be obtained even after exemption of food and low-priced clothing from a sales tax.

Senator VANDENBERG. As between a pay-roll tax and a sales tax, I understand you prefer the sales tax?

Mr. CRANCH. Provided it is limited to luxuries, that is right.

Now, as to the manufacturers' sales tax: The American Federation of Labor opposes without qualification any attempt to raise Government revenues by means of manufacturers' sales taxes.

Such taxes have a cumulative effect in raising the cost of living and are strongly inflationary.

CORPORATE EXCESS-PROFITS TAX

This tax is an essential element in our war taxation program, but great care should be used to see that it does not interfere with the productive efficiency of corporations or leave them too small a share of earnings to make necessary capital improvements required to expand production, and to increase their labor force. The American Federation of Labor approves of the excess-profits tax included in the House bill before your committee with one exception.

The United States Treasury some months ago made every effort to secure an excess-profits tax, exemptions from which would be based exclusively on a percentage to be earned on invested capital prior to the application of such excess-profits tax.

The bill, as finally passed, provides an alternative basis for exemption from this tax based on prewar earnings. Such an alternative base is difficult and complicated to administer and results in relieving from taxation under the excess-profits tax large amounts of income earned by some of our strongest corporations at rates sometimes exceeding 20 percent or more on invested capital. The only excuse for such a heavy exemption from excess-profits taxation is that these companies had succeeded in earning this rate on their invested capital during the pre-war period. The American Federation of Labor believes that to continue this alternative method of figuring the exemption from excess-profits tax is against the best interests of the United States. Such a method of calculating the exemption discriminates against new companies which have no prewar record of high earnings, and it further discriminates against companies with a high invested capital base, which have had only moderate earnings on invested capital in the prewar years.

In the opinion of the American Federation of Labor all corporate profits should be subject to the same scale of taxation. The closing of this loophole in the present law should yield more tax revenue to the Government than can be secured from the closing of any other available loophole.

DEPLETION ALLOWANCES TO OIL COMPANIES

Under the existing law, oil companies can deduct as part of their expenses depletion allowances which eventually total many times the cost of their oil properties. This is so manifestly unfair that it should be remedied in the new tax bill. The resulting saving to the Federal Government will be large.

TREASURY RECOMMENDATIONS AS TO RATES OF TAXATION ON INDIVIDUALS AND CORPORATIONS

The rates of taxation on both individuals and corporations have been reduced in the House bill far below the rates recommended by the Treasury Department, except in the lowest brackets, where they have been increased. The American Federation of Labor recognizes the importance of leaving to individuals and corporations sufficient net income so that they can continue actively and efficiently in the war effort, but we feel that higher income taxes are to be preferred to excessive sales taxes.

PRESIDENT'S SUGGESTION OF $25,000 AS MAXIMUM INCOME WHICH SHOULD REMAIN TO INDIVIDUALS AFTER THE PAYMENT OF FEDERAL TAXES

With regard to the President's suggestion that during the war no individual should retain a personal income amounting to over $25,000 after the payment of Federal taxes, the American Federation of Labor recognizes that the needs of war will demand a gradual tightening of everyone's belt, but at the same time we realize that many independent businessmen would find it necessary to restrict their activities, reduce their war work and decrease their employment of labor, if such an arbitrary limit was made effective.

We, therefore, recommend that no such arbitrary ceiling as a flat $25,000 be placed on individual incomes after taxes. There will, of course, be increasing taxation, in accordance with capacity to pay, but the Nation would indeed be short-sighted to limit productivity of its businessmen by such an arbitrary and inflexible rule. If such a program is included in the tax bill, there should be a relief clause under which individual businessmen, performing important functions in the war effort, can be allowed to retain sufficient net income to carry forward those of their business activities which are essential to the prosecution of the war effort.

The American Federation of Labor opposes a flat ceiling for workers' wages by arbitrary freezing, and justice demands that the same principle be applied to industrialists who now earn salaries yielding above $25,000 after payment of taxes.

The Federation approves of the high taxes necessary to win the war, but can see no justice in arbitrary wage freezing, either for the worker or for the employer. Let us get the necessary Federal revenues but let us be fair to worker and employer alike.

HEAVIER TAXATION ON PARTNERSHIPS AND INDIVIDUALS IN BUSINESS

Large businesses conducted as partnerships or as individual ventures are now greatly favored by present tax laws as compared with similar businesses conducted as corporations. During the First World War in 1918 the excess-profits tax then in effect applied to partnerships and to individuals as well as to corporations. A substantial amount of additional tax revenue could be secured by reviving this tax or something similar to it.

EXCESS-PROFITS TAXES ON WAGES

It has been suggested that there should be assessed an excess-profits tax on wages, based on the increased earnings of workers in the war period. One suggestion would be illustrated by this example:

A worker with $1,600 a year under the optional rates in the pending House bill would pay, if married and making a joint return, a tax of	$51
Such a worker might have secured a job paying $2,600 a year, under existing conditions, and he would then pay under the above optional rates	224
Or an increase in his tax of	173

Which means a jump in his tax of over 300 percent.

If the increased tax of such a worker was calculated under the individual excess-profits tax formula suggested, and if the rate on the excess was to be 50 percent, then such a worker's tax would be calculated as follows:

Tax on the first $1,600, as above shown	51
Individual excess-profits tax of 50 percent on the $1,000 by which his wages were increased during 1942	500
Total tax	551

If any such proposition were to be written into law, the tax of such a worker would be increased over 1,000 percent, while the tax of other workers who had made no contributions to the war effort would be increased only about one-third as much.

This would certainly result in most unjust treatment for those who have contributed their blood and sweat to the war effort.

Business Week of August 8, 1942, quotes a report from the Automotive Council for War Production stating that the average weekly wage of automotive plant workers is $50.29 now, compared with $40.91 a year ago and $30.87, 3 years ago.

Most of this increased earning is due to overtime worked. To penalize such workers with any such high taxation as has been proposed, would be to deprive them of the fruit of their toil to a degree which would mean a sharply lowered standard of living in the face of the heavy sacrifice being made by the worker through longer hours and more intense effort, at a time when living costs are increasing sharply. It would be hard to conceive of a more unjust tax, or one better calculated to serve our enemies through the destruction of the morale of our loyal citizens.

The increased rate of tax already provided by the present House bill is well calculated to draw from workers all than can be expected from them without endangering their health and efficiency.

The Treasury Department agreed to a reduction of personal exemptions for workers in the effort to make unnecessary the levying of sales taxes on food and clothing. Now there is danger that in spite of the lower exemptions adopted, there may also be sales taxes on food and clothing

Senator VANDENBERG. May I ask you at that point, Suppose you had to choose between the lower exemptions or a sales tax, which would you prefer?

Mr. CRANCH. If the exemptions were entirely eliminated, there might be something said in favor of having no sales tax whatsoever, but I think it would be fairer to have our lower exemption of $750 and $1,500 and a luxury sales tax than to put the exemptions down to a place where the poor man is sacrificing too much.

I will illustrate that. In the United States Business Week just lately, it has been shown that the great bulk, a very large percentage, almost half of the increased industrial earnings of workers in the last year or two has gone to the group with between $2,000 and $3,000 income. The marginal worker is the worker that is largely not in the war industries and that is suffering through holding his old job and turning out consumption goods, or working on some job where he is not getting high war wages, and he would sacrifice tremendously through the lowering of exemptions or a sales tax on necessities, such as food and the cheaper priced clothing.

Senator BARKLEY. What do you define as "luxuries"?

Mr. CRANCH. I would say that expansion of the present excise taxes to cover such things as soft drinks, which would produce thirty or forty million, and all clothing sold at more than the average price—that is what I worked out with Representative Disney—would be a satisfactory luxury sales tax.

I realize that those luxuries will have to be considerably restricted if we are to get the proper amount of war revenue, but I say in general, a luxury sales tax is one that will not hit the worker with less than $1,000 a year income.

Senator CLARK. Senator Brown used an example a few days ago—he said, for example, a pair of shoes would cost $3, or $4, or $5 was a necessity and ought not to be taxed by a sales tax, but he suggested that people buying shoes and paying $12 or $15 for them, that this is a luxury which might well be taxed.

Mr. CRANCH. Yes; that is just what we recommended to Representative Disney, that he take the retail sales of your retail dealer and take the average, and anything below the average would be free and anything above the average would be taxed.

Senator CLARK. If a man wants to pay $150 for a suit of clothes, that is a luxury, but a suit of clothing which a man needs as a necessity, the ordinary workingman's suit of clothes, that is a necessity and ought not to be taxed?

Mr. CRANCH. I think that would be a fair division.

One thing that would make such a tax almost intolerable, is that, if adopted, it would need to be accumulated on top of substantial sales taxes, already levied by the States, the proceeds of which are urgently necessary to meet the budgets of our State governments.

Each level of local government should be protected from overlapping taxation in fields which have long been recognized as the legitimate sources of State and local taxation.

You see, the whole question of local sales taxes is so fully established as a prime source of income for those States that have a limited amount of industrial development, it would be a great hardship to such States to put on top of it a heavy Federal sales tax.

Senator VANDENBERG. Do you support the State sales taxes?

Mr. CRANCH. I think they are inevitable. Take Mississippi for instance—I have done a lot of work there as representative of the legislative investigating committee and I know from experience that their revenues from industry have been comparatively small; of course, they are better now, but at the time I was there the farmers were taxed twice what they are in Pennsylvania, and if they did not have a sales tax, the burden of general taxation would be just simply impossible; so for the States, I believe the sales tax is justified and necessary, and that the Federal Government should keep away from that field in order to keep it to the States.

Senator DAVIS. What is the rate of the sales tax in Mississippi?

Mr. CRANCH. My Mississippi experience is so far back that it would not help you, but it was 8 or 9 percent when I first heard of it.

EXEMPTION OF INCOME FROM STATE AND MUNICIPAL BONDS

Here again the American Federation of Labor recognizes the wisdom of maintaining the independent sovereignty of our States and cities. We do not feel that such income should be free of all taxes, but that such income should be regarded as a legitimate field for taxation by the States, without interference from the Federal Government.

POST-WAR TAX REFUNDS

If the rates of tax on individuals and corporations are to be increased above the rates now appearing in the 1942 House bill, it seems vitally important, in order to prepare for the reconstruction period which will follow after the war, that provision be made for the return in cash, after the war, of a part of the high taxes to be collected under the Revenue Act of 1942.

In this case we can well be guided by the English experience which returns a high percentage of the tax now assessed against low-income workers, the percentage of the refund falling rapidly as the average income of the taxpayer rises, until the refund cancels out in the case of those taxpayers receiving what might be called a comfortable income.

Corporations also need a post-war reserve in order to maintain employment and convert their facilities after the war. We recommend that any corporation called on to pay over 75 percent of its total net income under the war tax laws, be eligible to receive a refund of such excess in installments after the war is over, such refund to be subject to a moderate income tax in the year of such refund. This plan would be vitally important in reestablishing normal business after the war effort is over.

SOCIAL SECURITY TAXES

Another fruitful source of additional tax revenues at the present time would be an increase in social security taxes. Such increases should be made with a view to ultimate increases in the benefits under social security laws, but temporarily the funds received would be available to the Government for war purposes, the cost of extending the benefits under the social security law only taking effect gradually in future years. The American Federation of Labor feels that the only tax deduction from pay rolls should be the social security tax.

That was supported very fully by yesterday's testimony as to the immense labor it would be to corporations to take out a tax subject to a variable exemption.

TAXES WITHHELD FROM PAY ROLLS

As just stated, the American Federation of Labor feels that social security taxes are the only taxes which can properly be deducted directly from pay rolls. If general income taxes are so deducted, there would be an inevitable tendency to place upon the statute books a direct tax on wages in addition to other income taxes. This should be avoided.

In order to make tax collections easier for new taxpayers in the lower brackets, it may become desirable to collect the income tax monthly rather than quarterly as at present. But to collect this tax at the source would lead to excessively high costs of collection and very complicated bookkeeping on the part of employers as well as the Government.

EXEMPTION OF EXPENSES DUE TO SICKNESS AND EXEMPTION OF LIFE INSURANCE PREMIUMS WHEN THE PROCEEDS ARE PAYABLE TO DEPENDENT BENEFICIARIES

Additional exemptions have been recommended to eliminate certain hardship cases. The American Federation of Labor wishes to go on record as in favor of a personal exemption to individuals covering bills for hospitalization and medical services paid within the tax year. We also favor the exemption of premiums on life insurance policies in favor of dependent beneficiaries, up to a reasonable amount, paid within the tax year.

Senator DAVIS. What would you term a reasonable amount?

Mr. CRANCH. I think where a man uses a life-insurance policy as a long-term big investment proposition, it is too big to take out in this way. I think that the standard is this, a dependent beneficiary such as a man's wife, normally has that insurance which will take care of her after the death of her husband.

We have an exemption, as you know, of $40,000 of insurance, from estate taxes.

Senator DAVIS. Yes.

Mr. CRANCH. In inheritance tax. To my mind it should not be above that.

Senator DAVIS. I am talking about the premium.

Mr. CRANCH. I would say that the premium on $40,000 of insurance would be the absolute limit, and that would be a very high limit. I would prefer to see a limit of the premium on $20,000 of insurance. I think it would be fairer.

THE PRESIDENT'S SEVEN-POINT PROGRAM FOR INFLATION CONTROL

One of the very important elements in the President's seven-point program is the increasing of taxation. The American Federation of

Labor supports fully the President's seven-point program but wishes to emphasize the fact that unless every one of the seven points is enforced equally, and at the same time, the objectives to be attained will be impossible. If heavy taxation of workers in the low-income groups is not accompanied by adequate price and rent control as provided by other points in the program, then heavy taxation of workers would result in a most unfair burden upon American working people.

TO SUMMARIZE

The American Federation of Labor favors only those Federal taxes the burden of which is distributed according to ability to pay.

The American Federation of Labor opposes all taxes unfairly burdening workers or having a serious inflationary effect, including—

1. Sales taxes.
2. Taxes on freight charges.
3. Pay-roll taxes other than for social-security purposes.

The American Federation of Labor further opposes taxes which will result in injustices between groups, such as:

1. Excess profits taxes unfairly favoring those companies with high pre-war earnings.
2. Excess profits taxes assessed against individuals not in business.

That is your pay roll excess-profits tax referred to there.

The American Federation of Labor also opposes all taxes which would restrict or hinder business activity and the employment of labor, such as:

1. An inflexible maximum income for any individual of $25,000 after the payment of Federal taxes, in those cases where the taxpayer's ability to do war business and employ adequate labor would be endangered by the application of such an arbitrary tax.
2. Manufacturers' sales taxes.
3. Taxes on business which in total take so much of a company's income that it cannot do business effectively and meet the demands of war production.

I thank you, Mr. Chairman, and gentlemen of the committee.

The CHAIRMAN. Thank you very much, Mr. Cranch.

Mr. Alvord, do you wish the other members of the chamber of commerce to come around at the same time, or do you wish them heard separately?

Mr. ALVORD. I would like to reverse the order of our appearances as it is shown on your calendar. This bill is unquestionably the most complicated you have ever had before you, both in form and in substance, and therefore we have divided our work.

Mr. Osgood, of our committee, will speak first, with your permission, and discuss estate taxes. Then Mr. Shorb, then Mr. Hopkins, and then myself.

The CHAIRMAN. You want to reverse this entirely?

Mr. ALVORD. Yes.

The CHAIRMAN. All right. Mr. Osgood, will you proceed with your statement?

STATEMENT OF ROY C. OSGOOD, CHICAGO, ILL., COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. OSGOOD. I am Roy C. Osgood, vice president of the First National Bank of Chicago and in charge of its trust department. I appear here, however, as a member of the Committee on Federal Finance, Chamber of Commerce of the United States.

My testimony will deal primarily with the estate and gift tax aspects of the bill. The points involved can best be discussed by a comparison of the bill as passed by the House of Representatives with the proposals advanced by the Treasury Department before the Committee on Ways and Means. To save the committee's time my verbal statement is supplemented by a technical discussion relating to several difficult subjects. I request permission to have this supplement appear in the record as a part of my statement.

The CHAIRMAN. Yes, sir; you may do so.

Mr. OSGOOD. Thank you, sir.

I am going to summarize orally, if I may, inasmuch as this statement will be before you.

The CHAIRMAN. Yes, certainly.

RATES OF TAX

Mr. OSGOOD. The Committee on Ways and Means of the House of Representatives is to be congratulated on its rejection of the Treasury proposal to increase the present high estate and gift tax rates. We trust this committee will make the same decision. This decision is a recognition of the following sound principles of death taxation.

1. Any increase in rates would magnify the Federal record of instability. It would emphasize for the sixth time in 10 years the inequality among individual taxpayers by making the amount of capital contribution of different citizens depend entirely upon the fortuitous circumstances of death.

2. Estate and gift taxes are not suited to an elastic tax system. These rates of tax cannot be expanded to meet revenue needs since there is no predictable tax base. Citizens die without regard to the needs of the Government and deaths are not subject to the control of the tax collector.

3. Any increase in rates would further violate the principle of tax moderation, producing disruption of the family's economic position, tax evasion, and harmful effects upon enterprise.

4. Any increase in rates would further deplete the tax base. The estate tax is essentially a capital tax and if capital is dissipated through excessively high estate-tax rates, the tax base, i. e., the capital which produces income subject to taxation, may be lost in future generations.

5. Any increase in estate-tax rates would directly reduce the tax revenues of the District of Columbia and the 25 States of Arkansas, California, Connecticut, Idaho, Illinois, Iowa, Kansas, Maine, Kentucky, Maryland, Massachusetts, Minnesota, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Carolina, Ver-

mont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. In these States the Federal estate tax is a deduction before computing the State death tax so that the State tax decreases as the Federal tax is increased. In addition all State death tax revenues would suffer indirectly by a reduction of the size of estates in succeeding generations through the imposition of heavy Federal death taxes.

The Committee on Ways and Means and the House of Representatives recognized that death taxes in this country already closely approximate those of Great Britain and Canada. This is disclosed by the following table:

Estate (before exemption)	British [1] (estate and legacy tax)	Canadian [2] (Dominion tax plus Ontario death duty)[3]	Present United States (Federal plus Illinois inheritance tax) [3]
$100,000	$13,400	$13,077	$10,110
$250,000	55,500	45,531	54,074
$500,000	150,000	121,166	132,584
$1,000,000	352,000	323,971	315,900
$5,000,000	2,670,000	2,585,588	2,443,000
$10,000,000	6,640,000	5,810,170	6,057,800

[1] These figures are obtained from the table submitted by the Treasury Department to the Committee on Ways and Means on Mar. 5, 1942.
[2] In Canadian dollars. If the Canadian dollar is valued at 90 cents the amount of the tax would be proportionately lower.
[3] Based on equal division between wife and 2 children.

You will see by glancing at that table that our rates already are almost fully as high as those for both Britain and Canada.

This rejection of any increase in these tax rates acknowledged that this war period is no time to incur an additional element of disruption in our productive capacity. Present estate-tax rates often produce a forced sale of assets, change of control, a strain on credit or liquidation of the enterprise, resulting in an impairment of the productive capacity of the Nation. Any increase in death-tax rates would merely aggravate the situation. The Secretary of the Treasury, in his statement of July 23 before this committee made no allusion to this particular subject except in the table appended to the statement.

I may say just one further thing. We hear a good deal of discussion about inflation. I think the rates are pretty high at the present time, and if you get into a situation of inflation during the war period that may run anywhere from 3 to 5 years or more, and then a subsequent depression, you would, in the case of physical properties, and in the case of merchandise inventories, and in the case of corporations whose stock had practically no market, run into a very bad picture because your rates would be high, your values would be high, and then the subsequent drop would probably leave a very bad situation as to funds to pay taxes with.

OTHER SPECIFIC TREASURY PROPOSALS REJECTED

The Committee on Ways and Means and the House of Representatives are also to be commended on their action on the following three particularly unsound Treasury proposals:

1. The rejection of legislative help in enacting an arbitary proposal designed to save the Treasury Department from having to prove the facts regarding gifts made in contemplation of death in difficult cases. This recognizes that much of the litigation which has developed on the question of contemplation of death (which litigation has generally been decided in favor of the taxpayer) is a result of a refusal of the Treasury Department to accept the theory that inter vivos gift transactions should ordinarily be taxed under the gift tax law where they belong.

2. The rejection of the Treasury Department proposal to curtail the amount of exemption of charitable, religious, and educational bequests and gifts is most commendable. Our tax legislation on this subject in the past has been fair and this is certainly no time to change when charitable, religious, and educational institutions are already suffering through reduced income yields, and when the increased income tax burdens on contributors are lessening their ability to give for such purposes.

3. The rejection of the proposal to carry over the decedent's income tax cost basis on inherited property was a recognition of the fact that the adoption of such a proposal would result in absolute confiscation in the case of going businesses which have grown from small to moderate size. This was a most vicious proposal. The reasons for its rejection appear in the supplemental statement.

If these three proposals are revived before this committee they should be rejected.

APPROVAL OF CERTAIN SPECIFIC PROPOSALS WHICH WERE ADOPTED

The action of the Committee on Ways and Means in adopting the following five specific proposals should be approved, namely:

1. The deduction for payments of pledges or subscriptions made by the decedent to public, charitable, and religious uses (sec. 406).
2. Correction of language to carry out the original intent of Congress relating to property previously taxed within 5 years (sec. 407).
3. The allowance of a deduction for amounts passing to public, charitable, and religious uses as a result of disclaimed legacies (sec. 408).
4. The amendment establishing the priority of the credit for paid State death taxes in computing the estate tax. This effects a more liberal application of such credits (sec. 410).
5. The amendment correcting the hardships of the *Enright case* in regard to the accrual of income in respect of decedents. While the amendment adopted entails some complications of accounting, we feel it is equitable and should be retained (sec. 125).

UNSOUND PROPOSALS ADOPTED

1. *Insurance.*—Section 404 of the bill eliminates the life-insurance exemption of $40,000 in the case of insurance payable to named beneficiaries, and section 413 establishes a $60,000 exemption on all property, including such insurance. This reversal of a wise and longstanding legislative policy relating to the specific insurance exemption will disrupt many individual estate plans. Insurance contracts have been written and estate tax arrangements have been made by taxpayers

over the years in reliance upon this long continuing specific insurance exemption.

Many medium-sized estates have depended upon this insurance exemption to provide ready cash to pay estate taxes which would be levied after the $40,000 exemption relating to the rest of the estate has been taken. It is no answer to say that a general exemption of $60,000 has been substituted relating to both insurance and other property.

The effect on outstanding situations is to reduce the exemption on other property from $40,000 to $20,000. Exemptions in a time of decreased income yields and higher estate taxes should be increased and not decreased. The bill reduces the present exemption of $80,000 to $60,000 in estates where $40,000 of formerly exempted insurance is present.

If any change is to be made in the insurance situation then it should be in the way of exempting from death taxes, as do most of the Canadian Provinces, all insurance earmarked for the payment of such taxes. Such a plan has had favorable comment from former members of this committee. This proposal is fully discussed in my supplemental statement.

Section 404 also purports to tax the proceeds of insurance if the decedent has either paid the policy premiums or at death has possessed incidents of ownership in the policy. Elaborate rules are set up which are difficult to apply and understand. The tests of taxability are in the alternative and seem to be irreconcilable.

Few will object to legislation making certain just what insurance is taxable at death. However, it is submitted that the statute should not enact two alternative and inconsistent bases of tax. It would seem that the ownership test would avoid many difficulties and be entirely fair to both the Government and the taxpayer. This provision should be clarified and should choose one of the two alternatives. This is detailed in my supplemental statement.

2. *Powers of appointment.*—Section 403 relating to powers of appointment is without doubt vicious in its effects and general implications.

This proposed change does violence to the fundamental concept of the estate tax.

The estate tax is an excise tax on the transfer of property of a decedent. It is to be distinguished from an inheritance tax which is an excise tax on the right to receive property from a decedent. Any amendment which bases the taxability of a transfer on the relationship of the parties is essentially an inheritance tax. This proposal is just such an amendment.

The question of a Federal inheritance tax was squarely placed before Congress in 1935 and was decisively defeated. This is an attempt to do indirectly what Congress refused to do directly.

Even the existing tax on the exercise of a general power of appointment violates the estate-tax principle as distinguished from the inheritance-tax principle as no property passes from the decedent who exercises such a power. Actually the exercise of a power of appointment is merely the completion of the transfer from the original donor of the power and this transfer is now taxed on the death of the donor of such power. It should not be subject to another estate tax when the power is exercised.

The existence of such a power does not constitute ownership of the property, legal or equitable and to tax such a power, whether exercised or not, is the result of a confusion of principles. A great part of the existing confusion and technical difficulty found in our Federal tax laws, has been the result of abandoning fundamental principles merely for the sake of a few, and in this case, very few tax dollars.

To tax the nonexercise of powers of appointment, except in certain excluded cases, would result in numerous injustices and would penalize the use of a procedure long recognized by laws applicable to estate administration as serving a valuable social purpose.

Powers of appointment can be used to accomplish a normal, sound, family-estate program. It may be desirable to discourage their use for any other purposes by imposing tax burdens on artifices bearing their label. But it is not desirable to penalize their use for a sensible purpose by prohibitive taxation.

The amendment results in the latter because of

(*a*) The proposed tax on nonexercise of the power, and

(*b*) The restrictive nature of the proposed excluded powers.

Many injustices are certain to result from the passage of an act which taxes the nonexercise of a power of appointment. First of all, there is the situation of the will of a testator who died 15 or 20 years ago. The draftsman may have included the power without any thought of the tax question and it may be that he could have used a limited power or omitted the power entirely and accomplished the same distribution.

Thus the accidents of draftsmanship will control the taxability of many well-advised plans of distribution.

Section 452 attempts to give relief in this situation by making certain exemptions in the case of the release of the power within a certain period of time. However, there is no possible way of granting relief. There are thousands of cases where powers of appointment are held by minor children who are legally incompetent to release their powers of appointment within the allotted time. Naturally these children are the ones who will suffer most.

Aside from this there is the legal question of how can a power of appointment be released? If the power is one to appoint by will, as most are, to whom is the release to run? Suppose the holder of the power executes a formal release. He must do so without consideration as there is no one from whom the consideration can move. There can be no mutual promises to furnish adequate consideration, and without consideration the release is invalid as a contract. There can be no delivery of the release to anyone for the ultimate remaindermen may not be in being at the time of the release. Consequently, without such a delivery there can be no valid and enforceable gift. Actually such a release would be little more than talking to oneself.

Another unjustifiable result is the taxing of a gift to the donee's children who take in default of exercise of a general power, while under the bill the excise of a limited power of appointment to them would be exempt. Why should not these children be permitted to receive the same benefits when they take by default of appointment as when they have the property appointed to them?

This circuity is both undesirable and illogical. Actually the decedent has exercised more control in the case of exercise of a limited power than in the case of the nonexercise of a general power.

The value of a power of appointment is necessarily determined by the control it affords. The imposition of a tax upon the nonexercise of a power reduces the value of the power because it induces the exercise of the power and thus impairs the effectiveness of the control. The spendthrift son who is the only possible appointee of a limited power, and who is as alert as he is extravagant, will be quick to realize that his mother will not be inclined to permit a large part of his father's property to go to the Government. Instead, she will probably make the tax-free appointment to her undeserving son. The control over her son's welfare, which the donor thought was assured, will soon disappear.

Under the bill the only powers excluded from the estate tax are:

(*a*) Powers to appoint among the decedent's spouse, his or her spouse's decendants, spouses of such descendents and charity; and (*b*) powers to appoint to a restricted class where the decedent has no beneficial interest, vested or contingent, in the property.

Exclusion (*a*) is an attempt to decide arbitrarily what special or limited powers shall be exempt.

It seems that it would be more in line with the purpose of exempting powers to define special or limited powers so as to exclude their capricious use, instead of attempting an arbitrary specification of exempt powers as the bill does. For example, a limitation to citizens of the United States may be so restrictive as to make its exercise free from tax under the present statute but it is, in essence, a general power and there can be little objection to taxing it as such. It may be desirable to define limited powers in such a manner as to eliminate such frivolous manipulation, but this should be done by comprehensive definition—not by abandoning the distinction between general and limited powers and creating an arbitrarily selected group of excluded powers.

Not long ago the Treasury tax expert, Mr. Randolph Paul, wrote a book on estate taxes. In volume 1, page 417, he said:

> A testator may feel it desirable to dispose of his property to only a temporarily limited extent, entrusting a devisee or even a stranger with the power and authority to fill in the blank which he decides to leave in his will as to the more remote future. Apart from any tax considerations the creation of such a power is a helpful expedient to provide against contingencies which even the most imaginative testator may not foresee when he drafts his will.

Why should the testator's right to provide for unforeseen contingencies be recognized more readily if the appointee is one of an excluded group than in a case where the appointee is not one of the specified persons but is, nevertheless, a natural object of the donor's bounty?

Many times the father and mother of the donor or donee of a power would be the normal takers in default or the normal appointees under certain circumstances. Should not they be included as well as those chosen by this bill? To read Mr. Paul's book, published in 1942, is to learn that the proposed excluded group is somewhat more restrictive than the group he there suggests be excluded. On page 480 of his book, he states:

> In this respect the legislator's choice should be determined by what he considers a socially desirable degree of protecting the devolution of property from

the dead to the living, and it should not be difficult to secure consensus of opinion in holding the donor's and the donee's children worthy and at the same time the only persons in real need of such protection. The statute would thus have to be changed so as to treat special and general powers alike, specifically excepting, however, special powers exercisable exclusively for the benefit of either the donor's or the donee's children.

If an attempt is made to define the exempt powers, provisions of this section should be expanded. After all, it is the creator of the power who is the planner and it is his use of this means of protecting the members of his family which concededly justifies the exemption of some powers of appointment. A more stringent restriction on the use of powers of appointment defeats the purpose which is presumably the basis of the exemption.

The power to appoint to the persons designated in the section is centered around the donee of the power, as the appointees under the power must be in his line of descent or married to someone who is in that line. Thus, the donor of the power is penalized if he does not wish to select a donee whose descendants are coincident with the natural recipients of the donor's property. He cannot give his oldest and wisest son the power to appoint to descendants of a younger daughter without incurring a tax. It must be admitted that this imparts too much significance to the status of the donee.

The exempt powers should consist of all powers to appoint to persons who are the natural objects of the donor's bounty, including all persons related to the donor or donee by blood or marriage. This is restrictive enough to prevent avoidance by manipulation, such as the use of limitations which do not actually limit—a good example being the appointment to citizens of the United States previously referred to.

It is broad enough to permit accomplishment of the family-estate plan in practically all cases, and compared to the limitations imposed by the section would greatly minimize the number of cases where a normal plan could not be accomplished.

If an attempt is made to base the exemption on the degree of relationship it is also logical to exempt from tax the exercise of a general power of appointment in favor of members of the same class. There is very little distinction in result between a general power of appointment and a limited power of appointment if both are exercised in favor of the same person.

It is not only recommended, it is urged, that sections 403 and 452 be stricken entirely from this bill.

3. *Amortization of bond premiums*.—The amortization proposal contained in section 120 of the bill is dealt with here primarily because of its effect on trust administration. The principal objection to this proposal is its impracticability. The general public is not particularly impressed with the simplicity of the present income-tax law.

Under the Treasury proposal one can readily imagine the difficulty of a widow who purchases a few municipal bonds. The average person has never heard of amortization and, if he has, he tends to think of it in terms of newspaper reports regarding defense facilities. The complicated records made necessary by this proposal will narrow the market for municipal securities, exasperate the taxpayer and cause endless auditing difficulties for both the Government and the taxpayer. A careful analysis of this provision reaches the inescapable conclusion that the Treasury, in order to collect a comparatively small amount of tax on nontaxable Government and municipal bond income by the indirect route, has induced the House to enact a maze of technical rules the cost of which to both the Government and the taxpayer is disproportionate to the revenue result.

It would be far simpler to provide straightforwardly that no loss shall be recognized on nontaxable Government and municipal bonds purchased at a premium and redeemed below the purchase price. These points are discussed in detail in the supplement statement.

I may say that if any of you care to get into the technical side of it and examine the supplemental statement you will find that a great many provisions of this part of the act practically are unworkable.

OTHER PROPOSALS

1. *Nonresident aliens.*—Section 412 grants an estate tax exemption of $2,000 in the case of nonresident aliens. This is highly desirable. However, there is a further recommendation which is not contained in the bill.

We recommend that foreign securities of nonresident aliens be exempt from the estate tax. The reasons for this proposal are discussed in the supplemental statement.

2. *Community interests.*—Section 402 includes (in the eight community-property States) in the gross estate of the decedent spouse the property of the surviving spouse, unless the property of the surviving spouse can be shown to have been received as compensation for services actually rendered by the surviving spouse, or derived originally from such compensation or other separate property of the surviving spouse. This provision does violence to the community property concept and will cause interminable administrative difficulties. We recommend that it be stricken from the bill.

I might say, Mr. Chairman—I am sorry Senator Connally is not here with us this morning—that when the Treasury was discussing the technical provisions of the bill on the second day of its testimony, when they finished with the excise taxes, Senator Connally asked if there was not an excise tax on community property and the Treasury said "no." I think they forgot that the estate tax is an excise tax, and it is still here.

3. *Gift-tax exclusion.*—Section 454 reduces the annual gift-tax exclusion from $4,000 to $3,000. This should not be enacted. The exclusion should be broadened rather than narrowed and some provision should be enacted eliminating the discrimination against gifts in trust. These points are further discussed in the supplemental statement.

That question of gifts in trust is a very serious discriminatory one and can be worked out. It was a difficult legislative drafting proposal, but I think it can be solved.

4. *Gift-tax exemption.*—Section 455 reduces the existing exemption of $40,000 to $30,000 relating to gifts made in the calendar year 1943 and subsequent years. This should not be adopted. It is no time to reduce the exemption when men going into the armed services need liberal treatment in arranging their family affairs.

5. *Service men's exemption.*—The Revenue Act of 1917 did not impose an estate tax upon the estate of any decedent dying while serving in the military or naval forces of the United States during the con-

tinuation of the war in which the United States was then engaged, or if death resulted from injuries received or disease contracted in such service, within 1 year after the termination of the war. The Revenue Act of 1918 carried the same provision but eliminated the 1-year limitation and provided for exemption from the tax in the case of a decedent dying from injuries received or disease contracted while in the service and further provided that any such tax collected should be refunded to the executor.

The Revenue Act of 1921 repeated this exemption and extended it to the estate of any citizen who died of injuries received or disease contracted in line of duty while serving in the military or naval forces of any country associated with the United States in the prosecution of the war or prior to the entrance of the United States into such war; it also provided that any tax collected upon such an estate should be refunded to the decedent's estate. The Revenue Act of 1924 dropped this entire provision. We call this to the attention of your committee should it desire to consider the enactment of such an exemption applicable to the present war.

If Congress does not care to go so far as to grant so sweeping an exemption, then we recommend that gifts inter vivos at any time after a fixed base date (such as the enactment of the first draft law), the gift tax shall apply exclusively to such a gift and that no assertion of an estate tax liability upon such a gift, based upon the contemplation of death theory shall be made.

Of course, I cannot conceive of any greater contemplation of death than a person going into combat services.

This would be no more than fair to those taxpayers who have arranged their affairs in contemplation of volunteering or being drafted into service.

As a matter of fact, the impact of the estate tax in all so-called contemplation-of-death cases should be abolished except in the case of gifts causa mortis, that is, in actual deathbed gifts. A volume of vexatious and unfair litigation, mostly adverse to the Treasury, has developed in estate-tax claims under the contemplation-of-death theory. This theory may have had some justification prior to the enactment of the gift tax. Since then, it has had none except in the case of an actual deathbed gift. Inter vivos transactions should be taxed under the gift-tax law, where they belong, thus ending a source of ill-conceived and costly litigation engendered by the attempt to torture a proper gift tax into an improper estate tax.

Thank you, sir.

The CHAIRMAN. Thank you, Mr. Osgood. Are there any questions?

(No response.)

The CHAIRMAN. There are no questions. We thank you for your appearance.

Your supplemental statement will be inserted in the record.

(The supplemental statement submitted by Mr. Osgood is as follows:)

SUPPLEMENTAL STATEMENT OF ROY C. OSGOOD, CHICAGO, ILL.

1. COST BASIS OF INHERITED ASSETS

The bill's rejection of the proposal to carry over the decedent's income tax cost basis on inherited property was a recognition of the fact that the adoption of such a proposal would result in absolute confiscation in the case of going businesses which have grown from small to moderate size. This was a most unsound proposal. An illustration is the best method of proving this point.

Assume that many years ago, A invested $100,000 in a business which has increased in value so that at the time of his death it is worth $5,000,000 and is the estate's sole asset. The estate tax alone on $5,000,000 is, under present rates, $2,468,200. In order to raise this amount of money, it would be necessary to sell at least half of the business. But a sale of one-half of the business would, under the proposal, result in a taxable profit of $2,450,000, which, under the proposed capital-gain tax rate of 25 percent would call for a tax of $612,500. Thus, the snowball rolls on. An additional part of the business must be sold to pay the capital-gains tax, and that very transaction results in a further tax so that more of the business has to be sold. And so the sales go on, each one required to raise money to pay the tax on the preceding sale until the apex of the pyramid is reached. If confiscation was the objective, it should not be necessary to devise such machinery. Why not just an estate tax of 100 per cent?

Naturally, the estates which would have been hardest hit by this proposal were those which consisted primarily of going businesses starting small and grown to moderate size. Thus, this would have been another blow to incentive. The large estate invested solely in Government bonds would suffer very little. This hardly seemed like a tax proposal designed to win the war. Rather, it was one certain to wreck the production efforts of those businesses whose owners might be so unfortunate as to die after the enactment of this proposal.

As to those engaged in the administration of estates of persons who have died prior to the enactment of this proposal, the administrative difficulties would have been serious. How would it have been possible to find the decedent's cost in estates where the decedent died 20 years ago? Usually the decedent's records, if any, would have been destroyed long ago. How would the Treasury Department have determined the cost basis when the decedent had died and his records were long since lost or destroyed? Obviously, the administrative difficulties were insurmountable. This alone was sufficient to negative this proposal.

Under present law the basis for computing gain on an asset acquired from a decedent is the asset's market value at date of death. It was proposed to change this basis to the original cost to the decedent. This proposal was quite properly rejected.

However, certain technical amendments in connection with this cost basis are entirely in order.

We recommend an appropriate amendment to section 113 (a) (5) of the code, which will definitely establish as the basis, for income-tax purposes, of property transmitted at death the valuation of such property which was used in the computation of the Federal estate tax.

There is a serious lack of correlation between the estate tax and the income tax at this point under the existing law. While the valuation of property used for estate tax purposes is prima facie evidence of its value at the date of death, it may be challenged by either the Commissioner or the heir, devisee, or legatee, in a subsequent income tax proceeding. This fact creates an incentive to change of position and litigation which should be removed. Section 3801 of the code does not operate to discourage such inconsistency since it does not apply where the estate tax is involved in one year and the income tax in the other.

Moreover, code section 811 (j) allows the executor or administrator to elect between valuation at the date of death or 1 year thereafter for estate-tax purposes, with a proviso that, if value at the later date is elected, then as to assets in the gross estate distributed or sold during the year, value at the date of distribution or the sale price shall be used. Yet section 113 (a) (5) of the code has never been amended so as to correlate with section 811 (j). It continues to define, as the basis of property transmitted at death, its value at the date of death. The result, in cases where the benefits of section 811 (j) are elected, is that the income-tax basis will usually, as a matter of law, be higher than the valuation used in computing the value of the taxable estate. This unfair discrimination should be corrected.

The proper remedy is to amend section 113 (a) (5) of the code to provide that the basis of property transmitted at death shall be the value at which it was included in the gross estate of the decedent (under section 811 of the code), in the determination of the estate tax. Where the property formed a part of an estate too small to require the filing of an estate-tax return, the income-tax basis will continue to be its value at the date of death.

2. LIFE INSURANCE

Section 404 of the bill eliminates the life-insurance exception of $40,000 in the case of insurance payable to named beneficiaries and section 413 establishes a $60,000 exemption on all property including such insurance. This reversal of a wise and long-standing legislative policy relating to the specific insurance exemption will disrupt many individual estate plans.

Certainly some means should be provided whereby the shock of the estate tax upon noncash assets may be lessened and the Government assured of prompt payment. Heretofore, this insurance exemption provided this source of payment in the small and moderate estate. The exemption should be retained and additional tax-free funds should be provided.

Two methods are suggested: (1) "Self-insurance," under which a liquid trust fund is specifically set up for estate-tax purposes; and (2) use of "purchased insurance" under a plan whereby there will be exempt from estate tax the proceeds of life insurance definitely earmarked for payment of death duties.

Self-insurance.—The self-insurance plan involves setting up a trust specifically for estate-tax purposes. If deemed desirable, the statute might limit the types of assets which could be placed or kept in such a trust, such as, for example, Government bonds, securities listed on the New York or other recognized exchanges, and the like. It is suggested, however, that no such special limitations be imposed, in order to avoid discrimination between investments, since the trust instrument would ordinarily contain provision as to liquidity.

In the interests of simplicity and prevention of possible income tax avoidance, such trusts should be permitted to be revocable, except that, after the settlor's death, the assets would be specifically earmarked for estate-tax payment and no further distributions could be made until such tax liabilities were liquidated. The trust instrument could provide for the disposition of earnings prior to the settlor's death, either by way of accumulation or distribution to him. In either event, the trust income would be taxable to the settlor. The instrument might also require as a guaranty of liquidity that the trust be liquidated within a relatively short time after the due date of the estate tax.

Whatever portion of the trust assets is required to pay estate taxes should be made exempt from such taxes, and any excess should be subject to tax. There should be no tax on the privilege of creating such trusts.

The principle of not taxing such portion of the estate as is required to pay the tax accords with the result now reached under the gift tax, where the tax is paid by the donor out of the estate remaining to him after a gift. The tax so paid is not taxed as a part of the gift and operates to reduce the estate passing at death and subject to estate tax.

Purchased insurance.—Past proposals in the field of purchased insurance have usually taken the form of exempting from estate tax the proceeds of life insurance, definitely earmarked in some way for the purpose, to the extent such proceeds are required to pay estate-tax liabilities, with any excess added to the corpus and subject to tax.

The great advantage of this plan is its simplicity. On the other hand, a limitation of relief to this plan alone may be deemed objectionable because it may discriminate between taxpayers, since all taxpayers are not insurable. For these reasons it is believed that some form of both plans should be recognized by the statute, leaving the taxpayer to select the form best adapted to his own circumstances.

Life insurance tax clarification.—Section 404 also purports to tax the proceeds of insurance if the decedent has either paid the policy premiums or at death has possessed incidents of ownership in the policy. Elaborate rules are set up which are difficult to apply and understand. The tests of taxability are in the alternative and seem to be irreconcilable.

It would seem apparent to the casual observer that the payment of premium theory and the incidents of ownership theory are entirely inconsistent. If one pays premiums on policies which he does not own, it would appear that a gift would be involved rather than an estate tax problem. On the other hand, it is not difficult to base an estate tax on insurance policies actually owned by the decedent. If someone else paid the premiums on the insurance owned by the decedent such a payment must have been in the nature of a gift to the decedent and there is certainly no reason why property received by the decedent prior to death should not be taxable at his death if he still owns the property at the time of his death.

Few will object to legislation making certain just what insurance is taxable at death. However, it is submitted that the statute should not enact two alternative and inconsistent bases of tax. It would seem that the ownership test would avoid many difficulties and be entirely fair to both the Government and the taxpayer.

3. AMORTIZATION OF BOND PREMIUMS

The amortization proposal contained in section 120 of the bill is dealt with here primarily because of its effect on trust administration. No one is more familiar with the meaning of amortization of bond premiums than are trust administrators. This is because the rule of trust law in many States is that bonds purchased at a premium must be amortized, unless the trust instrument provides otherwise, in order that the principal of the trust fund will remain intact.

The difficulties of administration, and oftentimes injustice to beneficiaries, caused by this rule have led most attorneys and trustees to recommend the drafting of trust instruments in such a manner as to prohibit the amortization of premiums.

This section now proposes to require amortization for tax purposes in certain cases. Thus, a good part of the progress made by attorneys and trust administrators would be set back by this proposal. Beneficiaries under trust instruments which prohibit amortization would be penalized, and, as most of these instruments cannot be changed, the resulting inequity will continue for years.

There are at least two theories of amortization, the so-called "straight line" method and a theory requiring the use of complicated bond-yield tables which are beyond the comprehension of anyone but a trained mathematician. Straight-line amortization is a purely arbitrary method of returning to the principal account, in equal annual installments over the life of the bond, the exact amount of the original premium paid. The resultant yield to the investor bears no relationship to the yield figure universally used by investment houses in offering securities. A simple example is as follows:

A $1,000, 10-year, 4-percent bond cost 120, or $1,200. Straight-line amortization at $20 per year leaves $20 per year as income, or a current yield based upon original cost of 1.666 percent.

On the other hand, a broker would state the yield on this bond as 1.80 percent.

The principal objection to this proposal is its impracticability. The general public is not particularly impressed with the simplicity of the present income tax law. Under the Treasury proposal one can readily imagine the difficulty of a widow who purchases a few municipal bonds. The average person has never heard of amortization, and, if he has, he tends to think of it in terms of newspaper reports regarding defense facilities. The complicated records made necessary by this proposal will narrow the market for municipal securities, exasperate the taxpayer, and cause endless auditing difficulties for the Government.

As an example of the seriousness of this section attention is directed to subsection (b), (1), which requires amortization to the call date of a bond. If all redeemable bonds were Government or municipal obligations, this provision requiring amortization for tax purposes to the first call date might be workable and fairly simple of interpretation. Such bonds are invariably redeemable at par and are priced in the market to produce a yield comparable to that of municipal bonds of like quality or other Government obligations maturing at around their earliest redemption date.

But corporation bonds (because they are redeemable usually at premiums and because the terms of redemption have no semblance of uniformity) present many complications and many cases where such a law will work a hardship. The extent to which this would be true is indicated by an examination of the list of callable corporation bonds from which one large trust institution is presently selecting its bond investments. Of the 71 bonds on the list, 25 are quoted at or below their current redemption prices, but 46, or close to two-thirds, are quoted above their redemption prices, all of which are above par.

For example, Mississippi River Power first mortgage 5's, due January 1, 1951, are actively traded on the New York Curb, a recent sale having been made at 112⅛. The bonds are redeemable on 60 days' notice on any interest date at 105. The purchaser at today's market would be compelled to amortize 7⅛ points, or almost a year and a half's interest, in the intervening 5 months prior to January 1, 1943. How would he proceed from that point?

Connecticut Light & Power first and refunding 7's, due May 1, 1956, issued in 1921, when interest rates were high and bond features had to be made attractive to bond buyers, are redeemable at 105 but only for sinking fund. Does a purchaser at the present market of 123 amortize to the next sinking-fund date in November 1942 the 18-point premium over call price, and, if so, and his bond is not redeemed, does he in each subsequent year when the sinking-fund redemption price drops one-half point amortize by that amount?

Or consider the case of the purchaser of Lexington Railway first mortgage 5's, due June 1, 1949, at a recent bid price of 112. This bond is redeemable only for sinking fund and at 110, but the accelerating size of the sinking fund will redeem all of the bonds in not over two and a half years. These bonds will be paid through call at 110 so that all except 2 points of the premium paid will be returned to the purchaser. If the bill forces him to continue amortization after the premium over 110 has been deducted he will have a cost for taxation less than the amount at which the bond will inevitably be redeemed. Much more common examples than the last (and their number is legion) are:

1. Philadelphia Electric Power first and refunding 5½'s, due February 1, 1972, currently quoted at 118¾, a bond that is actively traded on the exchange. To February 1, 1951, this bond is redeemable on 30 days' notice on any interest at 105½; thereafter to 1961 at 105; and thereafter each successive year to August 1, 1970, at ½ point less than the year previous. From that date it is redeemable at 100.

2. Armour & Co., first 4's due August 1, 1955, actively traded on the New York Stock Exchange and quoted at 106, are callable on 60 days' notice as a whole at 105, or for sinking fund on interest dates on 30 days notice at 102½. To which redemption price does the purchaser amortize?

3. Commonwealth Edison convertible debentures 3½'s, due July 1, 1958, is quoted at 110 and callable any time at 102¾ on 30 days' notice. Does the purchaser amortize the premium over call of 7¼ points within 30 days after purchase and do likewise in the case of innumerable other bonds selling above call which are also redeemable any time on 30 days' notice? Suppose the purchaser of a Commonwealth Edison 3½'s immediately writes his cost down to 103¾, and on account of the conversion feature within a reasonable time the bond duplicates the price of 131 at which it sold in 1940. If he sells at that price must he pay a tax on his theoretical profit of 28¼ points or on his actual profit of 21 points?

Again there is the question of the treatment of bonds with a delayed redemption price which is above par.

Canadian National Railways 5's, due February 1, 1970, quoted at 111½, are noncallable to 1950 when they may be redeemed at 105. On that date what treatment is applied to the amortization of the remaining 5 point premium?

These examples are typical, not isolated cases. A survey of bonds callable above par indicates there are over 500 such issues which are actively traded.

4. NONRESIDENT ALIENS

Section 412 grants an estate-tax exemption of $2,000 in the case of nonresident aliens. This is highly desirable. However, we have a further recommendation which is not contained in the bill.

Under the existing law, nonresident aliens are subject to estate and gift taxes only with respect to property, situated within the United States. However, the Internal Revenue Code provides in respect of both taxes (sec. 862 (a); sec. 1030 (b)) that stock of a domestic corporation shall be considered property situated within the United States, no matter where the stock certificates are physically located. In accordance with this theory, it is suggested that the statute should specifically enact the rule stated in the present regulations (Regs 80, at 50, and Regs. 79, art. 18) that stock of a foreign corporation shall be deemed to be property without the United States, regardless of the physical location of the certificates.

No similar inconsistency exists in the case of bonds, which are usually taxed in the place where the bonds are physically located.

We recommend that stock, bonds, and other securities of foreign corporations owned by nonresident aliens be specifically exempted from estate and gift taxes.

This recommendation is based solely upon practical considerations. There are many good reasons for encouraging nonresident aliens to keep their securities, whether foreign or domestic, in American custodian accounts. Employment and income are provided to numerous persons handling such accounts. The presence of these accounts facilitates the collection of other taxes due from the owners thereof. The transactions consummated by the custodians in American markets yield revenue in the form of stamp taxes and otherwise.

The existing law defeats its own purpose, viz, maximum revenue, by creating a tax incentive to foreigners to keep their foreign securities outside the United States, thereby defeating the policy of the changes in the income-tax law made in 1936 (code, sec. 231 (a)) which exempted nonresident aliens from tax on their capital gains realized by transfers on American securities exchanges. Also, since most persons prefer to keep all their securities in a single account, the result is that many accounts of such aliens are kept in Canada or elsewhere, which might otherwise be maintained in the United States. For these reasons, it is confidently believed that the adoption of the foregoing recommendation would, in the net, benefit the revenue. Also, it is believed that the estate and gift tax revenue derived from such nonresident alien securities is so small as to be negligible.

For these reasons, we recommend that paragraph (b) of section 863 of the Internal Revenue Code be amended by changing the period at the end thereof to a semicolon and adding the word "and," and that a new subsection be added reading as follows:

"(c) FOREIGN SECURITIES.—Stock in, and securities of, a foreign corporation or a foreign government or political subdivision thereof, owned and held by a nonresident not a citizen of the United States, without regard to the physical location of the certificates or other physical evidences representing such stock or securities at the time of the decedent's death."

The adoption of this recommendation should be accompanied by the addition to section 1030 of the Internal Revenue Code of a new subsection (c) with a text identical with that of the foregoing proposed section 863 (c).

5. GIFT TAX EXCLUSION

Section 454 limits the annual gift tax exclusion to $3,000 for each donee. It is a well-known fact that many individuals with dependents have enlisted in the Army and Navy with the understanding that their parents will take adequate care of such dependents. This amendment will in many cases intensify such a continued responsibility. A father with sons in the armed services will find it more difficult to care for his sons' wives and children for in each case the amount to any one person cannot, without tax penalty, exceed $3,000 per year.

It may be pointed out that in addition to the reduced exclusion there is the general gift-tax exemption. However, in cases where liberal exclusions will be most needed the general exemption will have been exhausted in prior years. The imposition of increased income taxes along with the existing gift taxes makes the continued care of such dependents a heavier burden for persons of moderate capital savings.

It must be remembered that the gift-tax exclusion represents the only means by which, without adding to his tax burden, one can care for persons to whom the donor owes a moral duty to support and maintain. Over-age servants, indigent relatives, widowed daughter-in-law, education of grandchildren, all must come within the gift-tax exclusion or the ability to provide for their sustenance may cease. On every dollar of gift over the exclusion, the donor must pay a gift tax, and, if the gift is made from income, its full amount is subject to income tax where received by the donor. Thus in a wartime-support situation the donor has, first, the added financial burden; second, an added income-tax burden on the income received, and, third, a gift-tax burden for all gifts above the amount of the exclusion.

One method of correcting the situation would be to exclude from gift tax all sums expended for the support, maintenance and education of persons to whom the donor owes any moral obligation. This, however, would result in so many administrative difficulties that it is impracticable. Moral obligations are difficult to test objectively and if a subjective test were applied the door to avoidance and evasion would be opened. Hence the only logical solution is a liberal gift tax exclusion. The existing $4,000 exclusion should be increased rather than decreased.

6. EXTENSION OF PRESENT EXEMPTION TO GIFTS IN TRUST

The present law's exclusion of $4,000 or the bill's exclusion of $3,000 should be intended to gifts in trust. Prior to the Revenue Act of 1938, gifts in trust enjoyed the benefits of the annual exclusion of $5,000 to the same extent as gifts made in other ways. The only exception was gifts of future interest, whether by trust or otherwise. Section 505 of the Revenue Act of that year reduced the annual exclusion of $4,000 for gift-tax years beginning on or after January 1, 1939, and denied its benefits altogether to gifts in trust.

The effect of the 1938 amendment will appear from a simple illustration. A man has two children, one of them a minor, 12 years of age, and the other an adult. He made a gift of $14,000 outright to the adult child in 1940. Of this amount, only $10,000 is subject to tax. Desiring to treat his children equally, but knowing his other child is a minor and without legal capacity to manage his own affairs, he sets aside $14,000 irrevocably in trust for the benefit of such child. The entire amount of gift is subject to tax, even if the trust provides that the income from the trust be distributed currently to the child or applied for his benefit. As a practical matter, however, it is difficult to make such gifts to minor children outright. Hence, such trusts, other than those established to provide for maintenance and support, commonly provide that the income be accumulated for the child until he reaches his majority.

This discrimination was thought to be justified on the ground that it was a practical measure to protect the revenue by minimizing the abuses growing out of such decisions as *Wells* v. *Commissioner* (88 F. (2nd) 339 (1937)), where it was held that the trust entity was the donee in the case of a gift in trust. This decision severely restricted the scope of the exception of future interests from the annual exclusion and encouraged the creation of multiple trusts for the same beneficiary in order to obtain a $4,000 exclusion for each trust.

This reason for the 1938 amendment has vanished by reason of the recent decision of the Supreme Court in *Helvering* v. *Hutchings* (March 3, 1941, 61 S. Ct. 653), which held that the donee of a gift in trust is not the trust entity but the beneficiary, thereby overruling the Wells case in principle. On the same day the Court ruled in *United States* v. *Pelzer* (61 S. Ct. 359) that, where a trust provides for accumulation of income during the minority of a beneficiary and the beneficiary's right to receive the accumulated income and corpus is contingent upon his surviving until he reaches his majority or other specific age, the interest given to the minor is a future interest and the annual exclusion does not apply. This decision is squarely contrary to the *Wells case*.

The reason justifying the exception of future interest, that is, the uncertainty as to the identity and the number of the donees of the remainder interests, does not apply to a case in which there is a present gift of the entire interest, with only the actual enjoyment of the income postponed during the minority of the beneficiary.

In order to correct these unwarranted inequalities, appropriate amendments to section 1003 (b) of the Internal Revenue Code should be adopted.

The CHAIRMAN. Mr. Shorb.

STATEMENT OF PAUL E. SHORB, WASHINGTON, D. C., COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. SHORB. Mr. Chairman and gentlemen of the committee, my name is Paul E. Shorb, an attorney, of Washington, D. C. I appear as a member of the committee on Federal finance of the Chamber of Commerce of the United States and will speak on certain provisions relating mainly to individual income taxes.

Although I have a prepared memorandum, in my remarks, I shall attempt to summarize the points thereof which we thing require further consideration in connection with the pending revenue act, but I should like my prepared statement and the appendix thereto, to appear in the record.

The CHAIRMAN. Yes; that will be done.

1. EXTENSION OF PERIOD DURING WHICH INCOME FROM DISCHARGE OF INDEBTEDNESS EXCLUDED

Mr. SHORB. This proposed extension to December 31, 1945, is in section 112 of H. R. 7378. We are in accord with the change and urge that your committee make further changes in the provision, namely:

(*a*) That there be eliminated from the present provisions of section 22 (b) (9), Internal Revenue Code, which deals with this subject, the requirement that the taxpayer establish to the satisfaction of the Commissioner or by any Federal agency authorized to make loans on behalf of the United States, that it was in an "unsound financial condition."

This requirement has made it difficult for taxpayers to use this provision. The requirement of a certificate of "unsound financial condition" should be eliminated. This has been discussed with the Treasury and joint committee staffs and we are hopeful that they will so recommend to your committee. As to the need of this change, we are entirely in accord with the statement made by Judge Fletcher before your committee on August 5, 1942, hearings, Revenue Act of 1942, pages 760–765.

(*b*) In addition to the above change there should be eliminated from section 22 (b) (9), Internal Revenue Code, the date of June 1, 1939 now appearing, and substitute therefor a recent date, such as August 1, 1942.

This is necessary to permit corporations which have recapitalized in receivership and bankruptcy proceedings since June 1, 1939, and down to the present time, to retire under this provision indebtedness issued since June 1, 1939. This code provision also is applicable to solvent corporations. Few of them have changed their capital structure since June 1, 1939, whereas many corporations in receivership and bankruptcy proceedings have been required since that date to make such change. The further amendment to this section which we here propose will make the provision applicable to this latter group of corporations which have adjusted their capital structure since June 1, 1939, especially those which acted with the approval of the courts or appropriate Federal commissions.

2. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS

Section 114, H. R. 7378, deals with this subject, and we recommend that this provision be retained in the bill. The Ways and Means Committee report on this, page 71, does not specifically state that this amendment is applicable to years prior to 1939, if they are still open by refund claim, Board appeal, Court suit, or otherwise. We think this is the intent of (c), but we think statement to this effect in your committee report would be clarifying and helpful and remove any doubt.

Further, we recommend a 7-year period of limitations for taxpayers under this section. This is needed to give adequate relief for back years under the provision. Our recommendation is in accord with a similar one we are making with respect to other technical and relief amendments made by H. R. 7378, such as refund claims to be filed under section 150 thereof.

3. NONTRADE OR NONBUSINESS DEDUCTIONS

Section 118 (a) of the revenue bill as passed by the House goes far to correct an inequitable and unjust situation which resulted primarily from the decision of the Supreme Court in the case of *Higgins* v. *Commissioner* (312 U. S. 212). The amendment to section 23 (a) provided by this section of the House bill allows as a deduction in computing net income:

In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.

This amendment, if enacted into law, will relieve hardships inflicted upon a large number of taxpayers.

Since, however, Congress is endeavoring to make it clear that all expenses paid or incurred in the production or collection of income or the management, conservation, or maintenance of property held by an individual taxpayer for the production of income are deductible so that the income tax will be levied only on true net income and not gross income, we desire to call your attention to certain specific items of expense which it is believed the bill or your committee report should clearly show to be deductible.

Such items are attorneys' fees, accountants' fees, or other costs incurred in the preparation of income-tax returns, in the defense of income-tax deficiencies, or in the recovery of taxes overpaid. While such fees would seem clearly to be incurred or paid for the purpose of conserving a taxpayer's property and thus would be covered by the language of section 118 (a) of the House bill, the possibility exists that the word "conservation" might be so narrowly construed as to prevent deductions of this type.

We therefore urge that either:

(*a*) The language of the bill be amended so as to make it clear that fees of this nature are deductible under this section, or

(*b*) That the Senate Finance Committee report contain language stating that it is the committee's understanding that fees of this kind are deductibleg expenses under section 23 (a) (2), which subdivision is added by section 118 (a) of the House bill.

Subdivision (a) (2), which section 118 (a) of the House bill proposes shall be added to section 23 of the code, by its terms applies only in the case of an individual. No doubt this is due to the fact that the decision of the Supreme Court in the case of *Higgins* v. *Commissioner* (312 U. S. 212), involved the case of an individual. It would seem that no question should arise in the case of corporations as to the deductibility of all expenses incurred by them. Nevertheless we understand that recently some revenue agents have been taking the position that the principle of the *Higgins* v. *Commissioner case* is also applicable to certain types of corporate expenditures, as for example attorney's fees and expenses incurred in connection with antitrust suits and similar litigation. Such expenses obviously grow out of the conduct of a corporate taxpayer's business and should be allowed as deductions. Certainly expenses of that type are incurred in the management, conservation, or maintenance of property held for the production of income and the same treatment should be accorded corporations with respect to this type of deduction as will be accorded individuals under the proposed amendment.

We recommend and urge that section 23 (a) (2) set forth in section 118 (a) of the House bill be amended to cover corporations as well as individuals.

In eliminating an amendment relative to this type of deduction in the revenue bill of 1941 the conference report (H. Rept. 1203, 77th Cong. 1st sess., p. 12) in reference to amendment No. 41 states that the conferees—

> were advised by the Treasury Department that wherever possible final decision by the Bureau of Internal Revenue on issues arising under the *Higgins* v. *Smith* decision would be deferred pending such later legislation. (This citation undoubtedly should be *Higgins* v. *Commissioner*, 312 U. S. 212.)

Section 118 (f) of the House bill indicates that the amendments proposed by that section are applicable to years prior to 1939 which are still open by refund claim, board appeal, court suit, or otherwise. This seems to be the intent of subdivision (f) but we think statement to this effect in your committee report would be clarifying and helpful and remove any doubt. We also urge that this provision be made retroactive under a 7-year period of limitation as is suggested by our committee elsewhere in its report with respect to other technical and administrative amendments, i. e., refunds permitted by section 150, H. R. 7378.

4. WORTHLESS CORPORATE OBLIGATIONS AND STOCKS SHOULD BE TREATED AS ORDINARY AND NOT AS CAPITAL LOSSES

Section 119 of the House bill properly liberalizes the statutory requirements relative to the deduction of bad debts in that it amends section 22 (k) of the code to allow a deduction for a debt which becomes worthless during the taxable year regardless of the year in which the debt is ascertained to be worthless or charged off. Furthermore, section 150 (a) of the House bill removes substantial inequities by proposing the addition of a paragraph (5) to section 322 (b) providing a 7-year statute of limitations for filing claims for refund in connection with bad debts and worthless securities. We favor these amendments and recommend that they be enacted into law.

However, we urge that your committee give favorable recommendation to further amendments which will remove the limitation now imposed by sections 23 (g) (2) and (3) and sections 23 (k) (2) and (3) of the code whereby worthless stocks and worthless corporate obligations are treated as capital losses.

Prior to the Revenue Act of 1938 a long series of revenue acts had treated losses sustained on account of stocks becoming worthless as ordinary losses deductible in full in the proper year (sec. 23 (3) (2) of the Revenue Act of 1936 and corresponding provisions of prior acts). Likewise, corporate obligations were treated as bad debts and if ascertained to be worthless and charged off within the taxable year, were deductible in full to the extent of their bases. They were also subject to the deduction allowed in the case of debts on account of partial worthlessness (sec. 23 (k) of the Revenue Act of 1936 and corresponding provisions of prior acts).

Congress deviated sharply from this policy by a series of amendments in the Revenue Act of 1938 (now found in sec. 23 (g) (2) and

(3) of the code, and section 23 (k) (2) and (3). The deduction allowed on account of partially worthless debts was made wholly inapplicable to these corporate obligations, which include bonds, debentures, notes or certificates, or other evidences, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form.

The net effect of the 1938 amendments was to include these losses in the category of capital losses, subject to the limitations imposed by section 117. The losses are to be treated as though realized by sale or exchange of capital assets on the last day of the taxable year during which the stock became worthless, or the obligation was ascertained to be worthless and charged off. If the loss so considered is a long-term capital loss, as most losses of this type are, only a portion of it is taken into account under section 117 (b) and such portion only can be offset against ordinary income, subject to the further limitations of section 117 (c) (2), the so-called ceiling provision.

If it falls into the category of short-term capital losses, it can be applied only to offset short-term capital gains of the taxable year under section 117 (d) and, to the extent of any short-term capital net loss not in excess of the net income for such year, it can be used, under the 1-year carry-over provision of section 117 (e) to offset short-term capital gains of the succeeding taxable year. The provisions of section 136 of the House bill relative to capital gains and losses are substantially as restrictive and do not remove the need for the elimination of section 23 (g) (2) and (3) and section 23 (k) (2) and (3).

We recommend that these amendments of 1938 be repealed retroactively and that the statute be restored to its form prior to the 1938 act, effective to years beginning after December 31, 1937, so as to cover the year 1938 (to which the 1938 Revenue Act amendments were applicable) and subsequent years.

Adverse effect on new enterprise capital.—We believe that the reasons which were assigned to justify the restrictions on the deduction of capital losses from ordinary income in the Revenue Act of 1938 and succeeding acts do not apply to worthless stock and bad debt losses because of their involuntary character. Our recommendation, however, is based both upon the proper concept of a capital loss, and upon considerations of sound legislative policy. We feel that provisions in the tax laws which unnecessarily clog the free flow of capital into new enterprise are against the public interest. We think it is plain that such is the tendency of these amendments and that the harm they may do far outweighs the insignificant amount of revenue involved, which should not be controlling in any event.

When equity capital or borrowed capital is sought in order to finance new enterprise, prospective investors are keenly aware of the inevitable hazard of partial or total loss of their investment should the enterprise prove to be a failure or only partially successful. They also know that if the venture proves to be very successful, they will be required to pay over a large portion of their gains and profits to the Government in taxes. Any arbitrary limitations on the deduction of investors' losses due to their capital investment in such enterprises becoming worthless, by increasing the hazard makes it just that much harder to finance new enterprise. It is our conviction that such limitations therefore defeat their own purpose in the end and clog the sources of the very revenues it is their professed purpose to protect.

5. FURTHER REVISIONS NEEDED IN SECTION 124, INTERNAL REVENUE CODE RELATING TO AMORTIZATION

We recommend that a number of amendments be made to section 124 of the Internal Revenue Code providing for the amortization of the cost of facilities constructed or acquired to meet the requirements of the Nation's wartime program. These amendments, most of them technical, are necessary to give effect to the original purpose of section 124 to facilitate the carrying out of the defense and wartime program by encouraging private capital to finance, so far as possible, the great expansion of plant machinery and other facilities which its successful execution requires.

Although there has been a considerable expansion of war facilities through private financing, the original purpose of section 124, because of its technical restrictions and requirements, has not been fully realized, and the result has been a tremendous additional draft on Government funds for financing facilities. The repeal on February 6, 1942, of section 123 (i) H. J. Res. 257, Public Law No. 436, 77th Cong., 2d sess.), which proved practically impossible of administration, cured the principal defect in the statute, but there are several other revisions in section 124 which should be made in the present revenue bill.

A. *Extension of deduction for amortization to persons other than corporations.*—The provision in section 140 of the revenue bill of 1942 to extend the deduction for amortization of emergency facilities to individuals and corporations should be adopted. Noncorporate enterprises have been increasingly drawn into the war-production program and they should be entitled, like corporations, to amortize the cost of emergency facilities acquired to meet the requirements of the Nation's war program.

B. *Revision of the June 10, 1940, base date.*—The revenue bill of 1942 as passed by the House of Representatives provides in section 140 that the base date of June 10, 1940, shall be moved back to December 31, 1939. As the Senate Finance Committee knows, this amendment adopts the base date which was originally decided upon by this committee in its consideration of the Revenue Act of 1940, but which was changed to June 10, 1940, before enactment into law.

The final adoption of the arbitrary June 10, 1940, date produced very unfair results because many companies, anticipating the tremendous needs of the Nation's defense program, and encouraged by the Government itself, went ahead with the expansion of necessary facilities well in advance of June 10, 1940. In fact, a considerable expansion of facilities of inestimable value in the war effort today was undertaken in the latter part of 1939, and the inequity of the arbitrary June 10, 1940, base date which excluded these taxpayers from the benefits of amortization is obvious. As a matter of fact, selecting an arbitrary date such as December 31, 1939, would work a real hardship in many cases, and it is recommended that the provision in the House bill be adopted with a further proviso that—

When the Secretary of War or the Secretary of the Navy is satisfied that an expansion begun prior to December 31, 1939, and subsequent to September 8, 1939, was made directly to aid the national-defense effort, as evidenced by contracts or request from proper officials of the War and Navy Departments, certification of facilities may be made regardless of the limitation date of December 31, 1939.

This addition, it is submitted, would effectuate the basic purpose of section 124 to permit taxpayers to write off the cost of emergency facilities over the emergency period. Certainly, taxpayers who were sufficiently foresighted to initiate vital and needed expansion programs should not be at a disadvantage as compared to those who did not undertake expansions to further the war effort until a much later period.

C. *Uncompleted facilities.*—There is no express provision in section 124 as it stands with respect to the status of emergency facilities which have not been completed at the end of the emergency period.

Many expansions which have been undertaken for war purposes and have been properly certified by the War or Navy Departments, or with respect to which necessity certificate applications are pending, will take time to complete. If the war ends, and the "emergency period" as defined in the statute, terminates before these facilities are completed, the contractors will be in a difficult position. The law does not permit amortization to be taken until the facilities are completed. A contractor which has begun the construction or acquisition of facilities and has a necessity certificate application pending at the termination of the emergency period is faced with two difficulties:

(1) the certifying agency may have doubt in such a situation whether a necessity certificate should issue and,

(2) even if certification of the facilities is made after the termination of the emergency period, the contractor cannot begin amortization unless the facilities are completed.

The latter difficulty is faced by every contractor to whom a necessity certificate has been issued and the facilities are not completed upon the termination of the emergency period.

Also, quite apart from the amortization provision, a loss might be claimed from abandonment or obsolescence of partly completed work. However, such a deduction is apt to fall in a year of post-war loss, when the taxpayer will obtain no benefit. The most equitable result is to allow the cost of the uncompleted facilities to be spread back over the period of construction. An amendment should be adopted to permit this to be done.

One method of accomplishing it would be to give the taxpayer an option to start the amortization period with the first month in which the expenditures are incurred with respect to the facilities. Depreciation of facilities is permitted on this basis, and there is no reason why it should not also be permissible for purposes of amortization. As a matter of fact, section 124 (a) refers to the deduction for amortization as being in lieu of the deduction for depreciation provided in section 23 (1), and this general provision should be implemented by the option provision to make it certain that a taxpayer can, if he chooses, start the amortization period with the first month in which such facility expenditures are incurred.

To alleviate any doubts in the minds of the certifying agencies as to their authority under the statute to issue necessity certificates subsequent to the termination of the emergency period, a specific authorization should be included as an amendment to section 124.

D. *Depletable facilities.*—A large number of emergency facilities are of such a character that they are subject to depletion rather than depreciation. For example, high-cost mines have been opened for war purposes, particularly in the development of strategic and scarce minerals, which cannot be operated successfully in peacetime. The operators of these mines should have the opportunity to recover their cost over the period of the emergency, rather than through depletion. Section 124 (a), however, states that the deduction for amortization is in lieu of section 23 (l), which relates only to depreciation. The Treasury and the service departments theretofore take the position that expenditures subject to depletion under section 23 (m) cannot be amortized. A change in the law in this respect would be desirable.

If section 131 of the House bill amending section 114 (b) (4) is enacted into law as proposed, it may be decided, since this provision is aimed at relieving the inequitable situation faced by mine owners as a result of war requirements, that a taxpayer with depletable facilities must choose between the privilege of amortization under section 124 and the depletion allowance under section 114 (b) (4) as amended by H. R. 7378.

E. *Facilities under emergency plant facility contracts.*—It is now clear that the amortization deduction of many taxpayers having emergency plant facility contracts will commence earlier than their inclusion in gross income of payments received from the Government under such contracts. The reason for this lack of synchronization between deductions and payments is that the deduction is tied in, under section 124 (a), with the acquisition or installation of particular facilities, such as machinery, whereas payments under the contract may commence only when the whole plant is completed. This lack of synchronibzation will, of course, work hardship in cases where a taxpayer has insufficient income from other sources to offset the amortization deduction in one or more of the periods in which it must be taken. It will also result in an inequitable distortion of taxable income if reimbursements have to be included in income after all amortization deductions have been taken.

To avoid this unfair result, the Treasury has issued rulings to some contractors upon request that reimbursement payments may be synchronized with amortization deductions under various theories, such as that all the facilities under the contract constitute a "single facility," the amortization deduction beginning with the reimbursement payments upon the completion of the "single facility." However, without a general ruling by the Treasury or a change in the law, contractors without rulings in their individual cases have a very uncertain status.

The only reason for allowing the contractor under an emergency plant facility contract any deduction for amortization when the contract guarantees him direct reimbursement of the entire cost of the facilities, is to protect him from taxation upon the amounts so received by him, the Treasury having already indicated that such amounts constitute income. (T. D. 5016, Section 19.124–6.) The provisions of emergency plant facility contracts provide for reimbursement in 60 equal monthly installments, presumably so that they will coincide with the tax deductions. It has been pointed out, however, that this assumption of coincidence of deduction and payment will often fail to be realized.

Also, section 124 (h) has provided that, if such a contract is terminated in less than 5 years, and the Government is obligated to pay the unpaid balance in a lump sum, a deduction may be taken equal to such amount, in lieu of the deduction otherwise allowed.

We therefore recommend that section 124 be amended so as specifically to prove either—

(1) That amortization deductions are to be synchronized with reimbursement payments under the contract so as completely to offset such payments; or

(2) That no amortization of facilities under an emergency plant facility contract shall be allowed and that payments under such contracts, to the extent they do not exceed the cost of the facilities, shall be excluded from gross income.

The effect of this latter amendment is to treat such contracts for what they in substance are, i. e., sales on deferred payments.

This recommendation is intended to cover cases in which the emergency plant facility contract involves in substance a positive sale, with a noncancelable obligation of the Government to pay for the facility and of the contractor to deliver it. The mere existence of an option under which the contractor is entitled to repurchase the facility upon a basis prescribed in the contract should not operate, however, to make the recommendation inapplicable. In cases where the contract does not impose such absolute obligation, a different problem is, of course, presented, but even in such cases, the law and regulations should be flexible enough to permit coincidence between the period in which payments are received and the amortization deductions are required to be taken as recommended under (1) supra.

F. *Defense plant corporation leases.*—There has been considerable uncertainty in the thinking of not only taxpayers, but also the Treasury, War, and Navy Departments as to the status of facilities acquired under Defense Plant Corporation leases with respect to certification and amortization under section 124. Although these agreements with the Defense Plant Corporation are designated leases and under the usual form of Defense Plant Corporation lease the Government has title and the lessee is required to pay rentals, the fact that under the terms of a majority of these contracts the lessee has an option to purchase and the rentals paid are to be credited upon the purchase price upon the exercise of the option, has raised the question under prior court and Board decisions on somewhat analogous facts, whether the lessee has a depreciable or an amortizable interest. (See *Helser Machine & Marine Works, Inc.*, v. *Commissioner*, 38 B. T. A. 1220; *A. B. Watson* v. *Commissioner*, 24 B. T. A. 466, affirmed 62 F. (2d) 35 (C. C. A.–9).)

It is understood that some lessors having the benefit of the Treasury's views on this problem, have filed applications for certificates of necessity so as to entitle them to amortization if it is determined they have amortizable interests under the leases. Other taxpayers, assuming that the agreement is a lease as designated by the Defense Plant Corporation, have not filed necessity certificate applications.

Since the fact that the facilities are covered by a Defense Plant Corporation lease clearly establishes them as necessary within the meaning of section 124, a simple amendment to section 23 (a) providing that a lessee's payments under a Defense Plant Corporation lease may, at the option of the taxpayer be deducted as rentals would solve this troublesome problem.

G. *Extension of time for filing necessity certificate applications.*—Section 140 of the House bill amends section 124 (f) (3) to provide that a timely application may be filed within 3 months after the date of the enactment of the Revenue Act of 1942 in the case of an emergency facility completed or acquired by a corporation after December 31, 1939 and before June 11, 1940. We recommend that section 124 (f) (3) be further amended to make the period 6 months instead of 3 months and to make this extension of time applicable for filing applications for certificates of necessity with respect to facilities acquired by corporations on or after the new basic date without limiting its effect to the period prior to June 11, 1940.

Many corporations did not file such applications because of the uncertainty as to the meaning and requirements of section 124 and the confusion created by the continued existence until February 6, 1942 of section 124 (i). The regulations clarifying the meaning of and the procedure under section 124 were not approved by the President and promulgated by the War and Navy Departments until May 22, 1942, and on that date it was too late to file applications for necessity certificates with respect to any facilities the acquisition or construction of which began prior to November 22, 1941. Even on February 6, 1942, when section 124 (i) was repealed (H. J. Res. 257), no applications could be filed with respect to any facilities the construction or acquisition of which began prior to August 6, 1941. As a matter of simple fairness to all taxpayers, particularly the small companies without the advantage of counsel, a further extension of time should be granted to a date 6 months subsequent to the date of the enactment of the Revenue Act of 1942.

H. *Limitation on amortization allowance in section 124 (f) (3).*—The amendment to section 124 (f) (3) proposed by H. R. 7378 reverts to the same type of objectionable limitation on the allowance of amortization which was incorporated in section 124 as originally enacted and subsequently eliminated by H. J. Res. 80, enacted January 31, 1941. The proposal of H. R. 7378 is to make the right to amortization depend upon the dispatch with which the certifying agencies issue a certificate. Section 149 (e) (1) provides that the amortization allowance is contingent upon the issuance of a necessity certificate prior to 9 months after the date of enactment of the Revenue Act of 1942. The analogous provision originally in section 124 which was repealed by H. J. Res. 80 made the amortization allowance contingent upon the issuance of a certificate prior to February 6, 1941.

As the House report on H. J. Res. 80 (H. Rept. 11, 76th Cong., 3d sess.) pointed out, it is—

> unfair to a taxpayer to cause it to lose its certification because the certifying agencies are unable to perform adequately their duties within the time specified in the statute, a fact over which the taxpayer has no control.

If the time for filing applications is extended for a 6 months' period beyond the date of the enactment of the Revenue Act of 1942, it is a practical certainty based on the experience of the certifying agencies in the past, that there will be insufficient time to issue certificates in many cases in the 3 remaining months of the 9-month period now proposed by H. R. 7378. At the present time it often takes much longer than 3 months for the certifying agents to pass on an application and issue a necessity certificate.

We recommend, relying on the reasons given in House Report No. 11 for the enactment of H. J. Res. 80 which were also adopted by this committee that the 9-months' limitation be stricken from H. R. 7378 and that no such limitation be placed on certification over which the taxpayer has no control. This would also mean striking the similar limitation in provision (d) of the proposed amendment to section 124 (f) (3).

If for some reason it is thought that there must be a limitation period for certification, it should in no event be less than 12 months from the date of the enactment of the Revenue Act of 1942.

I. *Election requirement should be relaxed.*—Section 124 (b) frequently requires the taxpayer to make an election whether to take depreciation before the certificate of necessity has been issued. There is no good reason for such rigid election requirements in tax statutes and the House bill has recognized this principle in eliminating the election requirement of section 114 (b) relating to percentage depletion which resulted in such inequitable treatment of taxpayers, particularly small taxpayers. *J. E. Riley Investment Co.* v. *Commissioner*, 311 U. S. 55.

We therefore recommend that section 124 (b) be amended to allow the election to be made by notice in writing filed with the Commissioner of Internal Revenue at any time within 6 months after the issuance of a certificate with respect to the facilities included therein or 6 months after the date of enactment of the Revenue Act of 1942, whichever is the later.

J. *Overpayments.*—Section 140 (j) of H. R. 7378 providing for refunds or credits resulting from the proposed amendments to section 124 refers only to "tax paid under chapter 1" and makes no mention of taxes paid under chapter 2. This would exclude refunds or credits of excess profits taxes covered by chapter 2 of which there would be overpayments because of the amortization allowance under the amendments of section 124, for the period from December 31, 1939 to June 10, 1942. This presumably was an oversight in drafting section 140 (j) and the provision certainly should be amended to include taxes paid under chapter 2 as well as under chapter 1.

6. CLARIFICATION OF SECTION 23 (1) WITH RESPECT TO WAR FACILITIES NOT COVERED BY NECESSITY CERTIFICATES

A large amount of depreciable plant facilities, machinery and other equipment will be used in the war production program to which certificates of necessary will not be obtained and which will not, therefore, be subject to the amortization allowance provided by section 124 of the code. Much of this property will have been constructed or acquired prior to June 10, 1940, the present basic date, but under the proposed amendment would qualify for amortization to the extent constructed or acquired between December 31, 1939, and June 11, 1940.

In many cases allowable depreciation rates will have been established based upon the estimated useful life of such property under normal or peacetime conditions. Obviously, such rates will be wholly inadequate under wartime conditions.

Obviously, such rates will be wholly inadequate under wartime conditions. There are several reasons why this must be so. First, such estimates of useful life will ordinarily have been calculated upon the basis of normal uses, perhaps 8 hours a day or 40 to 48 hours a week. But certain facilities, particularly machinery, power plant and the like, will wear out much more rapidly when used on the basis of the double or treble shifts necessitated by the war production program.

Second, the great expansion of employee personnel has made it necessary to dilute production staffs with a large proportion of inexperienced employees. Wear and tear on machinery must inevitably be accelerated during the period such employees are being trained. Third, the pressing demand for maximum production will allow less time for proper maintenance, repair, and resting of machinery. This factor will tend to shorten its useful life. Fourth, obsolescence factors will be very important and must be accorded due weight. Much plant and machinery will have little or no utility for peacetime production after the war is over. Much other equipment will become useless because of technological improvements incident to the war production program.

The Board of Tax Appeals has given some weight to the so-called principle of accelerated depreciation in a number of cases (C. C. H. 1942, 219.02–37).

The Bureau of Internal Revenue has also recognized some of the foregoing factors are entitled to consideration (I. T. 3398, CB 1940–2 P. 396; T. D. 5000, CB 1940–2 P. 397, at p. 405, under Vinson Act, but principles seem clearly applicable to income tax).

Nevertheless, the matter is of such vital importance that we believe Congress should insert in the statute a directive that the special factors which war has introduced shall be given due weight in the determination of the useful life of depreciable assets and the fixing of depreciation rates. Such a directive will encourage administrative officials to accord to such special factors the full weight to which they may be entitled.

7. THE BASIS OF DEPRECIABLE ASSETS SHOULD NOT BE REDUCED ON ACCOUNT OF DEPRECIATION IN PRIOR YEARS NOT BENEFICIALLY ALLOWED

It is recommended that the law be appropriately amended so as to provide, beyond any question of doubt, that excessive depreciation not beneficially allowed—i. e., not used to offset taxable income in earlier years—shall not be applied to reduce the basis of depreciable property.

It is also urged that the policies applied in the determination of depreciation deductions should be liberalized so as to accord more nearly with business and accounting practices.

Clarification of the existing statute at this time is also needed by reason of doubt as to the proper interpretation of its terms. This doubt is causing litigation and hampering the expeditious settlement of cases before the Bureau of Internal Revenue.

Prior to the Revenue Act of 1932 the statute provided for adjustment of basis on account of depreciation by the amount of depreciation allowable. In the 1934 act section 113 (b) (1) (B) was amended to its present form, viz, to provide for adjustment of the basis to the extent of depreciation allowed but not less than the amount allowable.

The report of the Committee on Ways and Means on the 1934 act, page 22, explained that the Treasury frequently encountered cases where a taxpayer who had taken and had been allowed depreciation deductions at a certain rate consistently over a period of years, later claimed, often after the statute of limitations had run, that the allowances so made to him in prior years were excessive and that his basis should therefore be adjusted by an amount less than the total of the amounts so allowed, i. e., that the basis could be adjusted only for the lesser amounts which were allowable. The report then went on to say that the Treasury ought not to be penalized for having approved the taxpayer's deductions.

The report concluded by stating that, while the committee did not "regard the existing law as countenancing such inequitable results, it believes that the new bill should specifically preclude any such possibility."

Legal history.—The Bureau of Internal Revenue in 1935 made its first published ruling interpreting the effect of the 1934 amendment. (I. T. 2944 XIV-2 CB 50.) It was held that the statute, as amended, required the basis of depreciable assets to be adjusted to accord with the amount allowed or allowable, whichever is the greater, irrespective of any statute of limitations applicable to the year of deduction, and that the depreciation claimed in the return for a given year which has been accepted by the Bureau is the amount allowed for that year. Whether or not the deduction offset income otherwise taxable is immaterial under the principle upon which this ruling is based.

This interpretation of the statute was successfully challenged by a taxpayer in the case (*Pittsburgh Brewing Co.* v. *Commissioner*, 107 F. (2d) 155) decided by the Circuit Court of Appeals for the Third Circuit in 1939. A unanimous court there held that depreciation is not allowed within the meaning of section 112 (b) (1) (B) of the 1932 act, the text of which has not been modified in the subsequent acts nor in the code, unless it is actually taken as a deduction against taxable income.

To illustrate, under this interpretation of the statute, if a taxpayer had a net income of $5,000 for the taxable year before claiming $20,000 deduction on account of depreciation, the basis of its depreciable assets should be reduced by $5,000, not $20,000. In other words, "allowed" is interpreted, in effect, to mean "beneficially allowed."

The interpretation enunciated by this decision is sound and has since been applied in the following court and Board of Tax Appeals decisions: *Don Lee, Inc.*, v. *United States* (U. S. District Court Northern District of California), 42 Fed. Supp. 885; *Kennedy Laundry Co.*, 46 B. T. A. 70; *Virginian Hotel Corp. of Lunchburg*, B. T. A. Memorandum Decision of May 6, 1942 (Docket No. 105, 826 C. C. H. Dec. No. 12,522-d).

Nevertheless, these cases cannot be regarded as settling the law on this question, particularly since the Government did not seek review of the *Pittsburgh Brewing Co.* decision by the Supreme Court on certiorari. The published ruling of the Commissioner cited above has neither been modified nor revoked by any later published ruling, although it is possible that some effect is being given to the decision of the third circuit in the settlement of cases. In any event, the question involved is of great importance to such a large group of taxpayers that any doubt as to the statute's meaning should be promptly removed by a clarifying amendment.

It is apparent that the above decision is consistent with the underlying rationale of the depreciation deduction. Congress has recognized the indisputable fact that depreciation is a part of the cost of carrying on business and is a part of the cost of production of goods and services. To the extent that depreciation is denied upon assets worn out or consumed in production, in computing taxable income from such production the income tax is perverted in effect into a tax on capital. The reduction of the basis of depreciable assets on account of allowable depreciation which cannot be used to offset taxable income in loss years denies to taxpayers the recovery of their capital investment. To go still further and penalize a taxpayer by reducing the basis where in past years he has, with no resulting tax benefit, mistakenly claimed an amount of depreciation as a deduction which exceeds the amount legally allowable, cannot be defended on grounds of either equity or sound legislative policy.

For these reasons it is submitted your committee should clarify this situation by an amendment to section 133 (b) (1) (B) of the code to the effect that the adjustment of basis of depreciable assets cannot in any case exceed the amount of depreciation beneficially allowed as a deduction, i. e., used to offset taxable income in prior years. Such an amendment is in accord with the rationale of the aforementioned court and Board decisions and also with the policy of the House in the amendment to the code proposed by section 144, H. R. 7378, to the effect that where deductions for bad debts, prior taxes and delinquency amounts did not operate to reduce the income-tax liability of the taxpayer for any prior taxable year, the recovery of such amounts in a subsequent year would be excluded from gross income. (See H. Rept. No. 2333, 77th Cong., 2d sess., p. 69 et seq.)

8. INCOME FROM SOURCES WITHOUT THE UNITED STATES

Section 116 (a) of the Internal Revenue Code excludes under certain circumstances from gross income and from taxation under chapter 1 thereof earned income from sources without the United States. Section 134 of H. R. 7378 would eliminate this provision. The provision has been in the revenue acts for many years and is needed if foreign trade of the United States is to be properly supported and encouraged. Your committee has heard testimony on this from many other witnesses, and we will not now dwell upon the subject, but we do strongly support the continuance of the provisions of section 116 (a), Internal Revenue Code, in application to bona fide nonresident American citizens.

9. INCOME TAX CONSEQUENCES OF MORTGAGE FORECLOSURES SHOULD BE SPECIFICALLY DEFINED BY STATUTE

This is a very technical and complicated subject. We will not discuss it at length with your committee now, but ask your consideration of a memorandum attached to this presentation as an appendix.

Thank you.

The CHAIRMAN. Any questions?

(No questions.)

We thank you very much. The appendix will be inserted in the record.

(The appendix submitted by Mr. Shorb is as follows:)

APPENDIX

SUBMITTED BY PAUL E. SHORB, WASHINGTON, D. C.

INCOME TAX CONSEQUENCES OF MORTGAGE FORECLOSURES SHOULD BE SPECIFICALLY DEFINED BY STATUTE

Perhaps in respect of no other common situation is the income-tax law in a more bewildering state of confusion and uncertainty than in the field of mortgage foreclosures.

A simple illustration will suffice to show a few of the points at which doubt and uncertainty exist. Suppose that John Smith owns a farm in Kansas for which he paid $25,000. In a prior year he mortgaged his farm to secure a loan of $15,000. In the year 1940 Smith was in default with respect to both principal and 1 year's interest, and foreclosure proceedings were brought by the mortgagee. At the foreclosure sale in October of 1940, the mortgagee bid in the property for $16,200, which included the mortgage debt, $750 interest, $250 unpaid taxes, and $200 costs of the foreclosure suit. The mortgagee thereby got title to the property for the amount of his investment. The fair market value of the farm at the time of the sale was $14,000. It is assumed that under Kansas law, Smith may redeem the property within a period of 1 year from the date of the foreclosure sale.

The following tax questions, among others, immediately arise. First, as to the mortgagor:

(1) Does the mortgagor, John Smith, sustain a deductible loss when he loses his farm on foreclosure?

(2) If so, is it an "ordinary" loss deductible in full or is it a capital loss subject to the limitations imposed by section 117 of the code? Is the answer to this question affected by the presence or absence of personal liability of the mortgagor for the mortgage debt?

(3) In what year may he lawfully claim the deduction, the year of the foreclosure or the year in which the statutory period of redemption expires, or some other year?

(4) What difference, if any, would it make from the point of view of the tax consequences if Smith, in order to avert the expenses and delay of judicial foreclosure, conveyed the farm to the mortgagee in consideration of the latter's canceling the mortgage debt, including accrued interest?

(5) What would be the tax consequences if he abandoned the property?

On the side of the mortgagee, even more baffling questions arise:

(1) What is the tax effect of the mortgagee's bidding in the property on foreclosure at a price which includes the accrued interest?

(2) Is the answer to this question affected by the fact that the fair market value of the property on the foreclosure date is less than the principal of the debt?

(3) If the price at which the mortgagee bids in the property is less than the basis of the obligations of the debtor applied in satisfaction of the bid, can the excess of the basis over the bid price be taken as a bad-debt deduction and, if so, in what year?

(4) If the fair market value of the property on the date of foreclosure is in excess of or less than the basis of the obligations of the debtor applied by the mortgagee in satisfaction of his bid, does the mortgagee realize a recognized gain or loss to the extent of the difference? If so, is such gain or loss classified as an ordinary or as a capital gain or loss?

(5) What is the mortgagee's basis of the property acquired on foreclosures?

FEW QUESTIONS ANSWERED

Despite the fact that such transactions are common and of frequent occurrence, one looks in vain to the statute for a definite answer to all these questions. Administrators and courts have been compelled to grope for answers thereto with no legislative directions or signposts to guide them. However, the selection of the best rule from among two or more possible alternatives may depend upon considerations of policy which are peculiarly appropriate for legislative determination. Confusion and conflict in judicial decision are rife. Only a few of the above questions have recently been authoritatively determined by Supreme Court decisions. Each of these decisions has undesirable practical consequences which may require correction by legislative rules.

In the case of *Helvering* v. *Hammel*, 311 U. S. 504, the Supreme Court held that the loss sustained by a mortgagor upon foreclosure is a capital loss, subject to the limitations imposed by section 117 of the Revenue Act of 1934. This decision overturned several decisions of the Board of Tax Appeals and of Circuit Courts of Appeal, and (as so frequently in judge-made law) completely overlooked the legislative policy upon which the capital loss limitations are based. The decision in *Betty Rogers* v. *Commissioner* (C. C. A. 9th), 103 F. (2d) 790, in which the court reached a similar result where the mortgagor, faced with a possible foreclosure, conveyed the property to the mortgagee in full satisfaction of the mortgage debt seems a fortiori correct, in the light of the *Hammel case.*

TREAT MORTGAGOR'S LOSSES AS ORDINARY LOSSES

We believe that the results in this case are of very questionable desirability from the point of view of policy. We recommend that the statute be amended so as specifically to provide that mortgagor's losses, whether upon foreclosure sale or voluntary sale to the mortgagee to obviate foreclosure, shall be deductible in full as ordinary losses.

Recent decisions have held that a mortgagor may establish an ordinary loss by abandoning the mortgaged property, at least in cases in which it has become so great a liability that he is willing so to do without first obtaining a release extinguishing his personal liability. (*Polin* v. *Commissioner*, C. C. A. 3, 1940, 114 F. (2d) 174; *Park Chamberlain*, 41 B. T. A. 10, appeal dismissed C. C. A. 7th.) But the fact of foreclosure is highly persuasive evidence that the mortgagor's equity in the property has already become worthless. Why should the technical event of sale operate to determine the character of the loss for tax purposes? The rule of the *Hammel case*, by assimilating losses on mortgage foreclosures to losses sustained on truly voluntary sales and exchanges of capital assets, will work a hardship on thousands of mortgagors whose transactions were not motivated by tax considerations. It may have repercussions prejudicial to the public interest in the field of mortgage loans by causing lenders to insist upon a wider margin of security. To that extent, the decision may act as a clog upon new housing construction which will be of vital importance to national economic welfare.

DETERMINATION OF YEAR OF LOSS

We recommend that the statute also be amended to state a definite rule for determining the year in which the loss of a mortgagor upon foreclosure shall be deemed to be sustained.

Originally the Treasury took the position in a series of rulings that the event which determined the date of the loss was the foreclosure sale. Hence, the loss could be taken in the year of the sale. This was a sensible and realistic rule. The percentage of cases of redemption from foreclosure within the statutory period is almost negligible, and should not govern the normal case. However, the Board of Tax Appeals, adopting a narrowly legalistic position, held that the loss was not sustained for tax purposes until the year in which the period of redemption expired. (*J. C. Hawkins*, 34 B. T. A. 918, aff'd. 91 F. (2d) 354

(C. C. A. 5th, 1937).) The Bureau accepted this unrealistic rule and published a ruling revoking its earlier rulings. ((G. C. M. 19367) 1937-2 C. B. p. 115.) In view of the activities of legislatures in the last decade in extending periods of redemption by moratory laws, the effect of this rigid and unfair rule in many cases is to defer indefinitely the year in which such losses may be taken as deductions. In the meantime, neither taxpayers nor the Government can be certain that the rule of the *Hawkins case* will survive should the problem later reach the Supreme Court for final determination. In the event of an ultimate reversal, confusion and injustice will result.

We recommend that the statute be amended, in line with the earlier Treasury position, so as to provide that a mortgagor shall be allowed to deduct his loss in the year of the foreclosure sale, unless he shall establish, by proof of abandonment or otherwise, that his equity became worthless in an earlier year, in which case the deduction shall be allowed in such year.

No difficulty need be apprehended in the occasional case where the mortgagor redeems the property in a subsequent year, as a proper adjustment would be made in the return for that year under existing principles.

POSITION OF MORTGAGEE

The position of the mortgagee after foreclosure is even more obscure, if that is possible, than the position of the mortgagor under existing law. The longstanding administrative rule (section 19.23 (k)-3 of Regulations 103) states that where a mortgagee bids in property at a foreclosure sale, he realizes gain or loss in the amount of the difference between the fair market value of the property at the date of the sale and the basis of the obligations of the debtor applied in satisfaction of his bid. It also states that he may deduct as a bad debt, if and when ascertained to be worthless and charged off, the balance of the basis of such obligations which is not satisfied by his bid. The bid price is treated merely as prima facie evidence of the value of the property. The peculiar results follow, under these regulations, that a mortgagee may realize a taxable gain upon the acquisition of the mortgaged property and in the same year claim a bad debt deduction for the unsatisfied portion of the mortgaged debt, where it is ascertained in that year that a deficiency judgment for such portion would be worthless and the requisite charge-off is made.

Suppose, however, that the mortgagee's bid price equals the amount of the mortgage debt, plus accrued interest, costs, etc., but that the basis of the debtor's obligations applied in satisfaction of the bid exceeds the fair market value of the property. It is apparent here that there is no basis for claiming a bad debt deduction, since the debtor's obligations have been satisfied in full by the bid price. In this situation the Supreme Court had held, in *Helvering* v. *Midland Mutual Life Insurance Company*, 300 U. S. 216 (1937), that the mortgagee is required to report the amount of accrued interest included in the bid price as "interest received," that the bid price conclusively establishes the value of the property for the purposes of the transaction, and that the actual fair market value of the property at the time of acquisition on foreclosure is immaterial. By parity of reasoning, the mortgagor is presumably entitled to a deduction of the accrued interest thus satisfied by way of credit against the bid price. It seemed to be a reasonable inference from the Court's opinion in the case that the mortgagee occupied the legal position of a purchaser; that he took as his basis the price bid at the sale; that he was entitled to a bad debt deduction only if and to the extent that the basis of the debt was in excess of the bid price and was ascertained to be worthless and charged off; and that the mortgagee realized gain only if and to the extent that his basis of the portion of the debt represented by the bid was less than the face amount thereof. So interpreted, the Supreme Court's decision raised grave questions as to the validity of the existing Treasury regulations.

That such uncertainty existed was well shown by the decision in *Hadley Falls Trust Company* v. *United States*, 22 F. Supp. 346 (1938), affirmed in part and reversed in part in 110 F. (2d) 887 (C. C. A. 1, 1940). (Cf. *Grigsby* v. *Commissioner*, 87 F. (2d) 96 (C. C. A. 7, 1937).) In this case the Commissioner refused to follow his regulations and denied the mortgagee deduction of a loss representing the excess of the amount bid by him on foreclosure over the actual fair market value of the property. The circuit court of appeals, while expressing grave doubt as to the validity of the regulations, reversed and allowed the loss on the slippery ground (always fictitious and invariably wrong) that the regulations had acquired the force of law by virtue of the repeated reenactment of the statute without material change.

The validity of these regulations appears to have been definitely sustained by other recent decisions. (*Malden Trust Co.* v. *Commissioner*, 110 F. (2d) 753 (C. C. A. 1); *Bowles Lunch Co.* v. *Commissioner*, 33 F. Supp. 239 (Ct. Cl.); *Helvering* v. *New President Corporation*, 122 F. (2d) 92; *Bondholders Committee, Marlborough Investment Co.* v. *Commissioner*, 62 U. S. 537.) The failure, however, of the Supreme Court in the case last cited to distinguish the *Midland Mutual Life Insurance Co. case* creates new uncertainties as to the meaning of that decision and the scope of its future application.

LEGISLATIVE ACTION IMPERATIVE

These and other illustrations which might be given show the imperative necessity of legislative action to remove the confusion and uncertainty now existing in this large group of every-day business and financial transactions. It is appreciated that the choice between alternative rules will in some situations involve difficult questions of policy. Also, it may be that the same rules ought not be applied to foreclosure of corporate bond issues, secured by blanket mortgages and bond indentures, as to ordinary private mortages and deeds of trust. But the situation demands solution. It is one where it is perhaps as important to have a definite and certain rule as to select the right rule from several alternatives. No rule is likely to work perfectly in all cases, but lenders and borrowers in the mortgage field can adapt themselves to a particular statutory rule which is reasonably definite and certain.

We recommend as the rule with respect to mortgagees, which will involve the least administrative difficulty, that which recognizes the fact that a mortgagee who himself bids in the property on foreclosure is engaged essentially in a salvage operation which should not be regarded as a closed transaction for tax purposes. We therefore urge the insertion of section 112 of an appropriate provision providing for nonrecognition of gain or loss to a mortgagee who acquires the mortgaged property, whether by foreclosure or voluntary conveyance, in total or partial satisfaction of his debt.

In the event that the mortgagee, subsequent to such acquisition, receives money or other property in reduction of the unsatisfied portion of the debt, the statute should provide for the application of such money and the value of such other property to reduce the basis of the property acquired on foreclosure, etc., any excess over such basis to be taxed as capital gain. In cases in which the acquiring mortgagee has sold the property in the interim, the rule should be that the full amount of property or other money so received shall be treated as capital gain. A correlative basis provision should be written into section 113, providing that the basis of property so acquired by a mortgagee shall be the same as the basis of the debt immediately prior to such acquisition, with any adjustments appropriate to the nature of the transaction.

We also recommend that section 22 (b) of the code be amended to exclude from gross income interest accrued on a debt secured by mortgage or lien on real property, or on leaseholds or other interests in real property, which is paid solely by means of being applied or credited in satisfaction of a bid by the mortgage creditor at a sale, or by a conveyance of the property to such creditor. Correlatively, section 23 (b) should be amended to deny a deduction of internal excluded from gross income under the proposed amendment to section 22.

The effect of these latter amendments would be to abrogate the rule of the *Midland Mutual case*, except in respect of value. The interest of the mortgagor is promoted if mortgagees bid on the property on foreclosure for the full amount of the debtor's obligations, for he is freed from a deficiency judgment. The mortgagee most certainly would prefer an established rule.

(The following supplementary statement was submitted by Mr. Shorb:)

Supplementary Statement of Paul E. Shorb, Washington, D. C.

TAX PROBLEM OF "A" COMPANY

The "A" company manufactures products essential to the war effort. Its Federal excess-profits tax problem is aggravated by an extreme expansion since 1939 of business for governments, foreign and domestic, the capital for which has been largely furnished by the governments. The situation of "A" company is not isolated as there are other companies which have a similar expansion in both volume of business and number of employees and upon which the impact of the corporation normal, surtax, and excess-profits taxes is equally severe.

The "A" company furnished the "know how." To illustrate, the company's volume of sales in the base period years of 1936–39, inclusive, averaged $15,600,000; the employees in 1939 numbered 4,000. The company now has 55,000 employees, and in 1943 when the present plant expansion program is completed, the company will have about 75,000 employees, and its volume of business then done by the company is estimated at about $600,000 000 as against an average in the base period of 1936–39 of $15,600,000. Briefly, the employment figures show an expansion due to the war effort of about twenty-fold and the volume of business has expanded forty-fold.

The following statement shows these figures in some detail and also the normal and surtax and excess-profits tax on the company's 1942 estimated income at the rates fixed by H. R. 7378 (1942 Revenue Act) as it passed the House:

	Income method	Invested capital method
Estimated gross sales (products sold at fixed prices)	$124,000,000	$124,000,000
Estimated value (cost-plus-fixed-fee) of products produced under cost-plus-fixed-fee contracts	266,000,000	266,000,000
	390,000,000	390,000,000
Income before Federal income and excess-profits taxes from:		
(a) Products sold at fixed prices	30,000,000	30,000,000
(b) Cost-plus-fixed-fee contracts	10,150,000	10,150,000
Total book income before taxes	40,150,000	40,150,000
Adjustments to book income in determining taxable net income	3,300,000	3,300,000
	43,450,000	43,450,000
Less excess-profits tax credit	1,683,000	3,160,000
	41,767,000	40,290,000
Federal taxes on taxable net income:		
Excess-profits taxes, at 90 percent	37,590,000	36,264,000
Normal and surtax, at 45 percent	757,000	1,422,000
Total Federal taxes on income	38,347,000	37,686,000
Book profits available for dividends	1,803,000	2,464,000
Percent of Federal taxes to book income	95.51	93.86
Percent of Federal taxes to taxable net income	88.2	86.7

The following figures are also illuminating on the business and employee expansion by "A" company:

	Gross sales including estimated value of products produced under cost-plus-fixed-fee contracts	Number of employees
1936	$14,501,000	4,900
1937	16,961,000	5,200
1938	13,877,000	3,300
1939	17,147,000	4,000
1940	23,000,000	6,700
1941	67,000,000	32,000
1942 (estimated)	400,000,000	65,000
1943 (estimated)	600,000,000	75,000

The company derives its income mainly from two sources, that is: (1) Fixed-price sales arising from the company's own plants, and (2) sales under cost-plus-fixed-fee contracts, practically all of which are from Government-owned plants. The cost-plus-fixed-fee contract method is being more commonly used by taxpayers engaged in the war effort. Under this arrangement the Government pays for the erection of a new plant, which it owns, and the taxpayer company operates the plant for the Government. The taxpayer provides the "know how" and management (in which there is a substantial personal-service element) in consideration for which it is paid a fixed fee. With respect to such fees from a cost-plus-fixed-fee contract, the "A" company has had no experience in the base period of 1936-39 and its invested capital is not increased although its burdens, activities, and responsibilities, as shown by the figures in the present case, are tremendously enlarged. The excess-profits-tax credit computed under the invested-capital method appears to be more favorable to the "A" company than the credit computed under the average base period income method. The company's 1942 excess-profits-tax problem as shown by the figures set out above is aggravated both because of substantial increase in its earnings and because its invested capital has not been increased on account of the taxable income derived from cost-plus-fixed-fee contracts, which income for 1942 is estimated at about $10,150,000.

The tax falls upon such income in this case the same as if said cost-plus-fixed-fee contracts were being performed by a subsidiary company, formed for this purpose, which has no invested capital nor average earnings for the years 1936 to 1939, inclusive. To illustrate: From such $10,150,000 of income before taxes there remains after excess-profits taxes only $1,015,000 from a gross volume of business of $259,400,000, or a return of about one-fourth of 1 percent. Such a low rate on sales does not afford adequate safety and business risk margin. (There may be numerous disallowances, statutory or otherwise, which would be ruinous to the company.) Business cannot safely function on such a low rate—after taxes as shown in the illustration above.

In making cost-plus-fixed-fee contracts, the departments have a basis for determining the fee which today is pretty much on a fixed or set schedule. For example, the fees under such contracts with "A" company are approximately 4 percent of the estimated cost of the product (the law permits a fee of 7 percent). Converting this 4 percent to a sales basis, the fee of the "A" company is approximately 3 percent of the sales value of the product. This 3 percent to a company whose over-all effective tax rate is 60 percent of its taxable income, results in a net fee of 1.2 percent, whereas in the case of the "A" company with the effective tax rate at 93.3 percent under the income-credit method (and 91.7 percent under the invested capital credit method) leaves it only 0.21 percent. This comparison shows that one company may therefore have left after taxes under the operation of the law for similar work on war contracts six times as much as the "A" company. Relief is clearly needed in this situation which will distribute the tax burden more equitably among companies engaged in the performance of cost-plus-fixed-fee contracts.

This concludes statement of the problem and we now turn to certain remedial legislative suggestions:

(*a*) *Excess-profits tax rate.*—The lowering of the proposed 90 percent rate to 80 or 85 percent would afford the sorely needed relief in this case. The adoption of a post-war credit provision would also help substantially.

(*b*) *Special brackets for income from cost-plus-fixed-fee contracts.*—A provision taxing income from such contracts at a specific 75 percent rate would provide some of the needed relief in this case. The company by its management and personnel provides the "know how" for operating the plants, built at Government expense, which produce this special class of income. The situation involves "personal service" and also is abnormal because the company has not increased its invested capital in this operation.

(*c*) *Increase of invested capital.*—A provision which would include in the invested capital of the taxpayer a sum equivalent to 50 percent of the cost of the facilities to the United States which are operated by the taxpayer under the cost-plus-fixed-fee contracts.

(*d*) *Amend section 719 (a) (2) so that advances by the United States Government to a taxpayer may be included in invested capital.*—Section 719 (a) (2), code, now provides that advances made to a taxpayer by a foreign government, where the contract provides for the repayment by the vendor of any part of such advance payment upon concelation of the contract by such foreign government, may be included in borrowed capital. It would seem that this section could be enlarged by including in borrowed capital similar advances made by the United States Government, and that borrowed capital of a taxpayer should be thus increased. Such amendment would give some relief in the case of the "A" company, particularly with respect to its fixed-price contracts with the United States. However, this would be a limited form of relief and if this route of providing relief in the case of "A" company, and other companies similarly situated, is taken, it is submitted that in addition to the amendment here suggested under section 719 (a) (2), code, there should be an amendment to the code which would increase the invested capital of the taxpayer by 50 percent of the cost of the facilities used in performance of cost-plus-fixed-fee contracts and wholly owned by the United States—as suggested in (c) above.

(e) *A ceiling limitation on total taxes.*—Relief would be efforded in this aggravated case by a provision which would fix a ceiling of 75 percent or some such rate on the total corporate normal and surtax and excess-profits tax (including declared value excess profits taxes) which should be imposed in any case. It is needed to supplement the special relief provisions, and its use would give immediate relief to the most aggravated cases. It would also give certainty of relief to that extent and should as an administrative matter solve substantially the tax problem of many in the class of case of which the "A" company herein is typical.

(f) *Broader special relief provisions.*—It is possible that the broadening of the present special relief provisions of the code, such as is under consideration, would afford some relief in this case. However, until such provisions are available, what relief, if any, would result, cannot be determined. Moreover, such method does not give certainty to the taxpayer at the present time but leaves the matter to be worked out by administrative procedure in later years, by which time a company in the situation described herein may have been ruined or forced into bankruptcy. For that reason such relief does not seem adequate or desirable because it may come too late. It is mentioned here for the sake of full discussion of the relief possibilities, but it is hoped that the taxpayer in this case, or taxpayers similarly situated, will not be forced to rely solely upon the special relief provisions as they may be finally broadened by legislation. In that connection it should be added that the present provisions of sections 721 and 722, code, do not seem to afford any adequate or sufficient basis of relief.

Respectfully submitted.

PAUL E. SHORB.

AUGUST 14, 1942.

The CHAIRMAN. Mr. Hopkins of the Chamber of Commerce of the United States.

STATEMENT OF ALBERT L. HOPKINS, CHICAGO, ILL., COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. HOPKINS. Mr. Chairman and gentlemen, I am Albert L. Hopkins, an attorney, of Chicago, Ill. I appear as a member of the committee on Federal finance of the Chamber of Commerce of the United States. My assignment is certain sections which we have designated administrative amendments affecting corporations. Several of these amendments are technical and are corrections or changes to meet other provisions in the statute and require no comment.

As Mr. Alvord explained, we have been assigned different sections. Mine are mostly technical and they are very dry, and I shall be accordingly brief, and with your permission, I should like to file my comments and would like to talk orally only on 3 or 4 of them.

The CHAIRMAN. Yes; you may file the brief and give us such oral statement as you desire.

Mr. HOPKINS. The first section I wish to comment on is section 129 in regard to fiscal-year returns, and I am advised that the committee said yesterday that they thought they knew a great deal about it already. However, we do urge that this amendment not be adopted.

The question of taxing fiscal-year returns at a different rate than in the previous laws first became prominent about June of this year, and it may be some months yet before this bill becomes a law.

Many companies have closed their years, they have paid their dividends, they have made their commitments, they have sent reports to their stockholders, they have reported to the credit companies, to the S. E. C., and to now retroactively increase their taxes may mean that they can pay it, if at all, only out of capital.

In the long run, we do not believe that the Treasury will be benefited. The same number of months, during the high tax year will be taxed whether they are on a fiscal-year basis or not.

My principal objection to it is the retroactive feature.

There is nothing in the constitution against retroactive legislation. There is, of course, against ex post facto law, but with the severe penalties, this may run into hundreds of thousands of dollars imposed retroactively, and if there was any occasion for the writers of the Constitution to prohibit ex post facto legislation, the same reasoning applies as I see it, to this, because the penalties are severe.

The fiscal year is usually a natural year with reference to particular businesses and I daresay that you have already been told that accountants have been urging it for a long time to avoid a great rush that comes in the first 2½ months of the year when they are on a calendar-year basis, and the Treasury Department has at least informally encouraged turning to a fiscal year.

It spreads the work out throughout the year, instead of dumping it all in the first 2 months.

My next section I wish to comment on is section 141, which deals with foreign tax credits. It is an amendment of section 131 (f) of the code and provides that a domestic corporation is deemed to have paid taxes not only of its foreign subsidiary, but of 100-percent-owned foreign subsidiaries of the foreign subsidiary.

It should be adopted but we think there should be a further amendment to section 131. A domestic corporation on the accrual basis may technically be charged with income on interest or royalties in a foreign country, and yet because of their prohibitions they cannot get it. That has been true in countries all over the world for a long time, and now it is, of course, worse than ever.

The Board of Tax Appeals has recently held that you are not chargeable with that amount of income if you cannot get it. Now it is suggested—what I am suggesting here is that if, as, and when they get that income, the foreign tax credit on that come with it.

Section 142 is the consolidated returns amendment. We approve the amendment.

Consolidated companies represent a common business enterprise. You cannot get the true income without consolidation. It is too easy to run one up and another one down. But if it is proper to consolidate them, which we think it is both for income and excess-profits tax purposes, there is no justification for penalizing them an extra 2 percent for doing it. It is a helpful thing to the Treasury and to the accountants that they can more accurately check companies which have to have separate corporations in different States. We simply object to the 2-percent penalty.

Section 150 is a statute of limitations amendment. There are several paragraphs in that amendment. The present statute permits the filing of a claim for refund within 3 years from the filing of a return, or 2 years from the payment of a tax, whichever is later. The proposed amendment is an attempt to limit the amount of the refund to the amount of taxes paid within the time limit of each kind of claim. The amendment is confusing and merely serves to whittle down the amount of refunds which may be made of amounts which the taxpayer has admittedly overpaid.

The next paragraph is in regard to limitations in case of waiver. It is highly desirable that the taxpayer should be permitted to file a claim for refund within such period as the Commissioner may make an additional assessment. Waivers are constantly being given by taxpayers, and in most cases, exacted, extending the time within which the Commissioner may make an additional assessment. This paragraph provides that in order for the taxpayer to have the benefit of this amendment, the waiver must be given within the time that the taxpayer could file a claim for refund, which may not be the same time within which the Commissioner may assess an additional tax. The paragraph then continues with about a page and a half of confused language, limiting and restricting the amount of the refund, partially to conform it to the preceding paragraph. There is no occasion to cut down the period of limitation below 2 years from the date of payment of the tax. The 2-year period is consistent with other provisions in the section. As stated, the attempt to deprive the taxpayer of a refund of an amount admittedly overpaid should not be encouraged.

Next is the return considered filed on the due date, section 150 (a) (4).

That paragraph should be adopted. As the law stands today, if you file your return on January 15, your statute of limitations begins to run on January 15. The Commissioner's statute begins to run on March 15.

This puts them on an equal basis. It is a relief section and, in our opinion is in order.

Next is the special period of limitation with respect to bad debts and worthless securities. That is apparently a relief section, but it does not carry out what the report says it does.

The Bureau is constantly disallowing bad debts and losses in a given year and says, "That was worthless 3 or 4 years ago, and it is too bad, we cannot refund it, the statute of limitations has run."

That fight goes on all the time.

The theory of this amendment was to extend the statute of limitations for 7 years for the taxpayer to get those refunds which the Commissioner throws back, but by providing that it shall not be effective to years prior to 1939, it will be 1947 before you get the full 7-year benefit. The need for it is just as great where they have determined that it is worthless in 1937, 1936, 1935 as to put it all in the future, so it does not, in effect, carry out what it purports to carry out.

The other section, about overpayments found by the Board—we approve of that amendment.

The excess-profits tax is my next section, section 201. It makes the statute applicable to years beginning after December 31, 1941, except as otherwise provided. One of the exceptions is section 129 in regard to fiscal years which we think should not be adopted.

Section 205, technical amendments made necessary by the change in base for the corporation tax—that is the title. Some of the amendments in this section seem to be in order if the basis for computing excess-profits net income is adopted.

Under the acts applicable to 1940 and 1941, taxpayers were authorized to carry forward their unused excess-profits credit computed on a certain basis. This section changes the method of computation and reduces the amount of the carry-over. The taxpayers have relied upon the prior acts, and legislation adversely affecting the taxpayer should not be retroactive.

If a taxpayer had sufficient income in 1941 to absorb the 1940 carry-over, he was permitted to use it. If he did not have enough income, the amount of his unused credit applicable to 1942 will be reduced.

Section 206, capital gains and losses in the computation of excess-profits net income—the effect of this amendment will be that long-term gains and losses will be excluded from excess-profits income for the taxable year and from the computation of the excess-profits credit. Net short-term gains are subject to excess-profits tax, but net short-term losses are not deductible from excess-profits income. There is no justification for this discrimination.

The amendment also takes away the deduction on losses on buildings which is permitted under the Code as it now stands.

It is done indirectly—I don't know whether it was done consciously or not. Building, being a depreciable asset, under the present law losses on the sale of the building were allowed. Under the present amendment, buildings even though depreciable are made capital assets and that has automatically eliminated the right to take that loss if it is a long-term loss and of course, you cannot have short-term losses.

My next section that I wish to comment is section 210, capital reduction in case of members of controlled corporations.

This section amends section 713 (g) of the code. Section 713 deals with the credit of corporations using base-period earnings. The code section provides that if there is an increase of invested capital after the base period, there may be an increase of the credit, and, correspondingly, if there is a decrease of invested capital there will be a decrease in the credit.

Under the amendment, if a corporation increases its stockholdings in controlled corporations, the excess-profits tax is decreased. It fails to provide that if a corporation reducess its holdings of stock of controlled corporations, there is a corresponding increase in its excess-profits credit. The amendment should be changed to provide for such an increase.

Section 212—without going into the detail of that—it has to do with the amount at which property paid into a corporation on its stock shall be included in invested capital—that is to say, that it shall be upon what is known as the base rather than on the cost.

We recommend that the cost shall be the amount that shall go into the invested capital rather than the base, with proper relief in exceptional situations, especially those involving reorganization and adjustments under court decree.

The CHAIRMAN. That seems to be a most important provision.

Mr. HOPKINS. I am sure that Mr. Alvord is going to discuss that. I have attempted to outline in the memorandum I am filing what changes are being made in the existing code. I did not think I should take your time, but I am merely suggesting that it would be better if it went on the cost basis.

The CHAIRMAN. If you take your tax base and disregard your cost base, it is very difficult to see how in many, many, many cases you could ever determine whether a taxpayer has had any earnings or what the earnings were.

Mr. HOPKINS. That is true. We have had a lot of experience in 1919 and a lot of grief; and finally got some invested capital established. We think if we started with that, we could work it out much more easily than to have it go back and have to take all of the years of a corporation perhaps since its inception to determine what its gain and loss was to determine the base. It is a terrific job.

I should like to make a personal comment.

If this bill as passed by the House becomes law, it will go a long way to destroy American industry.

No business can pay a 90-percent excess-profits rate under the provisions in this bill and survive. The reserves which are necessary to keep a business alive cannot be set aside. The disallowance by the administrative officers of salaries, bonuses, and other expenses of various kinds may well cause the exaction of over 100 percent of income. I talk of practicalities rather than theories.

A flat rate of 45 percent on corporate incomes (labelled income and surtax) means default or reduction of many preferred stock dividends, not to speak of common dividends. The people whose life savings are invested in corporate stocks will have their income seriously impaired. There are those, of course, who don't care what happens to the life savings of other people. Bear in mind, however, that it is these people who furnish the capital to make industry possible and who buy the Government bonds, the proceeds of which are necessary to finance the war.

From the standpoint of economics, a person with any capital would be wiser to live on his capital rather than invest in some enterprise. He always runs the risk of loss. If he wins, the Government takes practically all of it. If he loses, he takes the loss.

The bill is 320 pages long. The committee report is 187 pages of fine print. I should like to lay a wager that no one person could name 10 people who understand it. Of those who claim to understand it, I would wager that half of them will be wrong when the bill is finally interpreted. It will be the subject of the same kind of ridicule as the ancient debate as to how many angels can dance on the point of a needle. Yet, millions of taxpayers are required to understand it and report accordingly under threat of great pains and penalties.

I pay my respects to the skill of the draftsmen who have attempted to provide for every exceptional situation the Treasury Department has suggested. This attempt to legislate on exceptional problems and to stop so-called loopholes has been going on for over 15 years and has brought about the present monstrosity.

The fiscal necessities of this war are tremendous. There has been a great deal of agitation to buy bonds and to raise more taxes. It is difficult for me to believe that a sincere effort has been made to really meet the necessities. The great part of the income of the country is not taxed. It is that income which will cause the inflation. The effort to impose most of the burden on a few will cause diminishing returns. That few cannot and will not produce sufficient taxes to meet the fiscal requirements.

A tax on all earnings will raise revenue and go a long way to prevent inflation. It will hurt no one seriously, and, in my opinion, will be accepted by our people fairly and reasonably as a part of their duty to the prosecution of the war. On the average, wage earners are receiving increases greatly in excess of what would be a reasonable withholding tax.

If something of this kind is not done, to really raise revenue by a method that will be continuous and not destroy the source of income and also retard inflation, obviously there is a serious threat to our currency and our bonds.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you very much, Mr. Hopkins.

(The statement referred to is as follows:)

STATEMENT OF ALBERT L. HOPKINS, CHICAGO, ILL.

Mr. Chairman and gentlemen: I am Albert L. Hopkins, an attorney of Chicago, Ill. I appear as a member of the committee on Federal finance of the Chamber of Commerce of the United States. My assignment is certain sections which we have designated administrative amendments affecting corporations. Several of these amendments are technical and are corrections or changes to meet other provisions in the statute and require no comment.

I shall take up the sections chronologically as they appear in the House bill.

SECTION 124 (P. 51), COMPUTATION OF NET OPERATING LOSS CREDIT AND DIVIDENDS PAID CREDIT

This section is an amendment to section 26 (c) (1), 27 (b) and 27 (c) of the Internal Revenue Code and is intended as a correction of those sections. It has to do with loss carry-over and dividend carry-over and is in order if section 26 in the code is to remain in the statute.

SECTION 126 (P. 64). RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS

This section primarily amends section 47 of the code. That section projects the income for a period of less than 12 months to a 12-months' period in order to compute the tax on the basis of 12 months and then takes the ratio of the short period to a 12-months' period as the tax. The effect of this projection is to increase the tax, both by reducing the annual exemptions and credits to the shorter period and by increasing the rates where there are progressive rates.

The section seems to apply only to cases where there has been a change in the accounting period by the taxpayer with the consent of the Commissioner, as provided in code section 47 (a).

The amendment proposed in this Bill gives a certain amount of relief. If the taxpayer continues in business beyond the end of the short period, he may use a full twelve months from the beginning of his short period as the basis of computation before prorating it to the number of months in the short period. If the taxpayer ceases to exist, he is permitted to use a twelve months period ending with the short period as the basis of computation of the tax before proration. These methods of computation are permitted instead of a mathematical computation of projecting the short period to a twelve months period. The reduced tax, however, cannot be less than the tax on the income for the short period, standing alone.

The comparable section (208) which applies to excess profits tax net income, does not seem to be limited to changes in fiscal year.

SECTION 129 (P. 70). FISCAL YEAR TAXPAYERS

Since 1934, changes in Revenue Acts have been generally applicable to taxable years beginning after a certain date, usually the close of a calendar year. Under this system, regardless of whether his taxable year is a calendar year or a fiscal year, a taxpayer is subject to only one Revenue Act.

The prior rule required a fiscal year taxpayer to compute his tax under two Revenue Acts, his final tax being the sum of the proportions of such tentative taxes as the number of months subject to each Revenue Act bore to the number of months in the fiscal year. Section 129 of the Bill proposed to restore this rule, which was characterized in the Report of this Committee on the Revenue Bill of 1934 as "complicated" and was eliminated "for the purpose of simplicity and ease of administration" (Sen. Rept. No. 558, 73d Cong., 2d sess. (1934), p. 22).

It is believed that section 129 should be eliminated from the Bill. There are many objections both to the rule itself and to the time and manner of its proposed readoption, which may be briefly summarized as follows:

(1) It was late in the year when the proposal was first given publicity and it will be later still when the bill finally becomes law. Many fiscal years have already ended. Accounts have been closed, statements, some of which were certified, have been issued to the public and to stockholders, to the Securities and Exchange Commission, stock exchanges, banks, and credit rating companies; commitments have been made and dividends paid, relying upon the law in force since 1934. To increase the taxes of such corporations retroactively may cause them to be unable to meet their commitments and will certainly cause financial embarrassment. Dividends will have been found to have been distributed out of capital in many instances and many taxpayers will no longer have the ready cash with which to pay the increased taxes. Retroactive application of section 129 is completely without justification in view of the unreasonable hardships it would produce.

(2) It will tend to discourage the use of fiscal years. Most fiscal year corporations have adopted such a year because it is their natural economic year and not for purposes of tax advantage. Their use should be encouraged rather than discouraged. That section 129 will discourage the use of fiscal years is clear, because the complexities and additional labor involved in its application will be so great that the average taxpayer will prefer the comparative simplicity of the calendar year despite its disadvantages.

Many existing fiscal years are of long standing. To upset them now would be to interfere with long-established business practices. Accountants have urged the adoption of fiscal years and this change has to some extent been encouraged by the Bureau of Internal Revenue. The Securities and Exchange Commission has likewise on some occasions encouraged this type of taxable year in cases where it is more "natural" than a calendar year. It would be unfortunate to adopt a tax policy which would discourage a practice so generally admitted to be sound.

(3) The provision is administratively difficult. This is understood to be one of the reasons why the rule in effect prior to 1934 was discarded. For example,

the bill provides that corporations will be permitted to file consolidated returns for income-tax purposes in 1942. This was not permitted in 1941. How can section 129 be applied in the case of a taxpayer which wishes to file a consolidated return under the 1942 act? Another type of case which will present difficulties is that of an individual who is on a fiscal-year basis and who is a member of a partnership which is on a different fiscal-year basis. A third difficulty is that connected with carry-overs Although section 129 of the bill contains a provision on this subject, it is wholly arbitrary and does not represent a satisfactory solution of the problem.

(4) An arbitrary apportionment based on the time element alone ignores the fact that all or the bulk of the income for the taxable year may actually have arisen within the portion thereof which falls within only one of the calendar years involved. It seems completely unfair to subject to 1942 rates any part of a taxpayer's income which may have been realized entirely in 1941.

One argument for section 129 which has been advanced is that a fiscal-year taxpayer derives an advantage under existing law in a period of rising tax rates from the fact that impact of increased rates is delayed. It must not be overlooked, however, that this advantage will be offset when tax rates decline because the impact of the reduced rates will be similarly delayed. Both fiscal-year taxpayers and calendar-year taxpayers are subject to the same rates for the same length of time.

SECTION 141 (P. 100). FOREIGN TAX CREDIT ON AMOUNT OF SUBSIDIARY OF FOREIGN SUBSIDIARY

This is an amendment to section 131 (f) allowing credits for foreign income taxes paid by subsidiaries, subject to certain limitations. The proposed amendment extends the credit provisions to foreign subsidiaries of such foreign corporations where there is a 100-percent ownership of the voting stock.

We approve the amendment adopted by the House.

We think, however, there should be a further amendment to section 131 permitting a domestic taxpayer to take credit for foreign taxes in the year in which the foreign income is available to him and when he is required to pay the United States tax thereon. A domestic corporation may earn income in a foreign country such as interest or royalties, but because of prohibitions in those countries against the export of funds, the income is not available. The Board of Tax Appeals has held that such income shall only be taxable when it is available, and it is only fair that the foreign income taxes on that income should be a credit when the income is subject to tax in the United States.

SECTION 142 (P. 102). CONSOLIDATED RETURNS

We approve this section in the House bill permitting the filing of consolidated returns for normal and surtaxes as well as excess-profits taxes. An affiliated group or corporations is a single business enterprise, and the true income of such a unit can be measured only by consolidated returns. If consolidated returns are proper and are permitted, there is no justification for penalizing such a group by imposing an additional 2-percent tax.

SECTION 148. TECHNICAL AMENDMENTS

Section 115 (a) of the code defines the term "dividend" and excepts from such definition, by referring to certain other sections of the code, the term "dividend" as used in connection with the taxes imposed on insurance companies. Since the bill makes some changes in the taxation of insurance companies, and the term "dividend" appears in different sections, it is necessary to change the reference to the section numbers.

SECTION 150 (P. 140). STATUTE OF LIMITATIONS ON REFUNDS AND CREDITS

(a) (2) *Limit on amount of credit or refund.*—The present statute permits the filing of a claim for refund within 2 years from the filing of a return or 2 years from the payment of the tax, whichever is later. The proposed amendment is an attempt to limit the amount of the refund to the amount of taxes paid within the time limit of each kind of claim. The amendment is confusing and merely serves to whittle down the amount of refunds which may be made of amounts which the taxpayer has admittedly overpaid.

(a) (3) *Limitations in case of waiver.*—It is highly desirable that the taxpayer should be permitted to file a claim for refund within such period as the Commissioner may make an additional assessment. Waivers are constantly being given by taxpayers, and in most cases, exacted, extending the time within which the Commissioner may make an additional assessment. This paragraph provides that in order for the taxpayer to have the benefit of this amendment, the waiver must be given within the time that the taxpayer could file a claim for refund, which may not be the same time within which the Commissioner may assess an additional tax. The paragraph then continues with about a page and a half of confused language, limiting and restricting the amount of the refund, partially to conform it to the preceding paragraph. There is no occasion to cut down the period of limitation below 2 years from the date of payment of the tax. The 2-year period is consistent with other provisions in the section. As stated, the attempt to deprive the taxpayer of a refund of an amount admittedly overpaid should not be encouraged.

(a) (4) *Return considered filed on due date.*—This paragraph should be adopted. It provides that the period of limitations for the filing of claims for refund begins to run on the due date of the return, even though the return may have been filed earlier. It encourages the early filing of returns and fixes a common date—for example, March 15 for a calendar-year return—instead of making it necessary for the taxpayer to keep a check on the expiration of 3 years from the date of filing of each return.

A somewhat similar provision is made for advance payment of the tax—that is, that it shall be considered as paid on the last due date, or in any event not prior to March 15.

(a) (5) *Special period of limitation with respect to bad debts and worthless securities.*—The period of limitations for filing claims for refund with reference to specific items is supposed to be 7 years. The amendment should be adopted, but it should not be limited to taxable years beginning after December 31, 1938. The 7-year statute will not be effective until 1947. It should be made effective now. The taxpayer needs the relief just as much on debts and securities determined to be worthless in 1938, 1937, 1936, and 1935 as those determined to be worthless after 1938. Section 113 with reference to time of charge off should be changed accordingly.

(b) *Overpayment found by board.*—This provision amends section 322 (d) of the code.

The amendment provides that amounts of overpayment determined by the Board of Tax Appeals may be refunded if paid within the statutory period prior to the issuance of the 90-day letter. This is a relief section and should be adopted.

SECTION 201 (P. 194). EXCESS-PROFITS TAX

This section makes the Revenue Act of 1942 applicable to years beginning after December 31, 1941, except as otherwise provided.

Included in the exception, however, is section 129, in regard to fiscal-year taxpayers, which we think should not be adopted.

SECTION 205 (P. 197). TECHNICAL AMENDMENTS MADE NECESSARY BY CHANGE IN BASE FOR CORPORATION TAX

Some of the amendments in this section seem to be in order if the basis for computing excess profits net income is adopted. Under the acts applicable to 1940 and 1941, taxpayers were authorized to carry forward their unused excess-profits-tax credit, computed on a certain basis. This section changes the method of computation and reduces the amount of the carry-over. Taxpayers have relied upon the prior acts, and legislation adversely affecting the taxpayer should not be retroactive. If a taxpayer had sufficient income in 1941 to absorb the 1940 carry-over, he was permitted to use it. If he did not have enough income, the amount of his unused credit applicable to 1942 will be reduced.

SECTION 206 (P. 199). CAPITAL GAINS AND LOSSES IN COMPUTATION OF EXCESS PROFITS NET INCOME

This section is primarily an amendment to section 711 of the code.

(a) and (b). These amendments exclude from excess profits net income gains and losses from the sale or exchange of capital assets held for more than 15 months.

(c) The same exclusions are made to the income for the base period which is to be used as excess-profit credit.

(d) This provision seems merely to amend the section to make it applicable to "capital losses" instead of "short-term capital losses."

(e) This amendment appears to be self-explanatory. Gain on an inadmissible capital asset held for not more than 15 months is substituted for the expression "short-term capital gain."

The effect of the section will be that long-term gains and losses will be excluded from excess-profits income for the taxable year and from the computation of the excess-profits credit.

Net short-term gains are subject to excess-profits tax, but net short-term losses are not deductible from excess-profits income. There is no justification for the discrimination. The amendment also takes away the deduction of long-term losses on buildings, which is permitted under the code as it now stands.

SECTION 208 (P. 201). EXCESS PROFITS NET INCOME PLACED ON AN ANNUAL BASIS

Any comments applicable to this amendment would be the same as comments to section 126, where the income and surtax net income is placed on an annual basis.

SECTION 209 (P. 203). INTEREST ON CERTAIN FEDERAL OBLIGATIONS

We have no comment on the amendment.

SECTION 210 (P. 204). CAPITAL REDUCTION IN CASE OF MEMBERS OF CONTROLLED CORPORATION

This section amends section 713 (g) of the code. Section 713 deals with the credit of corporations using base period earnings. The code section provides that if there is an increase of invested capital after the base period, there may be an increase of the credit, and, correspondingly, if there is a decrease of invested capital there will be a decrease in the credit.

Under the amendment if a corporation increases its stock holdings in controlled corporations, the excess-profits-tax credit is decreased. It fails to provide that if a corporation reduces its holdings of stock of controlled corporations there is a corresponding increase in its excess-profits credit. The amendment should be changed to provide for such an increase.

SECTION 212 (P. 207). BASIS OF PROPERTY PAID IN

Section 212 of the bill amends section 718 (a) (2) of the code relating to the amount at which property paid into a corporation on its stock shall be included in invested capital. The amendment provides that if the property paid in has been disposed of before the taxable year then the amount which shall be treated as paid in as invested capital on account of such disposed of property shall be determined in accordance with the law applicable in the taxable year when it was disposed of.

Under section 718 (a) (2) as it now stands, the basis of property determines the amount of the invested capital, and property that has been disposed of is treated as though still owned. The basis may have been different under the law at the time property was paid in, and as to property disposed of, the basis may have been different under the law at the time of disposition. Under this amendment the amount of invested capital arising from the item of property which is disposed of is tied to the basis under the law of the year the property was disposed.

The amendment attempts to tie together or dovetail the computation of invested capital with the concepts of accumulated earnings.

We recommend consideration of the amendment of section 718 (a) (2) to provide for use of the taxpayer's cost rather than tax basis as a general rule where property is paid in for stock (with proper provisions for relief in exceptional situations, especially those involving reorganizations and readjustments under court decree).

SECTION 215 (P. 220). CONSOLIDATED RETURNS

This section repeals section 730 of the prior act which permitted consolidated returns for excess-profits tax purposes. This repeal is in order because of the provisions permitting consolidated returns for income, surtax, and excess-profits tax purposes.

* * * * * * *

A personal comment—

If this bill as passed by the House becomes law, it will go a long way to destroy American industry.

No business can pay a 90-percent excess-profits rate under the provisions in this bill and survive. The reserves which are necessary to keep a business alive cannot be set aside. The disallowance by the administrative officers of salaries, bonuses, and other expenses of various kinds may well cause the exaction of over 100 percent of income. I talk of practicalities rather than theories.

A flat rate of 45 percent on corporate incomes (labeled income and surtax) means default or reduction of many preferred stock dividends, not to speak of common dividends. The people whose life savings are invested in corporate stocks will have their income seriously impaired. There are those, of course, who don't care what happens to the life savings of other people. Bear in mind, however, that it is these people who furnish the capital to make industry possible and who buy the Government bonds, the proceeds of which are necessary to finance the war.

From the standpoint of economics, a person with any capital would be wiser to live on his capital rather than invest in some enterprise. He always runs the risk of loss. If he wins the Government takes practically all of it. If he loses he takes the loss.

The bill is 320 pages long. The committee report is 187 pages of fine print. I should like to lay a wager that no one person could name 10 people who understand it. Of those who claim to understand it, I would wager that half of them will be wrong when the bill is finally interpreted. It will be the subject of the same kind of ridicule as the ancient debate as to how many angels can dance on the point of a needle. Yet millions of taxpayers are required to understand it and report accordingly under threat of great pains and penalties.

I pay my respects to the skill of the draftsmen who have attempted to provide for every exceptional situation the Treasury Department has suggested. This attempt to legislate on exceptional problems and to stop so-called loopholes has been going on for over 15 years and has brought about the present monstrosity.

The fiscal necessities of this war are tremendous. There has been a great deal of agitation to buy bonds and to raise more taxes. It is difficult for me to believe that a sincere effort has been made to really meet the necessities. The great part of the income of the country is not taxed. It is that income which will cause the inflation. The effort to impose most of the burden on a few will cause diminishing returns. That few cannot and will not produce sufficient taxes to meet the fiscal requirements.

A tax on all earnings will raise revenue and go a long way to prevent inflation. It will hurt no one seriously, and in my opinion, will be accepted by our people fairly and reasonably as a part of their duty to the prosecution of the war. On the average, wage earners are receiving increases greatly in excess of what would be a reasonable withholding tax.

If something of this kind is not done, to really raise revenue by a method that will be continuous and not destroy the source of income and also retard inflation, obviously there is a serious threat to our currency and our bonds.

The CHAIRMAN. Mr. Alvord.

STATEMENT OF ELLSWORTH C. ALVORD, WASHINGTON, D. C., CHAIRMAN, COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. ALVORD. Mr. Chairman, I ask permission to file a memorandum and a supplemental memorandum for the record, then I will proceed extemporaneously as usual.

The CHAIRMAN. You may do so.

Mr. ALVORD. Mr. Chairman and gentlemen, I invite each of you to join an offensive. It does not require the opening of a second front. That front is here. It is an offensive, which, like all other offensives, will require courage, precisely the same kind of courage our boys are showing in action. Like other offensives, it may result in casualties. But the fight is very much worth while, for it is for the protection and welfare of every man, woman, and child in the United States. Defensive strategy is useless.

Let me outline to you, if I may, a few of the more important fiscal factors on which this fight is based. I regret to tell you that we are definitely as unprepared for this offensive as we were for the war itself.

You start with a national debt of $72,000,000,000. You start with estimated expenditures this year—not next year—of $77,500,000,000. You have an existing tax law which raises almost three times as much revenue as you have ever raised under any other law for any one year, estimated at about $17,000,000,000. That excludes all the additional revenues which the bill now pending before you is designed to raise.

The CHAIRMAN. Does that exclude social-security taxes also?

Mr. ALVORD. It excludes social-security taxes also; yes, sir. I am giving the net figure.

That gives you a deficit of $60,500,000,000, a deficit such as this country and no other country has ever contemplated.

You appropriate about $2,500,000,000 of trust funds that are in the Treasury. After that you are compelled to finance publicly $58,000,000,000. Your commercial banks upon whom has rested primarily the duty to finance your decades of deficits, already hold $26,000,000,000 of Government securities.

And, finally, I invite your attention to the fact that the fiscal year 1943, which has been discussed so much, is already expiring. The fiscal year 1944 is only about 10½ months ahead. You have no estimates for the next fiscal year, either of expenditures or of receipts.

I suggest that we plan our offensive for a period of not less than 5 years. Whether our war lasts that long—and I trust that it does not—the fiscal front will be with us for at least 5 years.

The Treasury insists that this bill raise for this current fiscal year about $6,000,000,000. It actually raises on the Treasury estimates roughly a little over $4,000,000,000. And then for the next full year of operation, which will not be the fiscal year 1944, they say that it must raise at least $8,000,000,000, and it is estimated to raise about $6,200,000,000.

Well now, gentlemen, I have been attempting to find out what the basis is for the demands of the Treasury. I cannot understand why they insist on $6,000,000,000 for this year and $8,000,000,000 for future years. I do not understand how they reached their precise dollar amounts in their demands for additional revenue. I have a guess, and my guess is based on precedent. The guess is that they sat down and worked out the tax program that they would enact into law if they could come up here and legislate without being accountable to the electorate, with no elections to face either this year or 2 years from now they would enact their tax program. They made their own estimates as to what that tax program would yield. And then they come to Congress and, using that total, say "we demand additional revenues of so many billions, raised in this manner."

Their total demand has no relation either to expenditures or receipts. And that fact is very clear, because estimated expenditures have jumped $14,000,000,000 since Mr. Morgenthau made his demand upon the Committee on Ways and Means. Whereas his demands have increased—and there were other reasons under which he increased his demands—his demands were increased by only $1,100,000,000.

Now, the actual truth of the matter is that no one in the Treasury or out can estimate within billions of dollars either our prospective expenditures or our prospective receipts.

I just throw out one factor which probably has not yet been considered by you gentlemen, or perhaps even by the Treasury:

Suppose the program for renegotiation of contracts remains in the law—I tell you that it will most disastrously affect the entire fiscal program of the Treasury. No one can tell you its probable effect upon the yield of the present law and the bill that you are now considering:

Finally and strangely enough, as Senator Byrd very appropriately brought out on the examinations of the Treasury witnesses, the bill now pending before you will actually produce almost exactly in the fiscal year 1943 what the Treasury wants, and also will produce almost exactly the $8,000,000,000 which the Treasury says it must have in the future.

Therefore, I do not understand this very determined and nevertheless serious criticism by the Treasury of the Committee on Ways and Means. I would suggest that we consider this criticism by the Treasury of the Committee on Ways and Means as being—well, I would say, even fanciful. Therefore, let us get down to the two real basic questions that you are confronted with.

Question No. 1. How much of this $58,000,000,000 can be financed by taxation? Obviously, it all cannot be financed by taxation.

Question No. 2. How should the balance of that $58,000,000 be borrowed?

In lieu of a piecemeal, annually revised, inadequate program, I suggest that we start this offensive with a basic program, a basic program for financing this war, a program that will remain in force during the entire period of the war. That program requires again but two comparatively simple policies.

First, get the maximum from taxation; second, borrow the maximum from the savings and current incomes in noninflationary borrowing.

Let me discuss inflation just a little bit. The Treasury insists that its program, as well as the House bill, be tested from two points of view. First it insists that the bill now pending before you must raise the minimum in revenues.

Secondly, it insists that the bill be the most effective aid in the fight against inflation.

I challenge the program of the Treasury directly on those two points.

First, as I have already indicated to you, the Treasury does not need the minimum of revenues; it needs the maximum, and it needs the maximum just as soon as it can get it.

Second, so far as the fight on inflation is concerned, you can throw the House bill completely and finally out of the window. There is not enough in the House bill to aid in the fight on inflation to justify your taking the time to consider it.

Let us look at inflation now just for a moment—both the kind of inflation which the administration officials talk about, this so-called excess of consumer purchasing power, and also, rather quietly, monetary inflation.

We all know that as we get into the war production, civilian production must be curtailed. As civilian production is curtailed, the supply of civilian goods necessarily becomes less. As our incomes increase, as they must and as they will, our demand for civilian goods increases. In fact our demand for civilian goods already exceeds the supply. You will see the effect of that demand as the shelves of our retailers become depleted, as they will.

You have our national income increased by about $10,000,000,000, you have our supply of goods constantly decreasing, and our purchasing opwer constantly increasing.

Just one more thought, gentlemen. If you are to stop the inflation that is bound to come when those forces meet, you must do it before they meet, otherwise it is too late. And the inflation that I am talking about is not a mere 10 percent increase in living costs or a 17 percent increase in living costs. It may easily be as much as a 50 percent increase in living costs.

If by very moderate and sound policies of taxation and finance, we can prevent that tremendous increase in our living costs, then our citizens stand some chance of retaining the balance of their increased incomes. Otherwise, they have no chance. We sometimes hear inflation likened to taxation. It is not. It is much, much worse. It produces substantially no revenues in the Treasury; it means increased cost of your war effort; it means increased cost of living. With tremendously increased costs for the war effort, the burden upon our citizens increases precisely that much. With increases in our cost of living, their ability to live decreases just that much.

If we are to help somewhat in this fight on inflation we must start now. We must be courageous. The unfortunate defensive doctrine of too little and too late, applies with equal force in the fiscal field.

Before we measure the maximum to be raised by taxation, we must consider just what it is we are trying to attain, where we are going, and how we are going to get there. Every person in the United States is beginning to realize the effect of your fiscal policies upon those two questions.

I suggest three objectives:

First. A maximum revenue consistent with our war effort. We must maintain—we must attain and maintain—maximum war production. Each day's delay on the home front means death on the battle front.

Second. Maximum protection against profiteering; and

Third. Maximum preparation for peace.

I would be very happy to have those three objectives debated. I have heard of no one who disagrees with them, and yet the bill pending before you violates every one of them.

Now, let us look at the situation from the point of view of inflation, because we are going to get maximum revenues and maximum protection against inflation.

Again, two very simple facts. At least $75,000,000,000 of your national income pays no income tax. And practically all the $40,000,000,000 of increased national income since 1940 pays no income tax.

Senator BYRD. Could you give a break-down on that, as to just how you arrive at those figures?

Mr. ALVORD. Yes, sir; I have a memorandum here which gives it, and I will be very happy to put it in the record for you.

(The memorandum referred to is as follows:)

MEMORANDUM ON DISTRIBUTION OF PROPOSED TAXES

The Treasury makes no estimate of total national income nor of total individual incomes for the calendar year 1942.

Mr. Marriner S. Eccles, Chairman of the Federal Reserve Board (as reported in New York Herald Tribune, May 26, 1942) used an estimate of total individual incomes for 1942 of $117,000,000,000.

The Department of Commerce (New York Herald Tribune, August 6, 1942) states income payments to individuals during June, as $9,537,000,000. This would be at the rate of $114,000,000,000 per year.

Recognizing the difference between such figures and those for net incomes (as defined by the tax laws), it is here assumed that a figure for total individual incomes of $110,000,000,000 is approximately correct. There might be a substantial variation in this figure, however, without materially affecting the essential comparisons here made.

Assuming that total individual income for 1942 will be about $110,000,000,000, an analysis of the tables submitted by the Treasury (exhibits A to H on pp. 56–71 of Senate Finance Committee hearings, unrevised) shows the general plan of raising revenues under the revenue bill of 1942 as passed by the House, taken in connection with existing law, which can be summarized as follows:

		Billions
From miscellaneous internal revenues and back taxes		$5.1
From income and profits taxes on corporate income of $16,900,000,000		10.3
From individual income tax:		
On $8.2 income in excess of $5,000	$3.7	
On 23.3 income below $5,000	4.2	
On 31.5 income taxable	7.9	
On 78.5 income not taxable	0	
		7.9
On 110 total		
Total revenue		23.3

From the standpoint of inflation, it should be noted that we plan to take from slightly over $30,000,000,000 of income, taxes of $7,000,000,000; and from approximately $80,000,000,000, to take nothing. Even if we should assume that the $110,000,000,000 total individual income was too high and should be reduced perhaps to $100,000,000,000, it would still show that less than one-third of the total individual incomes would be taxable, and over two-thirds would not be taxable.

It may further be noted that:

(1) The total taxable income over $5,000 is $8,200,000,000. If all of this income were confiscated, it would cover only slightly more than 10 percent of our estimated expenditures of $77,000,000,000 for the current fiscal year.

(2) The total of all corporate net income and all individual income over $5,000 is $25,100,000,000. If all of this income were confiscated, it would still pay less than one-third of our estimated expenditures for this fiscal year—and our entire productive economy would be wrecked.

SUPPORTING TABLES

The following tables show the derivation of the figures used in the above discussion from the Treasury tables (exhibits A to H on pp. 56–71 of Senate Finance Committee hearings, unrevised), together with certain other statistics (to which reference is made):

I. Total estimated internal-revenue taxes (for a full year)

[In millions of dollars]

	Present law	Pending bill	Total
Income and profits taxes (exhibit D):			
Corporations	7,647.1	+2,640.7	10,287.8
Individual	5,044.8	+2,872.3	7,917.1
Total, current	12,091.9	+5,513.0	18,204.9
Back taxes	404.0		404.0
Total income and profits taxes	13,095.9	+5,513.0	18,608.9
Miscellaneous internal revenues (exhibit E):			
Capital stock tax	290.0	−51.5	238.5
Estate and gift taxes	530.7	−7.1	523.6
Liquor and tobacco	2,008.1	+426.3	2,434.4
Transportation of property		+252.9	252.9
Gasoline; oils; autos; trucks, parts, etc.; tires and tubes; use of motor vehicles; etc	471.6	+13.9	485.5
Other	636.9	+123.8	760.7
Total miscellaneous	3,937.3	+758.3	4,695.6
Total internal revenue	17,033.2	+6,271.3	23,304.5

II. Sources of collection—pending bill

	Returns	In millions of dollars	
		Estimated income	Tax
(a) Corporations:			
Income (exhibit H):			
Surtax net income		10,330	
Adjusted excess profits net income		6,570	
Total, taxable		16,900	
Tax (exhibit D)			10,288
Individuals (exhibit A):			
Total amounts of annual income:			
Over $10,000	385,000	8,767	3,693.4
$5,000–$10,000	881,000	5,751	946.6
Total over $5,000	1 266,000	14,518	4,640.0
Under $5,000	25,634,000	45,186	3,277.1
Total of income on taxable returns	26,900,000	59,704	7,917.1
Amount taxable:			
Surtax net income (exhibit H)		31,530	
Income reported on returns but not taxed		28,174	

III. Individual income more or less than $5,000 per year

(*a*) We may allocate the total taxable income of $31,500,000,000, as follows:

The extent of net incomes in excess of $10,000 per year is found by deducting $10,000 for each of the 385,000 returns which show income in excess of that amount.

The extent of net incomes in excess of $5,000 per year is similarly found by deducting that amount for each return of a greater amount.

The difference between the amount of net income in excess of the $5,000 amount and the total taxable income will be the income below $5,000 which is taxed.

This results as follows:

Total net income	Returns	Net income	Below $5,000	In millions of dollars: Between $5,000–$10,000	In millions of dollars: Exceeding $10,000
Over $10,000	385,000	$8.767	$1,925	$1,925	$4,917
$5,000–$10,000	881,000	5,751	4,405	1,346	
	1,266,000	14,518	6,330	3,271	4,917
Under $5,000	25,634,000	17,012	17,012		
Total taxable	26,900,000	31,530	23,342	3,271	4,917

Taxable income in excess of $5,000	$8,188
Taxable income below $5,000	23,342
Total taxable	31,530

(*b*) The allocation of tax on incomes above and below $5,000 cannot be so accurately made but can be reasonably approximated (probably with sufficient accuracy for present purposes) as follows:

Assume the average tax on $5,000 net income would be $750. (It would be $920 for a single person; $746 for married with no dependents; $570 for married with two dependents, etc.)

	Millions
Total tax on 1,266,000 returns of income of more than $5,000	$4,640
Tax on that part of the income which is less than $5,000—1,266,000×$750	950
Leaving balance to represent tax on the $8,188,000,000 in excess of $5,000	3,690
Total tax estimated for returns showing net income under $5,000	3,277
Add tax on that part of larger net incomes which are below $5,000, as approximated above	950
Approximate tax on taxable income of $23,342,000,000 below $5,000	4,227

Senator VANDENBERG. When you say that these large sums are not taxable, you mean nonincome taxable?

Mr. ALVORD. Yes, sir.

Senator VANDENBERG. You also say that 25,000,000 of employables pay no income tax?

Mr. ALVORD. Yes, sir. That is based on the Treasury figures.

Senator VANDENBERG. Even with the exemption reduced $500?

Mr. ALVORD. Even with the exemption reduced $500; yes, sir.

Senator TAFT. You say it pays no income tax. It pays some income tax, doesn't it? The figures I have tend to show that $59,000,000,000 pays income and $36,000,000,000 does not, under the new bill.

Mr. ALVORD. I have been a little more moderate than you and I said $25,000,000,000.

Senator TAFT. I figure that the people who have an income of $59,000,000,000 pay some tax. Of course, in some cases it is very small, and that only $36,000,000,000 is wholly untaxed, so I think that you had better put in the figures on that by which you reach your figures, as Senator Byrd requested.

Mr. ALVORD. They are based on Treasury figures.

Senator BARKLEY. What are those figures based on as the estimated income of the people for this year?

Mr. ALVORD. I might point out to Senator Taft that one difficulty in statistics of this kind is that there is no direct relation between the national income figures and the net income figures which the Treasury gives us. There may be quite a difference, so I have made an arbitrary deduction. The Department of Commerce at the present time is estimating national income for this calendar year at about one hundred and fifteen billion.

Senator TAFT. Mine was based on one hundred and ten billion for 1942, which reflects into about ninety-five billion of net income.

Mr. ALVORD. I make a guess of one hundred billion, so that we are not far off.

The statistics which Senator Byrd requested are like these. Of income in excess of $5,000, there is a total of eight and two-tenths billion; of income below $5,000 which will be subject to tax, there is twenty-three and three-tenths billion, which gives thirty-one and five-tenth billion which will be taxed. Then I make my arbitrary deduction from the figure one hundred and five billion and reach my estimate of about seventy-five billion which will pay no tax.

Senator VADENBERG. You are referring only to the income tax?

Mr. ALVORD. I am referring only to the Federal income tax. We certainly must realize that there are many other taxes which will dig down into the pockets of the people that I am talking about, and I will discuss that in just a minute.

Senator VANDENBERG. You mean seventy-five billion of this income is in brackets under $5,000?

Mr. ALVORD. Under $5,000 not taxed. As a matter of fact, if you were to take all of the incomes over $5,000 that apply to those individuals in the country, and every penny of corporation income, you would only get $25,000,000,000.

Senator VANDENBERG. I don't understand your figures. We tax below $5,000.

Mr. ALVORD. Yes, sir. I constructed the figures to exclude—I just drew the line at $5,000 so that you can see how the line is drawn. Of all the incomes below $5,000, we will impose a tax upon an aggregate of only twenty-three and three-tenths billion.

Senator VANDENBERG. How much on incomes above $5,000?

Mr. ALVORD. Eight and two-tenths billion of income. That leaves roughly seventy-five billion not taxed.

Senator BARKLEY. Let me ask you this. That means about thirty-one billion below and above $5,000?

Mr. ALVORD. It will all be below.

Senator BARKLEY. You have got eight billion above $5,000, and you have got twenty-three billion below $5,000?

Mr. ALVORD. Yes.

Senator BARKLEY. Which makes thirty-one billion below and above $5,000.

Mr. ALVORD. That is true. But the remaining seventy-five will probably all be below five.

Senator TAFT. I don't understand your figures, Mr. Alvord, because the figures given by the Treasury and given in the tax data of income show a total taxable net income of fifty-nine billion. Which goes all the way down to $1,000. And of that, about thirteen billion is above five, and about forty-four billion is below five.

Mr. ALVORD. Senator, as you read those figures off to me, I don't think they include about thirty billion dollars attributable to exemptions and credits.

Senator TAFT. They are taxable returns.

Mr. ALVORD. That is right. And therefore, thirty billion dollars has already been taken out.

Senator TAFT. Of course, if you deduct all of your exemptions——

Mr. ALVORD. That is what I am doing.

Senator TAFT. That is a different question. But it is a little hard to say that a fellow with $1,500 of income and a $1,000 credit is a $1,500 income and is not taxed. It is taxed.

Mr. ALVORD. But if he has a $1,000 income and a $1,000 credit, then that $1,000 is not taxed.

Senator TAFT. If you want to exclude all of that, that amounts to about $30,000,000,000.

Mr. ALVORD. That is the difference.

Senator Barkley, for example, last year I think it was, stated that he thought the sound tax policy would be to tax all the increased national income over the prior year.

With that policy I agree, subject to certain practical limitations.

Senator BARKLEY. It is impossible to follow every dollar of that increased income into the pocket of the fellow who has it.

Mr. ALVORD. That is true.

Senator BARKLEY. Yet I have felt and I still feel that with an estimate increase of $30,000,000,000 in the annual income over last year, we ought to be able to reach eight billion of it.

Mr. ALVORD. I don't think you will have a $30,000,000,000 increase this year. You might have as much as fifteen.

Senator BARKLEY. It has been estimated around twenty-eight to thirty. We won't know until the year is over.

Mr. ALVORD. I think those estimates are for the next year. One hundred and fifteen billion is the highest estimate I have seen.

Senator BARKLEY. The Department of Commerce gave out a statement that the income for the first 6 months of this year was fifty-four billion.

Mr. ALVORD. Yes.

Senator BARKLEY. It will probably be more for the next 6 months.

Mr. ALVORD. Yes.

Senator BARKLEY. Last year it was ninety-five.

Mr. ALVORD. Yes.

Senator VANDENBERG. I still don't understand just what figures you gave. You mean there are 25,000,000 who get less than $5,000 a year?

Mr. ALVORD. That receive nontaxable income.

Senator BARKLEY. That is about half of the total number of people employed, if that is correct.

Mr. ALVORD. That is correct.

Senator VANDENBERG. You mystify me as much as the Treasury does on that.

Mr. ALVORD. I understand your mystification, but I am sorry I contribute to it.

Let me attempt to tie in a fiscal program again with inflation. We must have maximum revenues consistent solely with victory and complete victory in as short a time as possible, which means maximum production. We need maximum borrowings from savings——

Senator TAFT (interposing). I might just interrupt you a moment? I have talked to the Treasury about the number of returns, and if every wage earner makes a return, my recollection is they figure it will be about fifty-two million, whereas they figure that under this bill 26,900,000 will make returns, so that Mr. Alvord is approximately correct. It will be 25,000,000 even on the Treasury account who make no returns of people who are earning money one way or the other.

Mr. ALVORD. I might suggest to Senator Vandenberg that possibly the reason you are mystified is because I am using Treasury statistics.

Senator VANDENBERG. That is a terrifying coincidence.

Mr. ALVORD. We must have maximum borrowing from savings and incomes of individuals, and we must have minimum borrowing from commercial banks.

Secondly, and I know that Senator Byrd will be interest in this, we must have minimum spending for nonwar purposes. I commend the tremendous efforts and I congratulate him on the success of his committee so far. I am confident that as he says, "We have but begun."

Then I make the suggestion based also on Senator Byrd's report, that we should have the maximum efficiency in war spending. Bear in mind that you must have a tremendous amount of waste. Time and speed are much more important than economy in war spending. You will have waste—you might as well recognize it—but the point I make is, don't have any more than you have to under the circumstances.

I repeat that which I have been saying for years, gentlemen, and it is now almost too late, but consistent with war production, your policy should permit maximum production of civilian goods. It should promote it. In other words, if we are to have this fight between the supply in civilian goods and the money available to buy them, the fight between supply and demand, one way to help would be to increase the supply. That can still be done.

Now, let me apply my test to the Treasury program and to the House bill.

It is our judgment that both the Treasury program and the House bill fail to produce the maximum revenues, fail to encourage civilian production, jeopardize your entire war production program, give no opportunity at all to financial preparation for peace, provide substantially no control over inflation, adopt terrifically heavy and unnecessary retroactive burdens upon individuals, and fail to adopt provisions which will permit maximum revenues from individuals. They fail completely to aid in the maximum borrowing from savings and current income of individuals. They, therefore, place practically your entire fiscal program upon the one thing which for years we have been attempting to convince everyone must not be done—they base their entire program upon maximum borrowing from banks.

Well now, I will discuss if I may, maximum revenues consistent with the objectives I have outlined and consistent with our objectives in our fight against inflation, and it is very interesting to see how smoothly they will mesh together. Let me discuss individuals first, because each of your is an individual, and you know exactly what your needs are. Sometime when we get over into the corporate field, people are inclined to forget that corporations are composed of individuals. Their owners are individuals, their management are all individuals, and their labor are all individuals. That fact we sometimes overlook, so I will discuss individuals first.

Maximum revenues from individuals—how do we measure it? First, our citizens must live. There are certain minimum requirements below which you should not and dare not go. Quite true, their standard of living must be decreased. That applies to all of us. But there is the minimum below which you dare not go.

Secondly, we must support our churches and our charities and our schools. I hope the day will never come when our churches and our charities and our schools must rely upon Government aid.

Third, we must educate our children. There is nothing in the entire war program that should compel our children to go without educational opportunities.

Next, everyone of us has debts. We have to meet our life-insurance requirements; we have to pay interest and amortization on our mortgages on our homes. I do not believe we need pass into the tax collector's window our life-insurance policies and our homes.

Then, we have these extraordinary demands, such as death and sickness. Every one of us has them. And in determining how much a person can pay, that factor must most certainly be taken into consideration. We have all of these very practical, simple, ordinary everyday facts.

Now, let us look at it from the point of view of taxes for just a minute. There is practically no individual in this country who pays his taxes currently. I would guess that if there were any individual, I might be he, and I confess to you that I cannot do it. I make the best estimates on tax liability that I can, but I will be way off, for you gentlemen have established a very strange procedure, certainly from the point of view of individuals. You wait until September, October, or November, to pass a tax law which tells me in November what I have to pay on my income from the preceding January on. No person in the world can set aside or can save enough to pay taxes under those circumstances.

I regret that I was not one of those who conceived of this "pay as you go Ruml plan." I had heard of it roughly about 2 months ago. It was then, I thought, so incomplete that I discarded it. I was not wise enough to see its opportunities. For years many of us have been attempting to find some way of putting individuals on a current basis. Mr. Ruml has the solution, and the plan which he presented to you the other day is greatly perfected over the plan that I saw a couple of months ago. I think it will work.

Let me describe it to you just a minute. I don't know Mr. Ruml. I have never talked to him. I tell you that I am sorry that my name does not appear on the list of those who approve his plan. All he does, gentlemen, is to apply the principle of daylight saving to taxes. For example, it is now 12:20 according to your clock. Actually, it is only 11:20. All we have to do is to move the taxable year up, just as you moved the hands on the clock ahead. This roughly is his plan. It is described in detail in your hearings, at page 175. It is well worth the study of every one of you.

He says this—keep right on paying your taxes exactly as you have before, but as we pay our taxes in 1942, let them be taxes for 1942 and not for 1941. Now, the taxes that we pay in 1942 are what we owe on our 1941 incomes, out of which we have not saved nearly enough; so, enact your new rates, put them into force, and then pay 1942 taxes, and it now would really be 1943 taxes. File your return on the 15th of March of next year; estimate your tax except for the two or three provisions called relief provisions, which are eminently sound—your estimate must be your 1942 income, just exactly as it would be without this provision. But your 1943 tax based on 1942 income. Then when 1943 is over and you know what your income is, correct it; perfectly simple. It can be done administratively; I see nothing wrong with it. I am happy that the Treasury is studying it, and I hope that they will recommend it. If you should adopt that sort of a plan, then your whole basis for taxing individuals could be revised and put on some sort of a sensible current basis under which you will get the maximum, and everyone will be happy to pay it.

Senator HERRING. Suppose they write a new tax law next November?

Mr. ALVORD. It still works. That was a vice I pointed out in the earlier plan. You make those rates effective for the next year. It has exactly the same effect. For example, let us take this bill as it stands. You may not impose as tremendous increases in tax liabilities as the House bill does, but you will impose substantial increases. Those rates will be in force immediately, just exactly as though you had not adopted it.

Senator HERRING. It will be retroactive from the first of the year.

Mr. ALVORD. You will pay in 1943 precisely the same amount except that you pay it on the basis of 1943 liability and not 1942.

Let me explain the one essential difference. This is a very practical problem for which I have been trying to find a solution for years. Let me assume that a man making—say, $10,000—precisely your salaries, goes into the armed forces. He may go in at a salary, let us say, of $2,500. But under your present system, he must still pay after he gets into the Army, and out of his $2,500 income because he has not saved otherwise, he must pay a tax on $10,000. Unless he is exceptionally fortunate in having other resources or assets available, he cannot do it, because you are taxing him more than $2,500 under this bill as it stands. You take all of his income plus.

Under the Ruml plan, a very simple device exists for that sort of a situation. When a person changes, and I would limit it for experimental purposes to persons who go into Government service—there are other cases but I don't know just how far you can go—but, say, a person definitely leaves a $10,000 salary and goes into the Government at $2,500 salary. Under the Ruml plan, he then files appropriate certifications and pays his 1943 tax on his then known 1943 income.

Senator BARKLEY. When will he pay an income tax on the $10,000 that he got for the last year that he got it?

Mr. ALVORD. Never.

Senator BARKLEY. Never?

Mr. ALVORD. Nor will he pay it if you gentlemen don't adopt the plan.

Senator BARKLEY. They are not all $10,000 people going into the $2,500 class.

Mr. ALVORD. That is true. If he stays at $10,000, he stays exactly as he does under the present law. If he goes from $10,000 to $15,000, he will pay exactly what he does under the present law except that you will collect currently from him on the $10,000, and at the end of the year he will owe the tax on the additional $5,000. It would permit him, for example, or any of us, to file monthly returns and make advance payments on the $15,000 basis if our 1943 income is to be higher.

Senator BARKLEY. Do you advocate changing from an annual to a monthly basis on income tax?

Mr. ALVORD. With respect to certain items, yes, sir; and you can get tremendously increased revenues immediately into the Treasury if you do that. It would permit that. Should you adopt the Ruml plan, there is no reason in the world why you cannot provide for the complete withholding on certain types of income of the full amount of your normal tax, and perhaps the first bracket of your surtax. And your taxpayers will be delighted to have it done.

Our biggest burden is to find the cash to pay the taxes which you gentlemen impose. If you collect it currently, we can stand a terrific amount and it will get into the Treasury immediately. We won't have to wait until the fiscal year 1944. I would make the plan effective January 1, 1943, and the first withholding under it would be returnable to the Treasury in February, and then you get 5 full months in the fiscal year 1943 of substantial revenues.

Senator TAFT. He would never pay entirely his 1942 income.

Mr. ALVORD. Looking at it practically, you would pay into the Treasury on January 1, 1943, just exactly, beginning on that date, just exactly as you would did you not adopt the plan, plus many more billions which you would be happy to pay in currently.

Senator TAFT. The payment is made in 1942 on the 1942 income, which omits the 1941 income.

Senator BARKLEY. Otherwise you pay it on 2 years' income in one.

Mr. ALVORD. In effect, you pay your full increased rates on 1942 income in 1943. The only difference is this, as I have already indicated, if a man went into the Government service; or should you die in 1943. One of the best features is in relieving estates of the tremendous obligations of providing cash to pay not only estate taxes but also back income taxes. Your estate-tax collections will go up and your income-tax collections will go down. Sometimes we forget entirely that there is always a new generation coming on.

I think that the plan deserves the most serious consideration. Whatever flaws there may be in it, I am confident can be worked out. Then you can collect into the Treasury immediately several billions of dollars more than you will get either under the House bill or under the sensible bill which I trust you gentlemen will propose and pass.

Senator VANDENBERG. Does that apply only to individuals?

Mr. ALVORD. Yes, sir.

Senator BARKLEY. You mean under the Ruml plan, you get more money than you get under a sensible bill either by the House or the Senate?

Mr. ALVORD. Yes, sir.

Senator VANDENBERG. And if you die next year, you pay nothing

Mr. ALVORD. You pay no more income tax, because unfortunately you have no more income. You don't benefit, unfortunately, because you are dead.

Senator VANDENBERG. Is that what they mean when they say, "Oh death, where is thy sting?"

Senator TAFT. You pay on part of the year up to the time you die.

Mr. ALVORD. That is what you pay.

The CHAIRMAN. Then your estate has to pay the adjusted tax finally?

Mr. ALVORD. Yes.

Senator BYRD. So far as the year 1943 is concerned, you would make your March 15 payments on your earnings for 1942?

Mr. ALVORD. That is right.

Senator BYRD. And then you pay currently for the year 1943?

Mr. ALVORD. That is right.

Senator BYRD. In effect, you advance the collections.

Mr. ALVORD. That is right.

Senator BYRD. And thereby net more revenues to the Government.

Mr. ALVORD. You have to take the next step and also withhold from current income.

Senator BYRD. Then the adjustment is made?

Mr. ALVORD. That is right. For example, you solve completely the problem—this is only one of the incidental problems of the Treasury proposal to collect at the source; a proposal which I trust you will turn down.

Senator GERRY. How would the Treasury be able to compute the adjustments?

Mr. ALVORD. They do it now, practically. They are no more serious than the other adjustments which they make on an ordinary tax return. As a matter of fact, you would work out a system of credits, so that if you pay an excess on 1943 income—if your 1943 income is really less than your 1942, it will be credited when you file your return in 1944. Then you can withhold, as I say.

There are three kinds of income which are peculiarly capable of being withheld—on which a tax can be withheld at the source—compensation, dividends, and interest. Other types of income are not capable of being taxed by collection at the source, but those three are you can impose a withholding tax so that that money flows immediately into the Treasury and the Treasury will collect immediately substantial revenues.

Senator CLARK. I think that your statement and Senator Byrd's statement is different from the proposal made by Mr. Ruml which I have studied with some care. In the proposal, as I understand it, it is to take the payments being currently made in 1942 and apply them on the 1942 income, and with any excess or diminution, as the case may be, not to pay the 1942 income tax in 1943. In other words, he simply forgets the 1941 tax.

Mr. ALVORD. Yes; but he does not forget his 1942 tax.

Senator CLARK. The payments being made this year would apply to the 1942 tax.

Mr. ALVORD. That is right.

Senator CLARK. So that there would be a certain loss to the Government from people who died or ceased to be income-tax producers scattered over a period of 40 or 50 years, which would to some extent and possibly to a large extent—I have not got the figures on that—which would be offset by the certainty of collection.

Mr. ALVORD. Yes, sir.

Senator CLARK. Senator Byrd assumed that you would pay the 1942 tax in 1943 and also pay the 1943 tax.

Mr. ALVORD. Oh, no. You pay your 1943 tax in 1943 precisely as you would otherwise, measured by 1942 income. When it is paid, you are free.

Senator BARKLEY. When you get on a current basis and collect by the month, based upon the earnings of the month instead of the year, and in the case where a man would earn during the first 6 months at a rate that would put him in the taxable bracket, and during that first 6 months the Government would take out each month a proportion of it, and then during the last 6 months he reduced his income or was unemployed altogether, so that his total income would not put him in a taxable bracket, then the Government would have to refund all that it had collected by the month from that person?

Mr. ALVORD. That is right. On that type of withholding. I am going to suggest a slightly different type of withholding.

The CHAIRMAN. All right, Mr. Alvord. Let us see if we can make a little more progress now. We will study this Ruml plan.

Mr. ALVORD. I think it is deserving of very serious study.

In the absence of the Ruml plan or some such device as that, so that we can get away from our enslavement to the Treasury—everyone of us is really working as hard as we conceivably can to keep from falling back too far. We cannot conceivably get current.

In the absence of that, then, I most respectfully suggest that $1,000,000,000 retroactively imposed is the maximum which you should collect from individuals on 1942 incomes. Prescribe your rates applicable to January 1, 1943, at the highest consistent with your own consciences, but do not attempt to make those rates retroactive. Folks just cannot take it.

Now I come to corporations.

Senator BYRD. Before going on with that, how would you change this bill to accomplish that?

Mr. ALVORD. Mr. Stam can do it if you ask him to, in much less time than I can. If you would take the present law and provide rates about half-way between the present law and the House bill, you would just about reach that result.

Senator BYRD. As applicable to 1942?

Mr. ALVORD. Yes, sir; as applicable to 1942.

Now, I come to a discussion of the maximum to be collected from corporations, and again I ask that you keep yourself in the position of individuals, because corporations are really no different. Everything that I have outlined with respect to individuals is equally applicable to corporations, and then there are a few other facts which are of particular importance.

Let me discuss factor No. 1. I have been discussing this factor for years.

In determining how much you can tax a corporation, you must consider the requirements of that corporation for cash, just ordinary cash requirements. I think that some of you will still be surprised at my statement which I make to you every year. Your definitions of taxable net income have nothing to do with the earnings and profits of the corporation—practically nothing to do with it. And your definition of statutory net income has absolutely nothing to do with cash.

Paper profits are the profits which you gentlemen tax. I may not have one single penny in cash and still have a substantial tax liability.

Now, what does the corporation need cash for? Well, I suspect you would have an uprising if that corporation attempted to meet its pay rolls with promises to pay. It must have cash for pay rolls, it must have cash to meet its purchases, it must have cash to meet transportation charges, it must have cash to pay its debts and the interest on its debts, it must have cash to pay dividends, preferred or common. It must have cash for real, practical purposes. And last, but by far not the least, it must have cash to pay taxes—Federal, State, and local.

Now, how far can you afford to deplete the cash of corporations? Its cash comes from but two sources; it comes from sales of whatever it is that it is selling, even though it be personal services—it comes from sales, or it comes from credit.

Credit is the thing that is of the utmost importance. If you want to get cash through credit, you go to a bank. When you go to the bank, the bank says, "What chance is there of your repaying it? Let us see what your balance sheet looks like and what your prospective earnings and profits might be."

If you impair that ability to repay, as the House bill does most severely, if you impair the ability of that enterprise to repay its debts, it can get no cash through credit.

Now, I reach what to me is one of the most fundamental issues. Every enterprise in the United States devoted to war production, and every other enterprise, will be financed one way or the other. This tax bill may very well decide whether that corporation will be financed privately or by the Government, and I predict to you gentlemen that if the decision you make on the present tax bill should be to compel financing by the Government, that decision may very well be final; it cannot be reversed.

That is one of the most important considerations in determining the maximum which you can get from corporations.

I will summarize my conclusions very briefly. I can support them by all the statistics that you gentlemen want. It is my very mature conclusion that a 35 percent tax on normal profits is the very maximum—not the minimum at all but the maximum—which corporations to which this act will apply, can pay. Bear in mind they are not all war corporations; many of them have nothing to do with the war, many of them are disastrously affected from a profit point of view by the war. Many of them have been driven out of business entirely. A 35 percent tax on normal profits, in my opinion, is the maximum.

Now, let us see what we do with excess profits. Let me state one fact to you first. An excess-profits tax should not be designed to produce revenues. The primary function of an excess-profits tax is to control and to prevent profiteering. If it successfully prevents profiteering, it should produce nothing.

Therefore in taxing excess profits, we must define, draw a line between normal profits and excess profits. That is the first and most important job to do. If I can diverge for just a minute, I assume that you gentlemen have all reached the conclusion from hearing the technicalities of the present law and the technicalities of this bill that no excess-profits tax can stand as a part of our revenue system except for the period of the war. Just as the 35 percent normal rate is good only for the period of the war—it is much too excessive for ordinary periods of time, and I challenge anyone to write an excess-profits tax system which really can be administered.

Senator BYRD. Let me ask you this question. Have you made an estimate of the total Federal taxes of the average corporation, of the income tax of 45 percent, the capital stock tax and the excess-profits tax going up to 90 percent? Have you made an estimate of what the average corporation would pay under the House bill?

Mr. ALVORD. On the basis of the statistics that I have seen, they would pay 73 percent. That happens to be just the reverse of the Canadian system.

Senator BYRD. Are you speaking of corporations generally, those who pay excess-profits taxes and others?

Mr. ALVORD. Yes, sir.

Senator WALSH. You stated that this committee should seek to obtain the maximum income from war profits. Have you any proposal or plan for that?

Mr. ALVORD. Very specific.

Senator BARKLEY. The 73 percent is 73 percent of the total earnings?

Mr. ALVORD. No, sir; 73 percent of their statutory net income—not their earnings and profits.

Senator BARKLEY. That includes also that on which they pay a normal tax?

Mr. ALVORD. Yes, sir.

Senator BARKLEY. As well as the excess-profits tax?

Mr. ALVORD. Yes, sir.

Senator VANDENBERG. I think those are the National City Bank figures in their bulletin.

Mr. ALVORD. Yes, sir. The conclusion is drawn from that bulletin.

Now, your first job in imposing excess-profits taxes is to draw this line between normal profits and excess profits—an exceedingly difficult line to draw. Real care must be exercised in drawing that line, for otherwise you subject to these tremendously high, and I advocate confiscatory rates on excess profits, you make those rates apply to admittedly normal incomes. No person can live long if you do that.

As you gentlemen know, you have three principal ways of computing normal profits: You have the return on its invested capital; you have the average of its earnings for 1936, 1937, 1938, and 1939; and you have the so-called general relief.

I will speak just briefly with respect to each of those three.

On invested capital I make two points particularly.

The House proposes to cut the credit on invested capital, relying on Mr. Stam's statistics, from 8 and 7 percent under the present law, to a schedule of 8, 7, 6, and 5 percent. Those yields are utterly inadequate. Take the statistics and work on them as much as you want to. But I know that no person familiar with the demands of war production will concede that 8, 7, 6, and 5 are adequate.

You made a serious mistake last year in changing the law from 8 percent to 8 and 7. Don't further that mistake. It is much sounder to go back to the 8 percent—much sounder to take the 10 percent of the prior laws.

The second important suggestion is this: Now, in considering your credit on invested capital, bear in mind that the present law is an exceedingly arbitrary law in determining what goes into invested capital. I suspect that most of you will think that invested capital means the money that you put into the concern. It may be on that basis that Mr. Stam has said most corporations in the higher brackets never realize 5 percent. But, in fact, if he looks at actual earnings and profits he will find that the return is well over 7 percent over any period of time. But invested capital, I am compelled to tell you, has absolutely nothing to do with what you put into the corporation. That is a surprising statement—but I trust it will not be surprising to any of you, for I stated this fact to you in 1940, and again last year. Invested capital has nothing to do with the money that you put into your corporation. That is because of a little device, intentional and well planned and thought out, a definition which produces precisely the opposite results, which you gentlemen thought you were producing, precisely the opposite results from the one which should be produced. That is the point that Mr. Hopkins referred to very briefly—the distinction between cost and tax basis. It works against the Treasury and in favor of the taxpayer, and in favor of the Treasury and against the taxpayer. No one knows how it is going to work.

First, I will tell you that the tax basis cannot be computed, and I will stand on that statement.

Secondly, it should not be if it could be. I will give you a very simple illustration of precisely what I mean. I own this table here, and I sell it to the chairman. The table cost me $100 and I sell it to the chairman for $150. I have a $50 gain. I pay a tax on it.

The chairman then says, "This table cost me $150." If he depreciates the table, he does it on the basis of $150. If he sells it, he puts the gain or his loss on the basis of $150. Perfectly proper.

Now, if the chairman happens to be a corporation and I sell him this table for $150 exactly as I did before, but he pays me in his securities instead of cash—he could have done it either way—it made no difference to him whether he sold securities and got the $150 in cash and then paid me in cash, or whether he short-cutted that and paid me directly $150 worth of market value of his securities.

The cost to the chairman is $150 exactly as though he had bought it in cash. But that is not his invested capital. It is his investment in the table. But in computing his invested capital, we make the chairman find out what this table cost me. I may be dead or I may be gone, but he has to find out what the table cost me, which is $100, and then he has to deduct all the depreciation that I claimed on the table during the entire period that I owned it, and perhaps of several owners before I acquired the table. Those computations cannot be made even in the simple case that I gave you.

Now, the 1917, 1918, 1921 excess-profits tax soundly computed invested capital on the basis of cost—"what did the assets cost the corporation?"

Which is of course, the market value of the securities that the corporation paid for it. For some reason, and the only reason that has ever been told me is the reason of administrative simplicity—that cannot be the reason, but that is the only reason I heard—for some reason, the Congress upon the recommendations of the Treasury changed your old rule of cost and adopted the rule of the tax basis.

Now, I can show you cases where that rule helps me, as for example, it would help the chairman in the case I put—suppose this table had cost me $300 and I sell it to the chairman for $150 in his securities. What should be his invested capital? I still tell you that that invested capital should be the cost to the chairman, $150, and not 1 penny more.

What is it under the present law?—$300—absolutely no relation at all to the cost to the chairman.

The rule ought to be changed.

Now, I come to the question of the earnings credit. I will get through, Mr. Chairman, very shortly. Again, your earnings credit—which is one of the best devices—I am sorry to differ with Mr. Cranch who appeared before you the first thing this morning on this point—I doubt if he really thought it through, because it will hurt their men much more if earnings credit should be eliminated than any gain which could conceivably result.

I just ask each of you gentlemen as you sit here, how closely will 1936, 1937, 1938, and 1939 average of your incomes represent your normal income in 1942 and 1943? If you have no other income but your fixed salary, and if your expenses—let me say your expenses of campaigning are actually more and your tax liabilities remain the same, then it works. Otherwise it does not.

Now, there is one very serious defect, and I always point it out whenever your experts pull something out of the Canadian system and out of the British system and therefore recommend it to you as being sound.

I say, gentlemen, why don't you pull out the good things as well as the bad?

Your years 1936, 1937, 1938, and 1939 were not normal years. They were the tail-end of a decade of depression. Your year 1938 for most corporations was as bad as your year 1933. Your corporate net incomes for 1938 were only slightly higher than they were in 1933, and yet this is what you say—you say "take your 1936 income, your 1937 income, your 1939 income, and your 1938 deficit, treat the deficit as zero, total them up and divide by four, which gives your average."

Now, Canada and Great Britain have solved that almost exactly as I have suggested that it be solved. To the extent that we must rely upon these base period years, 1936, 1937, 1938, and 1939, rely on only three of them instead of four; let the taxpayer do exactly as they do in Canada and Great Britain if they are in existence for those periods of years, let the taxpayer take any one of those years and kick it out as being subnormal and then average the other three.

Your result even then is going to be wrong, but it comes closer to giving you a right starting point than any other system that I could devise. It will be wrong, for example, because those years will not reflect 1940, and bear in mind that your defense expenditures in 1940 were insignificant so far as the real national income or Government activity was concerned. You would be justified in taking 1940 and putting it into the earnings base and using 1940 for your normal growth provisions.

Mr. Chairman, your experts have done an excellent job, just as they have done in many parts of this most complicated excess-profits tax provision. They have done a swell job—it still needs improvement, and it will be improved as you give them time.

On relief, they have done an excellent job. There are, however, four general types of cases which I think you gentlemen would want to cover which are not now covered by the relief provisions as I read them.

First, the corporation—of which, unfortunately, there are many—which had a long series of deficits prior to this war; 1936, 1937, 1938, and 1939 were all deficit years, in which they did not make any money, and yet they are that peculiar type of organization which relies for its income upon the individual capacity of the fellow doing the job. The corporation has substantially no invested capital. Under this bill you take 90 percent of every penny they earn, and they are probably just coming into normal incomes in 1942 and 1943. Their activities may well have nothing to do with the war.

A second type is the corporation that happens to have ingenious management, so that it has done an extraordinary war job. The War Department or the Navy Department has insisted, because of its ability to produce and to produce on time, precisely what the War and the Navy Departments want, that they expand and expand and expand. Many such corporations have increased their capacity so that their sales will be 10, 20, or even 30 times more than they were in the base period years.

They have expanded on their own capital and on their own risks, they have lost their civilian customers, and yet you again take 90 percent of practically every penny they make. You take 90 percent of every penny they make on their increased volume, and I don't think you ought to do it.

Those types of corporations could well be provided for by a flat ceiling. It is hard to measure it—but it can be done; figure out the rate you want. I would suggest, as the very top, a provision, saying that for the period of the war these two types of corporations will not be asked for more than 75 percent of their entire income, for all Federal taxes.

Third, you have a type of corporation which has peculiarly efficient management, so that your war production agencies go to that concern, and say, "Please manage this war plant for us. We will build it, we will give you the money to build it, and you do the job. For that we will pay you a minimum compensation."

If that corporation happens to be in the excess-profits tax class, as it probably is, for every dollar that it gets in compensation for that very important war function, it pays 90 percent of it back to the Treasury. I don't think you want to do that. A perfectly simple solution for that is to put it right up to the War Production Board; let them say, if this particular concern is doing the job on a basis which means only minimum reasonable profits, that such profits shall be excluded from excess-profits taxes. Subject them to normal but not to excess-profits taxes.

Then you have another type of corporation—that type of corporation which, over a long period of time, has had a steady growth.

The figures which I have seen, for example, with respect to the public-utility industry are illustrative.

The figures are something like this—beginning back in 1920 and continuing right straight up to the present time, they show a normal growth of about 10 percent each year over that long period of time. It will be a little less than 10 percent, but the precise percentage can be discovered, and it is not now relatively important. Let us call it, for simplicity, 10 percent. That is the normal growth of that industry.

Now, what does it face?

You have a provision in this bill which is called, "normal growth" and, like many other provisions in the bill, it is misnamed. It is a perfectly sound provision and must stay except that it can be improved, as I have suggested, by the use of the year 1940, for example, in the growth formula. The real name of this provision should be "abnormal growth" and not "normal growth." It is abnormal growth because it applies only to that abnormal situation where 1938 and 1939, notwithstanding the 1938 depression, have produced substantially more income than 1936 and 1937, because otherwise your normal growth provision does not apply.

You also have a limitation on your normal growth provision that the resulting credit cannot exceed the maximum of any one year, which usually would be 1939. There is no justification for that limitation, but even if that is eliminated, the provision does not apply to an industry such as I have described.

That same industry is confronted with other peculiar provisions in the bill which apply fairly to others but not to itself. For example, the utility industry, as I remember the facts, invested substantial funds back in 1930 and 1931 and perhaps in 1932, attempting to encourage the effort to prevent the depression. They probably expanded their capacity far beyond all immediate use. That capacity is just now—maybe in 1939 in some cases, but usually in 1940 and 1941 and 1942—just beginning to show income, yet you take 90 cents out of every dollar it makes.

Another peculiar factor of that industry, as I understand it, is that even in normal times, the funds which they expend upon additions, and which they must expend upon additions if our homes are going to be served with electricity—do not produce income until from 1 to 3 years after they make the investment, with the result that the investments which they did make in 1936, 1937, 1938, and 1939 are not reflected in earnings until after the base period. You are taking 90 cents out of every dollar from that normal expansion and transferring it to the Treasury.

Then another strange factor is that the utility industry as well as many other industries were forced to expand through, not the issuance of common stock or preferred stock, in which event they would get the application of the additional capital provisions of the present law, but through borrowed money, and the facilities which they have erected with the borrowed money are just coming into earning capacity. Not one single adjustment or allowance is made for that.

That industry is typical. Certainly some solution must be found for permitting normal growth of any taxpayer who is a part of an industry which has witnessed normal growth, for example, over a period of 20 years; otherwise you are going to stop normal growth. The policy which we are recommending is precisely the opposite—encourage normal growth.

I am submitting two charts showing the trends I have discussed.

(The charts referred to appear on pp. 1783, 1784.)

Mr. Alvord. Now, Mr. Chairman, there are other things that I would like to take up, but I will conclude with just one very earnest recommendation. I am very glad that Senator Walsh is here. I recommend most seriously the immediate repeal of the provisions of law which became law on the 28th of April this year known generally as the "renegotiation provisions." I know personally some of the members of the Price Adjustment Boards which have been set up to administer this law. They are extremely able and excellent groups of men, well qualified and of the highest integrity. They are doing, and will do, their best with an impossible statute. After working out innumerable preliminary problems, they appear to have adopted perfectly sound and sensible policies insofar as the statute permits them to do so, but the fact remains that the statute is utterly impossible and cannot be administered. So long as those provisions remain in the law the entire fiscal program of the Treasury might as well be scrapped—it has got to be on a day-to-day basis. Secondly, and of equal importance, I merely tell you that I did not think that any of us would ever live to see the day when bona fide Government contracts became scraps of paper.

I will hurriedly refer to a few matters, and ask that you study my written discussion.

First, there is the new treatment of capital gains and losses under the bill. The adoption of a single 15-month holding period, in place of the complicated dual holding period of the present law, seems to me desirable in the interests of simplification. I think you might go further and adopt the suggestion made to your committee by Mr. Emil Schram that a 3-month holding period would be adequate to distinguish speculative gains from investment.

But I see no conceivable justification for raising the 15 percent flat tax on capital gains to 25 percent, or for limiting capital losses to the extent of capital gains. The rate of tax on capital gains should not fluctuate according to revenue requirements, or changes in the individual surtax schedule. Your committee decided in 1938 that 15 percent was the fair and practical rate to be applied, in view of the differences between capital gains and ordinary income. We ought to stick to that decision, and not continually disturb the markets by frequent rate changes.

Nor it is justifiable to tax capital gains when they exceed losses, but to disregard capital losses when they exceed gains. This is par-

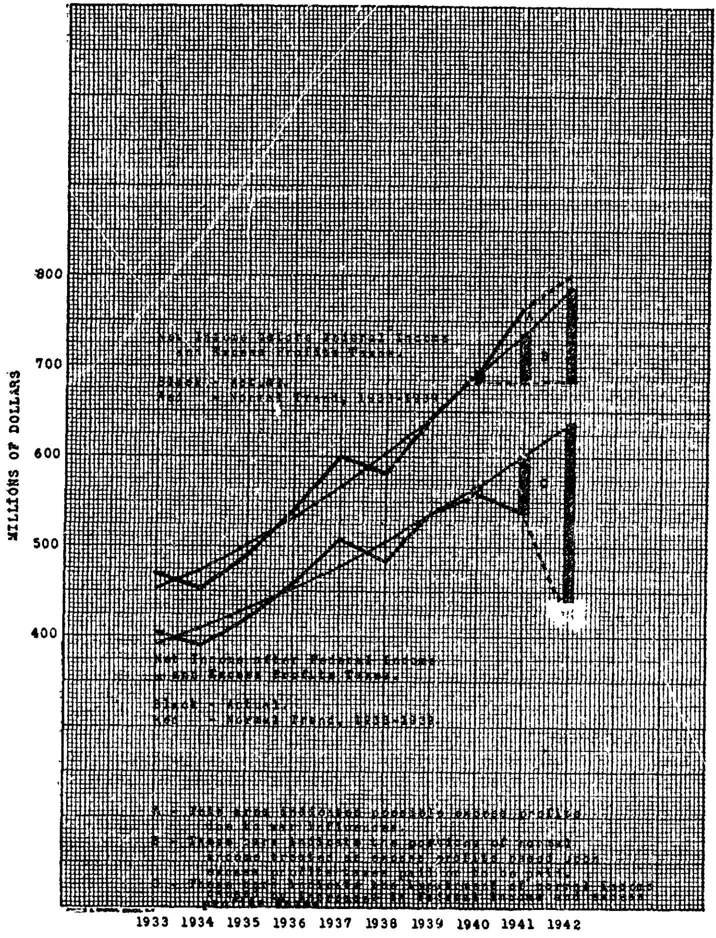


CHART I.—*The electric light and power industry* ticularly unfair to corporations, which have to deal in capital assets as a part of their ordinary business. If the present system does not produce net revenues, we ought to repeal the capital gains tax, instead of arbitrarily limiting losses.

A closely related matter is the problem of involuntary conversion, that is, property which has been requisitioned by the Government or destroyed by the enemy during this emergency. The bill proposes to treat gains from such conversion as capital gains, and losses therefrom as ordinary losses. This is very fair, so far as it goes. However, the bill limits the application of the section to depreciable property, held more than 15 months. Since all types of property,

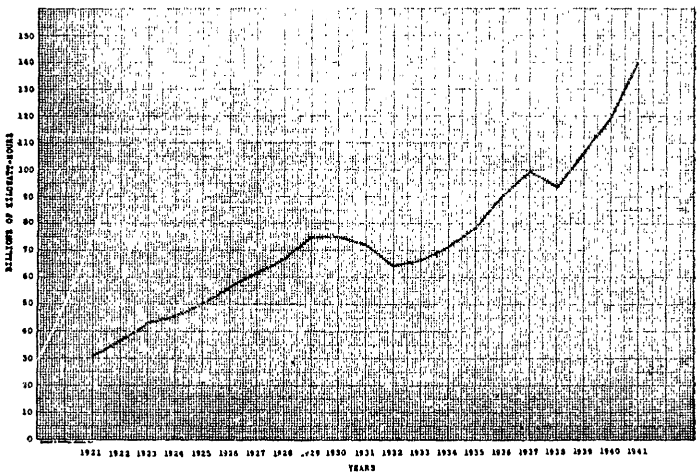


CHART II.—*Total kilowatt-hour sales to ultimate customers in the electric light and power industry*

depreciable or not, may be requisitioned or destroyed, I am at a loss to see why the provision is limited to depreciable property. Nor do I understand why the period of holding is material, since the taxpayer has no control over the event.

Finally, I wish to express our approval of the principle contained in section 114 of the House bill not to tax amounts recovered on bad debts, taxes, and so forth, previously deducted except to the extent that the prior deduction produced a tax benefit. I suggest, however, that the tax benefit rule should take the form, not of limiting the amount of income to be reported in the year of recovery and then taxing it at the rates applicable to such year, but of limiting the tax for such year to the amount of tax saved by the prior deduction. This will more nearly square with the real purpose of taxing such recoveries, which is to neutralize the benefits derived from the prior deduction. In any event, it should be made clear that in measuring the amount of the prior deduction which produced a tax benefit, a simple computation based on the tax liability with and without the deduction should be made and there should be no attempt to apportion a net loss among all the taxpayer's deductions.

Thank you very much.

The CHAIRMAN. You may put your brief in. And thank you, Mr. Alvord.

(The brief and supplement thereto submitted by Mr. Alvord are as follows:)

STATEMENT OF ELLSWORTH C. ALVORD, WASHINGTON, D. C., CHAIRMAN, COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. Chairman, gentlemen, I am Ellsworth C. Alvord, an attorney, of Washington, D. C. I appear as chairman of the committee on Federal finance of the Chamber of Commerce of the United States.

INTRODUCTION

The pending bill is unquestionably the most complicated in both form and substance we have ever been called upon to consider. A bill of 320 pages and a committee report of 181 pages of explanation compel a division of our testimony among the members of our committee. Mr. Roy C. Osgood will first discuss the technical provisions of the bill relating primarily to estate and gift taxes. Mr. Paul Shorb will then discuss the technical provisions of the bill relating primarily to individuals. Mr. Albert L. Hopkins will follow with a discussion of the technical provisions of the bill relating primarily to corporations. I will then discuss fiscal problems and the provisions of the bill relating to the excess-profits tax. We trust that our testimony will be of help to your committee.

OUTLINE OF FISCAL SITUATION

The more important fiscal facts confronting us may be outlined (in round figures) as follows:

(1) We begin the fiscal year with a national debt of $72,000,000,000.

(2) Our war appropriations and authorizations now total $206,000,000,000.

(3) Estimated expenditures for 1943 are $77,500,000,000.

(4) Estimated receipts for 1943 (making no allowance for additional revenues under the pending bill) are $17,000,000,000.

(5) The estimated 1943 deficit is $60.5 billions.

(6) About $2,500,000,000 of the 1943 deficit will be financed by the "use" of Social Security and other trust funds held by the Treasury—thus leaving a deficit to be financed through taxation and borrowing of $58,000,000,000.

(7) Commercial banks now hold approximately $26,000,000,000 of Federal securities.

(8) Fiscal 1944 is less than a year away.

ESTIMATED REVENUE REQUIREMENTS

The Treasury insists that the bill now pending before you must produce $6,000,000,000 of additional revenues for 1943, and $8,700,000,000 for the first full year of operation. It estimates that the bill as it passed the House of Representatives will produce for the same years about $4,000,000,000 and $6,200,000,000, respectively.

The Treasury does not tell us how it reached its decision upon the necessary amount of additional revenues. But it does tell us that its demands have no relation to expenditures or deficits. For our estimated expenditures, and therefore the deficit, for 1943 have increased $14,000,000,000 since the Treasury made its original recommendation to the Committee on Ways and Means, while the Treasury has increased its demand by $1,100,000,000.

The truth is probably this: The Treasury prepared the tax program which it would impose if it were the peoples' duly elected legislative representatives, estimated its total yield, and then demanded that total as its minimum requirements. In any event, there is precedent for this procedure.

But there is no formula by which revenue requirements can be computed. Furthermore, it is utterly impossible to estimate, within several billions, either our probable expenditures or our probable receipts. For example, the present law might well produce $20,000,000,000. In addition, if the present law providing for renegotiation of war contracts remains in force, no one can predict its effect upon future revenues—other than that it will be disastrous and uncontrollable. Again, no estimates can be made for 1944. And, strangely enough, on the basis of the Treasury's own statistics, the House bill will actually produce the entire amount demanded by the Treasury!

Thus, the issue raised by the Treasury seems unrealistic. Nevertheless, the Treasury rigidly insists upon its program.

A realistic approach to present and future fiscal problems presents the truly important issue:

(1) How much can be raised by taxation, and (2) How should the balance be borrowed?

FINANCING THE WAR

The Treasury insists that two basic tests be applied to its fiscal program, as presented to the Committee on Ways and Means and to your committee, and to the revenue bill of 1942 now pending before you: (1) The bill must raise the minimum amount of additional revenues required to finance the war; and (2) it must be an effective anti-inflationary weapon.

We challenge the Treasury program and the House bill. They pass neither of the two tests. Furthermore, the two tests themselves are insufficient. Our Government needs the maximum revenues, not the minimum, and must borrow the balance. Neither the Treasury program nor the House bill will contribute materially to the fight against inflation.

We recommend:

(1) A basic program for financing the war; (2) a composite and practical program for effectively fighting inflation; and (3) a thorough revision of the pending revenue bill to conform with each.

OBJECTIVES

A basic program for financing the war must, of course, provide for maximum revenues from taxation. Maximum revenues must of course be governed by agreed objectives. The overwhelming majority of our people now realize that fiscal policies have a more determining and final effect upon where we are going and whether we will get there, than the frequent repetition of phrases of assurance.

Although the Treasury program and the House bill disregard them completely and are frequently in direct conflict with them, it would seem that there can be little disagreement over the following objectives:

(1) Maximum production for war during the entire war period; (2) maximum protection against profiteering; and (3) maximum preparation for peace.

INFLATION

A program for effectively fighting inflation must likewise conform to facts:

(1) The supply of civilian goods must decrease as production for war increases.

(2) The demand for civilian goods increases as purchasing power increases and supply decreases.

(3) The demand for civilian goods already exceeds the supply, and therefore "excess" purchasing power must be controlled.

(4) All costs must be controlled if price control has any chance to be effective.

(5) Neither price fixing nor rationing guarantees a supply of civilian goods.

(6) It is spending that must be restricted, not production.

(7) At least $75,000,000,000 of our national income is now nontaxable.

(8) Most of the entire increase of $40,000,000,000 in our national income since 1940 is nontaxable.

(9) About 25,000,000 gainfully employed will pay no income tax—although every one of them stands ready to pay his share.

(10) A 10-percent increase in prices has the same effect upon the individual as a 10-percent tax—but further price increases will continue and may become uncontrollable. Furthermore, as prices increase, the costs of the war increase;

Government expenditures correspondingly increase, and our citizens will soon shoulder unbearable and avoidable burdens.

(11) Certain price increases will be proper from time to time. But spiralling must be stopped before it begins.

(12) A courageous offensive is required to fight inflation. Victory on the home front is vital. There is no place for appeasers. A fiscal program based upon politics is as doomed as a war program based upon appeasement.

INFLATION AND THE FISCAL PROGRAM

A basic program for financing the war must provide for maximum control over inflation. From a fiscal point of view, maximum control over inflation demands:

(1) Maximum taxation of individuals whose purchasing power is increasing.

(2) Maximum borrowing from savings and current incomes.

(3) Minimum borrowing from commercial banks.

(4) Minimum spending for nonwar purposes, and maximum efficiency in war spending.

(5) Maximum production of civilian goods consistent with war production.

There is no conflict between the objectives of a basic program for financing the war and the fiscal policies for effectively fighting inflation. They "mesh" smoothly and simply.

ANALYSIS OF TREASURY PROGRAM AND HOUSE BILL

It is our judgment that the Treasury program and the House bill—

(1) Fail to produce maximum revenues.

(2) Seriously jeopardize maximum war production.

(3) Afford no financial opportunity to prepare for peace.

(4) Fail to provide adequate control over inflation.

(5) Impose unbearable retroactive burdens upon individuals.

(6) Prescribe wholly inadequate measures for taxing the current income of individuals.

(7) Fail to provide incentive for maximum borrowing from the savings and current incomes of individuals and corporations and, therefore, rest their fiscal program primarily upon maximum borrowing from commercial banks.

(8) Will compel unnecessary curtailments, abandonments, and substitutions in the production of civilian goods.

SPECIFIC RECOMMENDATIONS

We offer the following specific suggestions for financing war expenditures:

(1) The maximum possible revenues from taxes for the duration of the war, consistent with our objectives.

(2) A definite incentive savings system for both individuals and corporations.

(3) Security issues designed to attract maximum additional borrowings of a noninflationary type, as from individuals, insurance companies, trust funds, savings institutions, and others.

(4) The elimination of all nonessential Government activities, and the reduction to the bone of essential nonwar activities. Wholehearted support of the Byrd committee will produce the results.

It is vital that the great bulk of our cash requirements during the war period come from current incomes and accumulated savings. Inflation will assuredly follow continued borrowing in substantial amounts from the commercial banks.

MAXIMUM INDIVIDUAL RATES OF TAX

The tax structure should be made to yield every possible dollar while the war lasts. The cornerstone of this structure is the individual income tax, based primarily upon the sound principle of ability to pay. But ability to pay has limitations. Confiscation is not an application of the princple. The fact must be recognzed that, as income increases, so do obligations. It requires sound judgment and careful study to fix the maximum rates of tax which can be borne by millions of individuals in varying financial and economic circumstances.

Recognition must be given to the following fundamentals:

(1) The individual must provide ordinary living expenses for himself and his dependents. His standard of living must be reduced, perhaps to the lowest point since 1932. But there is a point beyond which it must not, and need not, be reduced, just as it is unnecessary to deny an opportunity for reasonable advancement and improvement.

(2) The individual must pay his debts. Homes and insurance policies should not be sacrified to the tax collector.

(3) The individual must educate his children. It is not necessary to deprive them of opportunity for advancement.

(4) The individual must support his church, his charities, and his schools. They must neither be sacrificed nor compelled to demand Government assistance.

(5) The individual must be prepared for extraordinary expenses, which are familiar to every family—sickness and deaths, the needs and demands of dependents and friends, unexpected losses, and the like.

(6) Every individual seeks security for himself and his family, protection against loss of his job, from declining earnings, from increased living costs. He must have an opportunity out of his current income for savings and insurance. Thrift is still the bulwark of private security. The promises of Government to guarantee security are quite inadequate.

(7) His income from outside sources—dividends and interest from his savings and dividends on his insurance policies—has been and will continue to be greatly reduced; and the immediate value of his investments correspondingly confiscated.

(8) The individual does not set aside from current savings a fund for current taxes. He is always "a year behind." He is harnessed to a treadmill and must constantly increase his speed to keep from falling too far behind. Enslavement to the Treasury provides neither happiness nor incentive. It is not necessary.

(9) The current incomes of many individuals have remained constant, and in many cases have been drastically cut: Military service, priorities, rationing, price controls, prohibitions, Government service have had disastrous financial effect. Incomes essential for the support of widows, children, and dependents have been drastically reduced, and many are already facing a desperate future.

(10) The war need not produce paupers.

In summary.—Incentive, the force which drives every one of us to maximum effort, must not be destroyed.

Our conclusion.—Not more than $1,000,000,000 in additional taxes should be imposed retroactively upon individuals. But many billions more than the House bill provides can be imposed if collected currently as incomes are earned.

Our recommendation.—Financing the war from the savings and current incomes of individuals, in taxes and borrowing, must be approached as one problem. For example, the so-called Ruml plan should receive most serious consideration and, we believe, should be adopted. If adopted, then substantial sums can be collected at the source, as a normal tax, beginning January 1, 1943. Withholding at the source and incentive savings can also be made effective. Retroactive impositions can be avoided. And billions will pour into the Treasury in excess of the Treasury's expectations.

MAXIMUM CORPORATION RATES

Precisely the same considerations must be applied in determining the maximum rates to be imposed upon corporations—for owners, managers, and workers are all individuals. But additional factors are also involved:

(1) Cash requirements are ever increasing and must be met. Pay rolls demand cash, not promises. Purchases of raw materials and constantly increasing inventories must be paid for. New plants, new machinery and equipment, repairs and maintenance, demand cash. Transportation charges call for payment in cash. Existing debts must be serviced with cash, and debt retirement must be made with cash. Dividends must be paid in cash, and frequently a failure to pay preferred dividends means a loss of the business. The costs of litigation, including Government investigations and proceedings, must be defrayed with cash. And neither last nor least, taxes, Federal, State and local, must be paid in cash. And cash comes from only two sources: Sales and credit.

(2) Credit must not be impaired. Much of the current cash requirements must come from borrowing. Ability to repay remains the primary test. And

ability to repay means: Cash remaining after all other costs are paid—including taxes.

(3) Taxable net income, as defined under the present law and under the House bill, has little relation to business income, and has no relation to cash. Substantial increases in inventory values, for example, may result in a tremendous tax liability, having utterly no relation to income and, as previously pointed out, actually reducing "ability to pay." Similarly, the demands of war may prevent the maintenance of inventories essential to normal operation, and force postponement of replenishment until after the war. Certainly, paper profits resulting from the forced depletion of normal inventories should not be taxed. They are not real income and actually there is a decreased ability to pay.

(4) Inordinate tax rates which destroy the incentive to maximum efficiency will increase the cost of every product produced. Increased costs to the Government, for example, may well aggregate billions, while the tax revenues are increased but a fraction. And resulting increases in the cost of living will be equally disastrous.

(5) Not every corporation is engaged, or can or should engage, in war production. From a profit point of view, many are not benefited; and many are harmed.

(6) Practically everyone engaged in war production faces an obsolete plant upon the cessation of hostilities, and all face tremendous losses (from depreciated inventories, for example) and the necessity to transfer back to a peacetime pursuit.

(7) The present yield to its true owners, the holders of its common stock, is already far below the point where new capital investments can be attracted. The future holds their only hope.

(8) Taxes upon corporate incomes contribute nothing to a successful fight against inflation. Quite to the contrary, as just pointed out, inordinate tax rates have precisely the opposite effect. Increased costs and increased prices are seriously inflationary. They could well offset all the benefits of every other anti-inflationary measure.

(9) All the above considerations enter into the determination of the taxation of both normal profits and excess profits.

In summary.—Industry must and will be financed either privately or by the Government. Tax policies will provide the answer. And the decision will probably be final.

Our conclusion.—The maximum rate upon the normal profits of corporations should be 35 percent.

THE TAXATION OF EXCESS PROFITS

It has been our consistent position that true excess profits should be subjected to very high rates of tax. But again we point out the importance of defining with infinite care the dividing line between normal profits and excess profits. Normal profits must be protected against the confiscatory rates imposed upon true excess profits. The first excess profits tax was adopted in 1940. Demand for speed seemed to outweigh the need for justice and equity. As predicted, experience has developed innumerable instances of unintended injustices and inequities. Little opportunity was afforded during 1941 for improvements. Much remains to be done; and all can be done now.

The following principles are of first importance:

(1) The excess-profits tax should remain in force only during the period of the war.

(2) Excess profits must be averaged over the period of the war, and at least 1 year thereafter.

(3) Normal profits must not be confiscated, and normal growth must not be stopped.

(4) An unsound or unfair excess-profits tax law may cost this Government and this country, in increased costs and prices, far more than it will produce in revenues.

(5) The primary function of a true excess-profits tax is to prevent war profiteering, not to produce revenues.

SPECIFIC EXCESS-PROFITS TAX RECOMMENDATIONS

The House bill contains a few excellent improvements in the present excess-profits tax provisions, notably an extensive and creditable revision of supplement A, and a broadening of the general relief provisions of section 722. The House bill also increases the specific exemption to $10,000, although this change is practically nullified by the proposed increase in the normal tax to 45 percent. At the same time, the bill drastically reduces the invested capital credit, omits many essential changes, and contains some defective provisions.

Our specific recommendations with respect to the excess-profits tax are developed in detail in the discussion of technical amendments. The most important changes which are necessary are summarized as follows:

(1) The invested capital credit is wholly inadequate. The proposed reduction of the percentages of invested capital from 7 to 6 percent on capital between $10,000,000 and $200,000,000, and from 7 to 5 percent on capital over $200,000,000 is unsound and unfair. "Cost" should be substituted for "tax basis," as the general rule, in the computation of invested capital where property is paid in for stock (with proper provisions for relief in exceptional situations).

(2) The income credit must be improved. The use of the average of any 3 of the 4 years 1936-39 should be permissible, and 100 percent of the average base period earnings should be allowed, instead of 95 percent. Income allocated to the base period years under section 721 should be included in these years in the computation of the credit. Fifty percent of borrowed capital should be allowable as a net capital addition; and currently accumulated earnings and profits should be considered as capital additions.

(3) Credits once agreed upon as appropriate measures of normal profits should not be reduced by changes in mathematical computation.

(4) The so-called general relief provisions have been admirably improved. They play a most important part in drawing the line between normal profits and excess profits, in the many cases where both the earnings credit and the invested capital credit are inadequate. But further improvement remains to be done. For example, many enterprises had no earnings during the base period years and have little invested capital. Confiscation of substantially their entire incomes must be avoided. Again, many industries will show a steady, normal growth over a long period of years; but neither the normal growth provisions nor the relief provisions are applicable—and consequently their current normal incomes, resulting from normal growth and expansion will be confiscated under the bill as it now stands. A third case which admittedly must be avoided is an enterprise, already in the excess-profits class, which by reason of its managerial skill is called upon to manage a Government-owned plant, on a decidedly minimum basis. Certainly, everyone would be shocked to know that under the House bill it promptly pays back to the Treasury 90 cents of each dollar of its agreed compensation. A fourth typical example is an enterprise which has become so successful in war production that it has been asked to increase its capacity and output 10 or 20 or even 30 times, with all the attendant risks and with no opportunity for even a minimum increase in reasonable profits. Perhaps a segregation of cases of this type and the application to them of an automatic increase in their earnings credit and an over-all "ceiling" (so that their aggregate tax liabilities over the period of the war should not exceed 75 percent of their net income) is an appropriate and simple remedy.

Abnormalities of invested capital for corporations in existence prior to January 1, 1940, should be recognized. The penalty tax of 5 percent on the granting of relief is unwarranted, and should be eliminated. Relief for changes in the character of the business after December 31, 1939, should not be limited to commitments entered into before that date. The revision of section 722 should be retroactive to 1940 and 1941.

(5) Normal growth requires protection. The existing limitation in the so-called normal growth formula that the earnings credit shall not exceed the largest year in the base period (1939, for example) is outmoded and should be removed. Furthermore, the present provisions admittedly fail to permit true normal growth. They actually apply only to cases of abnormal growth which was sufficient in the last half of the base period to overcome the general adverse effect of 1938. Recognition should be accorded industries which have had a steady normal growth over a long period of years whose reverses in 1938 make the statutory formula inapplicable. Furthermore, capital additions made in the early 1930's were sometimes not productive of increased earnings until after the expiration of the base period, and frequently the earnings capacity of capital additions is not reflected for 2 or 3 years, or even more. In addition, the decade of depression has to a great extent compelled the use of borrowed capital for financing additions. Normal growth and expansion must be encouraged, not

stopped. The simplest and fairest solution is to supplement the present provisions by recognition of the calendar year 1940 in the average earnings computation. After all, our defense expenditures prior to 1941 were insignificant.

(6) Provisions should be adopted permitting the averaging of excess profits over a period of several years. A loss or deficiency in credit for any year should be applicable against excess profits either of preceding or subsequent years. The excess-profits credit carry-over from each year should be computed under the law applicable to that year.

(7) The policy of section 734, relating to adjustment for inconsistencies, should be reversed and the section completely rewritten. In no event should it be retroactive to years prior to 1932, and it should not apply to transactions of predecessors.

(8) Absolute accuracy in defining excess profits is probably impossible, even with the amendments suggested. Arbitrary rules for computing the credits cannot be avoided. For this reason, it is recommended that preliminary brackets or "cushions" should be permitted before imposing the maximum rate. All brackets should be based on a percentage of the credit, instead of absolute dollar amounts, as the present law provides. A gradual transition, or "notch," between the normal tax and steep excess-profits tax rate would thus be achieved.

Our conclusion.—The Treasury program and the House bill will confiscate normal profits; will destroy all incentive for efficiency and low-cost production; will deny even a minimum profit to many enterprises engaged in essential war production; and are in direct conflict with the objectives we have set forth—although no disagreement with or opposition to these objectives has been expressed.

INCENTIVE SAVINGS

An effective incentive to voluntary investment in Government bonds would go a long way toward solving two vital problems: (1) The immediate need for financing a large part of current deficits out of private income and savings, and (2) the admitted necessity for both corporations and individuals to provide resources now against the dangers and to meet the unforeseeable demands of the post-war period.

We are convinced that both purposes can be served by the adoption of an incentive savings plan, which may be outlined as follows:

(1) A deduction should be allowed to corporations and individuals in computing net income with respect to amounts invested in a special issue of Government bonds. Regardless of the amounts so invested, however, the deduction should be limited to prescribed percentages of taxable net income—20 per cent, for example, in the case of corporations.

(2) The bonds issued for this purpose should be non-interest-bearing and nonnegotiable during hostilities. But immediately upon the cessation of hostilities, they should be negotiable and bear interest at the rate of 2 percent.

(3) The bonds should be payable in five annual installments, beginning with the year following the cessation of hostilities.

This plan has a number of important advantages, both to the Government and the taxpayer. Among them, the following may be noted:

(1) It creates a definite incentive for investment in War bonds, which is now lacking in the Treasury selling campaign.

(2) It permits the imposition of taxes at extraordinary levels without undue hardship.

(3) It provides a tremendous source of immediate funds for the Treasury, perhaps as much as $15,000,000,000, annually.

(4) It creates for corporate taxpayers the necessary reserves for post-war reconversion to peacetime industry, and reemployment of soldiers returning from the war.

(5) It gives to individuals a similar security against post-war hazards of unemployment and loss of earning power.

(6) The use of non-interest-bearing bonds saves service charges on the debt during the war, and thereby lightens the war financing burden.

(7) Nonnegotiability of the bonds during the war gives definite assurance that these funds will be "frozen" for the period of the war, and thus will be effectively anti-inflationary.

(8) Negotiability immediately upon the cessation of hostilities assures them immediate credit value and releases a flood of purchasing power to protect against post-war deflation.

(9) A portion of the deduction, with appropriate limitations, can be allowed to permit reasonable and periodic repayments of existing private debts of individuals and corporations; that is, the deduction would be allowed in the aggregate for amounts paid on debts or invested in the special Government security.

In contrast to the foregoing, the plans of the Treasury and others for some sort of a post-war "refund" or "credit" are unworkable, inadequate, and discriminatory.

CAPITAL GAINS AND LOSSES

The House bill proposes an elaborate revision of the capital gain and loss provisions. In substance, the proposal is to substitute a single holding period of 15 months, to increase the alternative tax on capital gains from 15 to 25 percent, to allow capital losses of both individuals and corporations only to the extent of capital gains, to change in important respects the definition of capital gains and losses, and to provide a 5-year carry-over of net capital losses.

The adoption of a single reduced holding period is a step in the right direction. The sole purpose of the period of holding is to segregate speculative profits from investment profits, in order that the income of the speculator shall be taxed at the same rates as the ordinary current income of others. Unquestionably, this line is now much easier to draw, for speculative opportunities have practically disappeared. As suggested by the president of the New York Stock Exchange, Mr. Schram, a period of 6 months should be adequate for this purpose.

The present capital gain provisions were adopted in 1938, after several years of fruitless and unwise experimentation and after extended consideration by the Congress. At that time, the Congress determined that capital gains should be differentiated from ordinary income, by reason of their acrual over a period of years. The rate of tax to be applied to such gains was fixed at 15 percent, not for revenue purposes and not by reference to the individual surtax schedules. It was so fixed as a matter of judgment as to the fair and practical rate of tax. This rate should not now be increased for the sake of temporary——and insignificant—revenues. The real benefit of the system lies in its permanency. An investor today is primarily interested only in the probable tax to be imposed when he sells—usually several years from today.

The Treasury proposal to limit capital losses to capital gains is indefensible. If the present system produces no net revenue, the capital gains tax should be abandoned in favor of the British system, under which only speculative, or trading, gains are taxed. But the Treasury should not be permitted to collect revenues from capital gains, and at the same time prevent reduction of those revenues by arbitrarily restricting capital losses. This is particularly true with respect to corporate capital losses. Losses from the disposition of corporate assets are usually incurred in the ordinary course of business, and are not essentially different from other operating losses. They should be chargeable against ordinary corporate income.

The House bill also proposes to change the rule, also adopted in 1938, that property subject to the depreciation allowance is not a capital asset, by treating real estate improvements as a capital asset. This is proposed to avoid the allocation problem when land, with buildings thereon, is sold. The general rule is sound, and the technical difficulties in this particular case do not warrant the proposed exception.

Furthermore, as we have frequently recommended, losses resulting from securities becoming worthless should not be defined and treated as capital losses.

SALES AND WITHHOLDING TAXES

We recommend the adoption of both a retail sales tax and a true withholding tax on compensation, dividends, and interest paid to individuals, without exemptions or credits.

A retail sales tax (exempting Federal, State, and local purchases) with an effective rate of 10 percent and a 5 percent withholding tax would produce more than $10,000,000,000 of additional revenue, and would produce this amount currently, without delay in collection.

The Treasury stands in the most urgent need of this additional revenue. If we avoid the issue in this tax bill, we must face it in the next. It is time to be realistic. The plain, hard fact is that we must have the money, and there is no other place to look for it. These are the only two major, untapped revenue sources.

The arguments against both sales and withholding taxes are the same, that they fall more heavily on the lower income group and curtail the standard of living. But a realistic appraisal of the present situation compels the conclusion that these are precisely the reasons why we should have sales and withholding taxes now. If 30,000,000 families, each had $1,000 more income than last year, this would mean $30,000,000,000 of new purchasing power, competing for a diminishing supply of civilian articles. Taxes must cut down this purchasing power. Otherwise the $30,000,000,000 will vanish, absorbed by the increased price of goods. If we tax away a portion of this purchasing power, we may preserve the balance. If not, it wi be lost through inflation, and everyone, including the Treasury, loses disastrously.

We are not wedded to any particular form of sales tax or withholding tax. But a retail sales tax on tangible personal property will afford the only effective control (if we recall the days of bootlegging) over the inevitable "black markets."

The withholding tax should be collected at the source at a flat rate on all payments of compensation, dividends, and interest to individuals. No personal exemptions or credits should be allowed, although, of course, the amount withheld would be excluded from income in computing the net income tax. One method of applying the withholding tax would be to substitute it for the normal tax. The balance of individual income, after deductions, personal exemptions, and credits, would be subject only to surtaxes. A portion or all of the withholding tax might be treated as a loan if this is deemed desirable. But a concomitant of any withholding tax is protection against its collection being used as a basis for increased salaries and wages.

We are strongly opposed to the Treasury plan for advance collection of the net income tax at the source. It will be excessively difficult to administer, both for the Government and the withholding agent. Furthermore, the necessary office machinery to do the work simply is not available. The Treasury plan produces no net revenue, although it does advance collections and therefore increases cash receipts for the fiscal years under consideration. Since it exempts two-thirds of individual incomes before it applies, it will have too little effect upon the inflationary situation.

FOREIGN WAR LOSSES

Special provisions are necessary and should be promptly enacted to prevent years of uncertainty and litigation under the present law and to prescribe appropriate policies with respect to the extraordinary losses of American properties and investments in enemy countries, in occupied territories, and in the course of military and naval operations outside the United States. Such losses are essentially casualty losses, and, therefore, they should be treated as ordinary losses for tax purposes. In view of the character and circumstances of the present war, such losses, occurring in the period of 1941–42, should be allowed to be deducted in either year, as the taxpayer may elect. We endorse and recommend the adoption of the suggestions for remedial amendments contained in the statement of Mr. Arthur H. Kent, as chairman of the Conference of Taxpayers on Foreign War Losses, as the minimum which the present situation requires.

REPEAL OF CAPITAL-STOCK TAX

We recommend the adoption of the Treasury proposal that the tax imposed by section 1200 of the code, and its companion tax, the so-called declared-value excess-profits tax imposed by section 600, be repealed.

CONTRACT RENEGOTIATION

We strongly recommend repeal of the provision for renegotiation of contracts and subcontracts with the War Department, Navy Department, and Maritime Commission, adopted in Public No. 528, section 403.

This provision was never intended to be a permanent method of limiting profits on war contracts. It was hurriedly drafted and adopted as a stopgap. In addition, it was intended to clothe with statutory authority an informal procedure for voluntary renegotiation of contracts in use effectively by the War and Navy Departments. But the law goes far beyond the procedure previously followed.

The provision is arbitrary in the extreme, delegating an uncontrolled discretion to administrative officials to refix the price of any contract or subcontract at any time, and any number of times. It fails to define "excessive profits" or set up any standards for determining them. It should be unconstitutional, for it permits the Secretaries to impair the obligation of existing contracts at will, without obtaining the agreement of the contractor, or even providing any method of administrative or court review of their decisions. It is unbelievable that we should see the day when Government contracts are reduced to "scraps of paper."

As a result of this legislation, the whole war contract situation has been thrown into a state of utmost confusion. Contractors are being required to insert renegotiation clauses in every Government contract, although they are unable to determine what the clause means, or what ultimate liability to the Government it entails. A contractor can neither compute nor estimate his profits for any past, present, or future year. Various contracting offices are imposing different requirements and applying different standards.

The members of the boards which have been named to administer the law are of the highest caliber in integrity and ability. But the law is beyond reasonable administration.

It severely threatens Federal revenues, since its administrators are required to determine profits before Federal taxes, even though there will be no excessive profits after taxes. Its effect upon the Treasury's fiscal program may be disastrous.

The provision should be repealed. Actually, there will be no excessive profits on war contracts after the imposition of the taxes we have recommended. We have attempted to remove the issue. But if the Congress nevertheless believes that excessive profits on war contracts after taxes are still possible, then a statutory provision of general application should be adopted, to be applied only after all tax liabilities are provided for and after voluntary renegotiations have been concluded, under which all profits in excess of the prescribed limitation are recaptured and paid into the Treasury The chairman of your committee has already outlined suitable provisions for this purpose.

SUMMARY OF PRINCIPAL RECOMMENDATIONS

We have presented a detailed discussion of our recommendations. For convenience, our principal recommendations may be summarized as follows:

(1) An incentive saving plan, consisting of suitable deductions from taxable income of both individuals and corporations for voluntary investment in Government securities, non-interest-bearing and non-negotiable during hostilities, but immediately negotiable and carrying a small return and early maturities upon the cessation of hostilities.

(2) The avoidance of tremendous tax liabilities retroactively imposed upon individuals. The adoption of the Ruml plan would give a much needed opportunity to enact a well-rounded plan for taxing individuals upon a current basis.

(3) A corporate normal tax and war surtax of not more than 35 percent, with appropriate adjustments for net incomes of less than $25,000.

(4) Revision of the excess-profits tax credits and relief provisions in order to define more accurately true excess profits.

(5) The rates to be imposed upon excess profits must depend upon the balance of the tax program—for example, upon the rate to be imposed upon normal profits, whether only true excess profits will be subjected to excess-profits tax rates, and whether a workable incentive savings plan is enacted. If our recommendations are adopted, then the highest practicable rates should be imposed upon excess profits, with the safeguard of preliminary brackets at moderate rates.

(6) A retail sales tax, without exemptions (except for direct Government purchases) at an effective rate of 10 percent, with appropriate adjustments for articles of first necessity.

(7) A 5 percent withholding tax, collected at the source, on all compensation, dividends and interest paid to individuals.

(8) The rate of tax upon capital gains should be moderate—certainly no greater than the existing rate—and a shorter holding period should be adopted. Other-

wise, the basic provisions of the present law (except for a few minor changes, the necessity for which we have previously pointed out) should be maintained. Their efficacy lies in their permanence.

(9) Adoption of adequate provisions for the recognition of foreign war losses.

(10) Repeal of the provision for renegotiation of war contracts contained in section 403 of the act of April 28, 1942 (Public No. 528).

CONCLUSION

Under our program the Treasury will receive the maximum in tax revenues and the maximum in borrowing of a noninflationary type—that is, from savings and current incomes of individuals, trust funds, and savings institutions; and inflationary borrowing from commercial banks will be reduced to a minimum and, we believe, kept within manageable proportions.

Supplement to Statement of Ellsworth C. Alvord, on Technical Provisions of Federal Tax Laws—Amendments Urged

I. EXCESS-PROFITS TAX

(1) *Invested capital credit*

(*a*) *Percentages of invested capital allowed as credit.*—The proposal in the House bill to reduce the percentages of invested capital to be allowed as a credit from 7 to 6 percent on that portion of invested capital between $10,000,000 and $200,000,000 and from 7 to 5 percent on all over $200,000,000 is wrong in principle and result. This proposed extension of the feature which crept into the law last year, of reducing the credit by reason of mere corporate size, demonstrates the dangers which were inherent in taking the initial step in this direction. Congress should discard the proposal and should return to a flat 8 percent for all corporations.

Every corporation should be given the opportunity to make the same rate of return on its capital before paying excess-profits tax. A small stockholder of a large corporation should be entitled to the same rate of return on his investment as a small stockholder in a small corporation. This is the only sound principle. The fact that the large corporation is given the same return as the small corporation on its first $10,000,000 of invested capital contributes nothing to the preservation of this principle.

(*b*) *Cost in lieu of tax basis.*—The use of tax basis for property paid in for stock, in lieu of its actual cost to the taxpayer, in computing invested capital results in an abnormally low invested capital in many instances and consequently in inequities and discriminations.

It must be remembered that under the basis provisions of section 113 of the code, use of a predecessor's cost rather than the taxpayer's own cost is required for normal tax purposes in connection with many types of tax-free exchanges and reorganizations where an identity of interest does not exist after the exchange of reorganization, or where the transferor's resulting interest is unrelated to its former tax basis for the assets transferred. For example, the taxpayer may have originally issued its stock partly for cash and partly for property. Even though the new interest in the enterprise represented by the cash investment is the dominating interest, the taxpayer is forced to inherit the predecessor's tax basis for the property. If the transaction occurred prior to 1932, this is true if the new interest represented by cash did not acquire more than a 50-percent interest in the taxpayer.

Again, if the taxpayer acquired properties from a number of predecessor corporations and issued its stock to them according to the relative market value of their assets at the time of acquisition, the taxpayer would be required to inherit the predecessors' tax basis although the relative interests of the predecessors or their stockholders in the taxpayer are in no way related to their former tax basis for the assets transferred.

Although it is necessary to continue the transferor's basis for normal tax purposes in order to effect a mere postponement rather than an escape from tax on a tax-free exchange, there is no justification for using it in computing invested capital. The "tax basis" principle should be discarded in favor of actual cost except to the extent its retention is necessary for tax avoidance reasons in connection with future transactions.

If such a change is not made, then section 722, hereinafter discussed, should unquestionably be made broad enough to take care of situations such as those referred to above where the use of tax basis produces an abnormally low invested capital.

(c) *Necessary amendments if tax basis retained.*—If the tax basis provisions are to be retained in the law, then certain revisions are necessary in order to eliminate technical imperfections. (The underlying fallacy of the tax basis approach to computing invested capital, of course, cannot be removed unless such approach is abandoned.) Such technical improvements are as follows:

(1) The amendment proposed by section 212 of the House bill to section 718 (a) (2), which deals with the adjustments to be made if the unadjusted basis is a substituted basis, should also be included in section 720, relating to the adjustment for inadmissibles.

(2) The rule prescribed by section 760 of supplement C for determining the invested capital of a transferee in an exchange to which section 112 (b) (3), (4), or (5) applies where bonds are issued as part of the consideration must be modified. The rule has apparently been developed with a view to conferring upon the transferee the same invested capital result as if the transferor had made a distribution of the equivalent amount of bonds to its own stockholders without any exchange of property. The resulting rule is so drastic that the transferee can actually come out of the exchange with less invested capital than when it started, in spite of the fact that it may have doubled the amount of assets at work in the business. We have previously pointed out the extent to which tax-free exchanges (under sec. 112 (b) (3), (4), or (5), for example) can effect a rearrangement of proprietory interests and the extent to which new interests can be involved. To apply a rule for computing the invested capital of the transferee which is based on the assumption that there has been no exchange of properties at all but merely a distribution to stockholders is wholly unrealistic and produces extraordinary results which will seriously harm transferee corporations. To make it worse, the rule is made retroactive to 1940. It is essential that it should be modified to produce a fair result and that, as modified, it be applied prospectively only.

(3) The proper application of the present provisions of the law relating to the determination of invested capital is somewhat uncertain in the case of a reorganization effected under the Bankruptcy Act. For example, where a corporation, pursuant to a section 77 or 77B reorganization, has scaled down its bonded indebtedness through the issuance of stock to its bondholders, what is the proper invested capital adjustment for the "property paid in" for such stock? Since many corporations have gone through reorganization under the Bankruptcy Act, the method of computing invested capital after such reorganization should be clarified, and the clarification should be made effective for 1940, as well as for subsequent taxable years. The sound policy, and perhaps the proper interpretation of the present law, is that the invested capital should be increased by the amount originally received upon the issuance of the bonds, for example, which have now been exchanged for stock.

(2) *Income credit*

(a) *Three out of four years.*—It has been pointed out repeatedly that use of the average annual earnings for the 4-year base period 1936 to 1939, inclusive, does not provide a reasonable measure of normal profits. This is due to the fact that the years 1936–39 were not a period of normal earnings for most corporations. Many companies suffered depressed conditions during a major part of the period. For many others, who made reasonably good earnings in 1936 and 1937, or both, 1938 was a bad year and resulted either in losses or severe declines in profits. Many businesses enjoyed only a partial recovery in 1939. The only recognition given to these facts in the existing law is that the largest loss year of the four can be reflected in the 4-year average at zero. This is obviously an arbitrary and inadequate "solution" to the problem. This defective feature of the income credit should be corrected now by providing that the credit consist of the average of any 3 of the 4 years in the base period. This is an essential step in any effort to free normal profits from the excess-profits tax rates.

(b) *100 percent of average earnings.*—The limitation in the income credit to 95 percent of the base period average earnings should be removed. It is the result of a 1940 compromise having nothing to do with merit. It represents a direct extension of the excess-profits tax rate to normal profits.

(c) *Allocation of abnormal income to base period years.*—Section 721 of the present law provides for the allocation of abnormal items of income in the taxable year to the years to which they are properly attributable. In explaining the intended operation of this section, the Senate committee report on the 1940 bill states that—

"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" (S. Rept. 2114, p. 16).

In spite of this direct expression of legislative intent, the excess-profits tax regulations specifically provide that section 721 has no effect upon the computation of the base period net income, and therefore does not affect the computation of the excess-profits credit (Regs. 109, sec. 30.721-3). Thus, under the regulations, abnormal income is allocated to other years only to the extent that it falls into other excess-profits tax years.

Section 721 should, therefore, be clarified retroactively to provide specifically for the base period adjustment originally intended. Such adjustment is essential in order to reflect average base-period earnings where, for example, the abnormal item of income consists of the entire profit from a long-term contract completed in the taxable year but in respect of which substantially all the work may have been performed in the base period.

(d) *Borrowed capital.*—Under existing law, the income credit is increased by 8 percent of the net capital addition for the taxable year. A capital addition is limited to money or property paid in for stock or as paid-in surplus or as a contribution to capital. It should be expanded to include 50 percent of new borrowed capital, accompanied by a disallowance as a deduction of 50 percent of the interest payments thereon in computing excess-profits net income. And there is now no justification for a failure to increase the credit by reason of accumulated earnings and profits.

(e) *Supplement A.*—Much credit is due to the Treasury and congressional experts for the substantial improvements made in supplement A. Among other things, the qualified component corporation concept, which produced artificial limitations upon the operation of the supplement, has been eliminated; the computation of average base-period earnings has been standardized and simplified; the normal-growth provision has been added; the election between section 718 and supplement A (a trap for the unwary) has been removed; an effort has been made to provide for a constructed income for vacant years in the base period; and the taxpayer is given the right to apply those corrections and improvements retroactively.

The need for revising supplement A was immediately recognized and advocated in 1940, but revision has been postponed by reason of lack of time. Now that it has been undertaken, it should be carried through so far as possible to the elimination of technical imperfections.

Two features of the proposed revision at least can be improved upon:

First, there is no justification for authorizing the Commissioner in section 741 (f) (1) to require adjustments in all cases where the taxpayer acquired stock in the component corporation after December 31, 1935, for other than stock of the taxpayer. Such stock might have been acquired with bonds, uninvested cash, or in other ways which would not produce duplications if the average earnings of both the component and acquiring corporations were left undisturbed. The Commissioner's authority should be limited specifically to requiring such adjustments as may be necessary to prevent duplications.

Second, no expansion has been made in the type of transaction which is included under supplement A. There are many absorptions of one corporation by another where the principle of supplement A should apply. For example, substantially all the assets of one corporation might be acquired for preferred stock of the acquiring corporation, or for bonds. If the scope of supplement A is not to be enlarged in respect to the types of transaction covered, it should be made clear that the inapplicability of supplement A will not interfere with the taxpayer's right to establish the necessity for relief under section 722 by reason of the absorption of another corporation since the beginning of the base period.

(f) *Constructed income for period prior to commencement of business.*—Frequently corporations are incorporated several months or more prior to commencement of business. A vacant period of nonactivity on this account, when occurring in the base period, produces an abnormally low reflection of average base period earnings if it is treated as a period of actual existence in the average earnings computation. It should be made clear that for the purposes of section 713 (d) and section 741 (e), the phrase "in existence" refers to actual business existence, that is, existence after actual business activity has commenced.

(*g*) *Special credit for wasting-asset corporations.*—Wasting-asset corporations should be afforded a special credit entitling them to a normal profit per unit of production before imposition of the excess-profits tax. The necessity for such a credit is set forth adequately in the following statement in the House committee report:

"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" (p. 149).

An amendment was offered last year by Senator Johnson, of Colorado, providing for such a credit (Congressional Record, Sept. 4, 1941, p. 7483). This amendment should be adopted.

(8) *General relief*

The necessity for new provisions to protect normal growth and the extension of the relief provisions to four general classifications of industries have already been discussed. It is not necessary to repeat that discussion.

The proposed revision of section 722 represents a substantial improvement over that section as it now stands. However, increasing excess profits tax rates increase the necessity for removing from the general relief provisions any limitations which might stand in the way of affording relief in hardship cases where the standard provisions of the law work unfairly and produce abnormalities, or fail to remove them. To this end the following amendments to the House provision are suggested:

(*a*) *Abnormalities in invested capital.*—The House provision affords no relief from abnormalities in invested capital in respect of corporations in existence prior to January 1, 1940. The basic policy of the excess profits tax law is that a corporation shall not be subjected to an excess profits tax law unless its income exceeds its peacetime earnings measured by its average base period earnings, or exceeds a fair return on its invested capital. If the standard methods in the statute for measuring these two credits produce abnormalities in either, then the general relief provision should operate to reconstruct whichever credit is affected, or to reconstruct both credits if necessary.

It is quite possible, for example, for the corporate taxpayer to have experienced generally depressed earnings throughout the base period without encountering any base period abnormality which would entitle him to a higher constructive income credit under section 722. At the same time, its invested capital might be abnormally low as in the case of the illustration given in paragraph 3, page 147 of the House committee report or, for example, because of the operation of the unjustified "tax basis" rule previously discussed. Its competitor which also has a depressed base period earnings record is entitled to the alternative invested capital credit which may be fairly computed in his case under the standard provisions of the Act. The taxpayer should also be given this alternative protection through the medium of special relief.

If section 722 is revised to provide for a constructive invested capital in such cases, then, if the tax basis provisions of the law are retained, relief might be granted under section 722 when use of tax basis in lieu of cost fails to produce a fair measure of invested capital.

(*b*) *Changes in character of business after December 31, 1939.*—Under the House proposal changes in capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, are deemed to be changes in the character of the business on December 31, 1939, if the changes were made as a result of commitments made prior to January 1, 1940, binding the taxpayer to make the changes. This underscored limitation with respect to binding commitments prior to January 1, 1940 should be removed. It is wholly unnecessary for the protection of the revenues and will prevent the granting of relief in many meritorious cases.

The removal of the limitation will not afford the taxpayer an opportunity to obtain a constructive income based on income realizable from war production or war activity. The maximum amount of constructive income possible in any event is automatically limited to the amount of income that the subsequent change in capacity would have produced if the results of such change had been in effect during the base period. The amount of income which would have thus been produced by the base period is measured by the business conditions and economic circumstances then prevailing. Tacit recognition of the adequacy of this automatic limitation is found in the proposal to grant constructive income relief to corporations actually not coming into existence until afer January 1, 1940.

It is to be noted that the right to relief depends on a binding commitment prior to January 1, 1940. The House committee report (p. 146) indicates that a binding commitment is any change in position (such as the initial expenditure of money, or a resolution of the board of directors authorizing the expansion), which unequivocally establishes the intent to make the change. If this is the intent of the provision, certainly language should be used to express it. But, in any event, why should hardship be relieved when the initial evidence of intent dates behind January 1, 1940, and not be relieved when it occurs afterward? The discrimination between the old and the new corporation is clear and obviously unnecessary.

(c) *Modification of penalty.*—Subsection (e) (1) of section 722 as rewritten in the House bill imposes a penalty on the granting of general relief equal to 5 percent of the tax determined under the section. It is presumed that a penalty of 5 percent of the tax otherwise determined was intended. If so, such a severe penalty should not be imposed. The increase in normal tax liability resulting from granting general relief plus the penalty may result in a larger aggregate tax liability than if general relief had been denied.

The penalty represents a measure to facilitate administration of the section by keeping out cases where special relief, if granted, would be of inconsequential value to the taxpayer. This can be accomplished by making the penalty equal to 5 percent of the tax otherwise computed, or a fixed amount (say $20,000), whichever is less. Certainly, the penalty should apply for the first year only.

(d) *Clarification of intent in certain respects.*—The last sentence of proposed section 722 (a) should be amended to make it clear that a change in business occurring after December 31, 1939, but within the base period of the taxpayer may be considered in computing the constructive average base period income. Furthermore, the uncertainty as to when a change in capacity for operation or production consummated after the base period is deemed to have occurred (i. e., on December 31, 1939, or December 31, 1937) should be removed.

(e) *Retroactivity.*—Finally, section 722, as revised, should be made retroactive in application to the taxable years 1940 and 1941 The enactment of adequate relief provisions has been assured since the 1940 act, and hardships in 1940 or 1941 should not go uncorrected.

(4) *Excess-profits credit carry-over*

The excess-profits credit carry-over is merely one device to assist in measuring excess profits over a period of years. It was first adopted in the 1940 act for this purpose. However, the 1941 act required that, for the purpose of computing the carry-over from 1940 of the unused excess-profits credit for that year, the 1940 credit and excess-profits net income should be recomputed under the 1941 law. Section 205 (c) of the bill in effect provides that, in determining the excess-profits credit carry-over to 1942 (and subsequent years), the excess-profits credit and excess-profits net income for both 1940 and 1941 must again be recomputed, this time under the 1942 law. This extraordinary extension of the 1941 rule was predicted last year. Apparently, it means that, in order to obtain the benefit of a carry-over in any year, the taxpayer must assume the burden of completely recomputing his excess-profits tax for the 2 previous years. Unquestionably, this complicated device should be eliminated, and the simple rule adopted to the effect that the credit carry-over from each year should be computed under the law applicable to that year. Such rule should apply to the computation of tax for 1941, as well as for 1942 and subsequent years.

(5) *Section 734 (the inconsistency provision)*

Section 734 is directed at the problem of a taxpayer which takes a position for excess-profits tax purposes with respect to an item or transaction inconsistent with the position taken prior to 1940 by the taxpayer or its predecessor with respect to the same item or transaction for income-tax purposes. It solves this problem by permitting the inconsistency in the later year but correcting the earlier year.

Section 734 is fundamentally wrong in principle and should be repealed. Obviously, inconsistency may be eliminated either (*a*) by making the earlier position conform to the position in the excess-profits-tax year—the policy reflected in 734, or (*b*) by making the position taken in the excess-profits tax year conform to the earlier position—the policy we recommend.

The present law necessitates payment of deficiencies for the earlier year; disregard of the statute of limitations; lack of finality to closing agreements; and perhaps even reversal and disregard of final judicial decisions.

The policy we advocate is precisely the reverse. The earlier action stands; no prior-year deficiency is involved; the case is not reopened after the running of the statute of limitations; a closing agreement is not affected; and the doctrine of res judicata is adhered to. Furthermore, infinite complications and endless litigation disappear.

In some cases it may be deemed advisable to permit the taxpayer to adjust the prior year rather than to make the current year consistent, in order to avoid undue hardship, but such a provision should be strictly limited and should be applied only if the taxpayer, after being fully apprised of the situation, insists upon it.

If section 734 is retained in the law, then, because of the hopelessly complicated provisions and unpredictable application of the section, at least the following amendments should be made:

(1) It should not be retroactive behind 1932.

(2) It should not extend to transactions involving predecessors, except in connection with supplement A computations.

(3) The interest computed as part of the adjustment under the section should be returnable as income or deductible as interest expense.

(4) There should be no limitation upon the amount of refund as there is no limitation upon the amount of deficiency determinable under the section.

(6) *Disclaimer of excess-profits credit*

The present provisions of the excess-profits-tax law permit a taxpayer to elect to compute its excess-profits credit either on the average-earnings method or on the invested-capital method, whichever amount results in the lesser tax (sec. 712 (a) of the code). However, the law also provides that if a taxpayer specifically disclaims either one of those credits it may not obtain the benefit of the credit so disclaimed either in computing its tax liability for that year, or for the purpose of computing the excess-profits credit carry-over for subsequent years (secs. 712 (c) and 910 (c) of the code).

Many taxpayers were not sufficiently informed about the intricacies of the excess-profits-tax law in 1940 to be able to make an intelligent choice of credits. Moreover, the changes in the law in 1941 and those now proposed make it possible that the credit previously disclaimed would prove more beneficial in computing the excess-profits credit carry-over. These changes could not have been foreseen at the time the disclaimer was made in 1940. The disclaimer provision should, therefore, be eliminated, retroactively, if the taxpayer files, within a reasonable period after the enactment of the 1942 act, an amended return including the computation of the credit and the tax under both methods.

(7) *Extension of time for filing returns*

The Treasury Department has recently pursued a strict policy with respect to the granting of extensions of time for filing excess-profits-tax returns. Such extensions have been granted only in extraordinary circumstances. In view of the practical difficulties experienced by corporations in determining tax liabilities at the close of the year, and the unusual complexities of the excess-profits tax, a strict enforcement of the requirement for filing returns within 2½ months after the close of the year is not justified. While a legislative provision should not be necessary, it is recommended that the Treasury Department return to the liberal policy of allowing extensions which it followed in earlier years. Such extensions, of course, should be conditioned upon the filing of a tentative return and payment of at least one-quarter of the tentative tax, plus interest on any deficiency in the first installment.

II. GENERAL AMENDMENTS AFFECTING CORPORATIONS

(1) *Pension and profit-sharing plans*

Under the House bill (sec. 144) the present provisions of law relating to pension and profit-sharing plans are modified substantially. The proposed scheme for taxing these plans follows in general the suggestions made by the Treasury.

Since at least 1921 the revenue acts have consistently adopted the policy of encouraging the creation of pension, profit sharing, stock bonus, and other employee-incentive plans. For this purpose considerable flexibility was permitted as to the scope of the plan; as to the extent to which employees covered were to share in the plan; and as to the amount which the employer could contribute to these plans. The employee gained protection and a real incentive, and the Government gained increased revenues.

The effect of the provisions of the House bill will be to completely reverse the existing policy: (1) Arbitrary rules are prescribed as to the extent to which employees must be included. Employers who cannot afford to cover the requisite percentage of employees will be forced to discontinue existing plans or will not adopt new plans. (2) Contributions and benefits will have to be on a uniform basis. Employers will thus be prevented from making appropriate distinctions in benefits or contributions by reasons of differences in age, sex, length of service, nature of service, or lower retirement age. (3) The extent of the employer's contribution is limited to 5 percent of the participants' salaries; any excess must be spread over 5 years. A 5-percent contribution is not sufficient to finance pension plans adequately. Moreover, employers will not contribute any funds in excess of the 5 percent, since under the present tax rates they cannot afford to pay out funds for which no current deduction is secured. (4) Furthermore, the employer is prevented from recovering any portion of the funds which are not needed to meet his liabilities under the plan. This has erroneously been stated to represent no departure from existing law. (See p. 96 of the Senate hearings, unrevised.) The inability of the employer to recover any amount not needed actuarily under the plan will be a hardship on the employer and will not materially benefit any employee. (5) Finally, the limitations prescribed by the bill are wholly inapplicable to stock bonus and profit-sharing plans which are fundamentally different in character from pension plans.

The only justification for this reversal in policy is stated to be that these plans have been used for tax avoidance purposes. But no evidence has been presented either before the House or before this committee that these plans have been so used. The amount of possible revenue lost through the use of these devices cannot begin to compare with the amount of additional revenue collected as a result of the increased profits directly attributable to such plans. Moreover, the Treasury's proposals, as reflected in the House bill, go far beyond the mere prevention of tax avoidance. Rather, they are clearly designed to further certain undefined social objectives.

The question is, therefore, simply this: Does Congress wish to encourage bona fide pension and profit-sharing plans, thereby benefitting employees and resulting in increased revenues; or does Congress wish to stifle a substantial number of sound plans in order to catch the small amount of revenue alleged to be lost through the comparative handful of tax avoidance cases and in order to make all plans—bona fide, as well as tax avoiding—conform to untried social criteria?

The answer is obvious. We therefore recommend that the provisions of existing law be retained. Only minor amendments are necessary to prevent the use of these plans as a tax avoidance device for stockholders or for a small number of top-salaried officers. These should be adopted. If new social standards for all pension, profit-sharing, and other employee incentive plans are to be adopted, separate consideration should be given to that problem. A wartime revenue bill is neither the time nor the place.

(2) *Protection of normal inventories*

Priorities, scarcity of materials and other effects of the war are compelling the reduction of inventories which must eventually be replaced in order to carry on normal operations. The "paper profit" which may thus result from "profit" on sales out of normal inventory should not be taxed until replacement is effected and its costs determined. Such a postponement of the determination of the real profit is essential in order to protect the taxpayer from a tremendous tax burden upon purely illusory profits arising from forced liquidation of inventories.

(3) *Consolidated returns*

The proposed 2 percent penalty for filing consolidated returns should be eliminated and such returns should be permitted for all Federal tax purposes.

(4) *Accelerated depreciation*

Although the Commissioner of Internal Revenue has authority under existing law to allow accelerated depreciation, based upon overtime use and lack of adequate repairs, etc., the indications thus far are that wholly inadequate recognition will be given thereto if the present law remains unchanged. Taxpayers should be assured of adequate allowances for the extraordinary wear and tear on machinery and equipment as the result of wartime use, with machinery frequently overloaded and operated by inexperienced personnel, and for deferred maintenance.

(5) *Retroactive credit for undistributed profits tax*

Section 501 of the House bill grants retroactive relief from the undistributed profits tax to corporations which were unable to distribute a taxable dividend because their undistributed net income was in excess of accumulated and current earnings and profits. This situation arose primarily in the case of capital losses which reduced earnings and profits but were not permitted as a deduction from taxable net income under the 1936 and 1938 acts. This is a highly desirable relief provision, but it should be clarified to make it clear that it also covers the substantially similar case of the corporation with current earnings but prohibited from distributing dividends therefrom under State law by reason of an accumulated deficit resulting from past operating losses.

(6) *Income from recovery of bad debts, etc.*

Section 114 of the House bill, dealing with the exclusion from gross income of recoveries of bad debts, etc., provides for exclusion to the extent that the deduction of such items in a prior year did not result in a reduction of tax for that prior year. The section should be made clear that the tax advantage of the prior deduction is to be determined by comparing the tax computed when the item is deducted with the tax computed when the item is not deducted. Furthermore, the amount of the recovery which is subject to tax should be taxed at the rates in effect for the prior taxable year in which the deduction was taken.

(7) *Employees' benefit associations*

Section 101 (16) of the existing law provides that employees' benefit associations are exempt from tax if 85 percent of the income is collected from members. This limitation was inserted in the law to make sure that such associations did not derive more than 15 percent of their income from investments, etc. The Bureau of Internal Revenue maintains that amounts contributed by an employer to the associations are to be treated like investment income in determining the income derived from members. Thus, where an employer makes a substantial contribution to an employees' benefit association, the association loses its exempt status and is taxed on all its income, including employee contributions. This construction conflicts with the underlying purpose of section 101 (16) which was to encourage the establishment and maintenance of employees' benefit associations. The section should be amended retroactively to provide that irrevocable contributions made by an employer to an employees' benefit association will not destroy the exemption. They should be treated in the same manner as employee contributions.

(8) *Elimination of tax on transportation of property*

Section 621 of the House bill imposes an excise tax of 5 percent on the amount paid for the transportation of property within the United States. Obviously, the major portion of this tax will be collected on the transportation of essential war goods from the factory to seaboard, or to other destinations within the United States. The revenue to be derived from this source is illusory, since it will be paid by the United States in the increased cost of such products. Moreover, the tax will be collected several times on the same product, through transportation of raw materials, parts, subassemblies, and finished goods, which will be reflected in a pyramiding of the price. Such a tax, therefore, is highly inflationary and undesirable.

(9) *Percentage depletion*

The changes in the allowance for percentage depletion proposed by the Treasury Department have been fully discussed by other witnesses. The chamber committee is opposed to elimination or reduction of such allowances at the present time, since the fullest development and encouragement of the oil and mining industry is essential to the prosecution of the war.

(10) *Involuntary conversions*

Section 137 of the House bill provides that gains and losses from the sale of depreciable property, held for more than 15 months, and the involuntary conversion of such property (such as destruction, seizure, or requisition by the Government) shall be aggregated. If such gains exceed losses, the net gain is treated as a capital gain; if losses exceed gains, the loss is treated as an ordinary loss. The section also amends section 112 (f) of the code, to provide for recognition of a loss upon involuntary conversion, while continuing the nonrecognition of gain.

In general, this is a very desirable and necessary provision. However, no reason appears why it should be limited to depreciable property, since all types of property are subject to involuntary conversion, or why a 15 months' holding period should be imposed. The general requirement that property should be held for more than 15 months in order to obtain the benefit of capital gain treatment is imposed because of the speculative character of short-term transactions. In the case of seizure or requisition of property, however, the taxpayer has no control over the event, and there is no speculative element in the transaction. It is recommended, therefore that the provision be made applicable to all property, regardless of the holding period.

We also recommend a further amendment to section 112 (f), which would extend the period within which like property may be obtained to replace property involuntarily converted, to 1 year after the end of the emergency period. Under present circumstances, it is usually impossible to replace property which has been destroyed or requisitioned, owing to shortages and priorities. It is not clear under the present law whether section 112 (f) can be invoked if replacement is delayed until after the emergency.

The CHAIRMAN. Senator Lucas.

Senator LUCAS. I will only detain the committee for just a very few moments.

I have before me a number of telegrams from the State of Illinois which deal directly with section 129 of the proposed Revenue Act of 1941, and there is just a short statement that has been prepared by a Mr. Quinlan of Chicago, Ill., who could not be here, representing the Allied Mills Corporation, which I would like to insert into the record at this point if I may.

The CHAIRMAN. You may do so, Senator.

Senator LUCAS. It deals with this same provision——

The CHAIRMAN (interposing). The fiscal-year provision?

Senator LUCAS. That is correct.

(The statement submitted by Mr. Quinlan is as follows:)

STATEMENT OF J. J. QUINLAN, CHICAGO, ILL., REPRESENTING ALLIED MILLS CORPORATION

There was inserted in the 1942 tax bill a provision that companies operating on a fiscal year pay Federal income taxes on the basis of the new bill when passed for that portion of the year falling in the calendar year 1942. This item was included at the last minute just prior to sending same to the House of Representatives by whom this bill has now been passed. There were no hearings on the subject whatsoever, and we feel that the inclusion of such a provision is grossly unfair.

This company's fiscal year ended June 30, 1942, and in May 1942, the company declared a dividend payable in June of approximately $400,000. Had the company had any knowledge that such a provision would be included in the 1942 tax bill, undoubtedly the payment of this dividend would not have been made, or same would have been considerably reduced in amount. The whole financial program of the company had been set up based on the thought that the company would be liable for taxes until June 30, 1942, based on the 1941 revenue bill.

This company appreciates the necessity for the Government to obtain a larger proportion of taxes and is only too willing to pay its proportion, providing same is done on a fair and equitable basis. We believe that this sudden liability thrust upon many fiscal year companies will create a tremendous hardship.

If it is felt desirable that this tax be applied to fiscal year companies, then they should be given at least some notice of the intention to so tax. In other words, this method of taxing should not be applicable to 1942, but should commence for fiscal years ending in 1943; everyone would then be on notice that there was a possible increased tax liability for them.

This company has operated on a fiscal year ending on June 30 since its incorporation in 1929, for the reason that that is the natural year for this company whose business is largely agricultural, and at that time its inventories are normally at their lowest point.

Senator LUCAS. I should like to ask unanimous consent that the clerk of the committee copy merely the names and addresses of these individuals who have sent these telegrams opposing this particular section.

The CHAIRMAN. You may do that and not incorporate the entire telegrams—is that what you wish?

Senator LUCAS. That is correct.

(The names and addresses are as follows:)

Hess & Hopkins Leather Co., Rockford, Ill.; the Weiman Co., Rockford, Ill.; American Cabinet Hardware Corporation, G. W. Aldeen, president, Rockford, Ill.; Joseph Behr & Sons, Inc., Rockford, Ill.; Brown Building Corporation, Rockford, Ill.; D. P. Forbes, president, Gunite Foundries Corporation, Rockford, Ill.; J. L. McIntyre, treasurer, Cherry Burrell Corporation, 427 West Randolph Street, Chicago, Ill.

Fleming Coal Co., V. D. Buckley, vice president, Chicago, Ill.; J. G. Horder, treasurer, Horders, Inc., Chicago, Ill.; L. K. Rimer, treasurer, James H. Rhodes & Co., Chicago, Ill.

Masters Shoe Co., Rockford, Ill.; Rockford Chamber of Commerce, Rockford, Ill.; Micro Switch Corporation, W. B. Schulte, Freeport, Ill.; Howard H. Monk, Rockford, Ill.; Third Securities Corporation, Rockford, Ill.; John W. Conrad, Rockford, Ill.; John C. Ralston, Jr., Rockford, Ill.; Aircraft & Diesel Equipment Co., 4401 North Ravenswood Avenue, Chicago, Ill., Charles Kelleher, president.

Mattison Machine Works, C. L. Mattison, president, Rockford, Ill.; Collegiate Cap & Gown Co., H. L. Velgin, president, Champaign, Ill.; H. D. Conkey & Co., Mendota, Ill.; Belleville Auto Dealers Association, Harry Meyer, secretary-treasurer, Fourth and Main Streets, Belleville, Ill.; Illinois Glove Co., Champaign, Ill.; Sanford G. Englund, Rockford, Ill.; Allyn Harris, president, Cardox Corporation, Chicago, Ill.; Cotta Transmission Corporation, Rockford, Ill.; Rockford Machine Tool Co., Rockford, Ill.; Soft Water Supply Co., 214 North Fifth Street, Rockford, Ill.

Paul Doran, Vandalia, Ill.; J. J. Clark Manufacturing Co., Rockford, Ill.

Senator LUCAS. And one other letter which I have which I deem of considerable importance and it comes from the editor of the Illinois State Journal at Springfield, Ill. This deals with a different provision—it relates to section 425, found on pages 159 and 2173 of the present bill. I should like to ask unanimous consent that the entire letter of Mr. Smith be inserted into the record at this point.

The CHAIRMAN. It will be inserted.

Senator LUCAS. I thank the chairman very much.

(The letter is as follows:)

ILLINOIS STATE JOURNAL,
Springfield, Ill., July 24, 1942.

Hon. SCOTT W. LUCAS,
United States Senator, Washington, D. C.

MY DEAR SENATORS: My attention has been called to H. R. 7378, known as the revenue bill of 1942, and which, I understand, is now the subject of hearings in the Senate Finance Committee. The provisions in this bill relating to withholding taxes on bond interest, dividends, and salaries will undoubtedly create great confusion and burdensome calculations in the part of many businessmen and individuals. From the standpoint of our newspaper, the savings and loan association of which I am a director, small business, and even individuals, it appears to me that insufficient thought has been given to the problem of withholding taxes as now provided for in section 425 and related subsequent sections of the bill. These sections are found on pages 159 through 173.

You can readily imagine the amount of additional bookkeeping that will be necessary in the case of the complicated system created for the withholding tax on salaries, and especially in those cases where temporary persons are employed. While I am not arguing against the idea of salary deduction for tax purposes, I do think the Senate Finance Committee should give careful consideration to a more simplified method of handling the deductions.

According to the Congressional Record of July 18 at page 6555 it will be necessary for the Bureau of Internal Revenue to employ nine to twelve thousand additional people and it would cost at least $24,000,000 per year, without taking into consideration the important strategical material necessary to be used, including accounting machines, hundreds of millions of forms, etc. A complete set of records similar to that created by the Federal Social Security office numbering 40,000,000 accounts will probably have to be created in the Bureau of Internal Revenue. This is true only for the salary deductions. If bond interest and dividends continue to be treated in the final law as provided for in H. R. 7378, there will be even more accounts and more of a job, since income from bond interest and dividends in the hands of small savers would create millions of additional entries.

For example, the savings and loan associations of Illinois have approximately 350,000 members. The average account will run no more than $800 with any of them considerably less. The dividends on an average account will be approximately $12 semiannually, from which 60 cents would have to be deducted and remitted to the Bureau of Internal Revenue. Each savings and loan association will have to send a letter and credit statement to each investor apprising him of the deduction so that he can use the proper figure for his income-tax return and use the credit memorandum to help pay for his income tax. Failure to do this subjects the officers to heavy fines and possible imprisonment. The difference in treatment of certain individuals who might be exempt from tax withholding and corporations which are exempt will again create the need for cross-check files and many affidavits in addition to the amount of work in preparing and checking lengthy lists. It is safe to say that the expense of the withholding tax procedure in the case of these dividends will be at least 50 percent of the tax collected.

It seems that those who drafted the legislation realized one angle of this problem when they apparently exempted savings accounts in banks from the tax-withholding features. This they did by using the term "bond interest" rather than "interest" alone. Yet we find that the average account in a mutual savings bank for 1940 was $787.88, which is quite comparable to the average account in an Illinois savings and loan association. Mutual savings banks have 13,493,000 depositors; national banks have 16,138,000 savings depositors and savings and loan associations have 6 758,000 members. Hence, it seemss very discriminatory to exempt 2 large segments of the thrift type of institutions and not the third which is smaller and possibly whose problems are less in the minds of the Treasury officials, since they operate primarily as community institutions. The association of which I am a director has estimated that to do this job, the record keeping will necessitate at least

2 additional employees at a time when several of our young men have been called into the service and the requirements of governmental reports have been stepped up considerably.

I am reliably informed also that the tax-withholding feature as it relates to dividends on shares of savings and loan associations will create further confusion in the carrying out of laws of Illinois regarding the technical features of savings and loan operation. The mutuality of treatment of all shareholders alike will be violated, since some shareholders may be exempt from the withholding tax, while others will not. Thus in the serial plan associations there will be uneven maturity dates. Other problems too technical to be discussed will also be created and the supervisory officials will be forced to spend more time in the examinations of these associations with the net result of further increased costs and time spent.

I feel sure that if the matter had been carefully considered, the whole idea of a withholding tax of this character would either be greatly simplified or eliminated and I respectfully urge you to bring these facts before the Senate Finance Committee before the bill is reported out, lest grave harm be done through inadvertence.

Sincerely yours,

J. EMIL SMITH.

Senator WALSH. Mr. Chairman, I ask to have printed in the record of the committee hearings a letter addressed to Chairman George proposing an amendment on behalf of religious, charitable, or educational organizations, requesting exemption from certain excise taxes.

The CHAIRMAN. That may be done.

(The letter referred to is as follows:)

NATIONAL CATHOLIC WELFARE CONFERENCE,
Washington, D. C., August 12, 1942.

The Honorable WALTER F. GEORGE, *Chairman,*
Committee on Finance, United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: I have been directed by the administrative board of archbishops and bishops of the National Catholic Welfare Conference to inform you, and through you the Finance Committee of the United States Senate, of a situation existing because of certain excise taxation provisions in the internal revenue code.

In 1932 the Congress in the Revenue Act of that year enacted into law a provision imposing a temporary tax with respect to the sale of certain articles. This tax was imposed on the basis of the sale price of the article sold by the manufacturer to the retailer. This tax was passed on to the public in the retail sale transaction. Among the articles with respect to the sale of which the tax was imposed were tires and inner tubes, automobiles, radio receiving sets, mechanical refrigerators, gasoline, and certain other items.

The purchase by a religious, charitable, or educational organization of any article by the manufacturer to the retailer, the amount of that tax was passed so levied. For although the tax was levied with respect to the sale of the article by the manufacturer to the retailer, the amount of that tax was passed on by the retailer in the retail sale transaction.

However, the tax did not apply with respect to sales made "for the exclusive use of the United States, any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia." Consequently, political subdivisions of governmental bodies and agencies thereof did not feel the incidence of this taxation. The seller merely certified that the sale was made to an agency of Government, and, therefore the manufacturers did not have to pay over to the United States the amount ordinarily paid with respect to sales made.

The obvious additional cost of operation to religious, charitable, and educational organizations is a substantial handicap.

The preference accorded governmental agencies rendering essentially the same kind of social service as is rendered by these organizations, or, if viewed in another light, the discrimination against nongovernmental agencies rendering public service, is apparent. The monetary advantage to governmental agencies, the monetary disadvantage to nongovernmental agencies, is measured by the volume or purchase and the rate of taxation.

But because the list of items whose sale was taxed was a list of articles not normally purchased in quantity by such institutions, and because the rate of taxation was relatively low no real opposition was registered to this type of taxation at that time. Such religious, charitable, and educational organizations remained comparatively unaffected.

Furthermore, the tax was labeled "temporary."

The Revenue Act of 1941 drastically changed this whole picture. The tax so levied was made permanent. The rates applicable were increased. Many new articles were added to the list, among them certain articles purchased in large quantity by such nongovernmental agencies engaged in the rendition of public services without thought of private gain. The provisions exempting from the tax sales made to governmental agencies remain the same. No consideration has been given the problem of the status of religious, charitable, and educational agencies under this tax.

In addition, a completely new tax law was enacted which imposed a 10-percent tax on certain articles sold at retail. The tax-exempting provisions remain substantially the same as those provided in the manufacturers' excise taxation hereinbefore treated. At the present time religious, charitable, and educational organizations do not purchase many of the items on the list subject to this new tax. It is a luxury tax on jewelry, furs, toilet preparations, etc., but items may be added to the list as occurred in the case of the other tax.

We sincerely doubt the necessity of presenting to the Finance Committee of the United States Senate any extended arguments whose objective would be to convince the committee of the value, social and financial, of the services rendered by our nonprofit religious, charitable, and educational organizations throughout the United States. We are assured that this committee is well aware of the facts in this regard. Further, we hesitate to descend into lenghy discussions concerning the proper treatment by democratic government of these nongovernmental agencies. We feel it unnecessary to point out that for Government to assume the burden of discharging the duties presently being so successfully undertaken by these nongovernmental agencies would result, financially, in a cost to Government out of proportion to tax exemption, socially, in a price that democratic government cannot afford to pay.

We believe the action herein suggested would be a proper legislative act recognizing the indispensable social service rendered by these organizations as well as legislative recognition of the right of these organizations to carry on their work in a democracy, not only unimpeded by taxation, but also encouraged in every way possible. Established tradition indicates the complete propriety of action in conformity with these statements.

We, therefore, respectfully suggest to this committee that consideration be given to this situation. Section 101, subsection (6), of the Internal Revenue Code contains language exempting from income taxation those organizations which we here contemplate. The satisfactory manner in which this salutary provision has been administered would lead us to express the ardent hope that substantially similar consideration be given these organizations in connection with the two types of tax we have here treated. To this end we respectfully suggest that section 3442 of the Internal Revenue Code be amended to include a fourth category of sales with respect to which the excise tax of that chapter shall not apply. It should provide that no tax under this chapter shall be imposed with respect to the sale of any article:

(1) (For use by vendee in further manufacture.)

(2) (For resale by vendee for further manufacture.)

(3) (For exclusive use of governmental bodies.)

(4) For the exclusive use of any religious, charitable, or educational organization exempt from income taxation under section 101, subsection (6), of the Internal Revenue Code.

We furthermore respectfully request the new retailers' excise taxes chapter, chapter 19, be amended to provide for substantially similar treatment of religious, charitable, and educational organizations. To this end we respectfully suggest that section 2406 of said chapter be amended to provide that no tax under this chapter shall be imposed with respect to the sale of any article:

(a) (For exclusive use of governmental bodies.)

(b) (For export.)

(c) For the exclusive use of any religious, charitable, or educational organization exempt from income taxation under section 101, subsection (6), of the Internal Revenue Code.

With sentiments of deep esteem, I remain

Respectfully yours,

MICHAEL J. READY,
General Secretary.

Senator WALSH. Mr. Chairman, I request that there be printed in the record of the hearings a proposed amendment to section 1808 (c) presented by the Massachusetts Cooperative Banks.

The CHAIRMAN. It may be printed in the record of the committee hearings.

(The amendment is as follows:)

STATEMENT BY MASSACHUSETTS COOPERATIVE BANKS ON FEDERAL DOCUMENTARY STAMP TAX

MEMORANDUM CONCERNING RULING OF DEPUTY COMMISSIONER

1. By letter dated January 29, 1942, Deputy Commissioner D. S. Bliss ruled that the issue and transfer of paid-up and matured shares of Massachusetts cooperative banks are subject to Federal documentary stamp tax.

(*a*) Reference to this ruling is "MT: M; LBP."

(*b*) The law is found in Internal Revenue Code, sections 1800 to 1809, inclusive.

2. Section 1808 (c) of the code specifically exempts "* * * stocks and bonds issued by domestic building and loan associations substantially all the business of which is confined to making loans to members."

3. The January 29 ruling stated that the Massachusetts statutes provided separate laws relating to the organization of cooperative banks and building and loan associations and that therefore it was clear that the two are not the same. In a conference at Washington it was pointed out that the stated reason was clearly an error and reconsideraion was given.

4. By letter dated April 9, 1942, Deputy Commissioner Bliss affirmed the earlier ruling on the basis that section 1808 (c) exempts only such institutions, by whatever name called, as are organized under a specific building and loan association statute and are generally known as such in the State of organization. In another conference at Washington we argued the fallacy of that reasoning and were advised that the question would be referred to chief counsel.

5. By letter dated July 11, 1942, the ruling was reaffirmed, in this instance upon the basis that Congress, in specifically exempting cooperative banks by name in the 1916 income tax statute and failing to mention them by name in the 1928 revived enactment of the documentary stamp-tax law, did not intend to exempt cooperative banks from the stamp tax. Copy of letter of July 11, 1942, is annexed hereto.

6. Massachusetts has 182 cooperative banks with 360,000 mutual shareholders and assets of $400,000,000. About one-tenth of assets are necessary legal reserves and practically the entire balance are local Massachusetts home mortgages to members.

Section 1808 (c) of the Internal Revenue Code exempts from the documentary stamp tax—

"STOCKS AND BONDS OF DOMESTIC BUILDING AND LOAN ASSOCIATIONS AND MUTUAL DITCH OR IRRIGATION COMPANIES.—Stocks and bonds issued by domestic building and loan associations substantially all the business of which is confined to making loans to members, or by mutual ditch or irrigation companies; * * *."

7. Massachusetts cooperative banks exactly fit this exemption.

(*a*) See any authoritative definition of building and loan association. E. g., see Webster's International Dictionary; also see American Jurisprudence, vol. 9, secs. 2 and 3.

(*b*) See history of Massachusetts cooperative banks.

(*c*) Massachusetts cooperative bank statute (Gen. Laws. ch. 170) is our only building and loan statute.

(*d*) Our cooperative bank statute is substantially identical with what are called building and loan statutes in other States, for example, New York, New Hampshire, Pennsylvania, Ohio, Connecticut, and others.

(e) Court decisions and rulings support our position.

(f) For over 40 years Massachusetts Cooperative Bank shares have been treated as exempt from this tax. Documentary tax statute appeared first in 1898, was revived during first World War, and later revived in 1928.

(g) Massachusetts Cooperative Banks have pioneered the building and loan movement in this country. Our first State statute was in 1854. Massachusetts men were leaders in the building and loan movement throughout the Nation including the founding of the United States Building and Loan League and the American Savings Building and Loan Institute.

(h) It is universally recognized that Massachusetts Cooperative Banks are the purest building and loan association in the country. Massachusetts have adhered closest to the old-fashioned idea of mutual periodic saving of and loans to members with modest limits of share value and loan maximum.

(i) The reasoning of the letter of July 11, 1942, is not conclusive law relating to statutory construction.

(j) When Congress enacted the 1928 documentary stamp tax statute, it was merely reviving a statute which had been on the books on two earlier occasions antedating the income-tax law. It was completely natural for Congress to take in substance the old tried and tested statute. The exemptive language of this old statute contemplated Massachusetts cooperative banks in the genus "domestic building and loan associations, etc.," and no one thought of the detail of specifically adding reference to cooperative banks. If this detail had been thought of it would undoubtedly have been added without hesitation. It is generally known that the 1928 statute was aimed at stocks and bonds of profit-making enterprise which were being marketed in great volume and for profit investment and speculation during that pre-depression period.

8. In 1915 when the income-tax law was before Congress, Massachusetts Governor David I. Walsh, who was then also president of the Massachusetts Cooperative Bank League, enjoined Senator Weeks to make sure our cooperative banks were exempted from the income-tax law. Senator Weeks, having no reason to anticipate narrow distinctions nor to give elaborate study to other tax laws past and present, asked for the exemption of Massachusetts Cooperative Banks and his amendment was added without contest.

9. The ruling unfairly discriminates against and burdens the mutual shareholders of Massachusetts Cooperative Banks.

10. In some States where we find building and loan statutes there are several institutions which are named cooperative banks.

11. In no other State is the exemption denied to building and loan associations and cooperative banks as it is denied to Massachusetts by this ruling. tions, savings and loan associations, and cooperative banks as it is denied to Massachusetts by this ruling.

TREASURY DEPARTMENT,
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington, July 11, 1942.

MR. T. GREGORY SULLIVAN,
73 Tremont Street, Boston, Mass.

SIR: Further reference is made to your letter of April 24, 1942, protesting a ruling issued by this office under date of April 9, 1942, in which it was held that the issue and transfer of matured and paid-up shares of cooperative banks organized under the laws of the State of Massachusetts and located in that State incurred the documentary stamp taxes under section 1802 of the Internal Revenue Code, as amended.

Careful consideration has been given to your protest. Your principal contention is that cooperative banks are so nearly like building and loan associations in their purpose and methods of operation as to be included within the scope of section 1808 (c) of the Internal Revenue Code, as amended, which exempts from the documentary stamp tax:

"STOCKS AND BONDS OF DOMESTIC BUILDING AND LOAN ASSOCIATIONS AND MUTUAL DITCH OR IRRIGATION COMPANIES.—Stocks and bonds issued by domestic building and loan associations substantially all the business of which is confined to making loans to members, or by mutual ditch or irrigation companies; * * *."

Section 101 (4) of the Code exempts the following organizations from the income tax:

"Domestic building and loan associations substantially all the business of which is confined to making loans to members, and cooperative banks without capital stock organized and operated for mutual purposes and without profit."

A study of the legislative history of the act of September 8, 1916, in which the latter provision first appears, reveals that the bill, as reported by the House, exempted "domestic building and loan associations" (sec. 11 (a) fourth). When it came before the Senate for consideration, an amendment was offered on the floor adding the following language to the exemption, "and cooperative banks organized and operated for mutual purposes and without profit (Congressional Record, Sept. 5, 1916, p. 13847). The amendment was accepted. The reason stated for submitting the amendment was that in the State of Massachusetts there were certain institutions known as cooperative banks which were organized and operated for the mutual benefit of the members and without profit and were to all intents and purposes in the same class as building and loan associations and the purpose of the amendment was to grant exemption to these organizations. The bill then went to conference, where the amendment was modified to read, "and cooperative banks without capital stock organized and operated for mutual purposes and without profit," and in this form the bill became law.

Congress, in amending the income-tax law as originally enacted to include in addition to building and loan associations cooperative banks, by necessary implication recognized that the latter organizations were not comprehended within an exemption granted building and loan associations by name. In enacting section 1808 (c) of the code (sec. 441 of the Revenue Act of 1928), Congress incorporated that part of the income-tax exemption section which deals with building and loan associations, but failed to carry into the provisions of section 1808 (c) that part of the same subsection of the income-tax law dealing with the exemption of cooperative banks. In view of this action on the part of Congress it must be concluded that there was no intent to exempt cooperative banks from liability for the stamp tax imposed by section 1802 of the code.

In view of the foregoing, the ruling issued to you on April 9, 1942, is affirmed.

Respectfully,

D. S. Bliss,
Deputy Commissioner.

PROPOSED AMENDMENT TO PENDING TAX BILL

Sec. ( ). The phrase "domestic building and loan associations" as used in section 1808 (c) of the Internal Revenue Code, as amended, shall be deemed and construed to mean and include cooperative banks organized and operated for mutual purposes and without profit. This section shall be effective as of January 1, 1936.

The Chairman. In lieu of personal appearance, the New York Social Democratic Federation has submitted a brief for the record.

(The brief is as follows:)

MEMORANDUM ON FEDERAL TAXATION SUBMITTED BY THE NEW YORK SOCIAL DEMOCRATIC FEDERATION

The Social Democratic Federation desires to record its vehement protest against shifting the burden of taxation from the rich to the poor, in the manner proposed by the current tax bill passed by the House of Representatives which is now before the United States Senate.

By this bill the House of Representatives has perverted the principle of equity of sacrifice prescribed by President Roosevelt. To prevent the disaster of inflation, President Roosevelt formulated a program calling for the stabilization of wages and the abandonment of strikes as labor's contribution in support of the President's program. The same program presupposed that capital will accept limitation of income and profits by yielding to the Treasury's tax program.

Let it not be forgotten that in addition the workers have made much greater sacrifices. Many of them were alive at the time the new methods of taxation were adopted by the Treasury; they are dead now in the wrecks of planes lost and at the bottom of the ocean where they went down with their ships. Millionaires uttered patriotic lip service while labor has already made its contribution of lives and money.

According to the latest published reports the House has cut about $2,000,000,000 out of the Treasury's program for taxing the wealthy. To make up this loss it has been seen fit by the House to raise the revenue required for fighting inflation by exacting taxes from the poor, while corporate and individual taxes were reduced to about $6,000,000,000, or about 70 percent of what the Treasury proposed. The House proposes to go into the pockets of the wage earners who earn ever so little over $500 per annum to make up this deficiency of over $2,000,000,000 short of the administration's goal. And so the congressional lobbyists for the rich have been promised sales taxes and larger excise taxes that would transfer the tax load from the shoulders of the rich, where it belongs, to the backs of the poor, who will be further exploited for the benefit of millionaires on strike against the Government.

These facts become all the more aggravated in the face of the estimate that $2,000,000,000 in revenue from a general sales tax can only be obtained by exacting a sales levy of 6 percent on everything, including food, or, in the alternative, a 10-percent sales levy on everything but food.

The $2,000,000,000 cut in the burden originally intended to be carried by the rich, which the House proposes, consists of a reduction of $691,000,000 from the taxes on corporation, $750,000,000 from the income taxes of the rich, and finally a drop of $483,000,000 by the refusal of the House to plug loopholes in the Revenue Act under which wealthy individuals and corporations escape taxes. All of these moves on the part of the House were in direct contravention to President Roosevelt's original proposals that the burdens of taxation be placed on the shoulders of the rich, where they belong.

For all of these reasons the New York Social Democratic Federation requests that the Senate Finance Committee follow the Treasury's recommendations with respect to the enactment of the revenue act now pending before Congress.

Respectfully submitted.

ALGERNON LEE,
State Chairman, Social Democratic Federation.
WILLIAM KARLIN,
City Chairman, Social Democratic Federation.

The CHAIRMAN. We have been in session a little longer than usual and the committee will recess until 2:30 today.

(Whereupon at 1:15 p. m. the committee recessed until 2:30 p. m. of the same day.)

AFTERNOON SESSION

(Whereupon at 2:30 p. m., the committee met pursuant to recess.)

The CHAIRMAN. Mr. Reporter, here is a letter from the Secretary of State, also some briefs to be included in the record by Mr. Justin R. Whiting, president of the Commonwealth & Southern; and a letter from Mr. Monroe Webster, vice president of the Commerce Photo-Print Corporation, of New York, on the tax on photographic apparatus, to put in the record.

Also a letter from Kellar & Kellar of Lead, S. Dak., which Senator Gurney desires to have entered into the record.

Senator DAVIS. Mr. Chairman, may I have the honor of presenting a letter from the Westinghouse Electric Co. on their views affecting these pension trusts?

The CHAIRMAN. Yes, sir; you may offer it, Senator.

(Documents presented are as follows:)

DEPARTMENT OF STATE,
Washington, July 8, 1942.

The Honorable WALTER F. GEORGE,
Chairman, Finance Committee, United States Senate.

MY DEAR SENATOR GEORGE: I enclose for your information a copy of a letter which I have addressed to the Secretary of the Treasury with regard to a proposal, in connection with the pending tax bill, to impose a tax on imported bitters containing distilled spirits.

Sincerely yours,

CORDELL HULL.

Enclosure:

Letter to the Secretary of the Treasury.

DEPARTMENT OF STATE,
Washington, July 8, 1942.

The Honorable HENRY MORGENTHAU, Jr.,
Secretary of the Treasury.

MY DEAR MR. SECRETARY: I refer to a telephone conversation on June 23, 1942, between Mr. Robert Eichholz of your Department and Mr. Catudal of this Department regarding a proposal, in connection with the pending tax bill, to impose an internal revenue tax on imported bitters.

This matter was first brought to the attention of the Department by Mr. C. F. Abbott, vice president of C. W. Abbott & Co., manufacturers of Abbott's Bitters. According to Mr. Abbott, domestic manufacturers of bitters are under a serious tax disadvantage as compared with imported bitters, which disadvantage would be increased by the proposal to increase the internal-revenue tax on alcohol from $4 to $6 per proof gallon, for the following reason: Domestic bitters, which contain 45 percent alcohol, are produced from alcohol upon which the present internal revenue tax is $4 per proof gallon, whereas upon similar alcoholic bitters imported into this country (chiefly Angostura bitters from Trinidad) there is levied a customs duty of $2.50 per proof gallon, pursuant to item 802 of schedule IV of the trade agreement with the United Kingdom but this imported product is not subject to an internal-revenue tax on the alcoholic content by virtue of a ruling by the Bureau of Internal Revenue that it is "unfit for beverage purposes"; the result being that a gallon of domestic bitters is at present subject to a tax of approximately $4, whereas a gallon of similar imported bitters is subject to a tax burden (duty) of only $2.50; making a differential of approximately $1.50 in favor of the latter, which differential would be increased, under the pending tax bill, to approximately $3.50. It is my understanding that Mr. Abbott has submitted to the Ways and Means Committee a proposal to remove this differential by amending section 2800 (a) (3) of the Internal Revenue Code so as to impose a tax of $6 per wine gallon on "bitters of all kinds imported into the United States containing distilled spirits."

The situation whereby imported bitters enjoys a tax differential over domestic bitters was confirmed by Mr. Eichholz of your Department, who inquired whether the Department of State would raise any objection to legislation aimed at removing the differential.

Under the trade agreement between the United States and the United Kingdom effective January 1, 1939, the United States duty on bitters of all kinds, containing spirits (par. 802 of the Tariff Act of 1930) was reduced from $5 to $2.50 per proof gallon. Under the provisions of article XIV of the trade agreement, the United States reserves the right, with respect to imported products on which the duty is reduced or bound against increase, to impose a charge or tax in order to compensate for the internal tax which is imposed in respect of a like domestic product. This article reads as follows:

"The provisions of article IX, article X, article XI, and article XII of this agreement shall not prevent the imposition at any time on the importation of any article of a charge equivalent to an internal tax imposed in respect of a like domestic article or in respect of a commodity from which the imported article has been produced or manufactured in whole or in part."

Accordingly, it is not believed that there would be any objection, under the terms of our trade agreement with the United Kingdom, to the imposition of an internal revenue tax on the alcoholic content of imported bitters, so long as such tax does not exceed the tax to which domestically produced bitters are subject.

With regard to the specific proposal to amend section 2800 (a) (3) of the Internal Revenue Code by imposing a tax of $6 per wine gallon on bitters of all kinds imported into the United States containing spirits, I should like to raise the following points:

1. According to Mr. Abbott, domestic bitters contain 45 percent alcohol, on which it is my understanding that the internal revenue tax is levied on a proof-

gallon basis. Under the new tax proposal, imported bitters would be subject to the internal revenue tax on a wine-gallon basis, making the tax burden considerably higher on the imported product containing a similar alcoholic content than on the domestic product. In order that the internal revenue tax on imported bitters may precisely compensate for the tax to which domestic bitters are subject, and thus conform with our international obligations under the trade agrement, it would seem that the tax should be imposed on the alcoholic content of the bitters. Perhaps this could be accomplished by specifying a tax per proof gallon rather than per wine gallon.

2. The proposal would impose a new tax on imported bitters of all kinds containing spirits. It is my understanding that under existing law imported alcoholic bitters if fit for beverage purposes are now subject to the internal revenue tax applicable to distilled spirits and that it is only by virtue of a ruling that they are "unfit for beverage purposes" that imported bitters, such as Angostura, are at present exempt from internal revenue tax. The question is raised whether the language proposed, "bitters of all kinds imported into the United States containing spirits," should not be modified so as to make it clear that bitters fit for beverage purposes are not subject to double taxation. Perhaps this could be accomplished by changing the language "bitters of all kinds imported into the United States containing spirits" to read "all bitters imported into the United States containing spirits and not subject to taxation under any other provision of this chapter."

3. Since section 2800 (a) (3) at present relates only to imported perfumes, it may be questioned whether it would be desirable to amend that provision in order to accomplish the desired result, particularly since the tax on imported perfumes is levied on a wine-gallon basis. It is suggested that consideration be given to effecting the new tax on imported bitters by means of the addition of a new numbered paragraph under subsection (a) of section 2800, which might read as follows:

"(9) IMPORTED BITTERS CONTAINING DISTILLED SPIRITS.—There shall be levied and collected upon all bitters imported into the United States containing distilled spirits and not subject to taxation under any other provision of this chapter, an internal revenue tax at the rate of $[6.00, or whatever rate is imposed on alcohol] per proof gallon, and a proportionate tax at a like rate on all fractional parts of such proof gallon. Such tax shall be collected by the collector of customs and deposited as internal revenue collections, under such rules and regulations as the Commissioner, with the approval of the Secretary may prescribe."

Copies of this letter are being sent to the chairmen of the Committee on Ways and Means and of the Committee on Finance and to the Director of the Budget for their information.

Sincerely yours,

CORDELL HULL.

STATEMENT WITH RESPECT TO PROPOSALS FOR CORPORATE TAXATION IN 1942, SUBMITTED BY JUSTIN R. WHITING, PRESIDENT OF THE COMMONWEALTH & SOUTHERN CORPORATION

It is realized that this Nation at war must raise enormous revenue. Your committee, entrusted with formulating this kind of a revenue bill, of necessity cannot be influenced too much by the personal sacrifices resulting from increased taxes. This statement is made on the principle that you will not knowingly impose such high taxes as to detrimentally affect our national economy, of which the utility industry is an essential part. The threat of the Treasury proposals and later of the House bill being enacted into law have so seriously depressed the market on equity securities of this industry as to destroy them as a means of finance. This is not only a tragedy for the present investors, most of whom are people of small means, but it is detrimental to the true interests of the Nation. The utility industry in supplying power to war industries is doing a vital part toward the prosecution of the war. Anything which destroys the financial soundness of this industry will be the equivalent of a national disaster.

The management of the operating utility companies of this corporation have felt that the rates under the 1941 Revenue Act are about the limit that the public utility companies should bear because of the character of their business—fixed rates subject to regulation, slow turn-over of capital (about once in 5 to 7 years). To illustrate, a corporation with a 6-year turn over, the net profit after taxes must therefore be 36 percent of the gross receipts to equal a 6-percent return on capital invested. Their business as affected by the war does not substantially increase their net earnings. This is because the large increase in the business is in power furnished for war production which, being at industrial rates, increases the net income but slightly. Such companies in accruing during the first 6 months of 1942 $2,425,594 more for taxes over and above the 1941 rates, believed they were amply providing for all the taxes that would be required of them. As shown in the attached schedule the House bill rates of 45 percent for normal and surtaxes and 90 percent for excess-profits tax would require about $1,800,000 more taxes than were thus accrued. These companies have, therefore, deferred consideration of further dividends on their common stocks until more is known concerning the current tax rates.

The statement of earnings for the 6 months ended June 30, 1942, in the accompanying schedule shows the impact of Federal income and excess-profits taxes applied at the rates proposed in the House bill upon each of the 10 principal operating subsidiaries of this corporation. The figures contained in the statement clearly indicate the following:

1. Assuming comparable earnings and taxes for the last 6 months of 1942 to those shown in the statement, Federal income and excess-profits taxes for the entire year are indicated at approximately $33,500,000, or an increase over such taxes for last year of about $11,000,000. This increase in taxes is approximately $2,000,000 more than the total of all of the dividends paid on the common stocks of these companies during 1941.

2. Although the anticipated gross revenue for 1942 of $181,000,000 is an increase of $10,000 000 over 1941, after providing these proposed taxes, the net income will be $6,500,000 less than in 1941.

3. The times earnings ratio of operating company preferred dividends on the basis of the rates of tax proposed in the House bill will be materially reduced. Since the proposals for increases in taxes were made public the market quotations of the preferred stocks of these companies declined severely, some as much as 20 points. These stocks are owned by 77,000 persons and the average holding is 28 shares.

4. The amount of earnings shown to be applicable to the common stocks of these companies is less than 4 percent of the stated capital represented by such common stocks. Such amount even if available is not enough to pay fair dividends and give to the stocks a reasonable investment rating.

5. Since the first quarter of the year the boards of directors of the operating companies have not declared any dividends on their common stocks in view of the impending tax bill. This resulted in the passing of preferred dividends by the Commonwealth & Southern Corporation to its 17,264 preferred shareholders of whom 8,688 are women. The average holding is 87 shares.

Although the utility industry is expanding, requiring large amounts of new money for construction, the result is that in order to raise such money from the public to finance new construction it probably will be necessary to do so by increasing the debt of the companies. The Securities and Exchange Commission and the management of these companies have been endeavoring to reduce, rather than increase, their debt. A tax bill which forces financing by an increase of debt in the present national circumstances is not only unsound but vicious. The credit of any corporation depends on the standing of its equity securities. We implore the making of a war revenue law which will not ruin the credit of the utility industry.

To this end we respectfully submit that this committee give careful consideration to the following suggestions:

A. Irrespective of the tax schedules which are eventually adopted, the excess-profits tax should not be more than the amount by which the earnings of the taxable year (after normal taxes and surtaxes) exceed the average amount of earnings during the base period (after normal taxes), after making due allowance for normal growth and changes in investment.

B. If the present system of computing the excess-profits tax is retained, then two things should be done:

(1) The aggregate of the rates of normal and surtax should be sharply reduced from those contained in the House bill; and

(ii) The excess-profits tax should be made progressive so that the rates be graduated on the basis of the percentage of excess-profits net income over the excess-profits tax credit. The greater the ratio of such income to the credit, the greater the tax could and should be if it is intended to recapture by such tax undue profits arising from war business.

C. It is entirely misleading to impose as an excess-profits tax a tax which is computed before deduction of normal tax and surtax charges. There can be no excess profits if the amount available for dividends is less than during the base period. It is submitted that deduction should be made in the order first adopted in the Second Revenue Act of 1940, so that the normal tax and surtax are deducted before computing the excess-profits tax. The correct principle would be to leave the normal and surtax approximately as fixed by the act of 1941 and then to impose an excess-profits tax with sharply increased graduated percentages.

D. Corporations should be allowed a credit against net income, for the purposes at least of surtaxes and excess-profits tax, of all dividends distributed, so as to preserve to the corporations their preferred and common stocks as a source of additional capital and to preserve to the Government the dividends on such stocks as a source of taxable income to the stockholders.

E. A credit should be allowed against net income, for the purposes at least of surtax and excess-profits tax, of all payments made in reduction of indebtedness pursuant to sinking fund and installment obligations heretofore incurred. Such a credit would also tend to offset the incentive for increasing debt inherent in the House bill, and is therefore desirable since it is obviously in the national interest that all corporations emerge from the war in a sound financial position.

Respectfully submitted.

JUSTIN R. WHITING,
President, the Commonwealth & Southern Corporation.

Dated, AUGUST 12, 1942.

Ten principal operating subsidiaries of the Commonwealth & Southern Corporation

Statement showing estimated effect of Federal income and excess-profits taxes at rates proposed in pending House bill of July 20, 1942, as applied to the income for the 6 months ended June 30, 1942, of each of the 10 principal operating subsidiaries and to the cash made available from operations during such period (exclusive of cash on hand and amounts accrued for taxes) for sinking funds and installment payments under obligations previously contracted, for construction expenditures, and for common stock dividends. The excess-profits taxes have been computed on the basis of the excess-profits tax credit used by each of the several companies in accruing income taxes for the 6 months ended June 30, 1942, and are on the average earnings basis except in the cases of Georgia Power Co. and Mississippi Power Co., which are on the invested capital basis. Gulf Power Co. and Mississippi Power Co., in connection with their refinancing in 1941, deposited cash under their respective mortgages, subject to withdrawal against property additions, of which cash there remained at June 30, 1942, respectively, $2,361,945 and $1,827,528.

		Consumers Power Co.	Central Illinois Light Co.	Southern Indiana Gas & Electric Co.	Ohio Edison Co.	Pennsylvania Power Co.	Alabama Power Co.	Georgia Power Co.[1]	Gulf Power Co.	Mississippi Power Co.[1]	South Carolina Power Co.	Total
1	Gross revenue	$26,121,090	$5,620,594	$2,660,786	$13,120,124	$2,899,296	$13,883,410	$19,959,373	$1,327,411	$2,129,255	$2,798,944	$90,520,283
2	Operating expenses	9,106,652	2,192,716	1,015,202	4,485,590	1,275,943	4,613,846	7,990,355	628,536	969,897	1,268,869	33,547,606
	Provision for taxes:											
3	Property and other general	1,091,784	528,713	256,392	961,630	124,092	1,164,045	1,515,801	71,162	229,084	246,990	6,189,693
4	Federal excise on electricity	399,498	70,865	32,822	208,243	45,015	146,875	242,674	25,358	39,679	40,698	1,251,727
5	Federal capital stock	127,188	23,100	12,255	58,200	11,875	68,761	85,002	4,688	8,700	5,684	405,453
6	Federal income	2,276,843	543,000	269,014	1,172,800	230,175	316,950	1,661,031	114,770	210,690	162,361	6,957,634
7	Federal excess profits	3,483,309	470,000	221,611	1,330,200	415,857	----------	1,739,996	100,591	----------	258,675	8,020,239
8	Provision for depreciation and amortization	3,386,238	768,000	373,570	1,672,542	276,000	1,496,775	2,237,540	112,500	216,000	226,310	10,745,475
9	Gross income	6,269,578	1,024,200	479,920	3,230,919	520,339	6,076,158	4,486,974	269,806	455,205	589,357	23,402,456
	Income deductions:											
10	Interest on funded debt	2,104,704	312,980	126,225	1,538,089	154,025	2,483,814	1,931,965	87,510	139,484	297,603	9,176,399
11	Other income deductions (net)	229,721	42,408	33,815	183,517	13,177	1,908,434	[2]*66,483*	*5,812*	*1,978*	30,930	2,367,729
12	Net income	3,935,153	668,812	319,880	1,509,313	353,137	1,683,910	2,621,492	188,108	317,699	260,824	11,858,328
13	Dividends on preferred stock	1,712,408	250,803	206,148	933,462	105,000	1,134,635	1,338,032	33,078	124,158	85,719	5,923,443
14	Amortization of referred stock expense	391,670	----------	20,871	----------	19,799	----------	----------	----------	----------	----------	432,340
15	Balance	1,831,075	418,009	92,861	575,851	228,338	549,275	1,283,460	155,030	193,541	175,105	5,502,545
	Federal income and excess profits taxes based on pending House bill computed as follows:											
16	Net income as above	3,935,153	668,812	319,880	1,509,313	353,137	1,683,910	2,621,492	188,108	317,699	260,824	11,858,328
17	Adjustments to arrive at estimated taxable income	*237,854*	190,230	105,737	344,791	11,493	*1,071,121*	4,814	*6,294*	*13,901*	*3,389*	*675,487*
18	Add back Federal income and excess profits taxes above on lines 6 and 7	5,760,152	1,013,000	490,625	2,503,000	646,032	316,950	3,401,027	215,361	210,690	421,036	14,977,873
19	Total	9,457,451	1,872,042	916,242	4,357,104	1,010,662	929,739	6,027,333	397,175	514,488	678,478	26,160,714
20	Excess-profits tax credit	4,694,466	1,206,710	582,427	2,545,246	417,858	2,019,898	3,669,006	229,508	574,887	264,042	16,204,048
21	Adjusted excess profits net income	4,762,985	665,332	333,815	1,811,858	592,804	*1,090,159*	2,358,327	167,667	*60,399*	414,436	9,956,666

22	Total excess profits tax at 90 percent	4,286,687	598,799	300,434	1,630,672	533,524		2,122,494	150,900		372,992	9,996,502
23	Normal and surtax at 45 percent	2,112,510	543,020	262,092	1,145,361	188,036	418,383	1,651,053	103,279	231,520	118,819	6,774,073
24	Total, lines 22 and 23	6,399,197	1,141,819	562,526	2,776,033	721,560	418,383	3,773,547	254,179	231,520	491,811	16,770,575
25	Increase in Federal taxes on proposed bases, line 24 less 18	639,045	128,819	71,901	273,033	75,528	101,433	372,520	38,818	20,830	70,775	1,792,702
26	Which would leave for common stock and corporate purposes and coverage over interest and preferred stock charges—only	1,192,030	289,190	20,960	302,818	152,810	447,842	910,940	116,212	172,711	104,330	3,709,843
27	Times earned interest on funded debt (9 and 10)	2.98	3.27	3.80	2.10	3.38	2.45	2.32	3.08	3.26	1.98	
28	Times earned after proposed tax increase	2.68	2.86	3.23	1.92	2.89	2.41	2.13	2.64	3.11	1.74	
29	Times earned preferred dividends (12 and 13)	2.30	2.67	1.55	1.62	3.36	1.48	1.96	5.69	2.56	3.04	
30	Times earned after proposed tax increase	1.92	2.15	1.20	1.32	2.64	1.39	1.68	4.51	2.39	2.22	

[1] The excess-profits tax credits for Georgia Power Co. and Mississippi Power Co. shown herein would be lower if calculated under the provisions of the House bill for the determination of invested capital credit and the taxes would be greater, which would reduce the balances for common stock on line 26 and the ratios on lines 28 and 30.

[2] Italics indicate deficit.

EFFECT OF TAX PROPOSALS ON AVAILABLE CASH, EXCLUSIVE OF CASH ON HAND AND AMOUNTS ACCRUED FOR TAXES ON INCOME

1	Available for common stock, as per sheet 1	$1,192,030	$289,190	$20,960	$302,818	$152,810	$447,842	$910,940	$116,212	$172,711	$104,330	$3,709,843
	Add back:											
2	Provision for depreciation and amortization	3,366,238	768,000	373,570	1,672,542	276,000	1,496,775	2,237,540	112,500	216,000	226,310	10,745,475
3	Amortization of bond discount and expense	243,106	43,007	40,518	151,427	12,568	1,907,123	[2] *58,307*	*1,241*	*2,121*	19,279	2,355,359
4	Amortization of preferred stock expense	391,670		20,871		19,799						432,340
5	Total	5,193,044	1,100,197	455,919	2,126,787	461,177	3,851,740	3,090,173	227,471	386,590	349,919	17,243,017
6	Less: Semiannual cash sinking fund and installment payments under obligations previously contracted	125,000					750,000	843,750			28,510	1,747,260
7	Construction expenditures	4,453,558	259,651	854,125	1,500,440	231,118	2,490,065	3,068,545	874,528	368,528	273,276	14,373,834
8	Common stock dividends paid	1,177,615	210,000		431,076	110,000						1,928,591
9	Balance	*563,129*	630,546	*398,206*	195,271	120,059	611,675	*822,122*	*647,057*	18,062	48,133	*806,768*

failed to make the new election in 1934, not realizing the necessity for such procedure under the terms of the statute. Many taxpayers have not realized their right to election. The necessity for such election was not set forth on the return forms or the instructions attached thereto by the Treasury. Many small mines lacking experienced tax counsel have been unaware of their rights.

Many taxpayers assume that the "first return" from the property was the first one which showed net income and which required a depletion computation, and hence failed to make an election in case the property showed a loss. The Treasury took the view that an election must be made whether or not there was net income from the property. Through failure to make the election in the year specified by the Treasury, many such taxpayers have been prevented from exercising their rights to percentage depletion. To correct this injustice a new election should be granted at this time. Congress should require the Treasury to inform mining taxpayers that such new election is required, by direct statement on the tax return.

The other phase of the tax situation of particular interest to the mining industry at large is the need for an alternative basis of credit under the excess-profits tax in the case of mines, based upon the normal earnings per unit of production. Such provision would recognize the special problems of mines which are increasing production or commencing new production to provide needed materials for the war program, thereby using up their capital resources at an accelerated rate, but which find themselves penalized by an excess-profits tax which takes practically the entire earnings from the increased production. The proposal would recognize that such earnings do not constitute excess profits unless they exceed the normal earnings per unit of production. Normal profits of mines would of course be subjected to the full normal tax and surtax, but the excess-profits tax would apply only to true excess profits.

Senator Johnson of Colorado designed the amendment to meet this situation.

For example—(using the profit-per-ton as the fair measure of profit-per-unit, but recognizing that in some cases profit-per-pound or per ounce of metal production would be the appropriate unit to use), if the mine during the base period had produced an average of 100,000 tons of ore a year at $1 per ton average profit, $100,000 net income per year, this amount of $100,000 would be the basis for its excess-profits credit determined on base-period earnings. If in the excess-profits year the mine does not increase its production, it will have its allowance for $1 per ton of normal profit. If it produces only 100,000 tons and makes not more than $1 per ton of profit, it will not be subject to excess-profits tax; or if it makes $1.40 a ton on 100,000 tons, it will pay excess-profits tax on the excess 40 cents a ton—$40,000 of profits.

If in our example the mine produced 150,000 tons of ore and made only the normal profit of $1 a ton, its credit under present law would be limited to the normal profit on its normal production of 100,000 tons, but the $50,000 of normal profit on the additional tonnage would be treated as all excess profits and subject to the excess-profits tax.

If on the 150,000 tons production it made $1.40 per ton, under present law the excess-profits tax would be applied not merely to the additional 40 cents per ton profit, but also to the normal profit of $1 per ton on the 50,000 tons increased production.

The proposal of the Johnson amendment was simply to make available to mines an excess profits credit equal to the normal profit per unit.

Under such a provision, in the example cited, the mine with its basic credit of $1 per ton might receive this credit on its total tonnage of production, so that if it did produce 150,000 tons at $1 per ton profit, it would have its full excess-profits credit of $150,000 and would not be subject to excess-profits tax. If on its 150,000 tons production it made $1.40 per ton, a total of $210,000 profit for the year, it would apply its $150,000 credit (at $1 per ton on 150 000 tons), and its excess profits of $60,000 (at 40 cents per ton on 150,000 tons) would be subject to the excess-profits tax.

Another matter of importance to numerous mines is the exemption from excess-profits tax accorded to certain strategic metals in the 1940 act, but withdrawn last year. This exemption should be restored to encourage the development of new mines producing these needed metals.

Yours sincerely,

KENNETH KELLAR.

WESTINGHOUSE ELECTRIC & MANUFACTURING CO.,
Pittsburgh, Pa., August 3, 1942.

HON. JAMES J. DAVIS,
Senate Finance Committee,
Washington, D. C.

DEAR SENATOR DAVIS: The tax bill (H. R. 7378) recently adopted by the House of Representatives and now before your committee contains certain provisions affecting pension trusts concerning which we wish to suggest certain modifications, in order to clarify the intent and to avoid the possibility of unintended hardships and results contrary to the public interest.

We refer to the provisions contained in section 144 of the bill, which proposes to amend section 165 of the Internal Revenue Code relating to pension trusts. The provisions we have in mind are contained in paragraphs (3) and (4) of the proposed clause (a) of section 165. Paragraph (3) provides, in substance, that a pension trust will be exempt from tax if it is part of a plan which benefits either (subparagraph (A)) 70 percent or more of the employees, excluding employees employed not more than a minimum period prescribed by the trust, not to exceed 5 years, or (subparagraph (B)) such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of officers, shareholders, supervisory or highly compensated employees. Paragraph (4) provides similar exemption if the contributions or benefits under the trust do not have the effect of discriminating in favor of any employee whose compensation is greater than that of other employees.

The Westinghouse Electric & Manufacturing Co. has a pension plan which was created in 1929, under an irrevocable pension trust covering substantially all of the employees of the company and providing for pensions based on the employee's length of service and certain wage or salary classifications. The cost of the pension so provided is borne entirely by the company, without any contributory payments by the employee. Annuity certificates to cover annuities payable upon the employee's retirement from the company's service at retirement age were issued to the employees at the time the plan was put into effect, and additional annuity certificates, likewise payable upon such retirement, to cover the services of employees for subsequent years, were issued from year to year thereafter until the end of the year 1935. These annuity certificates were issued from year to year in so-called annuity units, based on the following classifications:

Yearly wages:	Number of annuity units
$1,500 and under	1
$1,501 to $2,100	1½
$2,101 to $2,700	2
$2,701 to $3,300	2½
$3,301 to $3,900	3
$3,901 to $4,500	3½
$4,501 to $5,100	4
$5,101 to $6,300	4½
$6,301 to $7,500	5
$7,501 and over	6

One annuity unit represents $1 per month payable upon the employee's retirement from the company service at retirement age.

Under this pension plan 2,763 persons have heretofore been retired and have received pensions, for the rest of their lives, ranging from $2 to $325 per month.

The pension trust established by this company might be construed not to be exempt from tax under the proposed subparagraph (A) of paragraph (3) because, as of January 1, 1936, due to the passage of the Federal Social Security Act, the issuance of further annuity certificates to employees for service for subsequent years, was discontinued and the number of new employees since that date is sufficient so that at this time 70 percent of the present employees are not included in the plan. However, all employees of the company were included in the plan from the time when it was established until December 31, 1935, when the issuance of annuity certificates was discontinued, and all employees of the company as of December 31, 1935, who are still employed are now included under the plan and the company has continued, and will continue for a number of years, to make payments to the pension trust in order to pro-

COMMERCE PHOTO-PRINT CORPORATION,
New York, July 23, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR: In the absence of Mr. Cheyney I wish to acknowledge receipt of your letter of July 17, and to thank you for notifying us that the public hearing conducted by the Senate Committee on Finance in regard to the 1942 tax bill will take place starting Monday, July 27.

We realize that in our telegram of June 13 we requested the opportunity of personally appearing before committee to voice our objection to the proposed increased rate in the excise tax on photographic paper, but due to the press of vital Government contracts we will be unable to have an executive officer take advantage of the invitation to appear. We would, however, deeply appreciate consideration being given by the Senate Finance Committee at the public hearing to the following written objection:

The House Ways and Means Committee have in the proposed 1942 tax bill agreed to impose a tax of 15 percent on photographic apparatus. Under this same heading ir bill H. R. 5417 for 1941 a tax of 10 percent was imposed. Included with photographic apparatus are photographic plates and sensitized paper, and the manufacturers of photoprint paper interpreted this law as applying to their particular product and therefor passed the tax on to their customers in the farm of a general price increase.

It is our contention that this tax is unfair in two respects.

The first is, we believe the intent of the law is to tax luxury users of photographic papers and cameras such as amateur photographers rather than small business users such as ourselves. We base this contention on the fact that X-ray film is specifically exempted under the present act and that cameras weighing in excess of 4 pounds are exempted in the present act. Obviously the large cameras, those over 4 pounds in weight, will primarily be used for business purposes such as aerial surveys, photo-offset printing, photoengraving, photostating, airplane construction and similar processes. The small cameras, those weighing less than four pounds, will continue to be sold to amateurs and can rightfully be considered a luxury, and just subject to the tax. The same is true of the products used in these small cameras and we strongly feel that if the House Ways and Means Committee saw fit to exempt from tax the cameras used for business purposes they should have also exempted from tax the paper used in these industrial cameras.

A large percentage of photoprint or photostat paper is now being used in connection with war work and the tax bill if passed as it now stands will increase the cost of the war effort, and the Government will in any event be assessed the increased cost indirectly. The paper cost on most Government work represents at least 50 percent of the selling price of the finished work and the cost to industrial companies engaged in war work approximates 40 percent. The paper cost is therefore a substantial part of the prime costs and an increase from the present 10 percent tax to the proposed 15 percent will seriously handicap a small essential industry in its efforts to continue in business.

The other point we would appreciate having the Senate Committee on Finance consider is the unfairness in the imposition of a high tax on the commercial photoprint industry while such competitive processes as blueprints, ozalid prints, black and white prints, litho prints, etc., remain unaffected. The papers used in these processes are also of a sensitized nature but they have not come under the tax measure as this type of reproduction is generally not considered to be in the photographic field. The commercial photoprint business is in more direct competition with this type of process than it is with photography, and while the present 10 percent tax makes it difficult to compete, if this is raised to 15 percent it would give our legitimate competitors a still further advantage.

It is our earnest plea that this unfair tax be eliminated entirely by incorporating into the 1942 tax bill a clause reading "with the exception of photoprint paper used by commercial producers in cameras weighing in excess of 4 pounds." This clause could be inserted following the one beginning "photograpic plates and sensitized paper." The revised item in its entirety would then read as follows:

(4) Photographic apparatus: Cameras, excepting those weighing in excess of 4 pounds; lenses; unexposed photographic films (including motion-picture films, but not including X-ray films); photographic plates and sensitized paper (with the exception of photoprint paper used by commercial producers in cameras weighing in excess of 4 pounds); photographic apparatus and equipment; and any apparatus or equipment designed especially for use in taking photographs or motion pictures or in the developing, printing, or enlarging of photographs or motion-picture films—15 percent.

As a point of information, we would appreciate an explanation as to why cameras weighing over 4 pounds were exempted in the proposed new tax act and yet the materials used in these cameras were overlooked. We believe every Senator and Representative will be asked for this explanation by their constituents who are engaged in the business of commercially producing photoprints.

We respectfully request that the most earnest consideration be given this subject in order to remove the present undue hardship being inflicted on the thousands of small, legitimate commercial photoprint concerns throughout the country.

Sincerely yours,

COMMERCE PHOTO-PRINT CORPORATION,
MONROE WEBSTER, *Vice President.*

UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
July 25, 1942.

Hon. WALTER F. GEORGE,
Chairman, Finance Comittee,
United States Senate, Washington, D. C.

MY DEAR SENATOR: I present for consideration the subject matter contained in the attached letter from attorneys Kellar & Kellar, Lead, S. Dak.

These attorneys have had much experience on the problems of the mining industry, and Lead, S. Dak., is the home town of the Homestake Mining Co.

I therefore present their letter, with the request that the committee give it full consideration, and that the letter be placed in the printed record of the hearings at the time you are considering that part of the 1943 revenue bill which has to do with the mining industry.

Sincerely yours,

CHAN GURNEY.

Enclosure.

KELLAR & KELLAR,
Lead, S. Dak., June 19, 1942.

Hon. CHAN GURNEY,
Senate Office Building, Washington, D. C.

MY DEAR CHAN: I wish to call your attention to two phases of the pending tax bill which, while in no way affecting our own operations, are of concern to the mining industry.

I refer first to the need of a new election for percentage depletion in the case of mines. It is urged that a new election relative to percentage depletion in the case of mines for taxable years beginning after December 31, 1941, be provided. This may be accomplished as follows:

SEC. ( ). PERCENTAGE DEPLETION FOR COAL AND METAL MINES AND SULFUR.—

(a) The third sentence of section 114 (b) (4) of the Internal Revenue Code is amended by striking out after the word "chapter" the words "in respect of a property," and substituting in lieu thereof the following: "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)."

(b) The last sentence of section 114 (b) (4) of the Internal Revenue Code shall not apply with respect to any taxable year beginning after December 31, 1941.

Many taxpayers have been deprived of the right to take percentage depletion which Congress intended. The taxpayers relying on their election made in 1933 vide the necessary funds for the pensions payable thereunder to its employees who have heretofore retired or may hereafter retire from the company's service at retirement age and who may hold such annuity certificates. In order to avoid any possible misconstruction or interpretation not in accordance with the purpose of the law, it is believed that the proposed subparagraph (A) of paragraph (3) might well be modified so that it would expressly permit exemption from tax of pension plans such as that established by this company, by making the 70-percent test apply as of the date when the plan was established.

With respect to proposed subparagraph (B) of paragraph (3) and proposed paragraph (4), it will be observed that the wage classifications stated above, and the differences in pensions resulting therefrom, are relatively narrow and, as is self-evident, were not intended to result and do not result in any large or discriminatory pensions to high-salaried employees. It will also be noted that the class'fications are based on fixed yearly wag groupings, with minimum and maximum wage limits for each group.

In the House committee's report it is stated that "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. However, the use of one scale for officials and a less generous scale for other employees would be discriminatory." It is believed that this statement of intention should be construed to afford this company's pension plan and trust exemptions from tax under the proposed law, inasmuch as the wage classifications were intended to be—and it is believed are—reasonable and fair and not discriminatory in any respect. While benefits under the plan are not determined by a fixed percentage of wages, they are determined according to blocked wage groupings which are eminently fair and just. Therefore, in order to avoid any possible misinterpretation of the provisions of the proposed law, it is respectfully submitted that in proposed subparagraph (B) of paragraph (3) the word "unfairly" be inserted before the word "discriminatory," and in the aforesaid proposed paragraph (4) the word "unfairly" be inserted before the word "discriminating." The addition of such word would, it is believed, avoid any possible interpretation contrary to the spirit and intent of the proposed amendment.

The question is important, inasmuch as the amounts involved are large, and your favorable consideration of the foregoing is earnestly requested.

Respectfully submitted.

G. H. BUCHER, *President.*

(The following communications have been ordered inserted in the record:)

CUDAHY BROS. CO.,
Cudahy, Wis., May 14, 1942.

SENATE FINANCE COMMITTEE,
United States Capitol, Washington, D. C.

DEAR SIRS: At the suggestion of Mr. Robert L. Doughton, chairman, House Ways and Means Committee, I am enclosing a copy of an article prepared for the National Association of Credit Men, and request that it be included in the hearings on present tax legislation.

Yours very truly,

CALDWELL R. KEYSER,
Credit Manager.

Enclosure.

TAX PLAN SUBMITTED BY C. R. KEYSER, MILWAUKEE, WIS.

The following tax plan is probably unconstitutional inasmuch as tax 4 is a direct tax on tangible and intangible property and the Constitution says that all direct taxes shall be in proportion to the population of the States. However, the four-point tax plan is my answer to the following question, Given a free hand and starting from scratch, what plan of taxation would you suggest?

For the future we know that Federal taxes will be very heavy. We also know that Federal influence on our economy is very great and the tendency is toward still greater influence and control. Taxes influence our individual and corporate activities. With the increase in taxes, that influence will be increased to be the dominant factor. Therefore by judiciously applying taxes, the economy of the individuals can be controlled and hence the economy of the Nation. In order that the legislators will be enabled to judiciously apply taxes, they should have available to them the profit and loss and balance sheet data of the taxpayers. The four-point tax plan substitutes a profit and loss and balance sheet return for our present income-tax return. The information is secured and the tax imposed on the basis of the profit and loss and balance sheet.

Credit men have more experience in analyzing statements than any other group of men. They can project their minds into the future and see how the financial statements will be affected by a certain additional expense or tax. I therefore feel that we credit men are more capable than any other group of evolving a tax plan and therefore suggest that we conduct a forum on the subject through the pages of our magazine, and I offer this four-point tax plan as a basis for discussion.

C. R. KEYSER.

FOUR-POINT TAX PLAN

PLAN FOR TAXATION

1. Tax all income at the source. Wages, salaries, fees, commissions, interest, rent, dividends, gifts, bequests, charity, prizes, bonuses, insurance benefits—all taxable, and tax to be remitted by person making the payment.
2. Tax all physical merchandise—a sales tax—but suggest it not be applied on percentage of retail sales—but rather as an excise tax of so much on each article, varying from nothing on production machinery and staple foods to large amounts on luxury items.
3. Tax increment in net worth. If a man is worth $5,000 on January 1 and $6,000 on December 31 he will be taxed on basis of $1,000.
4. Tax net worth—all tangible and intangible assets less all obligations.

EXPERIENCE WITH EACH TAX

1. This tax we have had for a number of years in the form of social-security taxation, so business firms could expand their handling to cover the other items in addition to wages and salary. Individuals would find it a little new, inasmuch as they would have to deduct and remit a tax when and if they pay rent, interest, contributions, lawyers, doctors, or other fees or payments which could be included as income for the recipient.
2. The sales tax has been effectively used by many States on a percentage of all retail sales. However, for a graduated scale, varying according to commodity, it would be more practical to use the stamp excise plan now used by the Federal tax authorities.
3. This tax is in all effects the same as our present income tax, but without the complicated forms. Our present income tax allows deductions for dependents, interest, losses, charity, and other necessary and ordinary expenses. If a man spent money throughout the year only for ordinary and necessary expenses he would have saved during the year the amount of his taxable net income as figured on the present income-tax return. In other words, taxable income under the present income tax would be the same as his taxable increment under this proposed plan. If an individual spends more, thereby reducing his increment and his tax liability, he would pay more sales tax because his additional purchases would enter the field of nonnecessities.
4. The State and local authorities have long been taxing physical property. It is proposed to tax also other assets, such as securities, notes, and nonphysical assets, but to allow deduction of the obligations against the assets. This would relieve the home owner whose home is mortgaged, but bear more heavily on security holder, now property tax free.

ECONOMIC EFFECTS OF EACH TAX

1. Taxes all income at source at time of payment, thereby spreading payments over entire year instead of all at one time. Reduces gross income by amount of tax, reducing inflationary tendency.

2. Falls most heavily on consumers above the bare-necessity class. Sales of luxury items which carry a large tax would drain off excess spending power while using little man-hours and materials in proportion. If luxury items are not purchased possessor of excess-buying power would not be encouraging inflation and would be subject to tax 3 on increment of net worth and net worth tax 4.

3. Same effect as our present income tax, with exception that gain or loss can be taken as sustained rather than when realized, thereby smoothing out tax payments and allowing a freer market for capital assets (since sales would not be promoted or withheld for tax purposes).

4. Would increase the desirability of home ownership on equity basis because tax would be on equity rather than on gross value, but would somewhat increase the cost of financing.

The greatest economic effect of this entire tax plan would be caused by tax 4 on intangibles. The money market lends money at a certain rate of interest. If we add a 2-percent tax to the capital, it would require interest rates 2 percent higher to yield the investor the same amount. This tax would make the investor more anxious to lend (since capital is taxed whether in idle cash or in securities) and the borrower would be less anxious to borrow because of increased interest rates. Such a situation would result in the investor absorbing most of the tax, say 1½ percent of the 2-percent tax and the borrower absorbing ½ percent. The net result would be an increase of ½ percent in interest rates and a 1½ percent lower yield to investors. On existing contracts, the entire burden would fall on the investor, unless adjustment of some sort were made. The adjustment could be in the form of relinquishing whole or part of tax on existing contracts until a certain date, or by imposing the tax gradually by adding ½ percent each year, with maturity compulsory within 4 years.

Any idle capital would soon be taxed away. Considerably more capital would be required to provide the same net income. Capital would therefore of necessity combine with management risk to maintain itself and have a possibility of increasing. Capital would become less timid, would become more venturesome, and stimulate new enterprises, some of which would be of general benefit to civilization.

ADMINISTRATION OF EACH TAX

1. Means of administering have been developed in present pay-roll-deduction taxes.

2. Means of administration have been developed by State sales tax authorities and Department of Internal Revenue.

3. Means of administration have been developed by income-tax department, but form of return would have to be changed as per the attached copy. This form would also be used to levy tax 4 and to check on taxes 1 and 2.

4. Means of administration have been developed by State and local authorities for assessment and taxation of real property, but not of intangible property. The present method of assessment and levy requires equalization boards and appeal boards to correct errors in assessor's judgment. It is the chief source of present income for all State and local governments and is unsatisfactory inasmuch as it puts the burden mostly on the most solid citizens—the home owners. The present difficulties of assessment would be increased many times if the assessors in the present system were also to assess intangibles, and I therefore suggest that each taxpayer assess his own assets. At first thought this might seem impractical and the source of much tax evasion, but the following rulings, I believe, will make the plan simple, effective, and just. (1) That any asset unclaimed becomes the property of the tax authorities. (2) Appraisal can be made by the tax authorities at any time with the cost of such appraisal to be paid by the taxpayer if the appraised evaluation is more than 10 percent different from taxpayer's evaluation, and expense is to be borne by tax authority if valuations vary less than 10 percent. Appraisal always to be made at death of taxpayer.

(3) Taxpayers evaluation can be used in lieu of condemnation proceedings. It is the intention not to punish by imprisonment, attempts at tax evasion, but to make the financial gain resulting from successful tax evasion out of all proportion to the financial risk involved.

COLLECTIBILITY OF EACH TAX

1. Tax is applied at point of transaction and the money is changing hands and therefore available for immediate collection.
2. Ibid.
3. This is readily collectible for the most part because the increment was in the form of money at some time during the taxable period. The exception is the fact that gain in value of assets held throughout the tax period is included in increment. It would only be in extreme cases such as a tremendous and sudden increase in value of an asset, that the collectibility would be curtailed, however in such an event the asset should be sufficient security to secure money to pay the tax.
4. This tax might be levied entirely upon assests which were not in cash form at any time during the taxable period. On income-producing assets no collection problem is encountered. There is a problem though on non-income-production assets such as homes. However this problem has faced home owners for generations and seems to have been satisfactorily met through all the years.

YIELD

1. A rate of 10 percent based on a national income of 100 B would yield 10 B;
2. Of the 100 B national income 10 B withdrawn at source would leave 90 B available and perhaps 70 B will be spent. Also probably 10 B from previous savings or a total of 80 B. A tax averaging 5 percent would yield 4 B;
3. The total of 20 B saved would be subject to tax on increment of net worth. An average of 30 percent would yield 6 B;
4. Estimating total assets of nation at 500 B a tax rate of 2 percent would yield 10 B; total 30 B.

Experimentation will be necessary to discover the exact ratio of tax rates that will produce the desired effect. For instance a higher rate on tax 2 and a lower rate on tax 3 would encourage people to save rather than to spend. Conversely a lower rate on tax 2 and higher on tax 3 will encourage people to spend because it would be too expensive to save. By judiciously applying various ratios of rates at the four points of taxation, the economy of the Nation can be influenced to follow the desire of the legislators without recourse to specific and usually ineffective economic legislation. This is more possible now that taxes are higher, because the taxes are now a more important part of each budget and will correspondingly exert more influence on the taxpayer's activities.

JUSTICE

The justification of any tax is that the Government must be supported. The justice of taxation is not that it be applied evenly but that it be applied to similar taxpayers in the same way and that the type of application be for the greatest benefit for the greatest number of people. In this light let us look at the justice of the taxes.

1. This is tax that reduces the actual income of each taxpayer. The greater the income the greater the tax paid to the Government. It includes all types of income, including life-insurance benefits, charitable contributions, interest, and dividends, which are new items. These incomes should pay their portion to the Government the same as wage incomes. I can think of no reason why they should not.
2. This tax is graded from little or nothing on food and essentials to very high rates on luxuries. The justice is that he who has enough money over and above the amount necessary for food and essentials also has enough to give more to the Government.
3. This tax is the same justice as the present income tax but in a simpler form. If a taxpayer's entire income is spent to buy essentials for his dependents, he pays no 3 tax and very little 2 tax. If he spends it on luxuries for himself, he pays no 3 tax but pays a large 2 tax. If he spends only for essentials and saves, he pays little 2 tax but big 3 tax.
4. This is merely expanding property tax to include all assets. This is the oldest form of taxation the justice of which is more doubtful than the others but is generally accepted due to precedent.

Name ________________ Age ______
Address ________________ Color ______
Post office ________ State ________ Sex ______

If you have any entry to place on any line, fill in the supporting schedule.
A. Name and address of dependents ________
B. Dependent upon ________

Income section:

1. Salary, fees, and commissions received ________
2. Net operating profit from business ________
3. Rent received ________
4. Dividends ________
5. Interest ________
6. Gifts and bequests and charity ________
7. Prizes, bonuses, insurance, and other income ________
8. Total ________

Expenditure section:

9. Salaries, fees, and commission paid ________
10. Rent ________
11. Dividends ________
12. Interest ________
13. Gifts, bequests, and charity ________
14. Prizes, bonuses, insurance, and other expenditures ________
15. Special ________
16. Nonconsumption expenditures ________
17. Consumption expenditures ________
18. Total ________
19. Net cash gain or loss for year ________
20. Net increase or decrease in value of assets ________
21. Net gain or loss for year ________
22. Net worth at beginning of year ________
23. Net worth at end of year which consists of ________

Asset section:

24. Land ________
25. Buildings ________
26. Machinery, equipment, furnishings ________
27. Bonds ________
28. Stocks ________
29. Receivables (secured) ________
30. Receivables (unsecured) ________
31. Personal property, supplies, inventory ________
32. Other assets ________
33. Cash ________
34. Total ________

Liability section:

35. Unsecured ________
36. Secured ________
37. Other liabilities ________
38. Par value outstanding shares ________
39. Total ________
40. Net worth ________

LIPE-ROLLWAY CORPORATION,
Syracuse, N. Y., July 30, 1942.

Hon. WALTER F. GEORGE,
Chairman, the United States Senate, Washington, D. C.

MY DEAR SENATOR: We wish to draw to your attention our company's position under the tax bill just passed by the House of Representatives, and in that connection are enclosing a statement which shows in figures and facts how we are situated.

We receive no benefit from section 213 of the bill, "Relief provisions."

We would appreciate your assistance to a company in our position, i. e., one with a low excess-profits tax credit; which has built up a personnel several times its top peacetime level; and now faces the inevitable lay-off with 95.5 percent of its current income being absorbed by taxes and dividends of a must nature.

Since no statement such as the enclosed was submitted to the Ways and Means Committee of the House, we ask that this be printed as a part of the record.

Yours respectfully,

LIPE-ROLLWAY CORPORATION,
J. S. OGG, *Comptroller.*

STATEMENT BY LIPE-ROLLWAY CORPORATION, SYRACUSE, N. Y., CONCERNING LIABILITY FOR TAXES AS IMPOSED BY TAX BILL PASSED BY HOUSE OF REPRESENTATIVES, JULY 20, 1942

Our excess-profits tax credit based on invested capital will be about $70,000, and we may reach a net profit for the year of $1,500,000. We are engaged in war work 100 percent.

The following tabulation gives a comparison of the application of the tax bill in our case, with the example quoted by the Ways and Means Committee, but after revising the excess-profits tax rate from 87½ to 90 percent. We assume that the committee considered such example as typical or average—

	House Ways and Means Committee example		Lipe-Rollway Corporation	
		Taxes		*Taxes*
1. Normal-tax net income	$3,000,000		$1,500,000	
2. Less dividends received	15,000		....	
3. Excess-profit net income	2,985,000		1,500,000	
4. Excess-profits credit	2,000,000		69,000	
5.	985,000		1,431,000	
6. Specific exemption	10,000		10,000	
7 Adjusted excess-profits net income	975,000		1,421,000	
8. Excess-profits tax, at 90 percent	....	$877,500	....	$1,278,900
9. Normal-tax net income	3,000,000		1,500,000	
10. Less adjusted excess-profit net income	975,000		1,421,000	
11. Net tax base	2,025,000		79,000	
12. Normal tax, at 24 percent	....	486,000	....	18,960
13. Add exempted interest	100,000		....	
14. Surtax base	2,125,000		79,000	
15. Surtax, at 21 percent		446,250		16,590
Total taxes		$1,809,750		$1,314,450
Total taxes, percent of item 1		60		88
Net income left after taxes		$1,190,250		$185,550
Net income percent of item 1		40		12
Net income ratio		3:2		1:0

On April 30, 1942, we released a preferred stock issue of 80,000 shares at a price of $14 or $1,120,000. Two days later, on May 2, the newspapers carried the announcement of the 94 percent excess-profits tax and the sale of the issue came to a virtual standstill at 25,000 shares, all of which had been contracted for in advance.

We had entered into negotiations with the Government for the manufacture of large additional quantities of critical war products and had asked the Government to provide plant and equipment with which to make same. We included nothing in our request to cover "funds," as we expected the sale of the above 80,000 shares of preferred stock to furnish this, but the uncertainty created in the public mind by the 94 percent excess-profits tax coupled with the renegotiation provisions of H. R. 6868 killed the sale of the issue. Prospective purchasers could find no encouragement to make an investment in the face of such hazards.

We are now applying for a loan under regulation V. Due to H. R. 6868, our balance sheet which normally is first class for substantial unsecured loans, no longer impresses a bank, as there is no telling when current assets appearing thereon may be snatched away by contract renegotiation.

This renegotiation enactment has done more to upset normal business and banking than anything else on the statute book. High taxes may be hard to bear but they will be borne, but the insecurity of renegotiation ought to be terminated.

If industry is to stand on its own feet in the post-war period, it must be allowed to retain reasonable funds to accomplish this, and tax burdens, as presently proposed and applicable in our case, should be modified. Our normal peacetime business is the manufacture of machine tools, chiefly lathes (50 percent) and heavy duty automotive clutches (50 percent). Our business has expanded greatly in the last 2 or 3 years, but when the war is over, the market for machine tools will be nil. Just what the market will be for clutches is not clear, but we are faced with the prospect of dropping about 250 lathe employees and a very heavy cut in our clutch employees.

We will need money to tide us over the readjustment period, to cushion labor lay-offs, and to develop new products to take the place of our then vanished machine-tool business. This development and marketing of a new product is expensive, but whatever its cost to a large corporation, its cost to us, a small corporation, is just as much. The large corporation could pay for this out of its "free" profits and never feel it, while our funds were being exhausted.

You will note that the tax bill leaves us $185,500, or 12 percent, of our net income, while leaving "the example" 40 percent or 3.2 times as much, but we do not attempt to say that this is disproportionate as we have no means of knowing the needs of such a corporation.

This $185,000 left us represents 3 percent on an expected sales volume of $6,000,000. From this we have to pay $117,000 in preferred and other dividends, so that all that is left us with which to expand our inventory, buy new equipment, develop new products, meet renegotiation demands, and establish a fund for post-war emergencies, is $68,000. For a company doing $6,000,000 per annum and heading for $9,000,000 in 1943, we submit that $68,000 per annum (1 percent on sales) is utterly insufficient for our purposes. Such a sum represents little more than 2 weeks of our present pay roll.

We believe that a corporation should be allowed to retain out of its annual income an amount equal to some certain percentage of its pay roll as a fund for post-war purposes. This retained amount would be treated in the same way as an "allowable deduction" but, to be granted, would have to be expended for Government bonds of a special issue and usable for such purposes only as would be recognized as tending to promote employment, and if not so used, would be forfeited. Included under such purposes might be disbursements in connection with new products and developments such as machinery, inventory, sales development, etc.

Finally, we would be glad to have you check our record on product, effort, and performance.

LIPE-ROLLWAY CORPORATION,
J. S. OGG, *Treasurer*.

SYRACUSE, N. Y., *July 29, 1942*.

AERONAUTICAL CHAMBER OF COMMERCE OF AMERICA, INC.,
Washington, D. C., February 9, 1942.

Hon. WALTER F. GEORGE,
Chairman, United States Senate,
Washington, D. C.

DEAR SENATOR GEORGE: I advised you in my letter dated December 30, 1941, that the Aeronautical Chamber of Commerce of America accepted on behalf of its members the invitation extended to it by your committee to express the views of our industry on current taxation problems.

Our accounting committee has prepared several recommendations which I now submit for the consideration of your committee. The first three of these recommendations were supplied you in previous letters dated August 22 and September 26, but are restated here for your convenient reference.

(1) It is the considered judgment of our accounting committee that the established basic date of June 10, 1940, for the amortization of plant constructions, alterations, and expansions denies equitable relief to those concerns which prior to this established date heeded the call of our President on September 8, 1939, when he declared a limited national emergency, and enlarged their plants to accommodate defense orders. The unprovoked Japanese attack on Pearl Harbor which precipitated our entry into World War II focuses the public attention on and their resultant approbation of, the farsighted policies of manufacturers who did not require assurances that amortization would be allowed before commencing expansion of their plants.

It is recommended that the basic amortization date be changed to September 8, 1939, and that the amortization privileges be extended to include those plants who enlarged their facilities to accommodate the needs of Great Britain and other friendly powers prior to the enactment of the Lend-Lease Act.

(2) It is believed that the existing inflexible provisions of the Internal Revenue Code, which prevent either upward or downward revision of capital stock values for the years 1942 and 1943, are undesirable. Never was there a time when prognostication of earnings was mode difficult than now. The uncertainty of the efficaciousness of existing and contemplated procedures to curb prices (and the resultant possibility of inflation) and the lack of any stabilization of wage costs cause the prognostication of future earnings to be extremely hazardous.

It is suggested that the possible drastic effects of these uncertainities be relieved by amending the Internal Revenue Code to permit either upward or downward revisions of capital stock values for the years 1942 and 1943. You will recall that during the enactment of the Revenue Act of 1941, such a provision passed the Senate but was stricken out in conference.

(3) It is foreseen that increased taxes which it is anticipated will be levied will bear most heavily upon the new companies of our industry which have already been or will be formed to participate in the defense and war program, since these companies will not have the specified earnings base period.

It is suggested that either these new companies be permitted to extend their base periods until 3-year earning periods are available, or that they receive constructive earnings credit of 10 percent of sales.

(4) It is our considered judgment that the anticipated intensive competition for export markets among the companies which will produce aeronautical products after the termination of the present war urges that this country adopt a plan which will place our manufacturers on an equal competitive footing with the manufacturers of other countries.

With this thought in mind, our accounting committee has drafted a proposed amendment to the Internal Revenue Code which would provide for the setting aside of reserves for post-war rehabilitation. It has been suggested that the funds so earmarked could be invested in defense savings bonds, thus giving the use of the moneys to set aside to the Government during the prosecution of the war. Copies of this suggested amendment are supplied herewith for your consideration.

In closing, may I express to you and your committee our appreciation of your invitation to express our views. We realize the enormity of the task confronting you in your effort to formulate legislation which will not defeat its own purpose by placing obstructions in the flow of important war materials which this and other industries are supplying to the Nation and its war allies.

Respectfully yours,

AERONAUTICAL CHAMBER OF COMMERCE OF AMERICA, INC.,
(Signed) JOHN H. JOUETT, *President.*

MEMORANDUM FROM THE CHAMBER OF COMMERCE OF THE STATE OF OKLAHOMA, WITH RESPECT TO HOUSE BILL 7378

1. We commend—

(a) The House action in its refusal to impose a limitation upon existing deductions allowed for bequests to charitable, religious, and educational institutions, for the reason that these institutions receive their main support from gifts and bequests and that any policy which would tend to diminish such support would impair the efficiency of such institutions. Their usefulness and value have not been challenged and it is doubtful if a substitute could be devised or provided.

2. We commend—

(b) The action of the House in declining to make joint returns for husband and wife mandatory, for the reasons that the Federal Government in order to increase its revenues during depression years, encouraged the creation of separate estates by husbands for their wives and a joint return would defeat the justifiable expectations of the donors, and, furthermore, we believe it is not the purpose or intention of Congress to uproot or destroy the principles of the community property law of several States which stems from customs and practices inherited from social and economic philosophies existing therein at the time of their incorporation as part of these United States. If Congress were to require a single income-tax return, then the gift tax law should be amended and also the inheritance tax law. Congress should not consider the husband and wife as a unit for income tax purposes and as separate persons for gift and inheritance tax purposes.

3. The Oklahoma State Chamber of Commerce sent to its board of directors of 68 members, a questionnaire covering the basic parts of House bill 7378. These board members are a cross-section of the manufacturing and industry, business and agricultural interests in Oklahoma. A copy of the questionnaire accompanies this memorandum and is marked "Exhibit A." A copy of the enclosure sent with the questionnaire is attached to this memorandum and is marked "Exhibit B." These exhibits will give the committee a view of the objectivity of our interest in the measure designed by our representatives whose purpose is to raise revenue and plenty of it. The Oklahoma State Chamber does not believe that it is the purpose of Congress to use Monsieur Colvert's formula of "getting the most feathers with the fewest squawks." The Oklahoma State Chamber believes that Congress wants to be informed of the effects of the proposed revenue bill and especially wants to be informed of the probable effects of the proposed taxes on the business and economy of those who will pay a large part of taxes.

Referring to the questionnaire and the responses, we submit the following summary:

1. *Shall we recommend a sales tax?*—All except one answered "Yes."

Reasons: (1) This is everybody's war. No classes, no exemptions. (2) Each percent will raise about half a billion dollars; rates, 5 to 10 percent. (3) A retail sales tax is anti-inflationary. (4) Its incidence cannot be shifted and can therefore operate efficiently along with price control.

1(a) *Shall we recommend a manufacturers' sales tax?*—Replies were unanimous against a manufacturers' sales tax.

Reasons: (1) A manufacturers' sales tax is highly inflationary, tending to increase prices to consumers without comparative benefit to Government.

(2) It is cumulative.

(3) The incidence can be shifted and therefore cannot operate with any price-control machinery.

1(b) *Shall we recommend further extension of selective excise taxes?*—Replies unanimously approved the rates and increases in House bill 7378.

* * * * * * *

2. *Shall we recommend a tax on pay rolls?*—Replies unanimously "No."

Reasons: A tax on pay rolls would immediately cause (a) an epidemic of strikes and demands for higher wages with two attendant adverse outcomes—(b) a stoppage or slowing down of output while labor and wage negotiations are going on and (c) an increase in the cost of the war.

The purpose of House bill 7378 is to raise funds to pay bills at present levels. Its purpose is not to increase costs.

2(a) *Taxes on dividends?*—Unanimously "No."

Reasons: Triple taxation—(1) the corporation pays taxes and the dividend receiver pays income taxes. If the dividends are taxed separately, it would mean that a dividend would pay three taxes in a row.

2(*b*) *Taxes on interest?*—Unanimously "No."

Reasons: If the tax is withheld, the collection would be difficult. If tax is added to the interest payment, the effect would be usurious. If paid by the recipient of the interest, it would be double taxation on the same income item. A Federal tax on municipal bond interest would be a paralyzing blow to municipal government.

* * * * * * *

3. *Corporation income taxes?*—Replies: (*a*) The replies were practically unanimous in favor of increased normal and surtax rates; (*b*) the replies were unanimous in favor of very stiff excess-profits taxes.

Reasons: No one approved the 45 percent normal and surtax rate. The replies are divided evenly at 35 and 40 percent, and are unanimous that above 40 percent would throw many firms into bankruptcy or force them to close out.

"Corporations must have a cushion or a backlog in war and in peace."

"A reasonable dividend should be paid to maintain a fair market price for corporate securities. Destruction of the market value of investors' securities deprives the investor of his capital and savings; it would effectively curb any initiative for new enterprises, and it would not benefit either the Government or the most advanced anticapitalist.

* * * * * * *

4. *Eliminate the capital-stock tax from the bill?*—Replies almost unanimously "No."

Reasons: We need revenue.

5(*a*) *Should the normal individual income-tax rate be increased from 4 to 6 percent?*—Replies: Unanimously "Yes."

Reasons: The group earning enough to pay an income tax can make the necessary adjustments in his domestic and private economy.

5(*b*) *Should the surtax which begins at 13 percent be increased or reduced?*—Replies almost unanimous in favor of letting the figure stand at 13 percent.

* * * * * * *

6. *Exemption—$1,200 for married persons and $500 for single persons?*—Replies: Not a single adverse comment to the above figures. There is much sentiment for eliminating or drastically reducing the $400 exemption for children and dependents.

* * * * * * *

7. *Precollection of a pay roll withholding tax?*—Replies: Only three replies were against the withholding tax and these were qualified.

Reasons: Some means are needed to provide a steady flow of cash into the Federal Treasury. The withholding tax, plus a retail sales tax will help mightily in providing a steady flow of cash and will prevent the tying up of enormous sums saved to pay income taxes on or before the Ides of March.

However, the withholding tax on wages and salaries will not touch 750,000 lawyers, doctors, and dentists, nor the 6,000,000 farmers nor the million and a quarter independent businessmen. We believe that it is not the intention of Congress to use the bill to bring about any social reform nor to bring about an economic change nor purposefully to exempt any group or groups from the burdens of the bill.

If the withholding feature is retained in the bill, something should be added to take in the groups named.

This organization favors the pay-as-you-go plan (known as the Ruml Plan), if the withholding tax is adopted.

* * * * * * *

8. *Post-war credit plan?*—Replies: Practically unanimous for a post-war credit if the excess-profits tax is allowed to stand at any point near 90 percent.

Reasons: Changes in plant arrangements, machinery, inventories, and personnel are costly and will require ready cash. Bankruptcy will face many firms unless some provisions for a post-war credit are incorporated in a bill, which provides for a high excess-profits tax.

* * * * * * *

9. *Reduction of nondefense spending?*—Replies: Unanimous for not only a reduction but also for the elimination of nonessential nondefense spending.

* * * * * * *

10. *Recommendations.*—Some provision should be made to allow a person or corporation enough to pay his legitimate debts, incurred some time previous to the date of passage of the bill. Paying debts is a type of saving and we

question the equity of allowing a person in debt to save and get financially well, and leaving to others, who are out of debt, the burden of paying taxes on the full net income.

Nevertheless, we think that a family paying on a home or hospital bills, and the like, or that corporations with amortization contracts should not be compelled to lose the home or the firm go into bankruptcy.

Perhaps a deferred tax payment could be provided, but, on the other hand, no favors should be granted a person or a corporation who happens to be in debt and could use a tax leniency to save.

Respectfully submitted.

CHAMBER OF COMMERCE OF THE STATE OF OKLAHOMA,
By FORD C. HARPER, *General Manager*.

DR. J. M. ASHTON,
Director of Research.

AUGUST 4, 1942.

EXHIBIT A. QUESTIONNAIRE CONCERNING VIEWS OF 1942 FEDERAL INCOME BILL

1. Shall we recommend a retail-sales tax? ______
   (*a*) A manufacturers' sales tax? ______
   (*b*) Further extension of selective excise taxes? ______
   Above, if so, what rates? ______
2. Shall we recommend a tax on pay rolls? ______
   Dividends? ______ and interest to be withheld at the source? ______

______

(This would further broaden the tax base in lieu of confiscatory increased normal and surtax rates imposed against individuals.) Not included in House bill.

3. Shall we recommend further increases in the corporate normal income and surtax rates and corporate excess-profits tax rate? If so, what increase in rates can reasonably be made to obtain the greatest amount of revenue and at the same time avoid interfering with the national defense program or destroying the private enterprise system? ______

______

4. Shall we recommend the elimination of the capital-stock tax and declared value excess-profits tax? If so, what substitute for the loss in revenue should be suggested? ______
5. (*a*) Should the normal individual income-tax rate be increased from 4 to 6 percent as provided in the House bill? ______
   (*b*) Should the surtax which begins with 18 percent be increased or reduced? ______ How much? ______
6. Shall the State chambers approve of the proposed individual exemption of $500 for single person and $1,200 for head of family, as provided in House bill?

______

7. Shall the State chambers approved the proposed precollection of a withholding tax? ______

   The bill proposes that for 1943, 5 percent, and for 1944, 10 percent, of all payments of bond interest and dividends and of all payments of wages in excess of certain specified deductions shall be collected at the source beginning with January 1, 1943. The amounts so collected are to be credited on the income tax of the recipient.
8. Shall the State chambers of commerce approve a post-war credit plan (not included in the House bill) which it is understood will be given serious consideration in the Senate? ______

   This question is definitely related to the corporate excess-profits tax. The House bill provides for a flat rate of 90 percent (increasing the exemption after excess-profits tax credit from $5,000 to $10,000). Such a rate is confiscatory unless there is a post-war credit available to the corporation for the purpose of providing necessary reserves which otherwise under the bill would be available through no other source.
9. Shall we insist upon a greater reduction of Government expenditures of a nondefense character? ______

Any other remarks: ______

______

______
(Company)

Per ______

OKLAHOMA STATE CHAMBER OF COMMERCE, *July 1942*.

EXHIBIT B.—*Summary comparison of portions of 1942 Federal revenue bill, as it passed the House and now before United States Senate*

	Present law	New House bill
INDIVIDUAL INCOME TAX		
Normal tax rate	4 percent	6 percent.
Surtax brackets	Bracketed from 0 to $5,000,000	Brackets stop at $200,000.
Surtax rates	6 to 77 percent; $200,000 bracket at 67 percent. Top bracket of $5,000,000 at 77 percent.	13 to 82 percent ($200,000 and over, 82 percent).
Exemptions:		
Single person	$750	$500.
Head of family	$1,500	$1,200.
Credit for dependents	$400	$400.
Collection at source—withholding tax.	None	5 percent for 1943, 10 percent thereafter. Applies to entire amount of dividends and bond interest. Applies to wages in excess of allowances. Bill provides schedule of allowances for each single wage earner, married wage earner, and wage earner with dependents, allowances being fixed for various payment periods such as weekly, monthly, quarterly, etc. Withholding agent must inform recipient as to taxes withheld. Recipient may credit total amount of tax withheld from him at the source against income tax payable by him in the following year for the taxable year in which these amounts were withheld.
CORPORATION TAXES		
(a) Normal tax:		
Rate for corporations having income of less than $25,000.	15 percent on first $5,000, 17 percent on next $15,000, 19 percent on next $5,000.	Same.
For corporation[1] having income in excess of $25,000.	24 percent or $4,250, plus 37 percent of excess over $25,000, whichever is less.	24 percent or $4,250, plus 31 percent of the excess over $25,000, whichever is less.
(b) Surtax:		
Corporations with surtax incomes of $25,000 or less.	6 percent	10 percent.
Over $25,000	6 percent of first $25,000, 7 percent on remainder.	10 percent on first $25,000, $2,500 plus 32 percent of the next $25,000; when surtax net income is $50,000 or over, 21 percent of entire amount.
(c) Combination of normal and surtax:		
Highest combined rate	31 percent	45 percent.
Deduction for excess-profits tax.	Limited to excess-profits tax itself.	Extends to entire excess-profits tax net income (including exemption and untaxed portion) except as to corporations obtaining special relief, when deduction is 90 per cent of excess-profits tax net income.
(d) Excess-profits tax: Rate	Bracketed from 35 percent of the first $20,000 to $254,000 plus 60 percent of excess over $500,000.	90 percent flat rate.
Specific exemption after excess-profits tax credit.	$5,000	$10,000.
Excess-profits tax credit:		
(1) Invested capital basis	8 percent on first $5,000,000; 7 percent on excess above $5,000,000.	8 percent on first $5,000,000, 7 percent on next $5,000,000, 6 percent on next $190,000,000, and 5 percent on all over $200,000,000.
(2) Average-earnings basis.	No change	No change. (Slight technical administrative corrections.)
(3) Both bases (invested capital—average earnings). Bonus payments made by Government agencies for production in excess of specified quota of a depletable product.	Included in determining basis	Excluded.

[1] The alternative is meaningless as to corporations having a normal tax net income of over $50,000.

EXHIBIT B.—*Summary comparison of portions of 1942 Federal revenue bill, as it passed the House and now before United States Senate*—Continued

	Present law	New House bill
CORPORATION TAXES—con.		
Relief provisions	......	These are greatly expanded and attempted to be made more specific.
(e) Consolidated returns	Allowed as to railroad corporations for all purposes, as to other affiliated corporations for excess-profits tax purposes only.	Allowed for all corporations except certain special classes of affiliated corporations such as insurance companies, investment companies, etc., on condition that return be made for both income and excess profits tax purposes.
SPECIAL INCOME TAX SUBJECTS		
Net operating loss carry-over	Allowed both as to corporations and as to individuals.	Allowed as to individuals only.
CAPITAL GAINS AND LOSSES		
(a) Short-term period of holding	18 months	15 months.
(b) Capital loss carry-over	Allowed for 1 year as a short-term only.	Allowed for 5 years as to both—considered a short-term loss in carry-over years.
(c) Deduction of net losses from ordinary income.	Allowed as to long-term only	Not allowed as to corporations. Allowed up to $1,000 as to individuals.
(d) Percentage of gain or loss taken into account:		
1. Short-term net	100 percent	100 percent.
2. Long-term net	66⅔ percent if held 18 to 24 months, 50 percent if held longer.	50 percent straight as to individuals, 100 percent as to corporations.
3. Maximum rate of tax	30 percent to individuals only	50 percent as to individuals, 25 percent on long-term only as to corporations—regular rates as to short-term.
Emergency facilities amortization	Allowed as to corporations only.	Allowed as to individuals, estates, trusts, etc.
Capital Stock and Declared Value Excess-Profits Tax.	Based on declarations of value made every 3 years.	Annual declarations.
GIFT TAX		
Amount of gifts to any one person deductible for any 1 year.	$4,000	$3,000.
Over-all exemption	$40,000	$30,000.
EXCISE TAX		
Distilled spirits, beer, wine, liqueurs, cordials, tobacco, cigars, and cigarettes.	......	Material increase in the taxes on distilled spirits, beer, wine, liqueurs, cordials, etc., tobacco, cigars, and cigarettes. Floor-stock tax on each of those items in the amount of the increase of the tax.
Telephone and telegraph:		
(a) Long distance	Graduated	20 percent of charges over 24 cents ad valorem.
(b) Local service	6 percent	10 percent.
(c) Telegrams and cables	10 percent	15 percent.
Photographic equipment	10 percent	25 percent.
Lubricating oils	4½ cents per gallon	6 cents per gallon.
Transportation fares	5 percent	10 percent.
Freight and express (except coal and for U. S. Government or its agencies).	None	5 percent (5 cents per ton in case of coal).

In the above summary comparison no attempt is made to cover scores of proposed technical and administrative changes in the present law or new bases of calculation of the taxes on insurance companies, investment companies, personal holding companies, employee trusts, and estates. Special study should be given to such proposed changes, a summary of which can be found in the enclosed bulletin from the United States Chamber of Commerce.

CHAMBER OF COMMERCE OF THE STATE OF OKLAHOMA,
By FORD C. HARPER, *General Manager*.

JULY 1942.

NATIONAL ASSOCIATION OF MANUFACTURERS,
Washington, D. C., August 10, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR: May we respectfully submit the enclosed memorandum setting out our views with respect to section 144 of H. R. 7378, amending sections of the Internal Revenue Code relating to pension trusts, with the request that this memorandum be printed in the record of the hearings on this measure.

Very truly yours,

WILBERT WEAR,
Chairman, Committee on Economic Security.

PENSION TRUSTS, STOCK BONUS, AND PROFIT-SHARING PLANS—ANALYSIS OF PROVISIONS OF H. R. 7378, WITH SUGGESTED REVISIONS

1. GENERAL OBSERVATIONS

The various employer-sponsored pension plans, profit-sharing plans, and other employee-benefit plans are the result of more than a half century of growth.

For many years Congress has followed the policy of encouraging such plans in revenue legislation.

In the current emergency, the social objectives accomplished by such plans are completely overshadowed by their effect upon production.

All of these employee-benefit plans build employee morale and contribute substantially to better and steadier industrial output, while profit-sharing, in particular, is specifically designed to increase production.

The Treasury has not advanced the pension-trust amendments on a revenue basis.

The restrictions proposed are so broad that it is obvious they are intended to prohibit some types of plans—not to raise revenue.

The purpose of the amendments contained in the House bill is to change the form of, or to abolish, many employee-benefit plans.

We submit that in our opinion these broad changes are not justified—they will not produce any desirable social objectives—they do represent an attack on the many benefit plans that have been designed by employers for many years to bring "social security" to their employees.

Treasury representatives have, however, told congressional committees that abuses have arisen under the present law.

It is presumed that the abuses referred to are cases in which large bonuses are paid to officers, directors, or major stockholders of corporations in lieu of salaries, and these bonuses are paid into trusts, with the result that tax payments are postponed.

Even in these cases it should be pointed out (1) that, as a salary payment to an employee of a corporation is a proper income-tax deduction, there appears to be no good reason to deny such deduction in the case of any reasonable payment in lieu of salary; and (2) that if, as, and when the money paid by the employer is constructively received by the employee, it will be subject to tax. It is clear, of course, that if payment is delayed until retirement, the rate of tax applicable to the individual's income at that time may be lower than it would be if the money were received during high-earning years.

If the purpose of the Treasury is to prevent abuses, which are clearly rare, such prevention should be accomplished without interfering with the thousands of trusts in which there is no intention of tax avoidance.

But the provisions of the House bill will interfere with many trusts which are quite legitimate in nature, which have been planned with no intention of tax avoidance, and which do accomplish worth-while objectives from both the social and the production points of view.

If it is not possible in the time available to draw amendments which will correct the rare abuses that have occurred in this field without compelling wholesale abandonment of these plans, the whole proposal should be dropped until further studies can be made.

The particular bill in which these amendments are incorporated is the heaviest tax bill ever presented to the American people. The tax rates it contains so overshadow these pension restrictions in importance that there can be little opportunity, in connection with this measure, to give the problem of employee benefits the study it deserves.

The amendments in the House bill draw no distinction between pension plans and stock bonus and profit-sharing plans. Yet the objectives of these types of plans may be quite different.

Pension plans are set up on an actuarial basis, either through reserves or with insurance companies, to provide pensions in old age and to encourage thrift.

Their purpose is to prevent old-age dependency, to give employees the sense of security that comes with the knowledge that old age is taken care of, to facilitate retirement of superannuated employees, and to provide younger men an opportunity for advancement.

Such plans usually require substantial financial resources. Contributions must be made regularly over a considerable period of years, through good times and bad.

Stock bonus and profit-sharing plans, on the other hand, are designed, not primarily to safeguard old age, but by permitting employees to share in the profits of the enterprise, to give the greatest impetus to maximum production and maximum efficiency.

Profit sharing may be, in some enterprises, a major factor contributing to maximum war production. It would, therefore, be particularly unfortunate if any legislation should be enacted at this time which would discourage the adoption or force the abandonment of such plans.

Unlike pension plans, profit-sharing does not require annual contributions to huge reserves against future liabilities. In fact, profit-sharing does not create future liabilities. Payments are made only when profits are earned.

For this reason, profit-sharing plans can be and have been established by many employers who are not able to carry the burden of a pension program.

In many cases, these companies have combined profit-sharing with thrift plans, calling for contributions by employees. And they have met the retirement problem by placing the employer's bonus or profit-sharing payments, along with employee savings, in reserves to be paid out in the form of retirement income.

Thus profit-sharing has, in many instances, become the answer of small business to the pension problem.

It seems elementary that if the primary purpose of a profit-sharing plan is to stimulate greater production and more efficient operation, the plan should provide the greatest incentive in the case of those employees who promote production and efficiency, reduce costs, and build profits.

Profit-sharing bonuses are properly payable to the particular employees whose efforts have been primarily responsible for profits earned.

Thus, for example, there are profit-sharing plans in which either all or specified classes of employees receive as a group a predetermined share of profits, if, as, and when earned, but in which the allocation of this share between employees in the group is determined in accordance with the individual contributions made by various employees to the earnings of the company.

Such plans are discriminatory. This does not mean that they are "bad," that they are "socially undesirable," that they constitute "tax avoidance," or represent a tax "loophole."

If it is desired to prevent corporation officers from using section 165 as a tax-avoidance medium, it should be possible to do so without jeopardizing the thousands of legitimate profit-sharing plans which have been established in good faith.

It would seem that a simple declaration that, to qualify under section 165, a plan must not discriminate in favor of certain people (people who are in a position to control corporation policy) by reason of the fact that they are officers, directors, or shareholders in the company, would be sufficient to prevent abuse of this section.

2. ANALYSIS OF HOUSE BILL PROVISIONS

The House bill, H. R. 7378, proposes several types of amendments in section 165 of the Internal Revenue Code.

Subsection A sets out the circumstances under which a trust forming part of a stock bonus, pension, or profit-sharing plan shall be exempt from taxation.

A major change occurs in paragraph 3. This paragraph sets up the following criteria:

1. The trust (or group of trusts) must benefit either 70 percent of all regular full-time employees with 5 years of service or a classification found by the Commissioner to be nondiscriminatory.

2. The contributions or benefits provided under the trust shall not discriminate in favor of highly compensated employees.

As the bill is written, a trust, to qualify, must "benefit" either 70 percent of employees or an approved group of employees. Attention is called to the fact that a plan which calls for a contribution by the employee may be offered to all the employees, but that if only 69 percent of the employees choose to participate in the plan it could be held that less than 70 percent are "benefited."

It is suggested, therefore, that this clause be clarified by substituting the words "permits participation by or makes benefits available to" for the word "benefits."

The Ways and Means Committee report amplifies the meaning of paragraph (3) (B) relating to nondiscriminatory classifications. It is indicated that it would be possible under this provision for an employer to limit a pension plan to those earning more than the $3,000 of annual wages covered by the Social Security Act, also that it would be possible to cover only certain departments or operations, employees who have reached designated ages, those with a designated length of service, or clerical or salaried employees.

The provisions of the suggested amendment itself, however, are quite ambiguous. It appears, therefore, that if this amendment be adopted, it will be necessary for many employers to obtain quick determination from the Treasury Department or to abandon their pension plans.

It is, therefore, suggested that the proposed amendment be clarified by declaring specifically in the bill that the above-mentioned classifications shall not be deemed discriminatory.

Paragraph (4) of subsection 165 (a) would prevent discrimination (in amount of benefits) between those who participate in the plan.

This provision again is ambiguous. In this case, the report seems to provide no satisfactory amplification.

Evidently the authors intended to permit supplementation of Federal social-security benefits. Yet this paragraph evidently would preclude such supplementation.

It would appear that with this paragraph as written it would be possible for an employer to include in the plan only those earnings more than $3,000 and to pay pensions only with respect to salaries in excess of $3,000, but it would not be possible to supplement social-security pensions in the lower-wage brackets.

Under the Social Security Act, the basic benefit rate of an employee earning $50 a month is $20 a month, or 40 percent of his salary; the basic rate of an employee earning $100 a month is $25 a month, or 25 percent, and the basic rate of an employee earning $200 a month is $35 a month, or 17½ percent of his salary.

If an employer should, for example, attempt to equalize these benefits by establishing a plan which would bring all benefits up to 50 percent of the salary, the plan would apparently violate the discrimination provisions of paragraph (4) as the employer's payments would clearly discriminate in favor of higher-salaried employees.

It is, therefore, suggested that this paragraph be amended to permit supplementation of social-ssecurity or railroad-retirement benefits.

This whole paragraph is evidently designed to regulate pension plans primarily. In the case of stock bonus and profit-sharing plans, the effect would, in most cases, be prohibition rather than regulation.

By comparison with pension plans, profit-sharing plans are essentially "discriminatory," for these plans, to be most effective, must "discriminate" in favor of those employees who have contributed most during the year to the success of the company.

It is here, possibly, that the abuses, if any, have occurred. And here, particularly, it is suggested that if the present law is to be amended, it can be amended in such a manner as to prevent current abuse and to do nothing more.

It is suggested, therefore, that a distinction be drawn between pension plans and other plans and that in the case of stock bonus and profit-sharing plans the amendment directly prohibit discrimination based upon any employee's position as officer, shareholder, or director.

It appears that such a provision would clearly prevent an officer or a group of officers from conspiring to have a corporation place their incomes in trust for them in order to defer taxation.

The following suggestions are made regarding the amendments to section 25 (p):

References to "5 per centum of the compensation otherwise paid" in paragraph (1) (A) and (1) (E) seem ambiguous. Presumably, 5 percent of the aggregate wages paid to all beneficiaries of the trust is intended. It is suggested that if this provision be retained, "aggregate" be inserted preceding the word "compensation" in each of these paragraphs.

With the additional restrictions proposed, there appears to be little reason for any limitation on this deduction. Payments to these funds are actual costs in the years in which they are made, and should be so treated.

It is therefore recommended that the 5-percent restriction be eliminated.

The 5-percent limitation will discriminate severely against any company with an irregular income, in favor of more stable employers.

Furthermore, such a restriction discriminates against any employer who seeks to establish a new pension plan providing benefits for past service, particularly if the past service liability is large. It is not practicable to meet a large past-service liability within the proposed 5-percent limitation.

Irrespective of past-service liabilities, the current cost of some plans providing pensions at the rate of one-third of prior wages is as high as 12 percent of pay rolls.

In earlier years when substantial interest could be earned and when labor turnover and mortality were both higher, a 5-percent restriction might have been reasonable.

Today this is not the case.

Interest rates are low, there is less labor turn-over than formerly, and mortality of industrial employees has been substantially reduced. Thus, while fund earnings have declined, a larger proportion of employees become eligible to receive pensions.

The result is that plans which used to cost 4 to 5 percent of wages now cost 8 to 12 percent or more, for the same coverage and benefits.

Under the proposed subsection 23 (p) as amended, the word "employee's" appears in paragraphs (1) (B) and (1) (D). In each case the plural (employees') should be used. It appears that the use of the singular in these cases might require vesting in the individual employee.

Finally it is recommended that if the Congress finds it necessary to restrict these various employee-benefit plans, such restrictions be limited to trusts created after the effective date of this act.

It seems to us important that the plans which have been established in good faith and which are now benefiting employees should be permitted to continue in their present form.

In the event, however, that these amendments are to apply to existing trusts, then we suggest a change in the effective date.

It is particularly important that time be allowed for modification or abandonment of the many trusts that will fail to qualify under these restrictions.

It seems obviously unfair to declare at this time that payments made into existing trusts during 1942 shall not be deductible. In view of the high rates of tax to be imposed under this bill, such a retroactive change would be particularly severe.

Furthermore, the enactment of such restrictions will necessitate many rulings and determinations by the Commissioner of Internal Revenue. Even if the effective date should be extended to January 1, 1943, it is doubtful whether this would allow time to determine which pension plans can be continued and which must be abandoned.

Unless such determinations could be had, abandonment would be the only course in many instances, as an employer cannot run the risk of incurring a tax of 90 percent on money paid into a pension fund.

It is, therefore, suggested that if the new restrictions are to apply to existing trusts, that paragraph (d) of section 144 of the bill be amended to make this section applicable with respect to taxable years beginning after December 31, 1943.

The CHAIRMAN. The committee will please come to order.

The next witness is Mr. Arkwright. Mr. Preston Arkwright.

STATEMENT OF PRESTON ARKWRIGHT, ATLANTA, GA., PRESIDENT, GEORGIA POWER CO.

The CHAIRMAN. Mr. Arkwright, will you come around, please, sir? Mr. Arkwright, you may have a seat or you can stand; just as you prefer. You may take that chair if you wish to sit down.

Mr. ARKWRIGHT. I won't talk as long sitting down, or as loud. Maybe I had better sit down.

The CHAIRMAN. Mr. Preston Arkwright of Atlanta, president of the Georgia Power Co. All right, Mr. Arkwright, you may proceed. Do you wish to finish your statement before answering any questions which the committee has?

Mr. ARKWRIGHT. Whatever meets with the pleasure of the committee, Mr. Chairman.

The CHAIRMAN. All right.

Mr. ARKWRIGHT. I have been president of the Georgia Power Co. for a little over 40 years.

In appearing before you, I do not represent the industry. I represent only my own company, and while it is a specific case, it will illustrate the effect on most of the companies in the industry.

My company furnishes electric light and power wholly in the State of Georgia over about 85 percent of the area to about 562 communities, most of which are small, rural communities, there being only nine with a population of over 10,000 each in the whole group.

We furnish power to nearly all of the manufacturing industries. I would say substantially all of them. There hasn't been one located in the State since we have been in the power business that has put in its own plant.

There is not a municipal operation that has put in its own plant since we have been in the power business. We serve a number of municipalities, 41 of them, wholesale, who redistribute it.

We serve a number of rural cooperatives, I think all in the State except two. I hope to their satisfaction.

We serve a number of war industries and camps, Army camps, naval bases, air bases, quartermaster depots, and so forth.

We likewise serve a number of war-production plants, including a bomber plant under construction and a shipbuilding plant under construction.

Our service is essential to the operation of those plants and essential to the operation of industries throughout the whole State. It is absolutely dependent upon it in the very largest part.

In 1941—in March 1941—we refinanced the company. We had a bonded debt of something like $125,000,000 with an interest charge of $6,237,000.

Under the direction of the Securities and Exchange Commission we refinanced that debt by issuing $101,000,000, in round numbers, of 3½-percent bonds and $13,500,000 of bank notes. Those bank notes are 2½ percent, they run 8 years, they require payments of installments of principal of $1,687,500 a year.

In that refinancing we reduced our total debt $10,000,000 and reduced our bonded debt $24,000,000, and we reduced our annual interest charges by the sum of $2,355,127. In order to bring about the refinancing, the Commonwealth & Southern Corporation, which owns the common stock of my company, was required and did put up $14,337,000 in cash. Likewise, they surrendered certain preferred stock they owned, which had cost them something like $4,332,877.

You can see that aside from the effect of the Federal taxes on us we have very greatly improved our financial set-up, considerably reduced our fixed charges, and put ourselves in much better position to carry on our service and the construction program.

But the refinancing deprived the corporation of a deduction of $2,355,127 which it formerly paid in interest. That resulted, of course, and does result, of course, in a very much increased normal surtax and excess-profits tax. But in order to do it it was essential, and a condition of the refunding, that we should agree to reduce the debt, which we did by borrowing $13,500,000 of 2½ percent notes on which we were obligated to pay $1,687,500 per annum. That was a condition imposed on us by the Securities and Exchange Commission, and a condition imposed on us by a proper method of financing the corporation in order to get the debt reduced.

We expected to meet that installment of principal out of the interest saving.

The difficulty about it is that with the taxes imposed on us under the House bill, it takes away all of that interest saving with the exception of $235,000 per annum, approximately. We can't pay $1,687,500, which we are obligated to, out of the amount left us under the saving of interest under the House bill.

When we apply to our 1941 earnings, after giving effect to the results of our financing, when we apply to the 1941 earnings the taxes imposed by the House bill, we have left only $984,548. We can't pay out of earnings these installments of principal. We can't pay $1,687,500 out of only $984,548. We can't borrow money to pay the debt with. We can't issue bonds for the payment of debt. We can't issue preferred stock and sell it under the very narrow margin of earnings which I will mention hereafter, which is left for the preferred-stock dividend.

Now, the only thing left to do that I can see is that we either have to apply the funds which are reserved for depreciation toward the payment of the debt or we have got to reduce the preferred-stock dividend, or we have got to default on the payment of the debt.

The company has 448,439 shares of preferred stock, and the dividends on it amount to $2,676,064. Under the House bill applied to our 1941 earnings these dividends would have been earned only 1.37 times; 1942, on an estimate, there would be earned 1.46 times.

That is an extremely narrow margin on those preferred-stock dividends.

We are subject to sleet storms in our territory. We are subject to tornadoes and wind storms. We are subject to drought. We have a good many water-power developments. We had a very severe drought in 1941, and they recur at intervals, and any little thing might happen to us that would completely wipe out that margin altogether on the preferred-stock dividend.

Now, I want to say about the preferred stock dividends, if you will let me, that of the total preferred stock shares, 272,215 are owned by people in Georgia, by 8,328 people. The average holding is about 32.6 shares per holder; 7,148 of them own less than 50 shares, 4,116 of them own less than 10 shares. We sold that stock under a customer-ownership plan. We sold it to small owners, small people, who are not very well versed in securities.

The preferred stock has paid dividends regularly ever since it has been issued. It happens that is free from advalorem taxes in the State of Georgia when owned by holders in the State of Georgia. It has been a favorite investment by these people.

If we had to reduce those dividends or pass those dividends, it would be a calamity. As far as I am personally concerned, I will have to leave the State of Georgia if my company can't pay dividends to those people who bought that preferred stock. I just couldn't face them, and I couldn't live there. They had a right to expect the dividends. They could get them regularly if the company is entitled to earn a fair return on what it has got in this property.

I was speaking so emphatically about it the other day to one of my friends. He said, "As I understand you, you would rather default the payment of your debt rather than default the payment of your dividends."

I told him I really believed I would rather default the payment of the debt rather than default the payment of the dividends to these people in the State of Georgia.

The CHAIRMAN. Is the issue of preferred stock owned by your stockholders?

Mr. ARKWRIGHT. The issues of preferred stock are owned by a number of individual stockholders, some trusts, some insurance companies, some corporations, but mostly individuals, and in Georgia there are 8,328 of them, and on the whole there are 12,704 of them.

The CHAIRMAN. I meant were these also the owners of common stock.

Mr. ARKWRIGHT. They are not. Common stock is owned exclusively by the Commonwealth & Southern Corporation. They don't own any preferred stock. They surrendered all of their preferred stock in order to allow us to perfect this financing. Every share of preferred stock they gave up without taking anything in return for it, and these preferred stockholders own nothing but preferred stock. Another characteristic of companies, electric public utility companies, at least, all public utility companies, and it applies to ours, that we are compelled to construct additions to our facilities every year and ordinary business can do it or not, as they see fit, largely, but we have got to do it.

As I understand it, we are even required by the law to serve anybody within reason who applies for service, and it isn't sufficient answer that we haven't got capacity to serve them, so we have got to do it, regardless of market conditions or regardless of anything else and, in consequence of that, we are spending money every year on new construction with this company, and so is the whole industry.

For instance, in 1940 we spent something over $7,000,000. In 1941 we spent something like $12,000,000, and in 1942 we will spend seven-million-one-hundred-odd-thousand dollars on new construction—$7,192,000 in 1942.

I want to say about the construction expenditure for 1942: We have been over the budget, I suppose, half a dozen times; cutting it down, suiting it to the scarcity of materials, cutting out what we think we can't do because materials are scarce. We revised it the last time on June 15 and cut it as much as we can.

There is a balance we have got to spend of $7,192,437 in 1942 for new construction. Let me say that we have been building and we just completed a 40,000-kilowatt steam station which has to be paid for largely in 1942. We have another 40,000-kilowatt unit under construction which will be completed in 1943, which we have got to pay for. We have got something over $2,000,000 of extensions of lines and transformer stations to serve war camps and also to serve war-production plants. We have got other necessitous services to render that require the expenditure of money, and we can't carry on the business and the business can't be carried on without expenditure of that money.

That is true of the entire industry. It has got to spend a large sum of money every year in order to meet the demand in the territory for the service and it always has had to do it.

In passing, I would like to call attention to the fact that in the furnishing of power I believe that it is the only item that enters into the manufacture of war materials and machines or in any other manufacturing enterprise; it is the only single item I know of where there is no rationing of power, where there is no scarcity of power as yet, and none immediately in sight. It is the only service and the only material that is furnished that enters into war-production plants, construction of war materials, or machines, the only single one of them where the prices have not been raised. The only one that there is no rationing of, and they are the only one in which the price is the same as the price was before the declaration of war, and I hope it will stay that way throughout the period.

But in order to carry on this construction, I can't sell any bonds for it. The fact of the matter is I seriously doubt whether the Securities and Exchange Commission would permit us to issue bonds even if we could sell them. We haven't got as low a ratio of bonded debt as they would like for us to have; our margin of earnings won't be sufficient to command a good price for those bonds, and it is practically impossible for us to sell any additional bonds at this time on that property.

We can't issue any preferred stock because of the very narrow margin that this bill imposes on the earnings applicable to dividend on the preferred stock. The only thing left to us to do, to apply to construction, is the earnings over and above preferred-stock dividends, which is $924,548, and the sum of money that we set aside for depreciation of the property of $4,011,600, which would provide us with something like $5,000,000 that we have got to use for the purpose of paying the installment on the principal of the debt, of $1,687,000, and also paying the construction expenditure of $7,192,437, and that means that we will have a deficit of enough money to pay the absolutely essential construction and the installment on the principal of our debt by the sum of $3,883,789.

As an operator of a utility, I am extremely ambitious to fulfill my duty of making the necessary construction in order to meet the demand for electric power and service in the territory. As I said, I think 85 to 90 percent of the whole industrial development of the State is dependent upon us.

Our power enters into everything they produce as well as everything any war plant produces; also enters into the operation of the telephone and telegraph and the signal lines on the railroad, the radio, newspapers, everything else in our territory, at least, and most other, is absolutely dependent on us; they have no other sources of power and under present conditions they can't get any other sources of power.

I am likewise interested, of course, in paying the interest on my debt, paying the principal on my debt, and paying the dividends to my preferred stockholders. But I would like to say in that connection that I am not so much interested in paying returns on the capital invested, except that I have got it to do if I am to get the additional capital necessary to make extensions to this property. I can't fail to pay rental on the facilities I have already got and then expect to go and get money from people to build additional facilities on which also I can't pay the interest or the return.

My own position about it is that we are entitled to such a return as will induce other people to put the necessary additional money into the property. That is the kind of return we are entitled to. That is the principal kind of return, as an operator of this property, I feel necessary that we should have.

Now, I don't want to take the time of you gentlemen to talk about the characteristics of this business. You know very well it has been regulated by the States beginning with Wisconsin in 1907; New York, 1907; my own State, 1907; and the future years immediately following, they extended it to nearly every State in the Union. It is regulated since 1935 by the Securities and Exchange Commission, by the Federal Power Commission. It is very strictly regulated.

It has to get a public franchise or consent to go on the public streets and through the obtaining of that, it likewise submits to other forms of regulation by municipalities and local governments.

The rates have got to be reasonable; can't yield any more than a fair return on the value of the facilities devoted to the service and necessary for the service, and it can only get that in a particular year. That is, it can recover in any year only the cost incurred in that year including a reasonable rate of return on the value of the facilities. It cannot recover losses sustained in the past.

When this war is over, if things get all right again and we have lost money during this period, as far as we are concerned, we can only get a rate that will yield us a reasonable rate of return at the moment, without adding anything to take care of the losses we have suffered or sacrificed in past gone days, which is somewhat quite different from other businesses.

Now, you can't get a rate increase very well. I never got but one in my life, and that was a trifle and it was during the period of the last war when all the prices of everything we bought went up about 200 percent, and we had to have some relief and we got. I think it was 2½ percent increase in the rates, and in a couple of years that was all taken away from us. With that one exception—and I consider that was decided against us—but every rate case I have ever had in my life before the Commission has been decided against my company. Notwithstanding that, I have never taken any electric-rate case to a court. When it was decided against us, we have taken it and done our level best to see if we couldn't increase the business sufficiently in time to beat the reduction in revenue brought about by the reduced rates.

Other things besides mathematics enter into rate making. Policies enter into rate making. For instance, we are required in my State to sell power to the gotton gins at less than cost. I know it is less than cost. The Commission knows it is less than cost. Everyone knows it is less than cost. But it is the policy of the State.

A lot of other things enter into rate making, and it is extremely difficult to get a commission—certainly where I am—to raise your rates, no matter what your circumstances or conditions are, and if they should think of doing it, then the O. P. A. enters into it and says it shouldn't be done, and that it is contrary to the intention of Congress that these taxes should be taken care of by an increase in rates. That is what it says. It has got nothing to do with it, except to keep it down, I guess, and with that it is just out of the question to talk about raising the rates.

And then we don't want to raise rates. It is just as necessary that the rates for electric power should be kept down, I think more so, than most anything else. Besides which we have got T. V. A. as our next door neighbor. They are tax exempt. They establish a rate lower than we can charge. And if our rates get very much out of line with theirs, why, it is good-bye to our business, that is all; we just lose it altogether. Besides that, a rate increase would be rather futile under this House bill where we have got to get \$100 increase in rates to result in \$10 in the ultimate earnings of the company, and we can't increase rates even with everybody's consent on any such basis as that.

I would like to say that I wish there was some way by which you could go back to the plan you had prior to 1941 in which you deducted income and surtaxes before you do excess-profits taxes.

You gentlemen know more about that than I do, but it strikes me as a very inequitable and unjust provision in the bill, and without any justification so far as I can see, except that it means to get a little more money out of us. I don't see why in the world you take the earnings of these companies and take half of them away. That is, 45 percent. Practically half of them away from them and then take that half and put them in the owners' pockets and say it is excess profits he has made and, therefore, turn around and take 90 percent of the taxes, the normal and surtaxes that otherwise would be owing to the Government and say that is earnings of the owner of the property and, therefore, subject to excess-profits tax. If you could do that—and I think it ought to be done—and if you could do it, it would, for my company at least, on the basis of 1941 earnings, mean a reduction in the taxes that are otherwise assessable against it under the House bill of \$1,102,504.

This business doesn't produce inflation. In no way, shape, manner, or form has it any effect on causing inflation. It doesn't make anything special out of the war; characteristically, it is hurt instead of helped by the war.

During the last war our business was hurt instead of helped by it.

Our prices don't increase. Prices of everything else in the war effort do increase, and we are called upon notwithstanding that, on fixed low prices, before the war prices, to pay additional taxes in order to pay the increased cost of the manufacture of somebody else's supplies of war material for the war purposes.

I would say that at least in the fight against inflation, we have made some contribution to it in keeping our prices down to the low levels prevailing before the war.

We also make some contribution to the expenditures of money which the Government has to make to buy these war materials by not increasing our own power—prices of our own power—which add to the manufacture of all those machines and materials.

I might mention, if you will let me do it, that it is the only business I know of which, to any large extent, is subject to Government competition. The ordinary businessman can suffer competition from anybody else where they both operate under the same rules and under the same tax burdens, but if I or private industry have got to operate on one set of rules and under very large tax burdens, and its principal competitor is to operate tax free and with other advantages, the result is absolutely inevitable: we will be completely destroyed.

I am not suggesting that municipal operations or Government operations should be taxed, although, personally, I think that ultimately that will have to come. When they take over the whole business you have got to get the revenue from somebody. But I do think that it is entitled to some consideration in determining what tax burden you will put upon this business that is subjected to that risk.

This is a unique business. It is different from any other business I know of. We have had a pretty tough time of it in the last several years. I think whatever evils existed in it—and I don't say they did or they didn't—have been eradicated, and as is always the case in correcting an evil they sometimes go a little further and add on a little punishment for past bad behavior. We have cleaned house. We are furnishing essential service that you want furnished at as low a rate as possible. Those rates can't be increased, and I would appeal to you that on account of the business being unique that some consideration should be given to the nature of the business in determining the tax to be imposed on it.

I thank you.

Senator BARKLEY. What is your suggestion as to the changes in the bill?

Mr. ARKWRIGHT. My suggestions of the changes in the bill are (1) to change the imposition of the excess-profits tax so that the income and surtaxes are taken out first before excess profits are levied; (2) in the alternative, that some provision be made by which we may be permitted to deduct these principal payments on our debt which were incurred for the purpose of reducing our interest and thereby increases our taxes.

I ask also that some special consideration be given to treat preferred stock dividends as a deduction, just as interest on debt is treated, as a deduction.

There are other suggestions which I am not competent to argue to you, Senator, because I am not a tax expert—some of them perhaps much more scientific than these plainer ones that I have mentioned.

I believe I am through.

The CHAIRMAN. Any questions by any member of the committee?

(No response.)

The CHAIRMAN. No questions?

(No response.)

The CHAIRMAN. Thank you very much, Mr. Arkwright.

Mr. ARKWRIGHT. I appreciate it very much, sir.

May I file one of these statements?

The CHAIRMAN. Yes; you may file a statement.

(The statement submitted by Mr. Arkwright is as follows:)

STATEMENT OF P. S. ARKWRIGHT, PRESIDENT, GEORGIA POWER CO., ON THE REVENUE BILL OF 1942 (H. R. 7378)

My name is Preston S. Arkwright, residing in Atlanta, Ga. I am president of Georgia Power Co. and have been president of this company and its predecessors for a little over 40 years. In appearing before you, I represent, of course, only my own company, and while it is a specific case, the effect of the pending tax bill on it is similar to its effect on the whole electric utility industry, which is similarly situated.

1. THE COMPANY

The company supplies electric light and power service to 562 communities (mostly small towns and rural settlements, there being only 9 cities of more than 10,000 inhabitants each) over about 85 percent of the area of the State of Georgia. It serves many Army camps, naval bases, air bases, Government hospitals, quartermaster depots, a number of war-production plants, including a bomber plant and a shipbuilding yard now in process of construction. It also supplies urban transportation in the cities of Augusta, Macon, and Columbus, near which large Army camps are located, and in Atlanta and Rome, Ga. It renders natural-gas service at Columbus and Fort Benning, Ga. There is an increasing demand on it for enlargements and extensions of its plants and facilities.

2. REFUNDING

Georgia Power Co. is particularly hard hit by the excess-profits taxes because during the year 1941 it refinanced under the rigid requirements of the Securities and Exchange Commission. Until March 1, 1941, the company had an outstanding bonded debt of about $125,000,000 ($124,483,700), with an annual interest charge (at 5 percent and on a comparatively small amount at 6 percent) of $6 237.112. The debt was refunded March 6, 1941, by the issuance and sale of $101.271,000 of first-mortgage 3½-percent bonds and borrowing from banks $13,500,000 on 2½-percent installment bank notes, the principal of the bank loans being payable in semiannual installments pro rata over a period of 8 years. The bonds were reduced approximately $24,000,000, the total debt $10,000,000, and the annual interest requirements were reduced by the amount of $2,355,127.

In order to enable this refinancing to be accomplished, and in accordance with the requirements of the Securities and Exchange Commission, the Commonwealth & Southern Corporation, owner of the common stock, invested, without receiving any additional securities of any kind, an additional amount of $14,337,319 in cash and surrendered for cancelation 53,286 shares of the $5 and $6 preferred stock of this company for which it had paid $4,332,877.57, and surrendered the dividends on such preferred stock retroactive to January 1, 1941. amounting to $274,286 per annum. Aside from the Federal taxes, this refunding and additional capital contribution obviously strengthened the corporation considerably by reducing its fixed charges, its preferred-stock dividends, and its debt, and improved its cash position to enable it the better to carry on its construction program.

But the refinancing also deprived the corporation of a deduction of $2,355,127 formerly available to it in arriving at its net income subject to income taxes and excess-profits taxes. Thus, by carrying out a Government order and by improving its financial position, the company seriously increased its Federal taxes, and under the bill as reported by the House will lose the greater part of the fruits of conservative policy.

In addition to this, it was a necessary part of the refunding that the amount of bonds outstanding should be materially reduced. As a necessary part of the refunding, without which it could not have been accomplished, the company had to borrow on its installment bank loans above referred to, the sum of $13,500,000, and obligate itself to reduce such bank loans in the principal amount of $1,687,-

500 each year for 8 years. It counted on its ability to make these principal payments out of the interest saving. The pending tax bill would deprive it of 90 percent of such interest saving, leaving it only $235,000 of such interest saving to be applied to its annual debt installments of $1,687,500.

The company's earnings, after preferred dividends, for 1941, after giving effect to the results of the refinancing and applying to such earnings the income and excess-profits taxes under the pending House bill, would amount to only $984,548. This means that the company will not be able, if the House bill becomes a law, to pay out of earnings these installments of the principal of its bank debt as planned. It cannot borrow or issue bonds or sell preferred stock to provide funds for the payment of this debt, so that it will be compelled either to default in the payment of the debt or to use the cash set aside out of the year's earnings for renewals and depreciation of its property for this purpose or pass or reduce its preferred dividends. Some provision should be made to cover this situation and similar situations that exist in many other companies, in order that debts of this nature, contracted prior to the passage of the act, can be paid. Especially is this true when the contracting of the debt increased the net earnings subject to income and excess-profits taxes more than sufficient to pay the debt installments.

3. PREFERRED STOCK

The company has outstanding 448,439 shares of preferred stock, of which 14,570 shares are entitled to dividends at the rate of $5 per share, and 433,869 shares are entitled to dividends at the rate of $6 per share. The total dividend requirements are $2,676,064. Under the House bill these dividends would have been earned in 1941 only 1.37 times. Based on the figures for the first 6 months of 1942 the ratio would be 1.48 and the estimate for the full year 1.46 times. These margins are so narrow that they may easily disappear. We all know there is an upward trend for increased operating expenses. We now have a wage arbitration pending for our transportation workers, and if any increases are granted it will necessarily lead to demands for other employees of the company. This margin is likewise imperiled by a great many other circumstances which may arise, such as widespread and disastrous sleet storms, windstorms, or severe droughts on our water power sheds, which are not rare occurrences, and numerous other contingencies which may arise.

The preferred stock dividends are almost the same as interest charges. It would be a calamity to reduce or fail to pay these preferred stock dividends. These shares of preferred stock have been a favored investment by the people in Georgia. The dividends have been paid regularly in full amount, ever since the stock was issued. The stock is free of ad valorem taxes under the present laws of Georgia. In consequence, 8,328 people in Georgia have bought this preferred stock and they own 272,215 shares, having a stated value of $27,221,500. These shares are owned largely by people of small means in small amounts, averaging 32.6 shares per holder, and 7,143 of whom own less than 50 shares each, 4,116 owning only 10 shares or less each. For the most part, they individually fall in the lower brackets under the income tax law, but if, because of excessive taxes on the company, the dividends cannot be paid in whole or in part, it would amount to assessing against these people 100 percent of their lost income from this source. The same principle should allow deduction of preferred stock dividends as now allows deduction of interest on debt. At least a credit should be allowed for preferred stock dividends against excess-profits taxes and corporate surtaxes, and certainly in the case of public utilities.

4. TAXES BEFORE AND AFTER THE ACT

Applying the 1941 Revenue Act to the income of this company for 1941, after giving effect to the results of the refinancing in 1941, the normal and surtax would have been $2,172,494, and the excess-profits tax $1,427,003, or a total of $3,599,497. Applying the provisions of the pending House bill to the same income, the normal and surtax would be $2,693,633, the excess-profits tax $2,205,005, or a total of $4,898,638, being an increase in Federal income and excess-profits tax of $1,299,141, effecting a like reduction in the balance to surplus from $2,283,689 to $984,548.

5. CONSTRUCTION

One of the characteristics of a public utility differentiating it from most all other businesses is that it must serve anyone within its territory who applies for service. It must be prepared to meet the demand on it. It can't answer that it hasn't sufficient capacity. Ordinary business can determine for itself whether it will make enlargements, but a public utility must make them whether profitable or not, whether the financial market is favorable or not, and regardless of conditions or circumstances. Besides, all the other activities of the territory are largely dependent upon an adequate supply of electric power. For instance, since 1920, in the territory served by Georgia Power Co. in the State of Georgia, no single manufacturing industry of consequence has installed its own plant nor any municipal electric distribution system, nor any but one commercial establishment of size, nor has any industry or municipality or commercial establishment (except one) substituted any source of power supply for the power being supplied to it by this company. Practically all the manufacturing, industrial, commercial, and municipal enterprises of the State are dependent on the service of the Georgia Power Co. for their electric lighting and power supply. Their demands are constantly increasing and their increasing demands must be met.

Georgia Power Co. has added 140,000 kilowatts to its steam electric generating stations in the last 12 months and is constructing a further addition of 40,000 kilowatts to be ready in 1943. It has expended on new construction $7,237,091 in 1940, $12,258,832 in 1941, and it is spending an estimated $7,192,437 in 1942. These expenditures may be reduced to some extent in the future due to the scarcity of materials, but they cannot be discontinued. If the company fails to meet the demands the war effort in this territory will be slowed down, as well as the entire activity of the territory. It may be worth mentioning that of all the essential material and services none are more essential than electric power, and yet electric power is the only one in which up to date there has been no shortage and no need of rationing and no increase in rates or prices. (There was a slight shortage for a few weeks in the early summer of 1941 in the Southeast due to the severest drought on record, combined with a great demand for power for the aluminum plant, but this was temporary and soon ended.)

We confront a serious problem in financing this required construction due in essence to the impact of the proposed taxes upon us. After meeting our operating expenses, taxes, interest, and preferred dividends, based on 1941 figures, we would have left about $984,548. The amount set aside for depreciation is $4,011,600. This gives us $4,996,148. Out of this must be paid the installment on the principal of our debt of $1,687,500, leaving $3,308,648. This will fall to pay the necessary construction expenditures of 1942 by the sum of $3,883,789.

We can't raise this by new capital; we can't sell preferred stock with so narrow a margin above the dividend requirements. We will be compelled to limit the construction and thereby limit essential service, or reduce or forego dividends on the preferred stock, which would be disastrous, or to increase our indebtedness on unfavorable terms.

The investors in this property are entitled to expect a fair rate of return on their investment. They have no chance for a speculative return in this business, under regulation. Nobody who has invested in these properties and remained with them has ever made any more than a fair interest return on the amount of money he put in. As an operator of a utility property, I am interested particularly in paying interest and dividends in order to preserve the property and get additional funds to meet the increased demands for service. I want additional capacity for needful service, and in ordinary times for constantly improving service, and the only way the company can accomplish this is by paying a reasonable rental on the capital already invested, which provided the facilities it already has, and with an assurance that it can pay a fair return on the capital necessary to be obtained to provide the additional needed facilities.

6. CHARACTERISTICS OF ELECTRIC UTILITY BUSINESS

The business is affected with a public interest. It is subject to regulation by State and Federal authorities. It has been regulated by State public service commissions in nearly all States since about 1907. It has been regulated by the Securities and Exchange Commission and the Federal Power Commission since

1935. It requires a public franchise and the consent of local governments to its construction and maintenance. It is subjected to innumerable conditions, rules, regulations, and police laws. Its rates, its capitalization, its accounting, its service, its extensions, its charges, its business generally, are subject to constant and continuous regulation and control. Its rates must be reasonable. They cannot yield more than a reasonable return on the fair value of its facilities actually in use and necessary for such use. It makes no profits in the real sense. It can recover in any year only the cost incurred in that year, including a reasonable rate to be paid for the use of the capital which provides the tools and facilities. It cannot recover losses sustained in the past. Under no circumstances can it make excess profits; any excess over a fair return would be taken away in rate reductions. It should be exempted from the excess-profits tax provision of the bill.

In any event, the bill should be changed so that the normal and surtaxes are levied and deducted before determining excess profits income. This is an inequitable and unjust provision as to all business and especially to public utilities. It is merely a device for collecting more taxes, but a manifestly unfair and improper one. It is immoral, whatever the revenue results, to require the company to pay the Treasury nearly half of its net earnings and then to provide that the amount so paid to the Treasury is an excess profit of the private owners of the business, which must be virtually confiscated by an excess-profits tax. If this amendment were made, tax revenue would be lost by the Government, of course, for many companies now subject to excess-profits taxation would be eliminated, but such companies clearly should not be subject to such a levy when in actual fact they have no excess profits.

This committee would do a great service in making the change, for it is productive of great harm and yet cannot be understood by the layman. If this change were made it would increase the normal and surtaxes under the bill for this company by the sum of $1,102,501 and eliminate all excess-profits tax on the basis of 1941 earnings, making its total normal and surtax and excess-profits tax $8,796,484 on the basis of 1941 earnings, or a reduction of $1,102,504 from the aggregate income and excess-profits taxes which would be assessed against this company under the House bill.

7. RATE INCREASES

It may be asked why the company does not increase rates to make up a part of the additional taxes. Of course it cannot do so of its own volition. It would require extended hearings before the State regulatory commission. Many different considerations enter largely into those decisions. Generally the company has to suffer a loss for a considerable period before a rate petition will be entertained. Then it is set down for a public hearing, with auditing and examinations of its accounts and records, valuations of its property, and related matters, and a very great reluctance on the part of commissions to granting any rate increase at all for any reason. But an increase would be futile in any event, for every dollar of increased earnings so brought about would be excess profits subject to a 90 percent rate under the House bill. Consequently to improve income $100 would require an increase in rates of $1,000. They could not possibly be increased to this extent. Also electric utility rates are compared with publicly owned utility rates. These rates are free of practically all taxes, certainly all Federal taxes. In our territory particularly, we are subject to an invasion of the territory by the Tennessee Valley Authority and encouragement of municipal competition with our service. Should we raise our rates sufficient to meet the increased tax cost we would invite sure competition from the governmentally owned tax-free electric power projects. Likewise, the Office of Price Administration, while having no control over prices of the regulated utility service, will nevertheless intervene, as they have done in other cases, stating "the approval of an increase in the utility rates because of increased Federal income taxes would be contrary to the intention of Congress, inflationary in character, and adversely affect the program and policies of the Office of Price Administration to stabilize prices."

8. GOVERNMENT COMPETITION

The electric utility industry is about the only business which is subjected to competition by Government. In ordinary business enterprises competitors operate under the same rules and under the same tax laws. They can survive in competition with each other because neither one is subsidized and neither one is relieved of taxes or other governmental burdens to which the other is subjected. There has been in recent years a very large program of the Federal Government going into the electric light and power business and promoting the entering into such business by municipalities, States, power districts, and other governmental subdivisions. These operations are tax-free, certainly completely tax-free so far as Federal taxes are concerned. They have other governmentally bestowed advantages as well. I am not urging that these operations be subjected to the same taxes that we are, although I think that eventually this will be necessary. What I do urge as a very cogent reason why we should not be taxed excessively is that if the present discrimination in treatment continues it will eventually force the taking over by Government of the entire electric light and power business. The effect of the imposition of Federal taxes on utility companies while the earnings of publicly owned utility services are exempted from such taxes is illustrated in reports of two companies, one privately owned and the other publicly owned. The privately owned Virginia Electric & Power Co. reported an increase in gross earnings of 20 percent during the first 5 months of 1942, compared with 1941, but its net income declined 35 percent because Federal taxes were so much higher. Contrast this with the earnings of the publicly owned Seattle municipal light and power system, whose gross earnings during the comparable 5-month period increased 26 percent, yet because it paid nothing in Federal income taxes its net income increased by more than 400 percent during the period. (Article by Elisha Friedman in the Journal of Commerce, July 29, 1942.)

9. INFLATION

One of the reasons frequently assigned for high taxes it not only to raise money for war costs but to drain money away in order to prevent inflation. There is no need for that in the case of a public utility. Its income will not be increased. Public utilities are characteristically hurt rather than aided by war. This was demonstrated in the last war. The utility company buys only durable goods and only sufficient of them to meet its absolutely necessary construction. These goods are all rationed and price ceilings fixed on them. The companies will have no surplus money to be siphoned away and they can't buy anything with what money they may have except under priorities for essential uses. On the other hand, one reason for high taxes is the increased prices charged the Government for war goods, materials, wages, etc. Our prices don't increase, and yet we are called on of such limited prices to pay additional taxes in order to meet the increased charges made by others. In the fight against inflation, we make a contribution in keeping our prices down to the low levels prevailing before the war. Our services enter into the manufacture of all war materials, machines and munitions, and it is the only item entering into their cost whose price is not raised by the war's demands.

10. EXTRAVAGANCE

High income taxes on business corporations tend to produce extravagance and cause inflation. It tends to increase the amount and cost of maintenance. It tends to increase the number of employees, their salaries and wages and bonuses and gifts. When a request for increase in wages or salaries is made it is most always accompanied with a statement that the Government is going to take away 90 percent of it anyhow and it will only cost the company 10 percent of the increase. For instance, to increase a salary $50 a month costs the company in addition to taxes that it will have to pay anyhow only $5 a month, under the House bill. It is a frequent argument used in the solicitation of gifts. It acts on the decision of all maintenance. This very argument has been urged in wage arbitrations and in decisions of wage-fixing boards. For instance, in the *Little Steel Wage case* a War Labor Board fact-finding panel found that the companies could afford the demanded increase, stating that they are so busy now with war orders that all but $2,850,000 of the $47,500,000 annual boost would have come out of excess-profits taxes.

11. CONCLUSION

Electric utilities have had a tough time of it for the last several years. They have been subjected to new and extremely harsh regulations, especially by the

Public Utility Act of 1935, and the orders and regulations of the Securities and Exchange Commission and the Federal Power Commission, by the extensive program of Federal Government construction and operation of electric power plants, and the promotion of municipal competition through Government grants and loans, and with low-priced, untaxed power from Government power developments, and from tax-free subsidized rates charged by these public authorities in comparison with the tax-burdened rates of the electric utilities, and from many other causes. The proposed tax bill imposes an unbearable burden upon them and makes it extremely doubtful whether they can meet their obligations and carry on their essential construction.

The public utilities are unique, and the nature of the business should receive consideration in determining tax policies as to them.

With your permission I would like to file later a supplemental statement or brief setting out in more detail the financial condition and earnings of the company and the changes in the proposed House tax bill which I suggest.

Respectfully,

P. S. ARKWRIGHT, *President*.

AUGUST 12, 1942.

STATEMENT OF THOMAS N. McCARTER, NEWARK, N. J., REPRESENTING PUBLIC SERVICE CORPORATION OF NEW JERSEY

The CHAIRMAN. Colonel, you may stand or sit, as you please, in making your statement to the committee.

Mr. McCARTER. I think, with your permission, I will stand.

The CHAIRMAN. Yes, sir.

Mr. McCARTER. Mr. Chairman and gentlemen of the committee, my name is Thomas N. McCarter, and my address is 80 Park Place, Newark, N. J.—that is my business address.

I want to say parenthetically, it is a great pleasure for me to follow Mr. Arkwright in presenting this issue. Mr. Arkwright is one of the outstanding men in the industry and has been, to my certain knowledge, for more than 30 years. In addition to that, he is an outstanding citizen of the State of Georgia, and I feel honored in following him, although it will be necessary perhaps for me to repeat some of the ground that he has covered.

From the formation of Public Service Corporation of New Jersey in 1903—and I may add again, parenthetically, that it was my privilege to be the founder of that corporation—until 1939, a period of 36 years, I was its president and of its subsidiary operating companies as well.

Since 1939 I have served as chairman of the board of directors of the corporation and its subsidiaries, and thus have been for nearly 40 years, and still am, its senior executive officer.

This corporation, hereinafter referred to as Public Service, through its subsidiary operating companies, furnishes electric, gas, and local transportation services to approximately 80 percent of the people of the State of New Jersey.

Its gross revenues for 1942 will exceed $165,000,000. This vast business has been built up on the basis of good service in all departments at reasonable rates, proper treatment of its more than 20,000 employees, and a fair return upon the capital invested in the enterprise as a matter of common justice and so as to make it attractive for further investment.

There are extant upon the various elements of the subsidiaries owned by the corporation approximately $200,000,000 in bonds and for the outstanding preferred and common stocks of Public Service the public, largely residents of New Jersey, have put into the treasury of the corporation a total of approximately $300,000,000 in cash during the last 40 years in almost equal amounts for the preferred and common.

During this period our plant account has increased something over $400,000,000, which increase was financed through the new money thus raised, surplus funds, depreciation reserves and other incidental resources.

The management of Public Service has followed with great concern the provisions of the new revenue act which has been passed by the House of Representatives.

Except for the $5 cumulative preferred stock of Public Service Electric & Gas Co., amounting to approximately $30,000,000 at par, and negligible amounts of certain other issues, Public Service owns all of the preferred and common stocks of its subsidiary operating companies, with the result that the stockholders of the corporation are in effect the beneficial owners of the subsidiary operating companies. There are 71,846 holders of the preferred stock, and 35,750 holders of the common stock of Public Service—well over 100,000 in all.

The business of the subsidiaries is entirely within the State of New Jersey, except as to a certain portion of its transportation business, which is carried on through the tunnels or over bridges into New York City and Philadelphia.

Neither the corporation nor the operating companies have any other interests outside of the State, except certain connections with other companies for the exchange of power made principally for the safeguarding of the service.

While Public Service is technically a holding company to the extent above indicated, its activities are wholly limited to the furnishing of these different kinds of service locally through its subsidiaries. It is practically an integrated unit confining its activities to one State. It has no outside activities whatever and, therefore, is not a holding company in the ordinary acceptation of that term.

Public Service is exempt from the Holding Company Act of 1935 in that its structure and operations fall squarely within the exemption provisions of section 3 (a) (1) of that act.

During the debate upon the Holding Company Act in the Senate, Senator Wheeler, who had charge of the bill, said:

> In other words, let me say * * * quite candidly that there is not any question about the fact that the Public Service Corporation of New Jersey, if I undertsand correctly, would be exempt under the terms of this bill.

The Wall Street Journal, of New York, in its issue under date of June 20, 1935, in reporting a press conference held by President Roosevelt on June 19, 1935, reports the following as the language of the President:

> (He (President Roosevelt) went on to explain that there are certain holding companies wholly intrastate such as Public Service of New Jersey, which, he said, was 95 percent to 98 percent intrastate. Niagara Hudson is another such example, he said, such companies are exempted from operations of the bill.

The subsidiary companies of Public Service serve an aggregate population of more than 3,900,000 people by one or another of the services—in over 400 separate municipalities—and approximately 80 percent of that number by all of such services.

Operations in the main are carried on by two major subsidiaries, Public Service Electric & Gas Co. and Public Service Coordinated Transport. Their rates are carefully supervised by the State commission and latterly certain Federal commissions also regulate its affairs.

It is practically impossible to secure substantial increases in rates.

Located on the Atlantic seaboard between New York and Philadelphia, the territory served is one of the most important industrial sections of the country, and particularly important as related to the Nation's war effort.

New Jersey occupies an outstanding position in the tremendous industrial effort in which this country is engaged, and ranks among the six major participants in the percentage of total war contracts.

To fulfill its duties in taking care of the normal increase of its business and of the abnormal business coming to it in connection with the war effort, it now has in course of manufacture two large additional generating units, one of 62,500 kilowatts and the other of 125,000 kilowatts. Of course, this involves an enormous outlay of money which the company has prepared itself to finance.

So interested in these units has the Government been that it is causing to be erected a large aluminum plant adjoining the station where the 125,000-kilowatt unit is to be installed, which will absorb a very large amount of the power of that unit. Where will the future units come from under a system of taxation such as is provided by this bill, especially as it is the tendency of commissions in these modern days to strongly urge—if not insist upon—equity security financing? It is manifestly essential that the credit of Public Service and its subsidiary companies be maintained if the war activities of these utilities are to continue.

On the other hand, Public Service is fully conscious of its duty to bear a fair share of the war burdens along with everybody else. It believes that it should pay by way of normal and surtax income taxes the same percentage of net earnings as are to be assessed against all corporations, although it should be borne in mind that the electric industry pays a special excise tax of 3⅓ percent of its gross receipts from residential and commercial sources, which tax, unlike most other excise taxes, cannot specifically be passed along to the consumer.

It shares, however, the common belief that 45 percent is too high a percentage for these particular taxes, and that that percentage should be substantially reduced so as to maintain a proper economic structure. Unduly high percentages defeat their purpose and will seriously disturb the financial equilibrim of the country.

While, as above stated, Public Service is prepared to pay its fair share, it strenuously objects to the change made in the 1941 tax law whereby the method of computing excess-profits taxes was changed so that the computation is made before the deduction of the normal tax and surtax instead of afterwards as had been the provision of the 1940 Revenue Act.

This resulted in the imposition of an excess-profits tax thus computed of 60 percent, and this occult and none too ingenious method of assessing excess profits is continued in aggravated form in the 1942 law as it has passed the House of Representatives, in that the percentage is changed to 90 percent, and where the capital investment return basis is used there is a drastic cut in the credit base which operates most inequitably, especially upon larger corporations.

The result of this change in taxes levied for 1941 and more especially by the proposed taxes for 1942 simply strangles the earnings of Public Service available for common-stock dividends.

In addition to the increase in the normal tax and surtax for the year 1941, this particular change—this excess-profits change—cost Public Service approximately $3,000,000, and will cost $4,000,000 in 1942 if the House bill is passed.

Under the 1940 law, Public Service paid no excess-profits tax. The adoption of a change of this character does not make earnings that were not really excess profits, bona fide excess profits, for purposes of taxation. What this tax really is, in effect, however, it may be described, is a substantial rise in the normal and surtaxes.

Under regulation public utilities practically can have no excess profits. To the extent, if any, that they have by reason of abnormal increases in business in times like the present, it may be proper that they should pay a tax upon such profits. But when additional enormous burdens—in the guise of so-called excess-profits taxes, which they are not—are placed upon a corporation such as ours, which is striving under very great difficulties to do its share of the war work, it is thoroughly inequitable, uneconomic, and unjust.

The public utilities of the country, generally speaking, are absolutely essential to a continuance of the war effort, and it is my contention that the law should revert to the former method of taxing so-called excess profits, certainly so far as the public-utility industry is concerned, or that this industry, because of its peculiar nature, should be altogether relieved from so-called excess-profits provisions. The facts shown herein demonstrate that the public-utility industry is a perfectly legitimate basis for special classification as to taxes.

Normal and surtaxes, whatever the percentage may be, are just as much an operating expense as are labor and materials, and to omit deduction of them in determining the base upon which excess profits are taxed is thoroughly unsound.

If, for any reason, it is thought necessary to continue this method, generally speaking, because of the very serious situation that confronts the utilities of the country, with their limitations of earnings, it certainly should be changed so far as utilities are concerned, which should be authorized to go back to the old method so as to give them a chance to carry on. The amount of these taxes that the Government will receive from the utilities from the pending bill is trifling in comparison to the havoc which will occur therefrom to the utilities, as will now be shown.

The effect of the pending bill upon the utility industry generally—and I am referring to the industry as well as my own company—is well illustrated by the Public Service situation.

The 1940 provisions for income taxes for Public Service and subsidiary companies amounted to approximately $10,500,000. In 1941 the Federal income and excess-profits taxes, calculated in accordance with the Revenue Act of 1941, amounted to approximately $16,800,000, an increase of over $6,300,000 over 1940 or 60 percent.

Upon the basis of the actual business done for the first 6 months of 1942, plus a careful estimate of the expected activities of the corporation for the last 6 months of the year, the indication is that if the bill is passed in its present form, these taxes will be over $26,000,000, or 55 percent over 1941 and 149 percent over 1940.

It means that the earnings of Public Service available for dividends upon its common stock will be reduced to an almost negligible amount, if, indeed, dividends upon the common do not have to be entirely discontinued.

This corporation has had a continuous record of common stock dividends since 1907. During the so-called 4-year base period ending December 31, 1939, to which Mr. Alvord so illuminably referred this morning, the average annual earnings per share of common stock of Public Service amounted to $2.64.

In 1940 similar earnings were $2.42 per share, and in 1941 $2.04 per share. As appears by the statements annexed hereto and filed herewith, the actual earnings available for the common stock for the first 6 months of this year, upon the basis of the pending bill, were 29 cents. It is easy to figure what they will be for the year.

In other words, while during this 6-month period Public Service has increased its gross business over 1941 more than $7.000,000 or 9⅔ percent, Federal income and excess-profits taxes will increase 47¾ percent and the amount available for common-stock dividends and surplus will decrease approximately 67 percent.

A similar comparison between the corresponding figures of 1942 and 1940 is even more startling. There the gross business has increased $12,287,000, or 17½ percent. Federal income and excess-profits taxes will increase 180 percent, and the amount available for common-stock dividends and surplus will decrease 76 percent.

It is impractical to meet this situation by raising rates for services rendered, because if they could be obtained, which they cannot—Mr. Arkwright explained his experience in that respect—under the pending statute taxes would absorb 90 percent of whatever increase was granted.

In other words, if one could imagine that we could get a ten-million-dollar increase in rates, our taxes would jump $9,000,000, and one million would be left for the stockholders of the company—a totally impracticable situation.

Nor, in the face of rising costs and increased demands for service, is it possible to make up these amounts by further economies in operation. If they could be made, which they cannot, again the Government would take 90 percent of such economies as were made.

Public utilities differ in many respects from corporations generally. Their rates and charges, rates of depreciation, character, and quality of service, financing, and various other functions are regulated.

I contend that with respect to the so-called excess-profits tax public utilities should receive special treatment. Special provisions for taxpayers with particular characteristics is nothing new. Every revenue act, since 1917 at least, has made such provisions, such as those relating to insurance companies, China trade corporations, corporations engaged in mining, and others, as set forth in section 4 of the Internal Revenue Code.

Secretary Morgenthau, in his familiar statement to the Ways and Means Committee of the House of Representatives on March 3, 1942, said:

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.

There can be no fair quarrel with the imposition upon corporations of a substantial proportion of the increased load of taxation required by our national peril. We are fighting for the maintenance of the very system of free enterprise which makes corporate profits possible. 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.

I endorse every word of that statement. But the pending bill in its practical operation will not permit any such result with respect to public utility corporations.

Though there are many other matters affecting public utilities that distinguish them from other industries in the matter of taxation, in the interest of simplicity and practicality Public Service respectfully confines itself to two requests, the reasons for which have been outlined above:

1. That the 45-percent rate assessed for normal and surtaxes upon all corporations is uneconomically high and should be substantially reduced. It should certainly not exceed, in my opinion, 40 percent.

Mr. Alvord says in his opinion—and he is much more experienced in that feature of it than I am—35 percent.

2. Either utilities, such as Public Service, should be altogether relieved from excess-profits taxes, or, at least, the method of computing such taxes, as enacted in the 1941 act and continued in aggravated form in the 1942 act, should be restored to the method used in 1940.

While the adoption of these changes would result in some diminution of revenue to the Government, the money made available therefore and paid in dividends would, of course, be taxable against the stockholders receiving such dividends.

Senator TAFT. In that connection you say you have over 100,000 stockholders?

Mr. McCARTER. Yes, sir.

Senator TAFT. Do you know how widely that is distributed and how many people are dependent on common-stock dividends?

Mr. McCARTER. Yes, sir. We are fortunate enough, or unfortunate enough, to have two large corporations own a substantial part of our common stock for which we are not responsible. One is United Gas Improvement Co. of Philadelphia, and one is United Corporation. They are in the process of filtering through to those stockholders so that the stock will in a reasonable time, if my information is correct, be distributed to their stockholders. With the exception of two stockholders, their holdings are small, of common stock, and the preferred stock is entirely held, with inconsequential exceptions, by insurance companies in various States, particularly in Kentucky and New York, by hospitals. I happen to know that St. Lukes Hospital in New York owns a very considerable amount of our preferred stock and by individual holders largely in New Jersey.

Senator TAFT. It would seem to me that this very heavy taxation was really double taxation on common stockholders, much more than on preferred stock.

Mr. McCARTER. I agree with you. They take it out of the corporation first and out of the stockholder when he gets it. Under this bill he won't get it.

Senator SMATHERS. How does the income of Public Service this year compare with the income last year?

Mr. McCARTER. The income last year was $151,000,000. This year it will be something in excess of $155,000,000. An increase approximately of $15,000,000, largely due to the activities in war enterprises, but none of it sticks. In my judgment, based upon 40 years of experience—I am getting to be an old man. I have given my life to this corporation, and I naturally hate to see the ground taken from under it. In my judgment the changes which I have recommended are essential if chaos is to be avoided not only to Public Service but to the utility industry in the country.

I desire to call the attention of the committee to a recent publication of the New York Journal of Commerce—a conservative financial newspaper—containing a compendium by leading economists from different parts of the country, all concurring in their statement that the proposed method of taxing utilities will prove to be disastrous and is likely to destroy the continuance of these companies in private operation.

I have had distributed copies of this publication for the use of the committee.

In the great majority of cases where the issue of local, private operation of utilities, as contrasted with Government ownership, has been submitted to the people, the result has been overwhelmingly in favor of private operation.

If the question is ever otherwise decided by the people, that will be a different matter. But as pointed out in the articles in this publication, this industry can be destroyed by an unwise tax policy. Perhaps this is just what some public ownership advocates want, but I do not believe that this committee will knowingly lend itself to this left-handed method of confiscation, which, incidentally, carried out to its paralyzing end, would deprive the Government of all utility taxes. The utilities, like the railroads and many industrial corporations, are doing a splendid war work. I appeal to you gentlemen not to jettison the utility industry.

About a year ago when the 1941 bill was pending, Mr. Wakelee, who succeeded me as president of Public Service, and I came to Washington to protest against the injustice of the method of computing excess-profits taxes, so far as utilities were concerned, as contained in the then pending bill. We saw several members of this committee who told us it was too late to make any change in the bill, as it probably was. It is now not too late to rectify a great wrong, at least so far as utilities are concerned, in this pending bill. I cannot overstress the seriousness of this question. We are at the parting of the ways.

If this bill goes through in this form, it is the beginning of the end of private operation of utilities in this country. It is the beginning of the end of any taxes from utilities and it means that in one form or another and sooner or later we will have Government ownership and operation of every utility in the country, and I don't believe we are prepared for that at this stage of the game.

As before outlined, there are annexed to my statement detailed figures of Public Service for the first 6 months of the years 1940, 1941, and 1942 under the pending bill. I will not burden you by the repetition of those figures. They show graphically the whole situation from the prosperous condition we were in under the average years down to 29 cents for the common stock for the first 6 months of this year.

Not only does that mean ruin of dividends of the common stock, but multiply it by 2, if you please, or a little more, because the last 6 months we may make a little more—suppose it is 80 cents or some other figure—what a slim margin that is over our preferred.

We have 150 millions of preferred in the hands of the public, all paid for in cash, every cent of it, and we would have under an 80-cent earning, we would have, in round figures, a million-dollar margin on 150 millions of preferred. Look at the markets where our stocks stand today and the stocks of every other utility. It is the beginning of the end if this goes through.

Thank you, gentlemen.

The CHAIRMAN. Thank you, Colonel McCarter.

Are there any questions by any member of the committee?

(No response.)

(The statistics submitted by Mr. McCarter are as follows:)

PUBLIC SERVICE CORPORATION OF NEW JERSEY AND SUBSIDIARY COMPANIES

Comparative statement of combined results of operations, for the 6 months' period ended June 30, with Federal income and excess-profits taxes computed as follows: 6 months ended June 30, 1942—Bill passed by House July 20, 1942; 6 months ended June 30, 1941—Revenue Act of 1941

	6 months ended June 30, 1942	6 months ended June 30, 1941	Increase or decrease (−)	Percent change
Total revenues	$82,233,343.00	$74,989,579.00	$7,243,764.00	9.66
Net income before Federal income and excess-profits taxes	20,436,465.00	19,168,779.00	1,267,686.00	6.61
Federal income and excess-profits taxes	13,924,515.00	9,425,520.00	4,498,995.00	47.73
Net income after Federal income and excess-profits taxes	6,511,950.00	9,743,259.00	−3,231,309.00	−33.16
Preferred-stock dividends	4,925,468.00	4,925,468.00		
Balance available for common-stock dividends and surplus	1,586,482.00	4,817,791.00	−3,231,309.00	−67.07
Per share of common stock	.29	.88	−.59	−67.07

Comparative statement of combined results of operations, for the 6 months' period ended June 30, with Federal income and excess-profits taxes computed as follows: 6 months ended June 30, 1942—Bill passed by House July 20, 1942; 6 months ended June 30, 1940—Revenue acts of 1940

	6 months ended June 30, 1942	6 months ended June 30, 1940	Increase or decrease (−)	Percent change
Total revenues	$82,233,343.00	$69,945,805.00	$12,287,538.00	17.57
Net income before Federal income and excess-profits taxes	20,436,465.00	16,601,070.00	3,835,395.00	23.10
Federal income and excess-profits taxes	13,924,515.00	4,980,310.00	8,944,205.00	179.59
Net income after Federal income and excess-profits taxes	6,511,950.00	11,620,760.00	−5,108,810.00	−43.96
Preferred-stock dividends	4,925,468.00	4,925,468.00		
Balance available for common-stock dividends and surplus	1,586,482.00	6,695,292.00	−5,108,810.00	−76.30
Per share of common stock	.29	1.22	.93	−76.30

The CHAIRMAN. Mr. F. W. Bird.

STATEMENT OF FRANK W. BIRD, BUTTE, MONT., PRESIDENT OF THE MONTANA POWER CO.

Mr. BIRD. Mr. Chairman, gentlemen of this committee, my name is Frank W. Bird, president of the Montana Power Co., a public utility operating entirely in the State of Montana.

For the sake of brevity, Mr. Chairman, I have written my statement, and I would like to read it.

The CHAIRMAN. Yes, sir; you may read it.

Mr. BIRD. It is very short.

This memorandum is respectfully presented to your committee to demonstrate the serious effects on the Montana Power Co. of the proposed taxation of corporations in the form now before your committeed. I am confining this, gentlemen, to the Montana Power Co., as Mr. Arkwright has covered the general situation of utility companies. In general, our situation is about the same as others except we have a rather extreme case.

The State of Montana embraces a territory one and a half times as large as all New England. It has a population of approximately 560,000 people—about the same as Buffalo, N. Y., or Milwaukee, Wis.

The Montana Power Co. serves 161 communities in the greater portion of this territory with electric power generated by 12 hydroelectric plants. It also serves natural gas to 15 cities and towns.

Labor conditions result in our paying the highest wages of any utility in the country. It takes approximately 3,500 miles of high-tension transmission lines to serve the company's customers—and the acquisition of additional business as a rule requires more than normal expenditures for transmission lines, due to lean territory and immense distances.

The Montana Power Co. is primarily a power company, as distinguished from the ordinary public utility; 92 percent of its output goes to industrial uses; 8 industrial customers use approximately 82 percent of its total output and only 8 percent is used for residential, commercial, and farm uses.

The largest of these industrial customers, Anaconda Copper Mining Co., is now taking 225,000 horsepower at a practically continuous rate, for the mining and reduction of copper, zinc, manganese, chrome, vanadium, and other metals. This is one of the largest power loads in the country serving strategic metal production, which is running at an all-time high rate of 73,000,000 pounds per month for this one customer.

The history of production of nonferrous metals shows violent and sudden changes—either a feast or a famine, from an earnings point of view; consequently, the earnings of the Montana Power Co., being largely dependent on the mining industry, follow the rise and fall of our local mining operations. This situation compels the Montana Power Co. to conserve all possible resources in good years to provide a cushion for the lean years.

Production of Montana mines has now reached its practical peak. While this may be maintained through the war period, business fluctuations in time of peace can consequently be in only one direction—downward.

Dependency of our population on the mining business will result during such depressions in curtailed use and inability to pay on the part of many residential, commercial, and other customers so that there will be an all around reduction in the earnings of this company. This is not a mere pessimistic prediction, but is based on oft-repeated history of the copper mining industry as it has affected the population of the State and the revenues of our company.

As operating head of this company, with a very heavy responsibility to our stockholders, I cannot but be alarmed at a situation that will arise should the proposed bill become law, a situation which reduces the available net income of this company by approximately one-half of the amount earned during the pre-war base period, and which still leaves us facing a heavy Federal tax payment in a low-earning year, in addition to the necessity of providing for future expenditures for necessary plant additions, and some return to the common stockholder.

Of course, that arises, Mr. Chairman, out of a very large industrial war load and a rather lean stake in a normal low year. We would have a very heavy income tax to pay after the mining business was curtailed in the post-war period.

During the last 5½ years, extending back to the beginning of the base period, this company has spent an average of over $2,300,000 yearly for plant additions, transmission and distribution lines, and other necessary facilities. Of this amount over $1,000,000 per year was taken from current earnings.

The average revenue before Federal income and excess-profits tax, sinking-fund requirements, and preferred dividends during the base period for this company amounted to $3,629,000—leaving a balance, after taxes, sinking fund, and preferred dividends, of $1,709,000 available for additions to property, additions to reserve, and common dividends.

The impact of the bill now before your committee on the earnings of this company reduces this available sum to slightly over $900,000—which is about half the amount earned during the base period. Note that this figure is less than 2 percent on the company's outstanding comomn stock, to say nothing of a provision for reserves against post-war famine.

The chart accompanying this memorandum shows graphically the drastic effect of the proposed taxes.

In bad years we must have adequate reserves to carry on and we must continue our preferred dividends in any event. The stock was issued in good faith in peacetime against a background of ample-earnings coverage and normal tax rates and is now held by 10,474 persons, over 8,000 of whom reside in Montana, with average holdings of 15 shares.

The following recommendations are made, having in mind the inevitable famine situation to come:

In computing the corporate normal and surtax, it is recommended:

(*a*) That deduction be allowed from taxable net income for 50 percent of preferred stock dividends payable by the corporation. This has the effect of taxing the earnings necessary for the preferred stock dividend requirements at a rate no higher than that which was in effect prior to the war.

I advocate that, gentlemen, for the reason that your normal tax in the pre-war period was 18 to 24 percent. It is now in this proposed bill 45 percent or practically double.

(*b*) That deduction be allowed from taxable net income for 50 percent of the average of net earnings of the company which remained for the common stock, averaged for the 4-year pre-war period of 1936 to 1939, inclusive. This suggestion contemplates that the net earnings which in normal times are used to provide sinking fund requirements, adequate coverage for fixed charges, adequate working capital, and accumulation of essential reserves, all as measured by pre-war standards, shall not be taxed at more than pre-war rates.

In essence: Tax at no more than pre-war rates the net earnings required to meet the bare essentials of maintaining financial and operating stability in good and bad years, and tax at war rates only the excess over such essentials.

I should like to touch briefly upon the subject of excess-profits taxes alone.

The Montana Power Co. is a public-utility company regulated by the Public Service Commission of the State of Montana, so that it is not permitted to earn more than a fair rate of return upon the fair value of its property. As so regulated, it is impossible for the company to earn excess-profits taxes in any true sense, and there is, therefore, no such thing as excess profits as to the Montana Power Co. Therefore, the arbitrary standards prescribed by the bill create as to my company wholly fictitious excess profits, upon which, however, are levied very real excess-profits taxes.

The standards of measurement of excess profits of a public-utility company under the tax law should be no different from those employed in limiting the utility's profits to a fair rate of return under the restrictions of regulatory procedure imposed by law upon such company.

An outstanding inequity in the determination of excess profits as now defined in the tax law is the fact that under the statutory definition excess profits are computed before deducting from corporate profits the so-called normal and surtax computed at the high war rates. The taxing of fictitious excess profits at the rate of 90 percent is indefensible and the earnings which are used to measure such excess profits should first be reduced by the normal and surtax levied by the tax bill.

Therefore, in computing excess-profits taxes, it is recommended that excess profits be defined as only those which remain after providing for deduction of normal and surtax and also a deduction for full dividend requirements on the preferred stock where it appears that the determination of the excess-profits credit under the law is not sufficient to provide for full payment of preferred dividends.

The above proposal has the effect of taxing at high excess-profits rates only such profits as are, in fact, excess in character.

I have prepared a chart here, gentlemen, that will probably visualize the situation of the Montana Power Co.

The top line here is the revenue before Federal income and excess profits [indicating]. The reason it turns down, gentlemen, we have reached the peak of our war production in the mining industry in Montana. We are also going short on labor and paying time and a half for the employees we have for excess hours which reduce our net earnings automatically.

The red is Federal income tax on the basis of the proposed bill before this committee [indicating].

The situation here from 1936, 1937, 1939, is our base period.

The blue line here [indicating] is required for a contractual sinking fund, the sum of $500,000 a year under the terms of our mortgage.

The green line [indicating] is our preferred dividends and the yellow space is the net available for additions to property and for common dividends.

The thing that alarms me, gentlemen, as an operating man, is: We run along here at about $1,700,000 earnings, which were used for plant additions, for common dividends, and now we find ourselves in the situation, with the impact of this bill, of having approximately one-half of that amount left and the tendency to descend downward.

I thank you, Mr. Chairman and gentlemen.

The CHAIRMAN. Thank you, Mr. Bird.

Mr. Kline.

STATEMENT OF CLAYTON E. KLINE, TOPEKA, KANS., REPRESENTING THE KANSAS POWER & LIGHT CO.

Mr. KLINE. Mr. Chairman, I would like to read this statement and then file it with the committee, if I may. It is not lengthy.

The CHAIRMAN. All right, sir.

Mr. KLINE. My name is Clayton E. Kline, and I represent the Kansas Power & Light Co., of Topeka, Kans.

This company is a corporation organized under the laws of the State of Kansas, and furnishing electric and gas service to approximately 365 cities, towns, and communities including rural areas, all within the State of Kansas.

Many of the communities are small, but service is made available over a large rural territory. The rates and services of the company are regulated by the State Corporation Commission of the State of Kansas. The issuance of securities and the borrowing of money by the company are regulated by the State Corporation Commission and also by the Securities and Exchange Commission of the Federal Government.

The Kansas Power & Light Co. is a direct subsidiary of the North American Light & Power Co., which is being dissolved pursuant to order of the Securities and Exchange Commission of December 30, 1941.

In turn, the North American Light & Power Co. is a subsidiary of North American Co. and it is now under a B (1) order or an integration order of the Securities and Exchange Commission.

When compliance with these orders of the Securities and Exchange Commission has been finally accomplished as to the North American Co. and the North American Light & Power Co., both the preferred and common stocks of the Kansas Power & Light Co. will be held by individual owners scattered throughout the country.

Attached to this statement, and marked exhibit A, is an income statement of the Kansas Power & Light Co. for the calendar years 1937 to 1941, inclusive, and for the 12 months ended June 30, 1942, and for the 12 months ended December 31, 1942, estimated. This exhibit shows that the total operating revenues of the company during this period of time have remained practically stable. I think they have increased just about $1,000,000 during that entire period of time.

While the operating expenses and taxes have increased approximately 50 percent. The net income, using tax figures as proposed in the Revenue Act of 1942 as passed by the House of Representatives, will have decreased more than 50 percent.

We believe it is common knowledge that public-utility companies, subject to State and Federal regulation, are never permitted to earn more than a reasonable return on the investment of the company.

Courts have consistently held that rates yielding returns of less than 5 to 6 percent net are confiscatory. Therefore, any tax which fails to leave to the public-utility company a return of a least 5 or 6 percent is necessarily confiscatory. Any tax which is confiscatory must necessarily lead to the destruction of the industry or of the particular company. The power to tax is the power to destroy. Therefore, in the enactment of a tax bill, the Congress must determine whether or not the exigencies of the situation demand the destruction of the particular utility or of the industry, generally.

The provisions of the Revenue Act of 1942 as passed by the House of Representatives, will practically eliminate all dividends to common stockholders of the Kansas Power & Light Co., and any further increase will prohibit the payment of dividends to preferred stockholders.

The Kansas Power & Light Co. will receive little, if any, benefit by reason of the war effort. Now, we have Fort Riley within our community. We have the new Sunflower plant at Angora, Kans., and also the base near Topeka and one at Salina, but, nevertheless, the current is served practically at cost to those various war industries and the chances are that its earnings will be reduced even eliminating the tax feature, for the following reasons:

1. Increased cost of materials. All materials have increased in price;
2. Increased labor costs. Our labor costs have gone up every single year since 1933. Up again this year;
3. By reason of priorities, inability to extend its facilities; and
4. Rates for service to war industries produce little more than cost.

The theory adopted in taxing public utilities under the Revenue Act of 1942, as passed by the House, is contrary to the general principles made applicable to those investing their money in war industries, generally, where a cost-plus theory prevails and those lending their facilities to war production are, in theory at least, insured a return on their investment.

Senator TAFT. Not at all.

Mr. KLINE. What?

Senator TAFT. I say not at all. Those are all fixed before taxes. I mean we tax them just the same as we tax anybody else.

Mr. KLINE. I was thinking, perhaps, about a contractor's profit more than anything else. That is what I meant. I didn't mean the plant itself where it was taken over by the Government.

Senator TAFT. I meant the tax is the same.

Mr. KLINE. That is correct.

Senator TAFT. You said the taxation was discriminatory. The taxation is the same.

Mr. KLINE. You mean as far as the provisions of the law are concerned?

Senator TAFT. Yes.

Mr. KLINE. The Kansas Power & Light Co. desires to do everything within its power to promote the war effort. It realizes the necessity of increased taxes. It is paying enormous revenues to the Government through taxation and desires to contribute its fair share at all times, asking only that its investors be treated fairly with others and that it be allowed to retain sufficient revenues to keep its plants in operation and making such necessary extensions to its plants and facilities as will permit it to do its ultimate in the service of the Government.

It is suggested for your consideration the following:

1. That no regulated utility theoretically has true excess profits, its return being limited to a fair return on the investment.

2. Moneys invested in a public-utility company subject to regulation must remain in the business and the investment is not recoverable out of profits for the reason that the industry is operated on a service at cost basis.

3. Capital for additional expansion must be constantly secured by attracting investment in the business, as it is not available from earnings.

4. Turn-over is very slow on the capital investment in a public-utility business. Approximately 5 years is required to turn the capital once. Most of the other types of business turn their capital one or more times each year.

5. At present an excise tax on certain classifications of electric current sold is paid by the company and indirectly by the investors in its securities, and this tax must be absorbed by the utility company and its investors. Other corporations are not so taxed.

6. The Treasury Department, I think, has stated that a sufficient margin of income and dividends should be left for safety. This is all that this company asks. If this is done, then, it will be permitted to do its full share in furnishing service.

Referring to exhibit A attached, it will be seen that the income taxes of the Kansas Power & Light Co. have increased from $401,000 for the year 1937 to an anticipated tax for the 12 months ending December 31, 1942, under the Revenue Act of 1942 as passed by the House, of $2,370,844, while its net income on the same basis has decreased from $2,111,818.18 in 1937 to $1,063,700 in 1942, being more than a 50 percent net decrease in income over the 5-year period.

That is true, even though we did have a $1,000,000 increase in gross during that 5-year period.

Attached as exhibit B is a statement showing the computation of income and excess-profits taxes of the Kansas Power & Light Co. for the year ending December 31, 1942, based on the provisions of the Revenue Act of 1942 as passed by the House.

In order to accomplish a fair and equitable basis for the taxation of income of public utilities, the Kansas Power & Light Co. suggests changes in the 1942 Revenue Act, as passed by the House, as follows:

1. Insurance companies, investment companies, and other corporations regulated by governmental boards or commissions are given separate classifications and treatment in the bill. Public utility companies should be given similar consideration.

2. All excise taxes now absorbed by public utilities should be allowed as a credit against normal income taxes.

3. If an excess-profits tax is to be assessed then it should be on a formula which makes it an excess-profits tax in reality and not in accordance with the formula which results in the determination of a purely fictitious excess profit.

4. Cumulative preferred-stock dividends should be treated the same as bond interest, for the reason that under regulation the capital invested cannot be recovered out of earnings and the preferred stock of these companies has practically the same status as the bonds. Therefore, preferred stock dividends should be placed in the same category as bond interest and deductions allowed accordingly.

And right there, if I may state: Corporations not subject to regulation could change every bit of their preferred stock into revenue bonds and take the deduction. Therefore, if this company cannot do it because——

Senator TAFT. I think that is a broad statement. I know most companies can't do that.

Mr. KLINE. Except those that are subject to the Securities and Exchange Commission. I say those not subject to regulation.

Senator TAFT. It is not an easy thing to do, anyway. My feeling is that the troubles you show in this revenue act apply just as well to every other company in the United States as well as the utility companies. I can't see the distinction; and, if they are unjust to utility companies they are unjust to all companies.

Mr. KLINE. I think they are unjust to all companies.

Senator TAFT. The important thing that I would like to get from the utility companies is why the excess-profits tax works out to produce a tax on profits that really are not excess profits at all. If it does it as to utility companies it is going to do it as to all kinds of other companies, perhaps not so universally and so generally. I would like to have a statement—we have lots of utility companies' statements, but none of them explain just why it is—you may have it in your exhibit B.

Mr. KLINE. I think I can show you.

Senator TAFT. Just why it is that the excess profits and normal taxes work out the way they do.

Mr. KLINE. I think we can do that. I think they work out more severely with utilities. I think it is wrong with all corporations.

Senator TAFT. There are lot of other companies that they work out exactly as they do with utilities.

Mr. KLINE. I think that is exactly the truth, Senator. I am just speaking from the utilities-company standpoint, which I happen to know more about.

5. Any excess-profits tax should be applied after normal and surtax instead of before. This was the taxing policy of the Government prior to 1940. The present system simply pyramids taxes and produces a total tax of far more than 45 percent of the net income of many utilities. I think that is true of other companies.

Canada applies the excess-profits tax after rather than before the normal tax. In Great Britain a corporation collects, at the source, the tax on dividends payable to shareholders. The party receiving the dividends is relieved of any payment of normal tax on these dividends. Under our acts the party receiving the dividend also pays the tax.

6. A fair return on the common stock should be permitted, say 5 or 6 percent, prior to the application of an excess-profits tax; otherwise confiscation must necessarily result.

Now, maybe 5 or 6 percent is too much. Maybe 2 percent is what it ought to be, but you should have some return before you confiscate the property, before you can say there is a true excess profit.

Senator TAFT. What I don't understand quite—I have an idea of it—is, if we say that there shall be no excess profits until a man has earned 5 or 6 percent on his invested capital and the public utility commissions say the same for the utility companies, why you don't have an excess-profits tax that gives you that 5 percent subject to whatever the normal tax would be. I can see why a normal tax would affect that return.

Mr. KLINE. That is right. They pay the normal tax.

Senator TAFT. But it seems to me the excess-profits tax ought to work out to obtain the same kind of excess-profits credit that the commissions give on 5 percent, on a return of 5 percent or 6 percent, whatever it is they may be allowing.

Mr. KLINE. That is normal return. There it ought to take normal tax.

Senator TAFT. I think the excess-profits tax ought to work out the same way.

Mr. KLINE. After that is out.

Senator TAFT. Except that we are proposing to take a higher percentage of everybody's normal tax to some extent, whatever it ought to be.

Mr. KLINE. That is correct.

Senator TAFT. And I should think we might take the same percentage of normal profit of utilities, the same as other companies.

Mr. KLINE. So long as it works out so they can live and have something left, I agree with you, Senator.

In conclusion we respectfully submit that if the tax policy of privately owned utility companies, as evidenced by the provisions of the 1942 revenue bill as passed by the House continues, bankruptcy of these utilities must inevitably result. It must follow, then, that all utilities will either be owned by the Government or by municipalities and these will pay no Federal income taxes. This will result in (*a*) consumers receiving service from these Government-owned utilities being subsidized by the rest of the country and wholly failing to paying their fair share of the tax burden; (*b*) a shrinkage in the number of taxpaying utilities to a point where this vase revenue will be lost to the Government and will have to be assumed by individuals and other industries.

At the present time no municipality- or Government-owned plant in the United States pays 1 cent to support the war effort. This policy can, and will, certainly kill the goose that lays the golden egg. Certainly, it is possible to work out a sound method of taxation of utility income which will allow those utilities to operate efficiently as private enterprises, to safeguard their credit, and provide low cost and plentiful electric and gas service for the period of the war, and thereafter to be in a position to do their part in accomplishing the economic reconstruction which we expect after the war, and, at the same time, if this treatment is afforded these utility companies, they will continue to pour enormous tax payments into the Federal Treasury, but they will not be constantly threatened with destruction.

It must at all times be remembered that it is impracticable to raise most of the utility rates sufficient to offset the increased burden of higher corporation taxes, as it requires approximately a $10 increase in rates to recover $1 increase in cost or taxes. Certainly, if corporate taxes are levied which cut returns to the utility to levels which are virtually confiscatory, these should be passed on to the consumer in the form of a special war tax. This, in effect, would be an excise tax on kilowatt consumption to be paid by the consumer. Should this be accomplished, then a $1 increase in tax would be a $1 increase to the consumer.

Regardless of any other consideration, utilities should be allowed to return to the method of computing taxes on a corporate income which prevailed prior to 1940. This method provides for the computing of the normal and surtax on normal income first and then computing taxes on excess profits. This method would certainly be fairer for all corporations, but it is an absolute necessity in the case of utilities. This method is fair to the Government, fair to the user of the utility company's service, and fair to the man who invests his money in the securities of the utility company.

Finally, under the provisions of the Revenue Act of 1942, as passed by the House, the poorly managed utility receives favored treatment over the utility which is well managed.

The Securities and Exchange Commission has insisted that corporations refinance in such a manner as to reduce the amount of their bonds and increase the equity money in preferred and common stocks. Under the 1942 Revenue Act, as passed by the House, the utility which is top-heavy with bonds is permitted to deduct all the interest on the bonds, whereas the utility which has followed the suggestions of the Securities and Exchange Commission and has secured a large portion of its capital through preferred and common stocks is penalized by reason of the fact that dividends cannot be deducted. The money of the individual invested in bonds is just the same type as the money invested in preferred or common stocks, and to us there is no apparent reason why a revenue act should discriminate against this type of investor. This discrimination would be eliminated if preferred dividends and a reasonable percentage of common dividends were permitted to be deducted before the imposition of the normal surtax and excess-profits tax, all of which we respectfully submit would now and in the future fairly and equitably distribute the tax, resulting in a utility paying its fair share of the burden and at the same time insuring the continuity of the utility both as a servant of the public and as a taxpayer of the Government.

I thank you, sir.

The CHAIRMAN. Thank you, Mr. Kline.

Any questions for Mr. Kline?

(No response.)

(The statement and exhibits submitted by Mr. Kline are as follows:)

STATEMENT OF CLAYTON E. KLINE, TOPEKA, KANS., COUNSEL, APPEARING FOR THE KANSAS POWER & LIGHT CO.

Re Provisions of Revenue Act of 1942 as applied to taxation of public-utility companies.

Hon. WALTER F. GEORGE,
Chairman, Member of Finance Committee of the United States Senate, Washington, D. C.

GENTLEMEN: The Kansas Power & Light Co. is a corporation organized under the laws of the State of Kansas, and furnishing electric and gas service to approximately 365 cities, towns and communities, including rural areas, all within the State of Kansas. Many of the communities are small and service is made available over a large rural territory. The rates and services of the company are regulated by the State Corporation Commission of the State of Kansas. The issuance of securities and the borrowing of money by the company are regulated by the State Corporation Commission and also by the Securities and Exchange Commission of the Federal Government.

The Kansas Power & Light Co. is a direct subsidiary of North American Light & Power Co., which is being dissolved pursuant to order of the Securities and Exchange Commission of December 30, 1941, which order is being carried out as rapidly as possible. North American Light & Power Co. in turn is a direct subsidiary of the North American Co., against which a dissolution order has been issued by the Securities and Exchange Commission. When compliance with these orders of the Securities and Exchange Commission has been finally accomplished as to the North American Co. and North American Light & Power Co. the preferred and common stock of the Kansas Power & Light Co. will be held by individual owners scattered throughout the country.

Attached to this statement and marked "Exhibit A" is an income statement of the Kansas Power & Light Co. for the calendar years 1937 to 1941, inclusive, for the 12 months ended June 30, 1942, and for the 12 months ended December 31, 1942, estimated. This exhibit shows that the total operating revenues of the company during this period of time have remained practically stable, while operating expenses and taxes have increased approximately 50 percent, and the net income, using tax figures as proposed by the Revenue Act of 1942 as passed by the House, will have decreased more than 50 percent.

We believe it is common knowledge that public-utility companies, subject to the State and Federal regulation, are never permitted to earn more than a reasonable return on the investment of the company. Courts have consistently held that rates yielding returns of less than 5 to 6 percent net are confiscatory. Therefore, any tax which fails to leave to the public-utility company a return of at least 5 or 6 percent is necessarily confiscatory. Any tax which is confiscatory must necessarily lead to the destruction of the industry or the particular company. The power to tax is the power to destroy. Therefore, in the enactment of a tax bill the Congress must determine whether or not the exigencies of the situation demand the destruction of the particular utility or of the industry generally.

The provisions of the Revenue Act of 1942 as passed by the House will practically eliminate all dividends to common stockholders of the Kansas Power & Light Co., and any further increase will prohibit the payment of dividends to preferred stockholders. The Kansas Power & Light Co. will receive little if any benefit by reason of the war effort, and the chances are that its earnings will be reduced even eliminating the tax feature, for the following reasons:

1. Increased cost of materials.
2. Increased labor costs.
3. By reason of priorities inability to extend its facilities.
4. Rates for service to war industries produce little more than cost.

The theory adopted in taxing public utilities under the Revenue Act of 1942 as passed by the House is contrary to the general principles made applicable to those investing their money in war industries generally, where a cost-plus theory prevails and those lending their facilities to war production are insured a return on their investment. The Kansas Power & Light Co. desires to do everything within its power to promote the war effort. It realizes the necessity of increased taxes. It is paying enormous revenues to the Government through taxation, and desires to contribute its fair share at all times, asking only that its investors be treated fairly with others and that it be allowed to retain sufficient revenues to keep its plants in operation and make such necessary extensions to its plants and facilities as will permit it to do its ultimate in the service of the Government.

It suggests the consideration of the following:

1. That no regulated utility theoretically has true excess profits, its return being limited to a fair return on the investment.

2. Moneys invested in a public utility company subject to regulation must remain in the business and the investment is not recoverable out of profits for the reason that the industry is operated on a service-at-cost basis.

3. Capital for additional expansion must be constantly secured by attracting investment in the business, as it is not available from earnings.

4. Turn-over is very slow on the capital investment in a public utility business. Approximately 5 years are required to turn the capital once. Most of the other types of business turn their capital one or more times each year.

5. At present an excise tax on certain classifications of electric current sold is paid by the company and indirectly by the investors in its securities, and this tax must be absorbed by the utility company and its investors. Other corporations are not so taxed.

6. The Treasury Department, through Secretary Morgenthau, has stated that any tax bill should leave "a sufficient margin of income for dividends and safety." This is all the Kansas Power & Light Co. asks. If this is done then it will be permitted to do its full share in promoting the war effort.

Referring to exhibit A attached it will be seen that the income taxes of the Kansas Power & Light Co. have increased from $401,000 for the year 1937 to an anticipated tax for the 12 months ending December 31, 1942, under the Revenue Act of 1942 as passed by the House, of $2,370,844, while its net income on the same basis has decreased from $2,111,818.18 in 1937 to $1,063,700 for the year ending December 31, 1942, estimated, being more than a 50-percent decrease in net income over the 5-year period.

Attached as exhibit B is a statement showing the computation of income and excess-profits taxes of the Kansas Power & Light Co. for the year ending December 31, 1942, based on the provisions of the Revenue Act of 1942 as passed by the House.

In order to accomplish a fair and equitable basis for the taxation of income of public utilities, the Kansas Power & Light Co. suggests changes in the 1942 Revenue Act, as passed by the House, as follows:

1. Insurance companies, investment companies, and other corporations regulated by governmental boards or commissions, are given separate classifications and treatment in the bill. Public utility companies should be given similar consideration.

2. All excise taxes now absorbed by public utilities should be allowed as a credit against normal income taxes.

3. If an excess-profits tax is to be assessed then it should be on a formula which makes it an excess-profits tax in reality and not in accordance with a formula which results in the determination of a purely fictitious excess profit.

4. Cumulative preferred stock dividends should be treated the same as bond interest, for the reason that under regulation the capital invested cannot be recovered out of earnings and the preferred stock of these companies has practically the same status as the bonds. Therefore preferred stock dividends should be placed in the same category as bond interest and deductions allowed accordingly.

5. Any excess-profits tax should be applied after the normal and surtax instead of before. This was the taxing policy of the Government prior to 1940. The present system simply pyramids taxes and produces a total tax of far more than 45 percent of the net income of many utilities. Canada applies the excess-profits tax after, rather than before, the normal tax. In Great Britain the corporation collects at the source the tax on dividends payable to shareholders. The party receiving the dividends is relieved of any payment of normal tax on these dividends.

6. A fair return on the common stock should be permitted, say, 5 or 6 percent, prior to the application of an excess-profits tax; otherwise confiscation must necessarily result.

In conclusion we respectfully submit that if the tax policy of privately owned utility companies as evidenced by the provisions of the 1942 revenue bill as passed by the House continues, bankruptcy of these utilities must inevitably result.

It must follow, then, that all utilities will be either owned by he Federal Governmen or by municipalities and these will pay no Federal income taxes. This will result in (*a*) consumers receiving service from these Government-owned utilities being subsidized by the rest of the country and wholly failing to pay their fair share of the tax burden; (*b*) a shrinkage in the number of tax-paying utilities to a point where this vast revenue will be lost to the Government and will have to be assumed by individuals and other industries. At the present time no municipal or Government-owned plant in the United States pays 1 cent to support the war effort. This policy can and will certainly kill the goose that lays the golden egg. Certainly it is possible to work out a sound method of taxation of utility income which will allow these utilities to continue to operate efficiently as private enterprises, to safeguard their credit and to provide low cost and plentiful electric and gas service for the period of the war, and thereafter to be in a position to do their part in accomplishing the economic reconstruction which we expect after the war, and at the same time, if this treatment is afforded these utility companies they will pour enormous tax payments into the Federal Treasury but they will not be constantly threatened with destruction.

It must at all times be remembered that it is impractical to raise most of the utility rates sufficient to offset the increased burden of higher corporation taxes, as it requires approximately a $10 increase in rates to recover $1 increase in cost or taxes. Certainly if corporate taxes are levied which cut returns to the utility to levels which are virtually confiscatory these should be passed on to the consumer in the form of a special war tax. This in effect would be an excise tax on kilowatt consumption to be paid by the consumer. Should this be accomplished then a $1 increase in tax would be a $1 increase to the consumer.

Regardless of any other consideration utilities should be allowed to return to the method of computing taxes on corporate income which prevailed prior to 1940. This method provides for computing the normal and surtax on normal income first and then computing taxes on excess profits. This method would certainly be fairer for all corporations but it is an absolute necessity in the case of utilities. This method is fair to the Government, fair to the user of the utility company's service, and fair to the man who invests his money in the securities of the utility company.

And finally, under the provisions of the Revenue Act of 1942 as passed by the House, the poorly managed utility receives favored treatment over the utility which is well managed. The Securities and Exchange Commission has insisted that corporations refinance in such manner as to reduce the amount of their bonds and increase the equity money in preferred and common stocks. Under the 1942 Revenue Act, as passed by the House, the utility which is top heavy with bonds is permitted to deduct all the interest on bonds, whereas the utility which has followed the suggestions of the Securities and Exchange Commission and has secured a large portion of its capital through preferred and common stocks is penalized by reason of the fact that dividends cannot be deducted. The money of the individual invested in bonds is just the same type of money as the money invested in preferred or common stocks, and to us there is no apparent reason why a revenue act should discriminate against this type of investment. This discrimination would be eliminated if preferred dividends and a reasonable percentage of common dividends were permitted to be deducted before the imposition of the normal, surtax, and excess-profits tax, all of which we respectfully submit would now and in the future fairly and equitably distribute the tax, result in the utility paying its fair share of the burden, and at the same time insure the continuity of the utility both as a servant of the public and as a taxpayer of the Government.

Respectfully submitted.

THE KANSAS POWER & LIGHT CO.,
By CLAYTON E. KLINE, *Counsel.*

EXHIBIT A

The Kansas Power & Light Co. income statement for calendar years 1937 to 1941, inclusive, 12 months ended June 30, 1942—12 months ended Dec. 31, 1942 (estimated)

	Year ended—					12 months ended June 30, 1942	12 months ended Dec. 31, 1942 [2]
	Dec. 31, 1937 [1]	Dec. 31, 1938	Dec. 31, 1939	Dec. 31, 1940	Dec. 31, 1941		
Operating revenues:							
Electric	$5,515,616.67	$5,565,716.66	$5,630,433.78	$5,823,626.73	$6,201,917.13	$6,315,642.42	$6,403,999
Steam heating	105,154.98	84,210.29	83,481.68	103,005.83	91,643.71	92,577.28	96,856
Natural gas	4,198,434.47	3,902,291.69	4,047,805.56	4,402,773.65	4,134,858.63	4,419,627.63	4,415,984
Transportation	349,424.73	329,385.99	318,127.61	318,406.86	329,543.44	362,209.46	360,131
Water	197,380.99	194,504.14	189,817.69	185,358.13	180,662.02	21,304.34	22,814
Ice	94,386.90	86,468.76	80,658.12	50,42[illegible].57	26,216.51	182,189.11	185,480
Total operating revenues	10,560,398.74	10,162,577.53	10,350,324.44	10,883,598.77	10,964,841.44	11,393,550.24	11,465,264
Operating expenses and taxes:							
Operating expenses	3,685,361.04	3,565,228.56	3,634,884.37	3,740,816.94	3,710,561.24	3,809,487.64	3,868,442
Maintenance	498,407.98	515,265.54	445,376.23	416,601.48	445,936.56	472,568.27	422,739
Appropriation for depreciation	1,544,024.21	1,590,883.50	1,585,369.54	1,697,000.00	1,710,300.00	1,714,147.00	1,716,853
Taxes, other than income taxes	862,939.85	788,719.40	829,308.72	8[illegible]1,747.08	860,541.54	875,421.08	902,283
Provision for income taxes	401,000.00	401,000.00	[3] 33,000.00	1,075,000.00	1,390,400.00	[4] 1,750,400.00	[3] 2,370,844
Total operating expenses and taxes	6,991,733.08	6,861,097.00	6,528,538.86	7,741,165.48	8,117,739.34	8,622,023.99	9,281,161
Net operating revenues	3,568,66[illegible].66	3,301,480.53	3,821,785.58	3,142,433.29	2,847,102.10	2,771,526.25	2,204,103
Nonoperating revenues:							
Net profit on merchandise sales		26,214.97	12,186.24	10,000.43	[5] 24,270.83	[6] 3,462.90	15,702
Other nonoperating revenues	10,738.97	804.09	190.73	1,654.33	928.86	2,826.27	2,826
Total nonoperating revenues	10,738.97	27,019.06	12,376.97	11,654.76	[5] 23,341.97	[6] 636.63	18,528
Gross income	3,579,404.63	3,328,499.59	3,834,162.55	3,154,088.05	2,823,760.13	2,770,889.62	2,222,631

Footnotes at end of table.

The Kansas Power & Light Co. income statement for calendar years 1937 to 1941, inclusive, 12 months ended June 30, 1942—12 months ended Dec. 31, 1942 (estimated)—Continued

	Year ended—					12 months ended June 30, 1942	12 months ended Dec. 31, 1942
	Dec. 31, 1937	Dec. 31, 1938	Dec. 31, 1939	Dec. 31, 1940	Dec. 31, 1941		
Deductions:							
Interest charges:							
Interest on funded debt	1,334,400.00	1,311,000.00	1,178,127.37	1,014,330.48	998,755.52	990,967.98	963,749
Amortization of bond discount (net) and expense	122,802.29	121,410.03	147,775.56	167,373.55	168,224.37	166,234.51	164,241
Other interest charges	16,442.86	12,313.75	9,500.92	12,322.66	17,099.85	18,195.60	10,997
Total interest charges	1,473,645.15	1,444,723.78	1,335,403.85	1,194,026.69	1,184,079.74	1,175,398.09	1,158,987
Less: Interest during construction charged to property and plant	6,058.70	8,304.24	16,532.81	34,286.13	2,920.58	9,597.20	8,749
Net interest charges	1,467,586.45	1,436,419.54	1,318,871.04	1,159,740.56	1,181,159.16	1,165,800.89	1,150,238
Miscellaneous income deductions		5,348.21	13,750.88	9,927.74	10,906.64	9,822.68	8,693
Total deductions	1,467,586.45	1,441,767.75	1,332,621.92	1,169,668.30	1,192,065.80	1,175,623.57	1,158,931
Net income	2,111,818.18	1,886,731.84	2,501,540.63	1,985,019.75	1,631,694.33	1,595,206.05	1,063,700

[1] The company adopted a new uniform system of accounts as of Jan. 1, 1938, which provided for changes in accounting classifications. Profit on merchandise sales for the year 1937 amounting to $42,795.18 is included in "Operating revenue—Electric," and "Profit on merchandise sales" of $1,411.97 is included in "Operating revenue—Gas" for the same period. Cash discounts amounting to approximately $8,000 are shown under "Other nonoperating revenue" for 1937; in subsequent years such discounts were applied to the cost of the particular materials.

[2] In computing the provision for income taxes for the year 1939 the redemption premium and certain other charges arising from the refunding of bonds during that year were applied as deductions in the determination of taxable net income. Without such deductions, the provision for income taxes for the year 1939 would have been approximately $445,000 in excess of, and "Net income" would have been correspondingly less than, the amounts shown in this statement.

[3] 6 months in 1942 based on 1941 Revenue Act.

[4] 6 months actual and 6 months estimated.

[5] Includes the following taxes:

Excess profits tax, at 90 percent (see attached schedule)	$1,209,704
Normal and surtax, at 45 percent (see attached schedule)	1,133,434
State income tax	27,706
Total	2,370,844

[6] Loss.

EXHIBIT B

Computation of Federal income and excess-profit taxes for the year 1942, based on 6 months actual and 6 months estimated earnings

THE KANSAS POWER & LIGHT CO.

Computation of excess-profits tax:	
Basis of excess-profits credit:	
Specific exemption (under 1941 Revenue Act)	$5,000
Excess-profits credit (income method)	2,379,330
Total excess-profits credit	2,384,330
Estimated net taxable income for the calendar year 1942:	
6 months actual, 6 months estimated	3,728,446
Less credit as shown above	2,384,330
Income subject to excess-profits tax	1,344,116
Excess-profits tax at 90 percent (A)	1,209,704
Excess-profits tax at 94 percent (B)	1,263,469
Excess-profits tax at 87½ percent (C)	1,176,102
Computation of normal and surtax:	
Estimated net taxable income (6 months actual, 6 months estimated) (D)	3,728,446
Income subject to normal and surtax (D-A)	2,518,742
Income subject to normal and surtax (D-B)	2,464,977
Income subject to normal and surtax (D-C)	2,552,344
Normal and surtax, at 45 percent of (D-A)	1,133,434
Normal and surtax, at 40 percent of (D-B)	985,991
Normal and surtax, at 45 percent of (D-C)	1,148,555
Total income and excess-profits tax at—	
45-90 percent	2,343,138
40-94 percent	2,249,460
45-87½ percent	2,324,657

STATEMENT OF C. W. KELLOGG, NEW YORK, N. Y., PRESIDENT, EDISON ELECTRIC INSTITUTE

The CHAIRMAN. Mr. Kellogg.

Mr. KELLOGG. My name is Charles W. Kellogg. I am president of Edison Electric Institute. My business address is New York City.

Edison Electric Institute might be described, in a general way, as the trade association of the electric utility industry, and one of its functions is to collect, digest, analyze, and distribute facts and figures with regard to the electric utility companies, countrywide.

I have prepared, Mr. Chairman, a statement, which I will not read, to save your time, but of which I am furnishing a copy to all members of the committee, and which, if it please your honor, I would like to have inserted in the record, to save your time.

The CHAIRMAN. You may insert it in the record.

Mr. KELLOGG. It consists of three pages of statement, as to points, many of which have been brought out by previous speakers, three or four tables giving the actual figures, countrywide, of the utility industry, and four charts which I shall refer to in a moment.

I would like to add a word or two of explanation to what I have included in my memorandum.

May I first answer Senator Taft's question about why it is that, with the rate of return allowed by State commissions to utilities, this excess-profits provision is not entirely fair. The answer, Mr. Chairman, I think, is this:

The rate of return allowed by public-utility commissions to public utilities, countrywide, is the net balance after the payment of taxes, so that, if these normal and surtaxes are not first deducted, you get an amount of return which is not in correspondence with the rate of return allowed by State commissions when they figure the rate of return to utility companies.

Senator TAFT. I was asking about the excess-profits tax credit.

Mr. KELLOGG. The excess-profits credit, if it is not taken off—or, rather, the normal and surtaxes, if they are not deducted before figuring a balance upon which excess-profits taxes are figured, does not take care of the allowance that the public service commissions make for rate of return to utility companies, and therefore in effect largely reduces it.

Senator TAFT. It does take care of some of it, doesn't it? I mean, they are always allowed a Federal tax deduction. I mean, there always was a normal Federal tax on a corporation.

Mr. KELLOGG. Yes; and that was supposed to be deducted in arriving at a net earnings, which is the return on the investment.

Senator TAFT. That was 24 percent. It was for a couple of years, I guess.

Mr. KELLOGG. Whatever it was.

Senator TAFT. Now we increase it to 45.

Mr. KELLOGG. That alone is a great burden, but the point I am making——

Senator TAFT (interposing). That doesn't affect the rates; your rates are still the same. The utility commissions haven't raised your rates because of that tax?

Mr. KELLOGG. They haven't raised the rates, and that is, of course, one thing we are rather proud of, which is shown on charts 1 and 2 of our brief.

Senator TAFT. What I really want to get at is this: Can the utility situation be cured better by changing the excess-profits tax credit, and how, or by changing the rate on normal and surtaxes—the tax on normal earnings?

Mr. KELLOGG. I would say that the first and most important relief would be the permission, as allowed in the 1940 act, to deduct normal and surtaxes in arriving at a balance which is called excess-profits tax.

Senator TAFT. I wouldn't agree to that at all. It seems to me that the present method is the right method, and then we ought to decide after that whether we are going to reduce normal profits or whether we are going to reduce excess profits.

I wouldn't be in favor of changing that method back, and that is why I want to find out if there is any other method by which public utilities can be—by which the situation can be changed.

Mr. KELLOGG. I have some other suggestion, Senator.

Senator TAFT. I don't see why that would affect the excess-profits-tax credit anyway.

I can see why, if you say you are entitled to all your normal earnings without deduction—of course, all corporations would like that, but the policy of the bill is different. The policy is to reduce, to some extent, the normal earnings.

Mr. KELLOGG. The reason—I will say this, Senator—for feeling that deduction should be made in the order I mentioned is that any tax, no matter what it is, is a tax, and it reduces the company's net earnings, and until all prior charges have been paid we feel that it is the inevitable conclusion that you haven't arrived at a balance that is excess profits.

Senator TAFT. But the theory of the bill is that we shall take normal corporation profits, and we shall reduce them for every kind of corporation—both utility and every other kind of corporation—because of the war their normal profits shall be less.

Now, I think it is too big. I think the reduction is too big, but still there is something to that principle.

And then, in addition, we shall take a large percent of excess profits.

Now, that is the theory of the bill as to other corporations, and if it is followed through as to other corporations I don't see why it shouldn't be followed through as to utilities, but I think the increased rate of normal profits is too high.

Mr. KELLOGG. I do, too.

Senator TAFT. But I don't see why changing that rate affects your excess-profits credit.

I can see why it affects your calculation of the excess profits, but what is it that makes your excess-profits credit inadequate?

Why is it that a lot of earnings are turned into excess profits?

Mr. KELLOGG. Well, I still come back to my point, Senator: That if these normal and surtaxes were first deducted you would have a smaller amount left over.

Senator TAFT. It doesn't affect the excess-profits credit, I don't think.

Mr. KELLOGG. It would the way we figure all of our other taxes. it would so result.

All of our other taxes, local taxes—3⅓ percent for gross receipts tax—all taxes are deducted in arriving at a final balance for any purpose.

Senator TAFT. This excess-profits tax credit is changed somewhat, you know.

You are not subjected to normal profits or anything over the excess-profits credit.

Mr. KELLOGG. I realize that, but the difference is quite slight.

Senator TAFT. It is 10 percent of the excess.

Mr. KELLOGG. Yes, sir; but in the grand total it doesn't make—it saves something but it doesn't make very much difference.

Senator TAFT. As I say, we have a lot of these operating statements showing the ultimate result, but could you furnish us with statements as to the different utility companies whose statements have been presented here, as to how their excess-profits credit is reached, and how the tax is calculated?

Mr. KELLOGG. I would be very glad to.

Senator TAFT. Hardly anyone has done that, except the gentleman preceding you.

Mr. KELLOGG. I would be very glad to, and I think we can bring that point out.

Mr. Chairman, my predecessors have covered the general points of difference between utilities and other industries so well that I will not go into that, as I otherwise had planned to do.

I do want to make this one statement with regard to the special investment situation of the utilities: That they require eight times as much investment in permanent plant per dollar of annual sales as does the average industry, and that is the reason why raising money for extensions—$5.50 to $6 of new money for every dollar taken in in gross sales—has, with the growth of the industry, made financing—raising new money—a continuous process, all through the life of the industry, and it is also why credit is so utterly essential to the development of the business.

Now may I refer briefly to one or two of the suggestions which we have made for alleviation of the difficulty as shown on page 4 of my memorandum.

I will leave out the first one, because that has been discussed and also been mentioned by various other speakers, but I should like to call particular attention to No. 2 wherein we recommend a deduction, in computing taxable net earnings, of one-half of all dividends paid.

We believe that that modification could be made and not cost the Treasury one cent.

The reason is that the amount of taxes that would be lost by the Government, at the rates provided in the House bill, from the deduction of one-half the dividends paid, would be recovered from individual stockholders.

The Treasury would not suffer, but, on the other hand, the utilities would remain strong to carry out their service function, and the individual stockholders who paid these taxes would at least have something left instead of the, in effect, 100-percent tax which would be involved in dividends not being paid to them, and I think it must be obvious, Mr. Chairman, that any money which, due to taxes, cannot be paid out must come out of the stockholders, because all of the other expenses of the company—charges on money and taxes and so forth—must be paid beforehand.

The third suggestion we have made requires a little explanation. I will make it as brief as I can.

That is, to provide an allowance for an expanding industry with a large investment per dollar of annual sales, in order to alleviate the hardship arising from the use of a stationary base period in determining what constitutes excess profits.

This matter was touched on by one of the earlier speakers today, but we have two charts—charts 3 and 4—in this memorandum, which illustrate the effect that I am talking about.

Chart No. 3 shows the gradual growth in sales of the electric business since 1912, showing an almost uninterrupted growth.

There was, of course, a drop during the great depression of the thirties, but the dotted line which accompanies that line of energy output shows what we call the mathematical trend of all of those figures, and it is continuously upward.

I will say parenthetically that this steady continued rapid growth has been a characteristic of the public utility industry during the entire life of 60 years that it has had. On that chart 3 you will notice, for the 4 test years—1936-39—that the output of energy has been shown in heavy lines so as to bring that out from the rest of the chart.

You will observe that, going on above there, there is a continuous increase in output year after year.

We maintain that, with an industry which has shown that growth record over such a long period, that it has really established a trend, and that that trend means that the base above which excess profits should be figured is a constantly rising base.

Now, in order to prove, if I may, that that is not a theoretical or fanciful claim, I should like to point out that, during the 3 years 1940, 1941, and 1942, the electric utilities will have spent about $1,600,000,000 by way of increased plant to obtain this increased output, so that it is only a factual representation of what the utilities are up against to permit of this gradually rising earnings base.

On chart 4 the same effect is shown with respect to net earnings.

You will notice, for example, that, on the trend basis, there would be a difference of almost $100,000,000 between the earnings base which would be used if the trend method were followed and the actual ceiling resulting from the application of the act.

The final point which we suggest in our brief as a method of amelioration is to allow a deduction for reasonable reserves to offset maintenance deferred on account of shortage of materials or adverse labor conditions, and I should like to explain what that is about.

You all are familiar with the shortage of materials which has resulted from the war effort, the necessity not only of rationing but of prohibiting the use of certain critical materials by all industry—copper, steel, what not. These have had a very material effect upon the ability of the utility companies to perform necessary maintenance work on their property.

We also, on account of the requirements of the military draft, have been obliged to go short on labor.

It has been difficult to get the men—skilled men—to do maintenance work that should be done, and we are recommending, therefore, subject to such drafting as your committee may see fit to permit, to allow a deduction for such measure of maintenance as cannot be done on account of causes I have mentioned, to be set aside through the purchase of Government bonds, for use after the war during the difficult readjustment period we all foresee, to expend for what would then be deferred maintenance.

The CHAIRMAN. That same suggestion, Mr. Kellogg, has been made by the railroads, and it would apply undoubtedly to other industries as well—not, maybe, in the same degree—as it does to your industry or the railways.

And then, on your constant increase in earnings, I assume that that also might apply to many other industries outside of the utility field.

Mr. KELLOGG. I daresay. I don't know, Mr. Chairman, that there is any other industry that has had as long and continuous——

The CHAIRMAN (interposing). If that doesn't apply it might be a fair basis on which your base credits might be increased, as in the case of the rapid growth corporations. They are already cared for in the bill. There are already certain provisions.

The rapid growth formula wouldn't apply to you, but if that constant increase over long periods is peculiar to your industry it might apply—the relief provisions of the act might be availed of by a very simple amendment.

Mr. KELLOGG. I realize, Mr. Chairman, that it is a real burden on the utilities.

As someone brought out this morning there is a lag of 1 or 2 or 3 years between the time plant expenditures are made and the time earnings come from them.

The CHAIRMAN. I appreciate that fact and I think the committee appreciates that fact.

The only point is whether or not that would not be a condition applicable to many, many industries in the country in which, by virtue of priorities and restrictions and shortage of labor, maintenance would have to be deferred.

It might be peculiarly true in your industry, but I certainly think it is peculiarly true in the case of the railroads.

Mr. KELLOGG. Railroads are also a form of public utilities.

The CHAIRMAN. Yes; but that has been presented to the committee, and we appreciate the arguments which have been advanced in support of it.

Mr. KELLOGG. Mr. Chairman, in closing I wish to emphasize once more the service function of our business. That is our real function, rather than as tax collectors.

We are in this war up to our necks. We are very proud, as Mr. Arkwright said this afternoon, of the record we have made.

Two years ago we pledged all of our resources to help carry on the industiral load of the war, and we predicted at that time, with a feeling of confidence, that we could carry that load.

In the face of a good deal of doubt expressed in high quarters we have done that, and we are very proud of it, and we want your committee, Mr. Chairman, to feel willing and inclined to support the credit of the utilities through such tax relief as they need in order to enable them to keep up this record, for the sake of the war itself and for the sake of the safety of the country.

I don't know whether you all realize how much greater the tax burden is in this war than it was the last time. During the last war the highest ratio we had between Federal taxes and net earnings was 5 percent; at the present time, with the new bill, it is about 45 percent.

So it really is a tremendously increased burden, although our service requirements are even greater than they were before.

Thank you.

Senator VANDENBERG. Are any figures available as to the total number of preferred stockholders and the total number of common stockholders in public utilities in the country, Mr. Kellogg?

Mr. KELLOGG. I would be very glad to try to get that up. I am not sure it is available in exactly that form. If you will permit, Senator, I will be very glad to try to get some figures together and turn them in.

There may, of course, be duplications, just as there are in figuring the total number of life-insurance holders from the total number of policies, which is not the same thing.

Senator VANDENBERG. I would like to see the figures. I think we have pretty nearly come to the time when we have got to think of corporations in terms of stockholders and employees instead of in terms of academic entities.

Mr. KELLOGG. Right.

The CHAIRMAN. If you will get those figures and furnish them to the clerk and Senator Vandenberg——

Mr. KELLOGG (interposing). I will also be glad to furnish them to Senator Taft.

The CHAIRMAN. Yes, sir. Thank you very much, Mr. Kellogg.

(Mr. Kellogg's prepared statement is as follows:)

STATEMENT OF C. W. KELLOGG, NEW YORK, N. Y., PRESIDENT OF EDISON ELECTRIC INSTITUTE

The purpose of this statement is—

(1) To show in a factual way the effect on electric utility companies of the new Federal tax provisions contained in H. R. 7378 now before the Senate Finance Committee;

(2) To indicate the considerations arising from the inherent nature of the utility industry which call for special treatment in this tax bill;

(3) To show the need to make provision for deferred maintenance to be performed during the post-war readjustment period; and

(4) To suggest remedies.

The electric utilities recognize that the present revenue needs of the Federal Government, on account of the war emergency, require heavy taxes on all elements of the Nation, consistent with maintaining the ability of each to continue to function adequately and to be able in the future to continue heavy tax payments.

The tax proposals now before the Senate Finance Committee would seriously impair the credit of utility companies and adversely affect their ability to perform their essential public and war service. It is believed that these injurious effects of the bill can be corrected without loss of revenue to the Treasury.

1. EFFECT OF TAXES ON UTILITIES

The effect of taxes on electric utilities is shown in tables 1, 2, and 3 attached hereto, which compare actual financial results for the years 1940 and 1941 and estimated results for 1942, the latter based upon actual results for the first 6 months of the year after applying the Federal tax rates provided in H. R. 7378.

Due almost entirely to bigger Federal taxes, the net income of electric utilities for 1941 decreased 3⅓ percent below their 1940 net income, and in 1942 it is estimated there will be a further decrease of net income of 19 percent below 1941. This 19-percent decrease is an average figure for the industry; the effect on many individual corporations will be more serious. It will force the cutting or omission of many dividends, including some preferred dividends. It already has caused a tremendous decrease in the market value of utility stocks. The credit of the utilities is hurt and financing for expansion is jeopardized.

2. CONSIDERATIONS CALLING FOR SPECIAL TREATMENT

Function of utility business.—The real function of the utilities is to furnish the public with an essential service as cheaply as possible. This function is recognized by the Federal Government with respect to municipal and governmental electric systems, in their being exempted from all Federal taxes. In justice, all consumers of electricity should be treated alike by the Federal Government, and the electric utilities should therefore have the same exemption from Federal taxes as is enjoyed by governmental power enterprises. In no event, however, should the electric-utility companies be taxed to such an amount that their ability to perform effectively in the war effort is impaired.

Large investment in fixed plant.—Essentially the electric utility business is one of a relatively large investment in fixed plant, the inducement to invest in which arises from the relatively stable nature of the business and from the regulation of the business by governmental bodies on a basis which allows a return on the investment at a rate sufficient to attract new capital to the business.

The electric-utility business requires about eight times as much fixed investment per dollar of annual sales as does the average industrial enterprise. From this inherent condition it follows, first, that with utilities fixed charges comprise nearly 70 percent of the total cost of doing business and, second, that with constant requirements for growth and expansion, the raising of new capital in large amounts is a continual necessity of the business in order to furnish adequate service. Thus, a given percent decrease in net income is much more destructive to utilities than the same percent decrease would be to the average industry. The maintenance of the credit of utility companies is absolutely essential for the proper carrying out of their service obligations.

Regulated rates.—Unlike other enterprises, utilities are unable to raise the price of their products or recoup themselves from higher costs. Their rates are strictly regulated. As a matter of fact, they have steadily reduced the average charges for their services. Attached hereto are two charts, (1) comparing the average unit price of electricity in the home with the cost of living for the last 30 years and (2) comparing the average unit price of wholesale electricity with all other wholesale prices and with their own unit pay-roll costs for the same period. The conclusion follows that there is ample basis for placing an industry, which, like utilities, has such characteristics, in a special class from the standpoint of taxation.

Effect on utility credit.—The very large fixed investment of about $13,000,000,000 in the electric utility business is represented about one-half by bonds and one-half by stocks, preferred and common. The bonds could not have been sold without the margin of security represented by the stock investment; and the stocks could not have been sold without the expectation of reasonable dividends thereon. As shown in Table 1, the net income available for stock in 1941 was approximately $539,000,000. Dividends paid, both preferred and common, aggregated about $450,000,000.

The estimated increase of $144,000,000 in utility Federal taxes for 1942 over 1941, as shown in table 2, representing over 30 percent of all dividends paid by utilities last year, can be taken only from the stockholders—there is no other source for these funds. The state of public utility credit in recent years has made the sale of their securities so difficult that it has been necessary to expend for extensions to public utility plant large amounts of net earnings which should have gone in dividends to stockholders. In 1940 and 1941 combined, some $182,000,000 of net earnings had to be withheld from stockholders. To the extent that net earnings may be still further reduced by increased taxes, payments to stockholders will have to be cut still deeper.

Necessity for allowance for growth.—The electric light and power industry throughout its 60-year life span has been and still is a relatively fast growing business. Its present long-term trend of normal growth, including the depression period, appears to be about 4 percent compounded annually. Actual growth during the past 6 years has been much faster. Power production has increased at the rate of 9 percent compounded annually, and gross revenues over the same period have increased about 5 percent compounded annually.

Thus, by the end of the present year, a normal growth of at least 12½ percent would naturally have taken place since the end of the base period for computing Federal excess-profits taxes. Chart No. 3, page 11, shows power production year by year and the mathematically computed curve of normal growth. Income requirements to maintain the expanded business this chart indicates are bound to increase somewhat in the same proportion.

To impose a stationary base or standard of income for tax purposes on an expanding business requiring heavy capital investment in plant and facilities is to class as excessive that part of normal income which really pertains to its natural growth. The effect of the excess-profits tax has been to place a rigid ceiling on a vital and growing industry and the longer it remains fixed the more it will threaten the financial stability of electric utility companies. Chart No. 4, page 12, and table No. 4, page 8, illustrate the effect of making no allowance for the growth factor.

The table shows that the ratio of Federal income and excess-profits taxes to net income before deducting such taxes has climbed from 5 percent during the last war to the prospect of 45 percent in the first year of the present war.

3. DEFERRED MAINTENANCE

Stortage of materials and labor is bound to result in the deferring during the emergency of considerable maintenance of utility plant. This will become more pronounced as the war progresses. The Interstate Commerce Commission has recognized this situation as concerns the railroads and authorized them to set aside reserves for deferred maintenance. The electric utilities should also be allowed to make reasonable accruals for this purpose. The money thus accrued could be invested in War bonds until peace is restored. This would serve to provide employment in the ensuing readjustment period.

4. REMEDIES

Having in mind the conditions above recited, the following remedies are suggested:

1. Exempt utility companies from excess-profits taxes, since being regulated as to earnings by governmental bodies they are precluded from true excess profits; or, as an alternative, allow utility companies to deduct income and surtaxes in computing excess profits net income, as was provided in the 1940 Revenue Act.

2. Allow the deduction of one-half of all dividends paid in the computation of corporate gross income for tax purposes. It is believed that this modification could be made without loss of income to the Treasury, since the taxes thus saved by the utility companies would be paid by their stockholders in individual income taxes. The reason for this is that, since it is impossible for the utilities to avoid paying their costs of operation as well as taxes and other fixed charges, the entire increase in their Federal taxes will have to be taken away from their stockholders in the form of reduced dividends.

3. Provide an allowance for an expanding industry with a large investment per dollar of annual sales in order to alleviate the hardship arising from the use of a stationary base period in determining what constitutes excess profits.

4. Allow a deduction for reasonable reserves to offset maintenance deferred on account of shortage of materials or adverse labor conditions.

TABLE 1.—*Income statement, electric-utility companies*

[Millions of dollars]

	1940	1941	Percent change	1942 [1]	Percent change from 1941
Operating revenues	$2,277	$2,475	+9	$2,650	+7
Operating expenses	863	955	+11	1,050	+10
Depreciation	260	279	+7	300	+7½
Taxes	404	511	+26	658	+29
Total deductions	1,527	1,745	+14	2,008	+15
Operating income	750	730	−3	642	−12
Income other departments	62	55	−11	50	−9
Nonoperating income	77	74	−4	55	−25
Gross corporate income	889	859	−3	747	−13
Interest and amortization	315	303	−4	293	−3
Other deductions	17	17		17	
Net income	557	539	−3	437	−19

[1] Estimated on basis of actual results for first 6 months of 1942 with Federal tax rates of House bill (H. R 7378) applied.

Source: 1940-41 as shown in Edison Electric Institute Statistical Bulletin No. 9, table 33, p. 39.

Table 1 shows that notwithstanding an increase in gross revenue of $198,000,000 in 1941, net income, due largely to taxes, dropped $18,000,000 or 3.3 percent. The big expansion in electricity sales took place principally in the lower-priced industrial use of electricity rather than in the higher-priced retail sales. This shift is becoming more pronounced in 1942 and has further slowed down the percentage increase in gross revenue.

Only about 35 percent of operating revenues represent costs which vary with the volume of output; all the balance are fixed charges of one form or another. With general manufacturing industry these ratios are approximately reversed—about 65 percent of their total costs vary with volume of output.

Table 3 shows that the relative tax burden has doubled since 1930, and in 1942, based on proposed tax bill, will be two and one-half times as great. It shows also, by the rise in the proportional amount required for operation and maintenance, that it has not been possible to offset the increased cost of labor and materials by economies and by the expansion of sales of electricity. It shows further that the increase in the tax burden has combined with this factor to reduce sharply the return on the investment, which in 1941 was one-third less than it was even in the depression year of 1930, and in 1942 bids fair to be only about half as large.

TABLE 2.—*Break-down of utility rates*[1]

[Millions of dollars]

	1940	1941	Increase	[2] 1942	Increase over 1941
Federal taxes:					
Income taxes	$129	$180	$51	$250	$70
Excess profits	6	45	39	110	65
3½ excise tax	44	49	5	53	4
All other Federal	11	20	9	25	5
Total, Federal	190	294	104	438	144
State and local taxes	214	217	3	220	3
Total taxes	404	511	107	658	147

[1] Preliminary figures, based upon reports covering 70 percent of total revenues.
[2] Estimate, based on actual results for first 6 months of 1942 and application of Federal tax rates contained in H. R. 7378.

TABLE 3.—*Growth of electric-utility tax burden—percent of gross revenue*

Year	Spent for operating, maintenance and depreciation	Spent for taxes	Balance available for return on investment and extensions	Total
1930	46	10	44	100
1935	48	14	38	100
1940	49	18	33	100
1941	50	20	30	100
1942 [1]	51	25	24	100

[1] Estimate, based on actual results for the first 6 months.

TABLE 4.—*Effect of Federal income and excess-profits taxes upon earnings of electric light and power companies*[1] *in the United States*

[Money amounts in millions of dollars]

Year	Net income before Federal income and excess-profits taxes	Federal income and excess-profits taxes				Net income after all taxes and charges
		Income	Excess profits	Total	Percent before taxes	
1917 [2]	122			6	5	116
1922 [3]	240			10	4	230
1927	508	36		36	7	472
1932	542	36		36	7	506
1933	437	33		33	8	404
1934	435	44		44	10	391
1935	459	39		39	9	420
1936	512	52		52	10	460
1937	575	66		66	12	509
1938	548	63		63	12	485
1939	628	89		89	14	539
1940	692	129	6	135	20	557
1941	764	180	45	225	30	539
1942 [4]	797	250	110	360	45	437

[1] All privately owned utilities, including multiple-service companies which supply gas, water, traction, and other services in addition to electricity.
[2] Based upon United States Census of Central Stations for 1917, which represented 78 percent of the electric light and power companies as now constituted.
[3] Based upon United States Census of Central Stations for 1922, which represented 87 percent of the electric light and power companies as now constituted.
[4] Estimated on basis of first half year and applying rates of Federal taxation as enacted by House of Representatives.

NOTE.—Years 1923 to 1928, inclusive, are actual collections as reported by Bureau of Internal Revenue. Years 1917 and 1939 to 1942 are as carried on utility books and may vary somewhat from actual collections.

The trend of electricity prices in the past 30 years is shown on the attached charts. These emphasize why utilities cannot meet big increases in taxes from increased gross revenue.

COST OF LIVING AND ELECTRICITY IN THE HOME

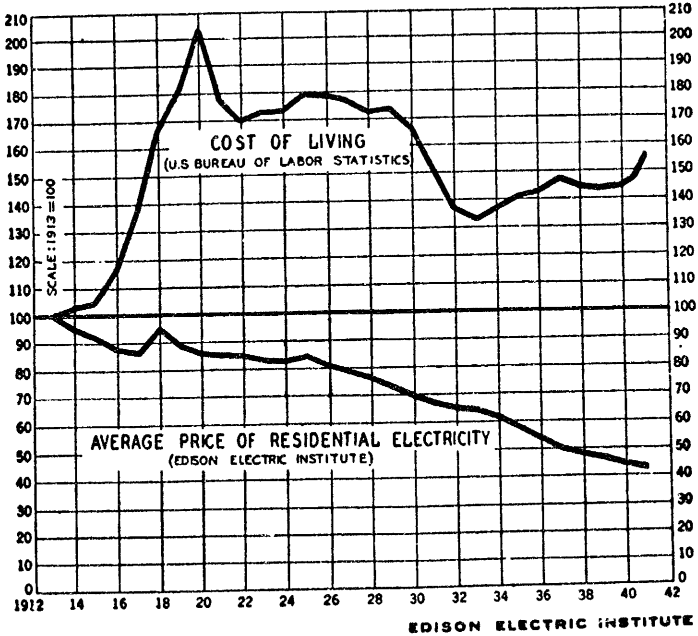


CHART 1

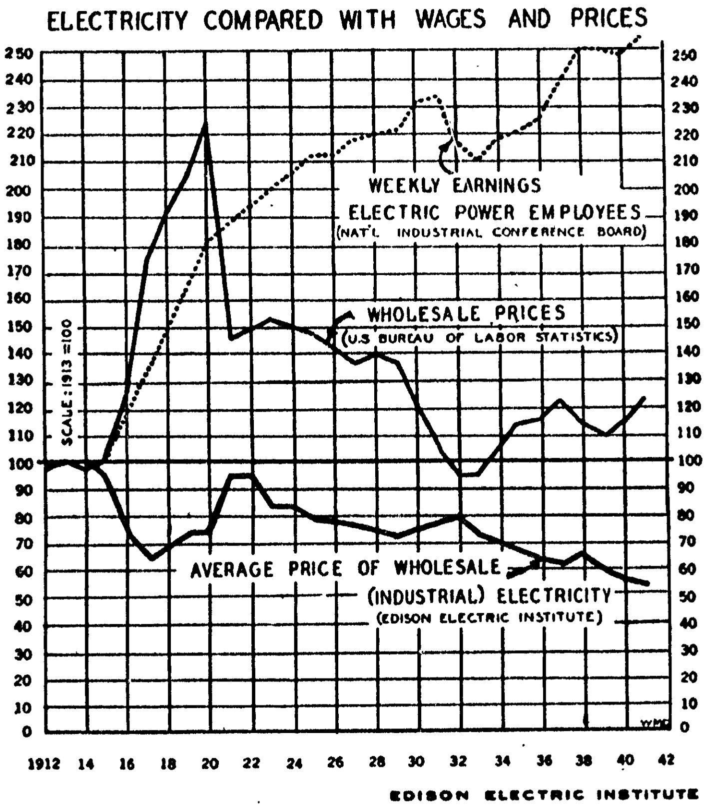

ELECTRICITY COMPARED WITH WAGES AND PRICES
WEEKLY EARNINGS
ELECTRIC POWER EMPLOYEES
(NAT'L INDUSTRIAL CONFERENCE BOARD)
WHOLESALE PRICES
(U.S BUREAU OF LABOR STATISTICS)
SCALE: 1913 = 100
AVERAGE PRICE OF WHOLESALE
(INDUSTRIAL) ELECTRICITY
(EDISON ELECTRIC INSTITUTE)
0
10
20
30
40
50
60
70
80
90
100
110
120
130
140
150
160
170
180
190
200
210
220
230
240
250
1912
14
16
18
20
22
24
26
28
30
32
34
36
38
40
42
EDISON ELECTRIC INSTITUTE

CHART 2

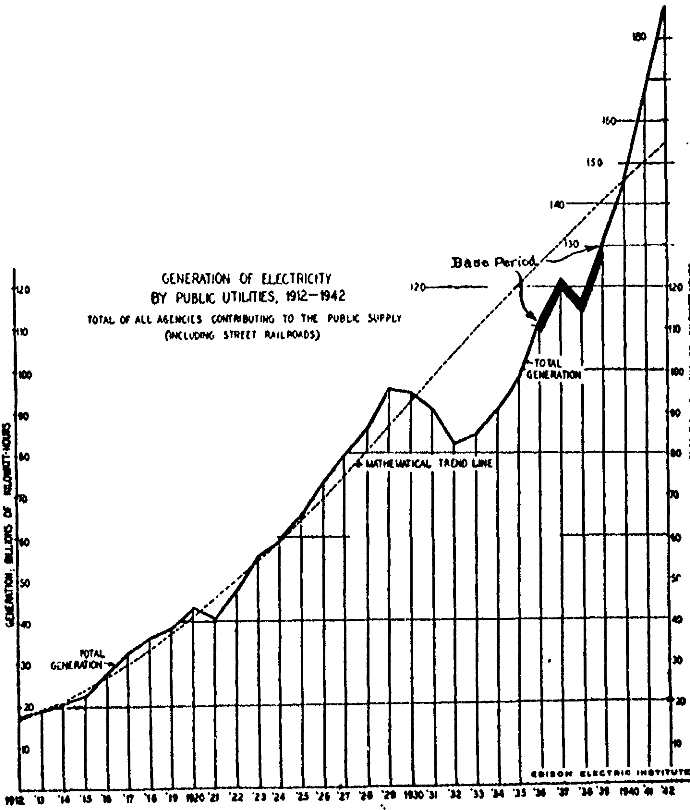

GENERATION OF ELECTRICITY
BY PUBLIC UTILITIES, 1912—1942
TOTAL OF ALL AGENCIES CONTRIBUTING TO THE PUBLIC SUPPLY
(INCLUDING STREET RAILROADS)
Base Period
TOTAL GENERATION
MATHEMATICAL TREND LINE
GENERATION, BILLIONS OF KILOWATT-HOURS
EDISON ELECTRIC INSTITUTE

CHART 3

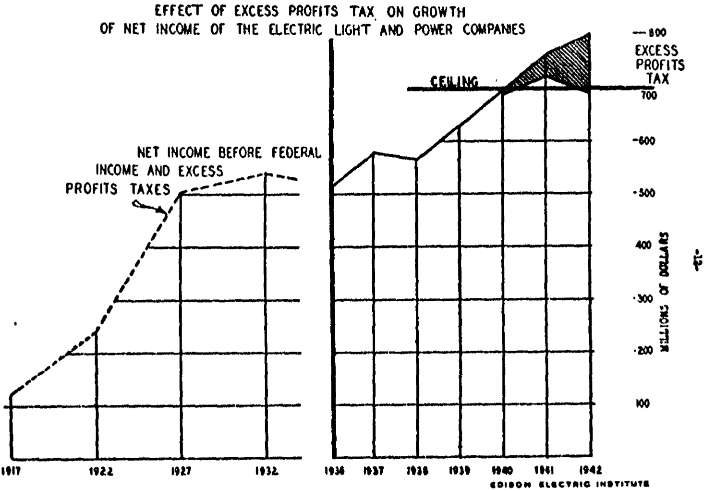


CHART 4

(The information requested of Mr. Kellogg is as follows:)

EDISON ELECTRIC INSTITUTE,
New York, N. Y., August 19, 1942.

Hon. ARTHUR H. VANDENBERG,
United States Senate,
Washington, D. C.

DEAR SENATOR VANDENBERG: In the course of my testimony before the Senate Finance Committee on August 12, you asked me the number of electric security holders, and I undertook to obtain and supply the information for you.

UTILITY SECURITY HOLDERS

There are about 2,000,000 share holdings in electric operating companies—about 500,000 holdings of common stock and about 1,500,000 holdings of preferred stock. (Source: Moody's Manual and direct questionnaire.)

There were in 1938 about 1,870,000 holders of utility holding company stocks listed on stock exchanges. (Source: Report of the Securities and Exchange Commission to the Temporary National Economic Committee, monograph No. 30, 76th Cong. 3d sess., 1941.)

As you know, the common stocks representing over one-half of the operating electric utilities are owned by holding companies, so that from the public point of view this ownership is represented by the stocks of the holding companies which in turn are widely held by the public. The addition of the holders of operating and holding companies' stocks is not therefore of itself a duplication. The combined number of stockholders in electric operating companies and utility holding companies is approximately 4,000,000.

For the larger utilities from whom we have the segregation, the women stockholders predominate over the men, which seems to confirm the unadmitted status throughout our American policy.

There are about 1,000,000 holders of electric operating company bonds. We do not have such figures for utility holding companies. Of 30 leading universities and colleges, 18 percent of productive funds were at last reports invested in utility bonds.

STOCKHOLDERS IN THE UNITED STATES

In 1938 there were eight or nine million stockholders in 1,710 domestic corporations in the United States, according to one Temporary National Economic Committee report,[1] and there were 14,000,000 record share holdings in these corporations.[2]

UTILITY INVESTMENTS OF INSURANCE COMPANIES, BANKS, AND INSTITUTIONS

The bonds, and to some extent the preferred stocks, of utility companies are widely held by insurance companies, trust companies, savings banks, national banks, and by institutions. The amount of such holdings, according to the latest publications, is over $6,000,000,000; life-insurance companies alone holding more than $4,000,000,000 in these securities. This covers electric, gas, water, and telephone utilities, but a very substantial part of the investment is in electric utility companies or in combination electric and gas companies. It is estimated that about a third of the total capital investment in electric operating companies is held by such organizations. The significance of thees figures arises from the fact that there are about 40,000,000 life-insurance policies outstanding and nearly 15,000,000 savings bank depositors.

UTILITY EMPLOYEES

Many utility employees are also stockholders. There are slightly over 300,000 employees of electric utility companies altogether with their gas, street railway and steam-heating departments, but not including the employees of affiliated gas and transport companies.

I trust that I have furnished the information which you desire, but if I have not adequately covered your question, please advise me further as to your wishes.

Very truly yours,

C. W. KELLOGG, *President.*

STATEMENT OF A. F. DAWSON, CINCINNATI, OHIO, REPRESENTING CINCINNATI GAS & ELECTRIC CO.

The CHAIRMAN. Mr. Dawson.

Mr. DAWSON. Mr. Chairman and members of the committee, my name is Albert F. Dawson. I am connected with the Cincinnati Gas & Electric Co., of Cincinnati, Ohio.

I come here today to bring some factual information to this committee, being engaged in a revision of the present revenue act.

I think this committee would like to know how the operation of the Revenue Act of 1941 is going forward, and whether in its operation it is carrying out the intent of Congress.

This present law may be entirely fair and just and proper for industrial corporations with excess profits from the war activities, but the actual results show that the present law cuts so deeply into the net income of low-earning companies operating under strict regulation as to endanger their very financial stability.

I shall confine my discussion, Mr. Chairman, to the question of how much income a company has left after it has paid all expenses and taxes.

That is a fair test, in my mind, to determine whether it can survive with reasonably good health, or whether it is to be crippled or destroyed by the impact of excessive taxes.

The figures which I wish to present are those from a typical operating company.

[1] Monograph No. 29, entitled "Distribution of Ownership Among 200 Financial Corporations," p. XVII, par. No. 9.

[2] Temporary National Economic Committee monograph No. 30, 76th Cong., 3d Sess., p. V.

The situation of the other utility companies in the State of Ohio, which serve about 85 percent of the people of that State, is the same as ours, varying only in degree.

These nine companies whose figures I have here are both electric companies and gas companies, and companies which serve both gas and electricity.

Ohio is a typical State, and the result there may be taken as a fair criterion of the result in the industry throughout the United States.

Now, the Cincinnati Gas & Electric Co., as I said, is an operating company which, with its jointly operated affiliates, supplies both gas and electricity to a community embracing seven counties in southern Ohio, and two in northern Kentucky, with a population of about 725,000 people.

I might say that the rates for household electricity in Cincinnati and in the cities of Kentucky which are served are practically the lowest in the United States, T. V. A. not excepted.

The company has been in business for over 100 years, and it now employs 3,800 people.

It is fairly typical of the great number of operating companies which are capably managed, carefully operated, and with a conservative financial structure.

This structure is soundly balanced between bonds, preferred stock, and common stock.

About one-third of the value of the property is represented by preferred stock, a very large percentage of which is owned by more than 8,000 people living in the community. This stock, which has continuously paid a 5-percent dividend, is mostly held in small blocks by thrifty people who need these dividends to meet their modest family budgets.

The report of the operations of our company for the year 1941, under the existing law, shows that the heavy taxes imposed in that law reduced the net income of the company nearly 25 percent below every one of the three standards that have been set up to measure the maximum in taxes which should be taken from a company.

Two of these standards were fixed by Congress and the other one was recommended by the Treasury.

Here are the simple facts from which this committee can judge whether or not the present law is actually working as Congress intended it should:

Standard No. 1.—Congress wrote into the law a yardstick for net earnings which was the average net earnings for the 4-year base period 1936 to 1939.

For our company that base-period average was $3,951,000. Our net earnings for 1941 were $931,000—almost $1,000,000,000 below the yardstick.

That was a slash in net earnings of 23.5 percent. Under the rates of the House bill now before you that deficiency would amount to 52.7 percent.

Standard No. 2.—The present law fixed 7 percent on invested capital as a minimum measure of fair return which should be exempt from excess-profits tax.

The House bill reduces this to 6 percent.

The income of this company is from rates based by law on the value of the property devoted to the public service, and this value is finally determined by public agencies

Under such determination the net income of our company in 1941 was 22 percent less than that particular yardstick.

Our company had to pay a large excess-profits tax because the technical formula for determining excess-profits tax fails to recognize the actual property values.

Standard No. 3.—The Secretary of the Treasury declared, in testimony before the House committee, that taxes should be levied so as to "leave in the aggregate about the same amount of income after taxes as during the years before 1940."

Compared with the average net income of this company for the 5 years before 1940—3 of those were depression years, when net income was subnormal—the actual net income for 1941 was 24.5 percent below that standard.

Under the pending House bill the decrease would reach 53 percent.

I say to you that when the net income of a company is reduced from 24 to 53 percent below the subnormal earnings of depression years it is obvious that—to use again the language of Secretary Morgenthau—this is dipping "so deeply into the income of a low-earning company as to seriously affect its debt-paying capacity, if not its very existence."

And these figures do not tell the whole story. Before income taxes are imposed, as you know, the electric utilities must pay a $3\frac{1}{3}$ percent excise tax on electric energy sold for domestic and commercial use.

In the original law that was passed on to the customer. In a subsequent revision it was loaded on to the company. Then again, in the case of our company, since 1939—which is the end of the base period—our company has invested $20,000,000 for expansion of plant and equipment largely to meet war demands.

The average earnings for the base period obviously do not include any earnings at all on this $20,000,000 investment, and when this is taken into account, still further reduction in the rate of return is apparent.

The present law produces some—what I call, almost paradoxical results.

Let me invite your attention to one result of a sharp and sudden increase in taxes upon a low earning regulated company.

You would naturally suppose that, if the net income of the company, before Federal income taxes were paid, if that net income went up, that the final net income of the company would go up also, or would at least remain stationary. It does not work out that way.

If you will turn to the chart that is on the back of the presentation that I have left with the committee, you will see the experience of our company in that respect, and that shows that, for the 2 years of 1941 and 1942, while the net income before Federal income taxes were paid. went up 30 percent, at the same time the actual net income went down 30 percent.

You will note, from this chart, the dotted line horizontal below the figure 4.

That represents the base period average of the company for which I am speaking, and that is $3,950,000.

You will observe, from that chart, that ever since the middle of 1939 the net earnings of the company have been below the base period average fixed by the Congress, and you will observe also that, beginning in 1941, this line begins to toboggan down to the point of danger.

Of course, a continuation of the trend, as shown in this chart, could lead only to financial disaster.

The CHAIRMAN. What you are saying altogether depends on the tax rate and the tax treatment given to corporations, does it not?

Mr. DAWSON. Yes, sir. I am showing the effect of the present tax rates upon the business of our company.

The CHAIRMAN. Yes, sir.

Mr. DAWSON. Now, these facts that I have presented to the committee for the Cincinnati Gas & Electric Co. are, in varying degree now, what is happening to other gas and electric companies in the State of Ohio.

I have collected information from nine of these companies which, taken together, serve about 85 percent of the population of the State.

Grouping these nine independent operating companies together, this shows:

(1) The net income in 1941 shows an average decrease of 15.7 percent below the 1936–39 average, under the present tax law.

(2) On the basis of actual business for the first 6 months of 1942, with the last 6 months of this year computed on the figures of the companies' budgets, the net income for 1942 under the rates in the House bill will be nearly, for these nine companies, nearly 45 percent below the average for the base period.

My understanding of an excess-profits tax is that the taxpayer should pay a substantially higher tax on the earnings beyond a normal rate of return under normal conditions.

In the case of public utility companies there can be, under present conditions, no earnings that could properly be regarded as subject to excess-profits taxes.

The present law provides that earnings of not over 7 percent of so-called invested capital are not subject to excess-profits taxes.

If the definition of invested capital would recognize the actual property values, public service operating companies would be exempt from excess-profits taxes, because their rates for service are subject to continuous regulation and are limited to a reasonable return upon the fair value of the property devoted to the public service.

For several years past the maximum rate of return so allowed by the Public Utilities Commmission of Ohio has been 6½ percent on gas utilities and 6 percent on electric, but it does not follow that all or any of such utilities were able to earn the maximum allowable return.

Let's examine the facts which bring about this present unusual situation.

In the first place war conditions have an adverse effect on public utilities.

It may surprise you to know that the gross revenue of our company for the past 8 years has increased less than 10 percent per year.

Ten percent would be considered an average growth in normal times in a progressive community, and we serve in a community which has its full share of the war industries that require power and gas, and which is the center, among other things, of the greatly enlarged machine-tool industry.

Increased sales of gas and electricity, because of the war effort, are to a considerable degree offset by the reduction in sales to nonwar industries which have been put out of business, due to the reduction in home use, due to the official curtailment of appliance sales, and to the ban on the sales of gas for house heating.

Thus the large increase in kilowatt-hours or cubic feet of gas, which necesssitates expansion of plant equipment, do not reflect themselves in a corresponding increase in gross earnings, because most of it is sold at low industrial rates, where the margin of profit is extremely lean.

Of course, the utilities are unable to escape increases in operating expenses caused by higher labor, material, and fuel costs.

The question naturally arises as to the possibility of increasing rates to meet this situation.

I think the facts already presented to the committee show that that is an impossibility.

The fact that any increase in rates that could be obtained would be taken under the House bill, 90 cents in taxes leaving only 10 cents to the company, would make it perfectly fantastic to request rate increases on that basis. The same holds true in effecting economics in the operation of the company.

No matter what efforts are made or what results might be obtained the same thing would result: Ninety percent of those savings would be taken in taxes, leaving only 10 cents to the company.

The fact is, gentlemen, that public utilities are now operating in what is virtually a financial strait jacket. They operate all the time, gentlemen, under a ceiling of net earnings fixed by the law and the regulation of public agencies, and this ceiling is lower, Mr. Chairman, than the one which Congress undertook to define in the tax law to mark the difference, to mark the line, between normal profits and excess profits.

A public utility has no way to adjust itself to rapidly increasing and excessive taxes. Both its hands are tied. It cannot recoup by cutting down operating expenses, because here again 90 cents of it goes for taxes and 10 cents of it remains for the company.

The same would be true of rate increases.

On the other hand, it cannot increase the price of the service itself for reasons already given.

In reality, all the gas and electric rates are now practically frozen—at least frozen on top, if they are still in a thawed condition at the bottom—and then, moreover, the Office of Price Administration has already intervened in opposition to a proposed rate increase by public-utility company and forced withdrawal of the petition, and we are informed that any such increases will be so opposed.

But, with the ceiling over earnings, with its hands tied where it cannot recoup, the floor under these utilities was sharply raised by a thick layer of taxes in the act of 1941, and the House bill now proposes to elevate it further with another layer of taxes that I would say was anything but thin.

The effect of the present law is to collect excess-profits taxes on a large percentage of the normal earnings of public utilities.

I can't emphasize that more than by citing to you the fact that, in the company which I represent here, in the year 1940, our excess-profits taxes were $165,000.

In 1941, the next year, it had skyrocketed to $1,811,000.

Now, this all boils down to the incontestable fact that a serious inequity has resulted from the operation of the present revenue law, in the case of at least two great industries—gas and electricity—both vital to the war production.

I feel sure that this was unintended, but there it is. The terms of the House bill will greatly increase that inequity unless some provision is made for relief.

These facts, I should add, are submitted with no thought of tax avoidance—that is the furthest thing from our minds. We recognize that heavy taxes are necessary to win this war, and we would willingly pay in taxes all income above an amount which would provide a reasonable return on the fair value of the property devoted to the public service, but the earnings after Federal taxes in 1941 were far short of such amount.

Of course, we have expected that war taxes would cut the net earnings of the company perhaps below the subnormal earnings of the depression years immediately preceding, but no one ever dreamed that earnings would be driven down far below the danger line.

These facts point also clearly to one other logical conclusion: There should be separate treatment in this bill for public-service corporations.

The taxation of public utility corporations constitutes a special problem, because of the many fundamental differences between public utility and industrial concerns.

Senator TAFT. Mr. Dawson, that I can't see. I can't see why they are any different.

Frankly, it seems to me that, as far as this tax problem is concerned, they are in exactly the same position as the companies, and it seems to me that what is unjust for the utility industry—and I think it is—is unjust for every other corporation—not every other but a large number of other corporations.

I don't see what difference it makes if the rates are regulated or not.

We are, in effect, regulating the rates of every industrial concern by saying they can't earn more than so much on their invested capital.

Mr. DAWSON. Let me point out the differences, these fundamental differences that I speak of. The public utility is a low-earning corporation.

Senator TAFT. Most corporations in the country, taken by number, are low-earning corporations.

Mr. DAWSON. As I understand, the intent of this law, in its excess-profits taxes, is to drain back into the Treasury these swollen profits of those which are made from the war effort.

Now, clearly, a public utility is entirely outside of that class of corporation.

Senator TAFT. If this law operates that way on a public utility it will operate that way on every other low-earning company, it seems to me—or a large number of them.

Mr. DAWSON. With steadily lower earnings, Senator?

Senator TAFT. Yes.

Mr. DAWSON. I think the public utility industry differentiates from nearly every other company, because they are steadily lower.

Senator TAFT. They ought to get a larger excess-profits tax, because, over those 4 years base period, they were better off, on the whole, than I think most industrial corporations.

Mr. DAWSON. I haven't seen the comparison. I have seen the statement made that, for the year 1941, the net earnings in the electric industry were 5.7.

Senator TAFT. I am most sympathetic with the position of the utilities, but I don't see why they are entitled to any different treatment, and I think what they have shown about this law is evidence for a reduction or a change in the method of taxing every kind of corporation in the United States rather than utilities only. I can't see the difference.

Mr. DAWSON. If we have pointed a way for justice to others as well as to ourselves, we feel amply repaid for our efforts, I assure you.

Senator TAFT. That is all right. I think you have performed a very useful service in that respect.

Mr. DAWSON. For the benefit of the other members of the committee as well as Senator Taft, let me call your attention to these additional fundamental differences:

A public utility is a low earning corporation constantly limited in its earnings, and under constant public regulation. I can't find any other class of corporations that measure up to those three particulars.

It has a slow turn-over with an annual sales being only 20 to 25 percent of the capital invested.

In contrast, the average industrial corporation may have an annual turn-over four or five times its capital.

It is plain to be seen there that on a capital basis what fits one company would not fit another as to equitable treatment.

Senator TAFT. But there are hundreds of other corporations in the United States—of all kinds—with a very low average turn-over.

Mr. DAWSON. Yes; but they are not——

Senator TAFT (interposing). This applies not only to industrial corporations but every kind of corporation that is doing business of any kind in the United States.

Mr. DAWSON. But they are not such under the operation of law, are they, Senator? Ours can't vary because of the limitations placed by law.

I agree with your point, but I still think that utility corporations—their situation is a little more aggravated than these, perhaps, that you had in mind outside, so I believe it is important to differentiate between regulated industries—or corporations with a slow turn-over—and unregulated industrial corporations having a quick turn-over. It is clearly in the public interest that these utilities, which are of vital importance in war production, should be maintained in sound operating condition, and in such financial health that it will attract capital necessary for its expansion.

Now, to meet this situation I do not know that I have anything new from what has been presented here before.

I should say that those of us who have appeared here today have each one appeared independently and of his own volition. We have had no conferences together as to what recommendations might be made, and so, if there is a similarity in the recommendations that have been made by these gentlemen that come from New Jersey and from Georgia and from the far West, and Nebraska and Kansas, then it is merely the fact, perhaps, that great minds are inclined to run in the same channel, but to my way of thinking, if this situation were to be met in a forthright manner, public utilities should be exempt entirely from the provisions of excess profits, because their profits are now limited to a definite ceiling by Government regulations, and that ceiling is lower than the ceiling fixed in this law.

Now, there are three other suggestions, three other considerations, that are respectfully suggested, in the hope that they may be given careful consideration:

One of these is to allow utility companies to deduct income and surtaxes in computing excess-profits net income.

Another is to permit a credit against net income, at least for surtax purposes, of all dividends distributed.

The last is to allow a credit against net income for surtax and excess-profits tax purposes of all payments made in the reduction of indebtedness.

And then—I am sorry the chairman is missing; I wanted to make one particular suggestion to him, so I will make it to the acting chairman, if I may, the Senator from Massachusetts:

I believe that this subject is of sufficient importance to warrant the chairman of this committee in naming a subcommittee to prepare a sound program of war taxes for public utilities, because the first year's experience shows that the present method is unsound, it is inequitable, and it is destructive.

Gentlemen, I thank you for your patient attention.

Senator BAILEY. I have one question: This tax bill—the House bill—is predicated upon the expectation of an increase in the national income—say $80,000,000,000 to $150,000,000,000; that is, a gain of $35,000,000,000.

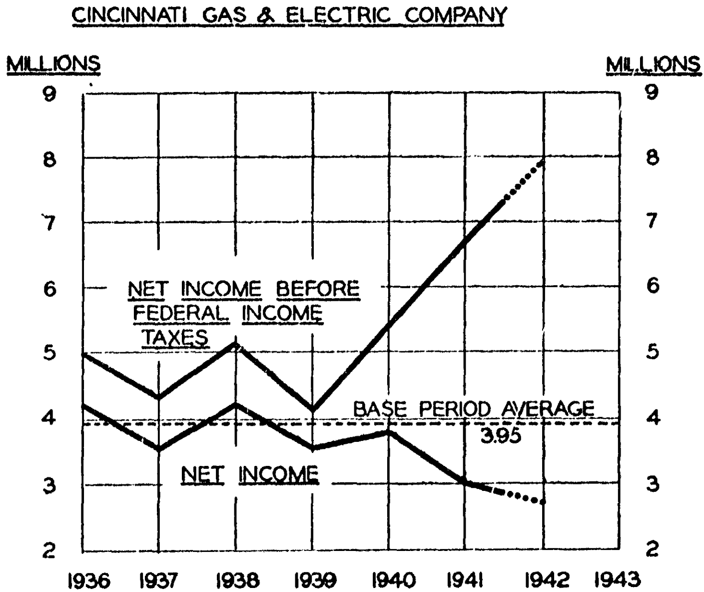
Is it your contention that the utilities will not share in that extra income, and, therefore, we should not undertake to make a recovery against them?

Mr. DAWSON. The public utilities will share to a very small degree, if any, in that increased national income.

Senator WALSH. Thank you, Mr. Dawson.

Mr. DAWSON. Thank you very much.

(The chart referred to by Mr. Dawson is as follows:)



Senator WALSH (acting chairman). Mr. Bean, Ormand R. Bean, of Salem, Oreg.?

(No response.)

Senator WALSH. Mr. Moylan, Omaha, Nebr.?

Mr. MOYLAN. Yes, sir.

Senator WALSH. Will you give the committee your full name and whom you represent?

STATEMENT OF FRANK J. MOYLAN, OMAHA, NEBR., REPRESENTING NEBRASKA POWER CO.

Mr. MOYLAN. My name is Frank J. Moylan. I am secretary and treasurer of the Nebraska Power Co. of Omaha, Nebr. I am here on behalf of that company.

The CHAIRMAN. Have you a brief that you would like to file with the committee?

Mr. MOYLAN. I have one that I would like to file later, but I will just make a few comments.

It is pretty difficult, Mr. Chairman, to say much different on the general condition of the industry other than has already been said here today.

We are, however, in the unfortunate class mentioned this morning as being subject to excess-profits taxes on what we consider just normal income. In that respect I should like to attempt to answer Senator Taft's question put to the previous witness.

Senator TAFT. Let me ask you the question, Mr. Moylan. If you take advantake of the average earnings credit, that credit, am I right in thinking that that credit for the 4 years represents a net income before Federal taxes?

Mr. MOYLAN. That is right; 95 percent of it.

Senator TAFT. If you take that credit now, why is it that you have an excess-profits tax—I cannot understand why the utility industry is forced to pay such a large proportion of its excess profits on such a large proportion of its income, and if it is, it seems to me it shows there is something wrong with the whole method of calculating excess profits, which I think applies to other companies as well as utilities.

Mr. MOYLAN. Senator, it does apply to these other companies if they are slow turn-over companies. The utilities, to get any additional net income since that base period of 1936 to 1939, have had to spend tremendous amounts of money for which they do not get any credit in that base.

Senator TAFT. You mean they get no credit for the additional capital invested since that time?

Mr. MOYLAN. That is right.

Senator TAFT. That might conceivably be appropriately added to the excess?

Mr. MOYLAN. I think it should be. But following your statement further, I believe that the utilities are being unfairly taxed in the increase in the surtax and normal tax as well as in the excess-profits taxes.

Senator TAFT. But you think the increase in the normal and surtax is a tremendous mistake in every kind of corporation, but that the utilities are not peculiarly hit in that.

Mr. MOYLAN. They are peculiarly hit in this way, that the utilities have always been subject to regulation; they have always had a ceiling. They have had no increases in rates since 1936 or 1939. They have absorbed not only all of the increased expenses of labor and everything that goes along in the regular operations of the company, but they have also absorbed the increases that have all come in as Federal income and excess-profits taxes. Other industries were able to get much of those expenses into their costs before the ceiling was placed, so that they are in rather a different position than the utilities are today. They are hit hard on the increase now, but they will have to stand in addition to that the increased taxes put on in recent years. That is one of the big differences, I believe.

Senator TAFT. And yet on the whole, your net earnings were just as good probably in 1939 as they were in 1935 or 1934.

Mr. MOYLAN. In 1939? You mean after taxes?

Senator TAFT. In 1939; after taxes.

Mr. MOYLAN. No; ours have continually gone down. I believe the general trend of all utilities has been down for several years. They went way down in 1929.

Senator TAFT. But I thought that since 1935 they had been pretty well maintained?

Mr. MOYLAN. They have been going down since then in our own case, and I think that is quite general.

Now, the Nebraska Power Co.—I should like to tell a few things about our own company. I have covered them more in detail in the statement that I would like to hand in later. We are serving practically 100 percent of the industries in the agricultural territory of the country in that area and consequently these industries are, for the most part, some type of food industry, such as flour mills and grain elevators, butter manufacturers, cold-storage plants, and packing houses. We have in Omaha 4 large packing houses to which we supply all of the electric requirements and, in addition, most of their live steam requirements. In addition, we serve large bomber plants, a shell manufacturing plant, a number of railroads including the railroad shops of the Union Pacific where many cars are being built, and 60 to 70 smaller manufacturing companies who are working on war contracts.

In conjunction with the Kansas Gas & Electric Co., we have just completed the construction of a high voltage transmission line from Wichita, Kans., to Omaha, and a distance of approximately 280 miles.

The cost of constructing this line was approximately $4,000,000 and it will guarantee an adequate power supply not only to the industries served by our company, but also to the airplane factories and other war industries in Wichita and other parts of Kansas.

We are also part of a power pool which is made up of some 10 or more companies and will supply the power requirements of a large aluminum plant in Arkansas.

Taking the period of 1936 to 1939, our company had average income taxes of $299,000 per year, an average net income or net earnings of $1,850,000 and we had an investment in plant and equipment of $36,600,000 as the average for that period.

That investment has increased up to June 30 of this year from $36,600,000 to $40,400,000, approximately 4,000,000, or 10 percent.

The income taxes and Federal excess-profits taxes in 1942 under the proposed bill will amount to $1,250,000 which is an increase of $950,000 or 317 percent over the base period, while our earnings for investors will decrease from $1,850,000 to $1,250,000 or $600,000 being a decrease of 32 percent. As stated here by several of the others who appeared, it is, of course, highly impractical to attempt to recover any of that loss revenue through an increase in rates.

As was pointed out, the excess-profits tax would take such a large portion of it that it would be entirely beyond reason.

In our case, for instance, it would take an increase in the rates sufficient to give us in excess of $6,000,000 more gross revenues, which is 60 percent or more above our present gross revenues, which total $9,700,000 so it is obvious that relief from that angle is completely out of the picture.

That leaves the only possible place for relief in the modification of the provisions of this act, and we sincerely believe that if something is not done, it is going to so strangle the utilities, that they will have an extremely difficult time in financing all of the additional equipment which they will require to continue the excellent job which they have been doing on the production end of the war effort.

Senator WALSH. Would it mean a suspension of dividends?

Mr. MOYLAN. It is getting very close to a cut in our preferred dividends, although we are still paying them. We have never missed paying preferred dividends since the company was formed in 1917.

The CHAIRMAN. Have you been paying them on your common stock?

Mr. MOYLAN. Yes, sir; we have.

The CHAIRMAN. You do not see how you are going to meet the common now and take care of the preferred?

Mr. MOYLAN. Naturally if it gets into the preferred, the common will have lost everything.

The CHAIRMAN. Thank you very much, Mr. Moylan. Your statement will be placed in the record.

(The statement submitted by Mr. Moylan is as follows:)

STATEMENT OF FRANK J. MOYLAN, REPRESENTING NEBRASKA POWER CO., OMAHA, NEBR.

To the Senate Committee on Finance:

This memorandum is submitted by the Nebraska Power Co., an operating electric utility company, rendering electric-utility service to practically all homes, commercial enterprises, and industries, including railroads, packing plants, a bomber plant, and numerous other companies engaged in war work in Omaha, Council Bluffs, and surrounding territory. The company is regulated as to rates.

We are suggesting modification of the present and the proposed revenue acts in order that public utilities, because of their peculiar situation, may not be burdened with more than their fair and reasonable share of the war taxes.

The Nebraska Power Co., along with practically all other utilities, is being seriously burdened by the rapidly soaring Federal income and excess-profits taxes now being or to be collected to help pay the cost of war.

It might be well to state at this point that due to all of the other electric utilities in Nebraska being publicly owned, the Nebraska Power Co. is the only electric utility in the State which is presently subject to Federal taxes of any nature.

The company is not suggesting that it should escape its fair and reasonable share of war taxes, nor are other utilities doing so. The reason for this statement is to call attention to the fact that as these taxes are now being collected, and as the new tax law proposes to increase them, the tax burden of this company and of all other utilities will be more than the fair and reasonable share that the utility industry, as compared with other industries, should carry.

WHY A 45 PERCENT INCOME TAX IS INEQUITABLE TO UTILITIES

Secretary of the Treasury Morgenthau stated a sound principle when he appeared before the House Ways and Means Committee a short time ago and said: "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."

Unfortunately for the utilities of the country, their customers, and their investors, nothing has been done, at least as yet, to provide against the hazards of which Mr. Morgenthau has spoken.

Public utilities unquestionably fall in the class of low-earning corporations referred to by Mr. Morgenthau, as the average rate of return, after depreciation of some 350 or more electric, gas, telephone, water, and street railway utilities for 1937 was a little less than 6 percent (New York Journal of Commerce, July 29, 1942). With the material rate reductions that have been made since that year, electric utilities at least are probably earning even less.

In the case of the Nebraska Power Co. the net revenue available for depreciation on plant and equipment and for interest, dividends, and surplus in 1937 amounted to 9.6 percent of the company's electric plant account. In 1941 this had dropped to 8.5 percent, or a reduction of 11.3 percent, and estimates for 1942 indicate that this figure is going to be approximately 7.5 percent.

A 45 percent tax on corporate net income might actually become a 100 percent tax on the stockholder if the effect of such a rate of taxation is seriously to impair the corporation's ability to pay a fair return to its investors. To tax a stockholder 100 percent on his income from corporate earnings would be a violation of the principles of taxing on a nondiscriminatory basis.

COMPARISON OF UTILITIES' SITUATION WITH OTHER INDUSTRIES

Many other industries, because of conditions hereafter stated, are in a much better position than utilities to absorb higher income taxes without undue sacrifice by their investors or hazards to their financial stability. Some of these conditions are:

(1) The ability of such industries more easily to raise the price of their products, while utility rates are subject to regulation and exceedingly difficult to increase. Increase in utility rates, even in these wartimes, are practically unknown.

Becaue of this close regulation, most utilities have, for some time, been feeling adverse effects of rising costs of labor, fuel and materials, as well as taxes, without the ability to obtain relief.

(2) The ability of such other industries, because of characteristics peculiar to their types of business, to rapidly increase the output of their products. These industries have offset the effect of higher taxes by sharp increases in their sales. On the other hand, public utilities, even in abnormal times such as the present, enjoy only moderate expansion in business, and such expansion is far from sufficient to counterbalance the soaring tax costs.

For example, while the gross sales of Nebraska Power Co. for the year 1941 were 14 percent higher than the average for the years 1936 to 1939, inclusive, Federal income and excess-profits taxes for the year 1941 were 142 percent higher than the average of those taxes during the base period; and net earnings available for dividends in 1941 were 15 percent lower than the average of such earnings from 1936 to 1939.

(3) Utilities require a plant investment of some $4 to $5 for each dollar of new business while most other industries require only $1 of plant investment for five or more dollars of new business. Consequently, financing at this time while not a serious problem for such other industries, is a major problem for utilities, in the face of rising costs and resulting lower net earnings.

Under the rate regulation to which utilities are subject, the investment required to obtain increased business yields no more than a fair return to investors even under normal conditions. Under the present and the proposed Federal income and excess-profits tax rates, utilities could not retain enough net earnings, from such new business, to pay reasonable depreciation on the investment in additional plant and equipment required to take care of such business, to say nothing of a return on that investment.

Nebraska Power Co.'s estimated net income available for dividends in 1942, under the proposed income and excess-profits rates, will be less, by $600,000 or 32 percent, than the average of such net income for the years 1936 to 1939, inclusive. At June 30, 1942, the investment of the company, in its property, was up nearly $4,000,000 or 10 percent over the average investment during the base period. If the income and excess profits tax rates, as proposed, are enacted into law, the Nebraska Power Co. not only will fail to obtain any return on this additional investment but will also suffer an alarming reduction in the return on the balance of its investment.

(4) Rates of return allowed by regulatory bodies on utility investments are considerably less than returns commonly earned by other industries, with the result that a high income tax is far more serious to the utilities than to other types of business.

Utilities have other special taxes, also, such as the Federal 3⅓-percent tax on electric energy sales, State franchise taxes, city occupation taxes, and the like, that are not assessed against other corporations. During 1941 Nebraska Power Co. paid a Federal 3⅓-percent tax on electric energy sales in amount of $188,000, a State franchise tax of $36,000, and an occupation tax to the city of Omaha amounting to $178,000. The sum of these three taxes which are applicable only to utilities was equal to 18 percent of the company's net taxable income before deducting these items.

UTILITIES CANNOT HAVE EXCESS PROFITS

The occasion for excess profits may be said to be more business at higher prices combined with greater use of the corporation's investment in plant and equipment with no great increase in costs other than direct labor and material costs. For instance, some manufacturers, in addition to obtaining materially higher prices for their products, are working the same plant three shifts, as compared with one shift in normal times, with only nominal increases in overhead costs. On the other hand, the characteristics of a utility business are such that the load factor (use of investment) has not been materially increased by war conditions; and present sales, in practically all cases, are at pre war low rates in spite of increased costs.

To complete the illustration, it may be seen, from the downward trend of its net earnings compared with its continually increasing investment, that the Nebraska Power Co. has had and will have no excess profits.

THE EARNINGS BASE, 1936 TO 1939, IS NOT A FAIR MEASURE

It seems contrary to all that is fair and equitable to declare as excess profits, subject to a rate of 87½ percent, net taxable income in excess of the average net taxable income for the years 1936 to 1939, without giving full effect to the increased investment required to obtain such additional net income.

In the case of most utilities the substantially increased normal and surtax rates (which under the proposed law would be applied to the amount of net taxable income comparable to the base period) would result in increases in Federal taxes which would far more than offset the increase in net earnings before income taxes.

If normal income and surtaxes were deducted from taxable net income, as in the 1940 act, in arriving at the amount of excess profits net income, there would, of course, be no earnings of such utilities subject to the excess profits levy.

SUMMARY OF EFFECTS OF PROPOSED TAX LAW ON COMPANY

In summing up the effects of the present and proposed rates of Federal income and excess-profits taxes on Nebraska Power Co., we find that—

(1) The 1941 earnings available for dividends were down $277,000 or 15 percent below those for the average of the years 1936 to 1939 while Federal income and excess-profits taxes increased $424,000 or 142 percent over the average of such taxes for the base period.

If the proposed new rates for these taxes were applied to 1941 taxable income the increase in these taxes over the base period would be $685,000 or 229 percent, while earnings available for dividends would be reduced by $538,000 or 29 percent from the average for that base period.

(2) Our figures for the year 1942—6 months actual and 6 months estimated—indicate that our Federal income and excess-profits taxes, at the proposed new rates, would increase $530,000 or 73 percent over those charged against our 1941 income while earnings available for dividends will be down $323,000 or 21 percent below those of 1941. Such 1942 taxes will be up $950,000 or 317 percent over the average for the base period, 1936 to 1939, while earnings available for dividends will decrease $600,000 or 32 percent from the average of such earnings during the base period.

(3) The company has made and will continue to make substantial increases in its investment since the establishment of the average earnings base, but the present and proposed laws give no effect to such increase in investment in determining the income subject to excess-profits taxes.

The combination of a sharp upward trend in taxes and an equally sharp downward trend in earnings is a source of great concern to the managements of all utilities.

SUGGESTIONS FOR CONSIDERATION OF COMMITTEE

In view of the peculiar situation of the utilities we respectfully suggest that your committee consider the following proposals:

(1) The normal and surtax rates applicable to regulated utilities should not be increased.

(2) The presently existing 1941 Revenue Act should be modified as follows:

(a) To give effect to the increase in investment over that of the base period, 1936 to 1939, when determining the amount of excess-profits credit as computed on the average earnings basis.

(b) To provide for the deduction of normal taxes and surtaxes, as provided in the 1940 act, in determining the amount of excess profits.

Respectfully submitted.

NEBRASKA POWER CO.,
By By F. J. MOYLAN,
Secretary and Treasurer.

AUGUST 10, 1942.

The CHAIRMAN. Is Mr. May present?

Mr. MAY. Yes, sir.

STATEMENT OF WILLIAM H. MAY, COMMISSIONER OF AGRICULTURE OF KENTUCKY, FRANKFORT, KY.

Mr. MAY. My name is William H. May. I am the Commissioner of Agriculture from Kentucky and my address is Frankfort, Ky.

Mr. Chairman, I desire to appear for 8 or 10 minutes as a friend of the committee, and after what I have heard all afternoon, I think it is badly in need of one. I have, in the past, appeared once before this committee and twice, I believe, or three times, before the House Committee on Ways and Means in protest of the increase on tobacco; that is, increase in the tax on tobacco.

In the few years that I have been commissioner of agriculture of the State of Kentucky, I have constantly and consistently opposed any proposal that increases the taxes on tobacco. When the Treasury proposals for additional increases were issued several weeks or months ago, I immediately obtained a copy of those proposals and began a study of them with agricultural leaders throughout our State.

After considerable study and consultation, it was agreed by that leadership and by us that it was the duty of the Kentucky Department of Agriculture to support the Treasury's proposal for taxes on tobacco.

One very inviting thing for our support was that a provision was made in that proposal for the salvation and saving of the so-called 10-cent cigarette, tobacco industry.

That industry had its beginning in Kentucky and has been a very sizable thing for us and we are very insistent that it continue as a thriving industry, and are very anxious that it continue to serve as a means of competition in the various tobacco markets of our State.

The proposal that this differential be granted by the Congress in the consideration of this tax bill has been challenged on the ground that it would be ruinous to the 15-cent cigarette manufacturers.

The vast majority of Kentucky's tobacco is sold to the 15-cent manufacturers and I have no desire to do anything that will drive that customer out of our State, but as a public official, I think I owe something to an existing industry and I owe something to a business that has brought competition into our tobacco markets that we heretofore did not have.

I have some rather interesting figures, even though you have been burdened with a lot of them here today—these are very brief, and I should like to call your particular attention to them. 1931 was the last year of unrestricted monopoly by the Big Three in the tobacco business, because in 1932 is when the 10-cent brands entered the field. In 1931 the Big Three earned for its stockholders $110,000,000 to be divided if they wanted to, among the stockholders.

Senator BARKLEY. What do you mean by the "Big Three?"

Mr. MAY. I mean the makers of Lucky Strike, Senator, the makers of Chesterfield, and the makers of Camels.

Senator BARKLEY. That is the American Tobacco Co., Liggett & Myers, and R. J. Reynolds Co.?

Mr. MAY. Yes, sir. I would like to further emphasize that to you. We had the lowest tobacco market in the memory of man. Our farmers received a little better than $8 a hundred pounds for their tobacco. That year those three companies earned for the benefit of their owners $110,000,000.

That same year they paid all of the farmers of the South a total of $88,000,000 for all of the tobacco that went into all of these cigarettes. They made in profits $22,000,000 more than they paid all of the farmers for all of the crops, for all of their labor, and all of the time of the farmers.

But that was the last year they had the run of the place.

The following year the 10-cent cigarette people come into the picture, they entered our markets and bid in our markets, and I have the comparison now for the year 1941, which is 10 years later. After 10 years of competition, instead of the industry accruing profits to itself of $110,000,000, those same three companies accumulated $65,000,000 and in that same year instead of paying $88,000,000 to the farmer for his tobacco, they paid him $332,000,000, which is $244,000,000 more that the farmer received with the 10-cent cigarette people in competition went into the picture.

Senator BARKLEY. Are these figures that you are giving what three companies paid, what the total crop brought?

Mr. MAY. They were the only buyers that year.

Senator BARKLEY. I mean your 1941 figures.

Mr. MAY. Fifteen percent can be deducted there if you so desire, for the purchasers of the other tobaccos.

Senator BARKLEY. What I am trying to get is whether the $332,000,000 includes——

Mr. MAY (interposing). That includes the 10-cent cigarette people.

Senator BARKLEY (continuing). Whether that represented only that amount paid by the three big companies, or is that the total?

Mr. MAY. That is the total.

Senator BARKLEY. Which the farmers received from all of the purchasers of cigarette tobacco?

Mr. MAY. Yes. What I am trying to emphasize is that the farmer's stake grew by $250,000,000, very nearly, because of the competition in the field; in other words, it is my conclusion that the competition caused it.

Senator BAILEY. But you overlook the fact that there was a great growth in the sale and consumption of cigarettes. You attribute it to one cause, whereas it may have been the consequence of a good many causes.

Mr. MAY. I might answer that by saying that in 1941, for this $332,000,000 the trade received 200,000,000 pounds less than they got for the $88,000,000. Does that correctly answer the Senator?

Senator BAILEY. Your argument was that just one simple fact of competition was what accounted for this enormous increase. As a matter of fact, there has been an enormous increase in the production and sale of cigarettes in those years, has there not?

Mr. MAY. There has been no increase in the prices to the consumer, despite the greater amount that they paid to the farmer.

Senator BAILEY. Added sales might just as well account for that as well as the competition.

The CHAIRMAN. Do you give the A. A. A. any credit?

Mr. MAY. Yes; I think they are entitled to the lion's share of the credit. I think they are, sir.

The point I was trying to make simply was this, that in 1931 at a time when tobacco was more or less stolen from the farmer, the time when everybody agrees there was no competition, and at the time when the Federal court records show there was none, I am trying to say that the cigarettes sold at the highest price in the history of the cigarette business, which was $6.85 a thousand, and the farmer did not get his just share of the profits. That is my argument.

In answer to Senator George's discussion of the A. A. A., I might say that unrestricted crop control would—or rather the lack of crop control—would be the end of the tobacco farmer. We are now growing about the equivalent of the disappearance in the tobacco business. For the first time the disappearance of tobacco is about equal to the production, which is a healthy situation.

The argument has been advanced in these hearings on the other side of the Congress that if you create this differential, thereby giving a chance to the low-priced manufacturers to live, that you immediately make all the cigarettes 10-cent cigarettes.

Well, there have been times more inviting than these for the 15-cent cigarette people to go into the 10-cent cigarette field. Camels were started in 1915 as 10-cent cigarettes. I don't think that you can show that it is a fixed rule, that all cigarettes would drop to 10 cents, because there is only one taxing authority in the United States that I know of where there is a differential, and that is the one created by the Kentucky Legislature in 1936. We recognized the necessity of that for the preservation of this industry and this competition, so in enacting our tax bill we provided that a 2-cent tax stamp should go on the 15-cent cigarettes and the 1-cent tax stamp should go on the 10-cent cigarettes.

After Congress in 1940 raised the tax on cigarettes 25 cents per thousand, the 10-cent brands began to disappear. They have dropped off constantly since, except in the State of Kentucky, where that differential was provided, and that was not done at the expense of the 15-cent brands, because they have progressed right along with the 10-cent brands. Their increases have been consistent.

This argument of a differential in taxes on tobacco is fundamental. It is purely fundamental. The committee is confronted with the proposition of raising revenue, and I do not think that you will find a single working laboring farmer who will come in here and tell you that he cannot bear this, because this does not come off of him. The consumer pays this tax. There is only one time that you can hurt the farmer and that is when you make the tax high enough so that you hurt the consumption of the product, and you have not got it high enough for that.

Senator BAILEY. Why wouldn't you hurt the farmer if you put a tax system that induced everybody to sell 10-cent cigarettes and buy 10-cent cigarettes?

Mr. MAY. I don't think it will do that. That is what I am arguing.

Senator BAILEY. Just the fact that a little addition to the tax in Kentucky did not bring it about is no reason for saying that a national policy won't bring it about.

Mr. MAY. If you make a better product, they will buy it. When you make a 15-cent cigarette and make it as good as it is now, it will be bought and sold by jobbers and sold to the consumers. When you make a 10-cent cigarette, you do not kill the 15-cent cigarette; in other words, the 10-cent cigarette is smoked largely by the fellow with a dime. I doubt if there is a member of the committee that smokes them. That is the fellow who smokes that 10-cent cigarette, the fellow with a dime. And I will tell you this—he is the fellow that needs help through all of this matter. His smoke is just as precious to him as the fellow who smokes the 15-cent cigarette.

It is the farmer that I am trying to speak for here today. We have 110,000 tobacco growers in my State. Two or three thousand of them have been to Senator Barkley's office in the last 15 or 20 years, I know, on the subject of tobacco, because they have had the money to come here and——

Senator BARKLEY (interposing). Your figures are modest. The last time we had this question of taxing the cigarettes up here, there were that many in Washington; they came by special trains.

Mr. MAY. Not of the kind of farmer that I represent. What I am trying to say is this, we have 110,000 tobacco growers in our State, and two or three thousand of them are the plantation type, the great big growers—they will manage to get here and make their desires known on this question. But the other 106,000 are the fellows with the patch in his overalls, that is the fellow I came to speak for here.

Senator BARKLEY. You said awhile ago that this increased tax would not hurt the farmers. I have for years been arguing against increases on tobacco products which now pay about $800,000,000, on the ground that the tobacco buyers, largely the big tobacco buyers used an increased tax as an argument in favor of keeping the price of tobacco down to the farmer. They went to the farmer to buy his crop and they said to him, "We cannot pay you any more because the Government is levying such a big tax." They made the farmer the goat. Legitimately and logically, the consumer ought to pay the tax, but I do know in many cases that the increased tax has been used by the big tobacco buyers as the reason why they should not pay the farmer more for the tobacco.

Mr. MAY. I have used the same argument and it is baseless.

Senator BARKLEY. In other words, it is logically baseless but as a matter of fact it has been used as a pretext to keep down the price.

Mr. MAY. Many things have been used to do that. The House hearings will show, Senator, that Mr. Clay Williams—with whom many of you are familiar—says in the record that the industry does not pay the tax and they never will—they will pass it on to the consumer—and the consumer, I am sure, has not been here asking you not to do this.

This committee is hunting money, and I have come here on behalf of the growers, the growers of nearly one-third of the tobacco of the country, to say that they do not care if you tax this tobacco.

Senator BARKLEY. We hear these chants in which it is claimed that each of these chaps that do the chanting have a better grade than any other type because they buy the finer and the higher grades of tobacco. If that is true, who is going to buy the lower grades and the less fine grades of tobacco—and there are many such grades?

Mr. MAY. I think the question is self-answering. Those are the grades that have gone into these 10-cent cigarettes. The Office of Price Administration has shown you clearly lately that the cost of the tobacco in the 10-cent cigarette is not as much as in a 15-cent cigarette. That is why it sells for less, and we do not think this Congress ought to make it pay an equal tax with its competitor. That is the basis of our argument.

Senator BYRD. If this differential is not established, what will happen to the 10-cent cigarette?

Mr. MAY. I am not in the business, sir; but I have made a sufficient study of it—and the people in my department have made a sufficient study to believe, that if you let this flat tax of $3.50 go through, that you have raised the bracket so high and brought them so closely together that the 10-cent brands are done. In other words, the 25-cent raise of 2 years ago just about finished them except where the Kentucky tax provided for that. My opinion is they will be gone, in other words.

Senator BARKLEY. And do you know the comparative profits made by the cheaper cigarette manufacturers according to the volume done, and the larger 15-cent brands?

Mr. MAY. Senator, I do not, but I can give you a rough outline of that by saying this, that the 10-cent cigarette industry is more or less domiciled in our State. The Axton-Fisher Tobacco Co., which I guess is the father of the 10-cent cigarette business, has been owned by at least 8 or 10 combines in the last 7 or 8 years since Wood Axton died. It has been owned by everybody from New York to San Francisco, which is proof of what is happening to them.

The Brown & Williamson Tobacco Co., which is another big manufacturer of 10-cent cigarettes, is in debt to the United States Government to a very great extent, which is well known to you.

And I would say this, that the 10-cent industry is faltering and practically gone.

Senator BAILEY. Brown & Williamson were a British institution, isn't that so?

Mr. MAY. It is my understanding that it was in a financing arrangement through the Reconstruction Finance Corporation, which was made for the convenience of the British Government. Now it is virtually an American Government institution.

Senator BAILEY. Who owns the beneficial interest is undisclosed.

Mr. MAY. I understand it is yet to be determined.

Senator BAILEY. You don't know who owns the beneficial interest?

Mr. MAY. I know that its board of directors and management is dictated by the R. F. C.

Senator BAILEY. It was a British institution taken over by Jesse Jones as an accommodation to the war situation, and I think he advanced them thirty or forty million which they advanced to the British Government account.

Mr. MAY. The industry is about gone. I can prove that.

Senator BARKLEY. They have not paid any million-dollar bonuses to any of their officers, have they?

Mr. MAY. No, sir. The year that that was so scandalous, that was in 1931, some stockholders of the Big Three later made them pay them back. I left that out of my figures because they were later repaid.

That constitutes about all that I have to say on this subject. I am probably guilty of treason to a State which is practically 70 percent agricultural in my position here, but I have counselled with my people and I have usually tried to represent them in this matter, and I have been consistent in opposing these taxes, and now I find what looks to me to be a time of stress and emergency when everybody must make a sacrifice, and I have come here in behalf of our tobacco growers to say that they are ready to do it.

One general conclusion for the benefit of the committee. I make it my business to know what public opinion is. Being an elective public officer that travels my State constantly I think I know a little about what people think, and I have rather elaborate machinery whereby I am able to determine what people think.

Senator BAILEY. You are almost equal to Dr. Gallup?

Mr. MAY. He is a little more precise.

Senator BARKLEY. You do a good deal of galloping throughout the State?

Mr. MAY. But to conclude, I want to very definitely state that my advice to the committee—if it cares to accept it—is that the public mind right now in my State, and my State represents very much what everybody in the country thinks—we are a little bit east, and we are a little bit west, and we are a little bit north and a little bit south—in the Civil War we gave 110,000 soldiers to the Union and 108,000 to the Confederacy, and we have always been pretty well mixed up in everything, but our State very clearly indicates its attitude in this matter. The farmer who works and the farmer who does the job, and not the farmer who spends all of his time in Washington purporting to be a dirt farmer, but the real farmers, those whose boys will do the bleeding and the dying in this war, he is the farmer that I represent.

Senator BARKLEY. Your position is that there must be increased taxes and you do not oppose them on this product which has been ever since World War No. 1 a large contributor to the Treasury; in fact, at one time it contributed one-sixth of the total revenue of the United States to operate the Government of the United States, and that if there is to be an increase in these taxes that that ought to be based upon a percentage increase rather than upon a flat rate?

Mr. MAY. By all means. And I believe the tax proposals of the Treasury are entirely bearable by the consumer and by the industry.

The CHAIRMAN. Thank you very much.

Mr. Robertson.

STATEMENT OF H. M. ROBERTSON, LOUISVILLE, KY., REPRESENTING THE BROWN & WILLIAMSON TOBACCO CO.

Mr. ROBERTSON. Mr. Chairman and members of the committee, my name is Harrison M. Robertson. I live in Louisville, Ky., and I am appearing here in representation of the Brown & Williamson Tobacco Co.

I have also been requested by the Axton-Fisher Tobacco Co. and the Stephano Tobacco Co., manufacturers of 10-cent cigarettes, to speak for them in the remarks I am about to make.

Senator BARKLEY. Stephano—that is a Philadelphia company—the last one you named?

Mr. ROBERTSON. Yes, sir. We are appearing to urge the enactment of the Treasury Department's proposal with respect to cigarettes. There are few figures I want to give with regard to the results of taxation of cigarettes, and I will not try to go into any oratorical ventures on this.

There has been a great deal said from time to time, and I believe there are many honest farmers who believe that any increase in the price of a package of cigarettes will result in a tremendous drop in consumption. For many years I myself thought that, but we have seen the taxes raised, we have seen the States put on taxes, and we have seen the consumption of 15-cent cigarettes go up.

My company manufactures both 15-cent cigarettes and 10-cent cigarettes. Sixty-five percent of our business is in the 15-cent and only 35 percent of it is in the 10-cent cigarette at the present time, because of the taxation that we have had to bear, which we consider unfair.

The tax on 15-cent cigarettes is only 130 percent of the manufacturer's selling price. On the 10-cent cigarettes, it is 250 percent of the manufacturer's selling price. The general theory of some people has been that this increase in price of any kind, whether it is due to taxation or costs, will result in a decrease of consumption. I want to show you by the facts as to what has happened all over the world that there is no decrease in the consumption of cigarettes—that is, the 15-cent cigarettes, which constitutes 65 percent of my company's business, if there is a change in price of about 1 or 2 or 3 cents a package.

Nobody knows where it happens. That is with this condition, if it happens at a time when there is large employment and high wages or a time of inflation.

I shall first take up the figures of this country at the time of the last war.

In 1916 the taxes on cigarettes were $1.25 per thousand. That is 2½ cents a package.

During the period from 1916 to 1919 the taxes were increased to $3 a thousand, or 6 cents a package.

The consumption in those years were—in 1916, 21,000,000,000 cigarettes; in 1917, 30,000,000,000 cigarettes; in 1918, 36,000,000,000 cigarettes; in 1919, 38,000,000,000 cigarettes; in 1920, 50,000,000,000 cigarettes—about 150-percent increase, with the taxes increased from $1.25 to $3.

The consumption of cigarettes is governed almost entirely by the purchasing power of the people at the time. A man will buy a cigarette almost before he will buy bread, and if he has got the money to buy it he will buy it, and the thing we have found to our great grief is that he will buy what he thinks is the best cigarette. He does not come to the 10-cent cigarette except in one case, and that is when he has not got the money to pay a higher price for it.

I should like to ask permission to file a statement taken from the records of the Internal Revenue Department giving the consumption of cigarettes.

The CHAIRMAN. You may file it.

(The statement referred to is as follows:)

Consumption of imported tobacco in Great Britain and Northern Ireland

Year ended Mar. 31—	Pounds	Per head of population pounds	Duty per pound	Approximate equivalent tax in United States dollars per thousand cigarettes at $4 to pound sterling
1924	128,810,070	2.89	8⅙ to 9 1/12 shillings	$4.25
1925	129,093,118	2.87	8⅙ to 9 1/12 shillings	4.25
1926	134,786,912	2.99	8⅙ to 9 1/12 shillings	4.25
1927	137,004,370	3.03	8⅚ to 9⅚ shillings	4.50
1928	137,902,933	3.04	8⅚ to 9⅚ shillings	4.50
1929	141,910,692	3.11	8⅚ to 9⅚ shillings	4.50
1930	151,470,548	3.32	8⅚ to 9⅚ shillings	4.50
1931	154,704,912	3.37	9½ to 10½ shillings	5.00
1932	145,455,740	3.16	9½ to 10½ shillings	5.00
1933	150,526,516	3.25	9½ to 10½ shillings	5.00
1934	152,160,308	3.27	9½ to 10½ shillings	5.00
1935	159,002,106	3.41	9½ to 10½ shillings	5.00
1936	168,757,383	3.60	9½ to 10½ shillings	5.00
1937	174,539,262	3.71	9½ to 10½ shillings	5.00
1938	187,909,696	3.97	9½ to 10½ shillings	5.00
1939	191,999,265	4.04	11½ to 12½ shillings	5.50
1940	200,550,035	4.21	17½ to 18½ shillings	[1] 9.00
1941	190,424,901	[2]	19½ to 20½ shillings	10.00

[1] As reported in the New York Times Apr. 15, 1942, Sir Kingsley Wood, the Chancelor of the Exchequer, stated that under the more than 50 percent increase in tax in 1940 the consumption of tobacco had increased.

[2] Figures not available.

NOTE.—On Apr. 15, 1942, the British tax was further increased 10 shillings per pound, 50 percent more, making the total tax there now 30 shillings, or $6 per pound, or about $15 per thousand cigarettes, or 30 cents per package.

Official figures from Bureau of Internal Revenue for fiscal years 1900 to 1933 as appears at page 95 in the Record of Tobacco Tax Hearings before the subcommittee of the Ways and Means Committee, March 27–31 and April 10, 1934

[Cigarettes weighing not more than 3 pounds per 1,000 (small cigarettes, class A)]

Fiscal year	Rates of taxation	Tax collected	Quantity tax-paid (number)	Average yearly consumption per capita (number)
1900	Effective June 14, 1898, $1.50 per 1,000	$3,953,177.09	2,635,461,393	35
1901		3,407,433.91	2,271,622,626	29
1902	Effective July 1, 1901, 54 cents per 1,000 when wholesaling at not over $2 per 1,000, if over, at $1.08 per 1,000.	2,655,974.88	2,642,961,944	33
1903		3,009,020.06	3,031,893,732	38
1904		3,203,334.67	3,226,682,261	40
1905		3,321,297.58	3,368,212,740	41
1906		3,728,949.97	3,783,266,213	45
1907		5,117,765.03	5,151,862,130	60
1908		5,346,603.75	5,383,204,630	61
1909		6,068,795.69	6,086,201,908	68
1910		7,921,284.90	7,863,215,808	85
1911	Effective July 1, 1910, $1.25 per 1,000.	11,541,513.00	9,133,210,400	99
1912		14,027,031.23	11,221,624,984	119
1913		17,845,963.95	14,276,771,160	149
1914		20,512,083.92	16,409,667,136	168
1915		20,925,596.14	16,740,476,912	169
1916		26,332,745.84	21,066,196,672	211
1917		38,127,168.93	30,501,735,144	299
1918	Effective Oct. 4, 1917, $1.65 per 1,000; Effective Nov. 2, 1917, $2.05 per 1,000.	66,370,961.45	36,931,539,378	358
1919	Effective Feb. 25, 1919, $3 per 1,000.	90,440,806.73	38,075,946,158	366
1920		151,208,481.61	50,408,827,557	476
1921		135,053,369.43	45,018,195,810	417
1922		150,127,514.62	50,042,874,873	455
1923		182,584,806.83	60,862,005,247	543
1924		203,661,330.58	67,884,238,780	595
1925		225,032,702.07	75,011,251,037	647
1926		254,824,808.19	84,941,702,929	720
1927		278,928,561.81	92,976,410,840	775
1928		301,752,588.34	100,584,522,083	831
1929		341,951,551.22	113,984,905,526	934
1930		359,816,274.69	119,941,342,857	975
1931		358,915,187.84	119,653,193,893	965
1932		317,533,080.02	105,850,336,916	847
1933		328,418,413.58	109,401,818,246	868

Average warehouse floor prices to farmers for 15-cent cigarette grades of tobacco and 10-cent cigarette grades of tobacco (U. S. Department of Agriculture figures), 1931–41, inclusive

PRICES TO FARMERS OF 15-CENT CIGARETTE LEAF TOBACCO GRADES

Year	Burley	Eastern flue-cured	Western flue-cured
1931	16.04	22.88	24.83
1932	(1)	27.15	29.08
1933	21.71	27.36	31.27
1934	26.78	37.92	42.37
1935	35.01	31.07	31.58
1936	61.71	35.11	41.50
1937	36.71	34.94	38.42
1938	27.00	31.44	33.33
1939	25.14	24.58	26.88
1940	28.71	28.11	32.25
1941	42.71	37.77	42.75

PRICES TO FARMERS OF 10-CENT ECONOMY CIGARETTE LEAF TOBACCO GRADES

1931	5.98	8.20	2.65
1932	(1)	6.70	5.89
1933	10.35	9.10	9.61
1934	15.23	14.63	13.37
1935	15.54	9.91	7.48
1936	38.00	8.71	9.08
1937	20.33	11.43	13.13
1938	16.02	15.58	16.60
1939	15.91	11.68	11.85
1940	17.21	14.21	14.13
1941	31.33	26.54	25.35

[1] Government figures not available.

Mr. ROBERTSON. In England, when this war commenced, they had a tax in 1938 of 9½ shillings to 10 shillings, which amounts to about $5 per thousand cigarettes. Immediately after the war they raised from 11½ to 12½ shillings, which amounts to $5.50. Later, in 1940, they raised from 17½ to 18½ shillings, which amounts to about $9 per thousand cigarettes. These are duty rates on the pounds of tobacco. In 1941 they raised it again from 19½ to 20½ shillings, which amounts to approximately $10 per thousand on cigarettes.

I do not have the official figures, but there was a statement in the New York Times in April of this year in which the Chancelor of the Exchequer said that notwithstanding that last increase, where the taxes were doubled, that more tobacco was smoked in England in that year than had been smoked when the taxes were only half as much. The Chancelor of the Exchequer wanted to stop the importation of tobacco, because they have not got the ship space for it, and they have raised it to 30 shillings per pound, which means that the tax is now some three times what it was prior to the war, and yet there has been no decrease of consumption. I think the 30-shilling rate will decrease consumption—which they all want.

I next come to the effect of State taxes. There are 28 States in this country that have imposed cigarette taxes. Those taxes are generally 2 cents per package of cigarettes. In some States, like Louisiana and Arkansas, they go as high as 5 cents.

There has been no evidence in our business, and on the figures that we get from the jobbers, there is no evidence in the business of other manufacturers that there has been any decrease in the consumption of the 15-cent cigarettes on account of these taxes. On the contrary, in the case of the 10-cent cigarette, which is a cigarette sold almost entirely on price appeal and which uses a kind of tobacco that had no market prior to the time that these 10-cent cigarettes came in, there has been a drop of from 25 percent anywhere up to 70 percent in Pennsylvania in the 10-cent cigarettes on account of these State taxes.

I should next like to mention the case of Canada. In 1938 and up until September 1939 Canada had a tax of $4 per thousand on cigarettes. Immediately on the war commencing they put it up to $5, and early in 1940 they put it up to $6 per thousand, and only recently they have raised it to $8 a thousand cigarettes.

The consumption of cigarettes in Canada, that is the tax paid cigarettes, in 1938 was 6,870,000,000. In 1939 it was 7,126,000,000. In 1940 7,573,000,000. In 1941 8,582,000,000.

So that notwithstanding this increase in taxes of more than 50 percent in Canada, in the year 1941 in which the tax was 50 percent higher than in 1938, the consumption had increased from 6,800,000,000 to 8,850,000,000 or almost a 30-percent increase.

So we come to the point that I know you would hardly think that a manufacturer would say this, that we believe that we can raise the tax, and we are very much interested in having the rates raised because of the fiscal conditions of the country, $137,000,000 more by following the Treasury plan than under the bill as enacted by the House.

Under the House bill which provides for a flat increase of 25 cents per thousand, there would be raised, according to the Treasury

Department's estimate, $51,000,000 of additional revenue. The Treasury estimates that under their scheduled proposal of $4 on 15-cent cigarettes and $3.50 on the 10-cent cigarettes that there will be $188,000,000 additional coming to the Treasury from cigarettes alone. We believe that is to our advantage.

But the principal, selfish interest I have is that we are for this differential to allow us to compete in the tobacco business. For 10 years we have made these cigarettes bearing a tax of from 230 to 250 percent under the 25-cent increase, whereas our competitors—and we are competitors of ourselves in our own 15-cent cigarettes with our 10-cent cigarettes—the 15-cent cigarettes have only borne the burden of from 115 percent to 130 percent. We believe that these 10-cent cigarette manufacturers being in the tobacco industry has had a good effect for the consumers, for the farmers and, I believe, for our competitors, because there are many things that they have not done since we have been in there which they used to do prior to the time that we were in there.

In the case of the farmer, I would merely like to cite briefly what has been the thing that has made the farmer's lot better. I am not saying that we did it all. but with the control program and with this competion that created these new markets for tobacco, what happened was that the grades of tobacco that constitute the greater part of the 10-cent cigarette have gone up in price since we have been in the market and furnishing this competition, over 600 percent. The grades of tobacco which predominate in the 15-cent cigarette have gone up only slightly over 100 percent.

Cigarettes, I should like to explain—I don't want to get into the technical part of the business—are generally composed in this way. We know it because we make both classes. The predominant tobaccos in the 15-cent Camels, or Lucky Strike, or our Raleigh, and the Kools and the Chesterfields are the higher grade of tobaccos, with some medium and perhaps some lower grade. The 10-cent cigarette has very little of the higher-grade tobacco. It has a substantial number of mediums and a lot of lower-grade tobaccos, and we are making competition all along the line, but we are also making a market for this lower-grade tobacco.

We make a good, smokable cigarette, but it is a cigarette for which there is no other market except to the people who cannot afford and will pay but a few cents for a cigarette. It is the people to whom a few cents' difference in the price makes a difference whether they will smoke cigarettes or not.

If we are not relieved of this unfair tax burden as we conceive it, if we have to continue paying almost double the tax rate to sell our cigarette than is imposed upon the higher-priced cigarette than the 10-cent cigarette, the economy brand cigarette has got to go off the market. It cannot bear that burden and continue under the price ceilings and maintain a differential that properly should be, as it is, advantageous for the farmer and for everyone because of the grades of tobacco that are in there.

What we are asking you to do is to enact this Treasury Department proposal and raise for the Government $137,000,000 more than the House proposal and give to these cigarettes a fair tax structure. And I particularly want to say that we are convinced that it will not hurt the 15-cent cigarettes, because the majority of our business is in the 15-cent cigarettes, and I think that we are selfish enough not to do anything that will hurt the majority of our business.

Senator BARKLEY. How many pounds of tobacco are there in a thousand cigarettes?

Mr. ROBERTSON. It varies, but it is generally said that there is 3 pounds of farmers' weight in a thousand cigarettes. The tax law itself says that cigarettes weighing not more than 3 pounds per thousand are taxed at such and such a rate.

Senator BARKLEY. That might include something else besides the tobacco, although the paper does not weigh much.

Mr. ROBERTSON. They weigh the cigarette with the paper on it, that is true.

Senator BAILEY. It takes 3 pounds of farmers' tobacco to make a thousand cigarettes.

Mr. ROBERTSON. These long cigarettes—the so-called king size—are the maximum. It is generally accepted that it is 3 pounds of farmers' weight to a thousand cigarettes.

Senator BARKLEY. What is the manufacturer's price on the 10-cent cigarettes and on the 15-cent cigarettes per thousand?

Mr. ROBERTSON. The manufacturer's price on the 15-cent cigarette is $6.53 a thousand less 10 percent, less 2 percent, which comes down to $5.76, from which there is $3.25 tax to be deducted and leaves the manufacturer $2.51 to deal with.

Senator BARKLEY. What is the manufacturer's price on the 10-cent cigarettes?

Mr. ROBERTSON. On the 10-cent cigarettes the manufacturer's price is $5.15 less 10 percent and 2 percent and less the tax of $3.25, which comes down to $1.29 against $2.51, and that is where the difference of taxes comes in.

Senator BARKLEY. Out of the $1.29, the 10-cent cigarette manufacutrer has got to pay his labor and expenses and whatever profit he gets?

Mr. ROBERTSON. Yes, sir; has has to pay everything.

Senator BAILEY. He has to buy the tobacco cheaper.

Senator BARKLEY. Can you tell the comparative scale of wages paid in the 10-cent cigarettes and in the higher-priced cigarette factories?

Mr. ROBERTSON. I think that the wages are about the same throughout all parts of the industry. The 10-cent cigarette industry does operate—Brown & Williamson and Axton-Fisher—what we call union shops. We have union contracts and we have union labor, but I don't think that we pay any higher rates of wages at the present time than the other companies.

Senator BARKLEY. At least the question is, do you pay as much? Is there a fairly level scale of wages in the 10-cent cigarettes the same as exists in the 15-cent cigarette factories?

Mr. ROBERTSON. Yes, sir; that is my understanding.

Senator BARKLEY. So that it is logical to suppose that there would be a difference in the margin after paying those wages out of the $1.29 left to the company, and the $2.51 on the 15-cent cigarettes?

Mr. ROBERTSON. Those margins—I don't think there is any question, because it has been found by the O. P. A. that the margin in a 10-cent cigarette is somewhere from 15 to 20 cents. I was thinking of the margin for selling, advertising, and profit. In the other cigarette, it is slightly over a dollar for those things. The profit on the 15-cent cigarette—I say this because we make both of them—as found by the O. P. A., even after all increased costs is 45 to 55 a thousand, and on the 10-cent cigarette it is from nothing up to 5 cents. It is nothing now.

Senator LA FOLLETTE. I am not so familiar with the various types of tobacco from the standpoint of the farmer, but am I correct in supposing that a farmer, for instance, in Kentucky or any other tobacco-growing region, is going to have tobacco of both the higher and the lower grades to sell at the end of his harvest?

Mr. ROBERTSON. Yes, sir.

Senator LA FOLLETTE. So that, from the standpoint of the farmer, the purport or the increased price, which has come as a result of the competition insofar as it was a factor, for the low-grade tobacco has helped all of the tobacco growers who grow tobacco for the cigarette market. Is that true, or not?

Mr. ROBERTSON. That is definitely true; and I am filing a statement here which shows, as I think I stated in my main testimony, that since we have been in competition and created a market for these so-called lower grades of tobacco, the prices of those tobaccos have increased from 500 to 600 percent. In other words, when this business was started those tobaccos sold from 5 to 10 cents per pound, and today those tobaccos sell from 20 to 25 cents a pound, and the tobaccos that in those days sold for 33 or 34 cents a pound are not selling for any more today. In other words, all of these averages for the farmers have been made, and what has put the money in his pocket, as Mr. May stated, the difference between the $88,000,000 and the $250,000,000, is because these low-grade tobaccos have gotten money for him. Of course, one farmer's crop might be better than another farmer's crop, due to different factors of land, soil, and cultivation, but there is no farmer, however good he is, who does not have some low-grade and some common and some medium tobaccos.

Senator BARKLEY. You have them on the same stalk.

Mr. ROBERTSON. Yes; you have them on the same stalk.

Senator LA FOLLETTE. That is all I wanted to bring out, because I think that those who are not familiar with the flue-cured tobacco might assume that one farmer might have a good type of tobacco exclusively, and another a medium, and another a poor.

Mr. ROBERTSON. All farmers have good, bad, and indifferent tobacco.

Senator BARKLEY. And since the Government has gone into the enterprise of helping to grade the tobacco scientifically, these differences are more varied and more numerous. I used to raise tobacco, and we had three grades: The leaf, the medium, and the lugs. The lugs were near the bottom of the stalk where it was close to the ground, and between that and the top was the medium. The leaf was at the top of the stalk. So that every stalk of tobacco contains three or four different grades of tobacco which has to be sorted out in the process of preparing it for the market; but since the Government has entered into the work of helping the farmers to grade their own tobacco and teaching them how to grade their own tobacco, there have been many more grades of all sorts of tobacco than there were prior to that program.

Mr. ROBERTSON. Yes, sir. The Government now grades the tobacco on the floors, so the farmer himself has something to go by.

Senator BARKLEY. During the period of the increase in the price of tobacco which goes into the 10-cent cigarette, that 10-cent cigarette price has still been maintained?

Mr. ROBERTSON. There has been only one increase in the price. Of course, when the 25-cent-a-thousand tax was added, that was passed on, because tobacco taxes are all passed on to the consumer. They only affect the processor and the farmer insofar as they affect the consumption.

You asked whether the prices of the 10-cent cigarettes were changed. Prior to the tax increase of 1940 of 25 cents a thousand, the 10-cent cigarette had a list price of $4.75, but on a list which has 10 percent and 2 percent off or $4.19 less $3 tax, or for the processor $1.19 for all his costs and expenses of every kind and for profit. With the 25-cent increase in it came to $5.03 I think it was. Then subsequently some of the 10-cent manufacturers—I think we were the first ones to do it—we went to $5.15, and that is the increase which was about 12 cents less 10 and 2 or the $1.29 to the maker.

Senator BARKLEY. That is the list price, and that is the price which the manufacturers got, but when the cigarette is bought by the consumer in the drug store or the tobacco store, does he still pay 10 cents for the package?

Mr. ROBERTSON. No, sir. When you put on a 25-cent tax, you put on a half a cent a package, and it was obvious that we could not absorb it, so the price generally went to 11 cents or two for 21. That was what the price in the general trade was.

Senator BARKLEY. But so far as the tax goes, if the increase is a flat tax, you have to add the same amount to the 10-cent cigarette package as is added to the 15-cent?

Mr. ROBERTSON. Yes, sir. I don't know how long we will be able to do it. We will be out of business in a little while if that is the case.

Senator BARKLEY. I am assuming that the 10-cent cigarette continues to be made. If you add the tax on it, it is the same tax that is added to the 15-cent cigarette.

Mr. ROBERTSON. Yes, sir; under the House bill.

Senator BARKLEY. And any other flat tax would be the same way?

Mr. ROBERTSON. In other words, that would be, as we view it, a continuation of this unjust and unequal method of taxation that puts more burden on the man who can least afford to pay for these cigarettes. He is the fellow that wants to buy his cigarettes for 10 cents, or 11 cents. As soon as you give a fellow more money—I don't like to say this for advertising purposes—but as soon as you give him more money, he will buy these 15-cent cigarettes, and that is the reason it will not affect the business of the 15-cent cigarettes. We just see our customers going on account of that.

It is an unfair method of taxation that imposes a greater burden on the consumer who cannot afford it than on the man to whom a few cents does not make much difference.

Senator BYRD. If the 10-cent-cigarette manufacturer does not secure this lower-grade tobacco, what market would there be for that?

Mr. ROBERTSON. Prior to the time of the 10-cent cigarette, there was no cigarette market for that tobacco.

Senator BYRD. Could the grower sell it for any other purpose if the 10-cent-cigarette manufacturer did not take the poorer grades?

Mr. ROBERTSON. They sold it for 5 or 6 or 7 or 8 cents a pound prior to the time of the 10-cent cigarette. It might go to the fertilizer companies.

Senator BARKLEY. It went to somebody for whatever purpose he could use it.

Senator BYRD. This was the only time it got a proper price, was when it was sold to the 10-cent-cigarette manufacturer?

Mr. ROBERTSON. Yes.

Senator BAILEY. You say that the 10-cent cigarette brought out an increase in income to the farmer, but the facts are against you. The average price for the 10-year period 1920 to 1930, which was before you had the 10-cent cigarette, was $21.32 a hundred pounds. In 1931 to 1940, the last 10 years, and since the 10-cent cigarette came in and we have had the controlled program, with the benefit of all the Government policies, nevertheless the average was, during that period, 17.6. There is a difference in favor of the 15-cent-cigarette period of nearly 5 cents. Those are the figures that I have from the Department of Agriculture.

I have the same thing here about the flue-cured in North Carolina. From 1921 to 1930 flue-cured, prior to the introduction of the 10-cent cigarette, the 10-year average was $20.42 a hundred; 1931 to 1940, 10 years subsequent to the introduction of the 10-cent cigarette, the average price is $18.13 a hundred. That is a difference of 2⅓ cents. That is data which I will give you if you want it, from the Department of Agriculture.

Senator BARKLEY. But in making up the average for the latter 10 years you take into consideration the fact that 1931, 1932, and 1933 and until the price of all tobaccos, smoking and others, was increased, you have got the lowest prices that the farmers have received for probably a quarter of a century; 1931, 1932, and 1933, the burley type of tobacco, as well as other types of tobacco, was being produced in my State below the cost of producing it.

Senator BAILEY. I can take the 8.7, which is the low point of 1931, and put that in the first period—that is the flue-cured—and the average, taking that 8.7, which is the lowest price, and throwing that into the period prior to the introduction of your 10-cent cigarette, the average then for the pre-10-cent-cigarette period would be 19.3, the subsequent period of 1932 to 1940 is 18.6; and still it shows that the period prior to the introduction of the 10-cent cigarette, the average for the farmer in the 10-year period was more than it was in the period since. There are the figures from the Department of Agriculture.

Mr. ROBERTSON. But Senator, there is a point there. The 15-cent-cigarette manufacturers claim that they use only the very high-type quality. They pay more for it than anybody else. If you will take the average of the top grades in 1931 through 1939, which is the market that they still control, you will see that the average of those tobaccos is what has brought down this average. The common tobaccos, the medium tobaccos, the 10-cent-cigarette tobaccos, have gone up four or five or six times.

Senator BAILEY. Notwithstanding all that you say, tobacco sold for more in the 10-year period prior to the introduction of the 10-cent cigarette than it has sold for any 10-year period since. You can argue anything you please, but those are the facts from the Department of Agriculture.

The CHAIRMAN. Did any of those low-grade tobaccos go abroad prior to the time the 10-cent cigarette was begun in this country?

Mr. ROBERTSON. I would not be competent to answer that, Senator, but from my general knowledge I would say that some of it did.

Senator BARKLEY. There are certain types of heavy tobacco that found their market abroad to the extent of 85 percent, none of which go abroad now at all.

The CHAIRMAN. How about cigarette tobacco?

Mr. ROBERTSON. I was at one time connected with a company which had a business in which they sent over 100,000,000 pounds of tobacco a year to China, and since the war in China started, I think you could put all of the tobacco that now goes to China right on that table there.

Senator BAILEY. That was very cheap tobacco.

Mr. ROBERTSON. Yes, sir.

The CHAIRMAN. Who commenced to manufacture the 10-cent cigarette in this country?

Mr. ROBERTSON. There was a 10-cent cigarette made prior to 1932 by the Phillip Morris Co. called the Paul Jones, but they were not aggressive competitors. I was informed by their officials that they did that to work off a lot of tobacco they had. The Brown & Williamson people were the next in 1932, which was at the time of the depression and a good time to sell a 10-cent cigarette, and our volume went up enormously. Then Axton-Fisher came in, and then Stephano Bros., and then I believe the Lorillard Co.

Senator BAILEY. What is the volume of the 10-cent cigarette today compared with the total volume?

Mr. ROBERTSON. We estimate that it is from 10 percent to 12 percent of the total volume today—only 10 to 12 percent of the total volume.

Senator DANAHER. Were the Treasury rates arrived at in consultation with representatives of the industry?

Mr. ROBERTSON. I at one time spoke to the Treasury officials about it, but whether they had any other consultation, I don't know.

Senator DANAHER. Do you know what happened in the House that these changes have resulted in the disparity you complain of? How were these rates arrived at in the House?

Mr. ROBERTSON. I don't know. The committee voted out a flat increase of 25 cents a thousand to raise $51,000,000. What happened there is certainly not of record.

Senator BAILEY. The House voted for that determination because of the provisions in the rates on cigars which were testified to here the other day. Tobacco is selling at 5 cents a pound in Pennsylvania. Our whole system is based on a poundage tax, and you run at once into that thing. You put the 10-cent cigarette people into the 15-cent cigarette market.

Senator DANAHER. There is something peculiar about it. The two-for-a-nickel rate on cigars is increased under the House bill 25 percent, while on the 5-cent cigar the rate of increase is 250 percent, although the price of the cigar in competition is only double.

Senator GUFFEY. The two-for-a-nickel cigar accounts for 88 percent of all of the cigars made in this country. If you lose that market, you lose your big cigar revenue. The income, if you lose that, you will have to get from the expensive cigars.

Senator DANAHER. Is a nickel cigar an expensive one?

Senator BARKLEY. Are you talking about wholesale or retail prices?

Senator BAILEY. The price still determines the volume.

Senator DANAHER. There is something odd about those rates.

The CHAIRMAN. Did you say that you were speaking for Mr. Stephano?

Mr. ROBERTSON. Yes, sir. Stephano Bros., of Philadelphia. He said that he would like to appear just to make some little short statement, but the main statement represents his views, as well as ours.

The CHAIRMAN. I would like to finish this subject tonight. We will hear Mr. Stephano if he wishes to make a statement.

STATEMENT OF WILLIAM C. ALEXANDER, REPRESENTING STEPHANO BROS., PHILADELPHIA, PA.

Mr. ALEXANDER. Mr. Chairman and gentlemen, Mr. Stephano does not care to speak and I am speaking in place of him. I am a director of the company as well. I have nothing further in particular to add to what Mr. Robertson has said, other than the fact that our experience has been that since the increase of the tax from $3 to $3.25 in the Revenue Act of 1941, our sales in connection with the sales of all other manufacturers of the so-called 10-cent cigarette have declined, and we feel that in view of the fact that the cigarette is purely a price cigarette, that the industry is in jeopardy by any tax that does not give us the same differential that we would formerly have from a price standpoint.

Persons that buy the economy cigarettes are, as Mr. Robertson has just said, people who buy it from a price standpoint, and the difference between 10 cents and 15 cents is, of course, a great difference, but without that difference, when it disappears, the result is as has been stated.

I merely want to add that we feel in the same position as Mr. Robertson, that the industry is in jeopardy unless we have some substantial protection by way of a differential in the tax.

The CHAIRMAN. Thank you, sir.

Is it the determination of the committee to adjourn until tomorrow morning?

Senator BAILEY. You have Mr. Lanier and Mr. Caldwell on this cigarette tax, and I think it would be best to go over until tomorrow. It is 10 minutes after 6 o'clock now.

The CHAIRMAN. We have an unusually large number of witnesses tomorrow. We have several that we have not heard today.

Are there any witnesses on this list who prefer to file a brief with the committee rather than remain over until tomorrow? There is a possibility that you would not be able to be heard tomorrow.

Senator BAILEY. Are you going to have the remainder of the tobacco witnesses in the morning?

The CHAIRMAN. Sometime tomorrow. They will have to go to the foot of the list, and that is the reason I made the inquiry.

Mr. STRONG. I will file a brief and be very brief orally if I may.

The CHAIRMAN. You spoke to me earlier in the day. You may file your brief and make a statement now if you wish.

STATEMENT OF HOMER STRONG, ROCHESTER, N. Y.

Mr. STRONG. My brief is very brief and I will leave it with you. I will merely read the summary. I am not here objecting to any taxes. I have a feeling that we are in the position where we are not limited to just what we are proposing to tax today; we have to tax for a great many years, and we should make this tax bill such that we can continue that taxation until the war is out of the way and paid for.

The summary of my brief is this:

1. Broad and high individual taxes upon true income; allow credit for expense incurred in obtaining income; eliminate credits and debits for capital losses and gains.

2. Tax corporations heavily, but allow for reasonable profit for incentive and dividends. Provide some form of refund for reconstruction to peace activity. Recognize the tax burden upon the common stockholder of corporate and personal taxation.

3. A broad sales tax which will produce substantial returns and will result in reducing the price of necessities.

I firmly believe that a sales tax will keep the price of the ordinary, every day needs, that we use and wear, down. I think without a sales tax the consumer will pay more than he would with a sales tax attached.

The CHAIRMAN. Thank you very much. Your prepared statement will be incorporated in the record.

(The statement is as follows:)

STATEMENT OF HOMER STRONG, ROCHESTER, N. Y.

Senator George and members, Senate Finance Committee: My purpose in appearing before you is based on the desire to present some constructive ideas that may be useful in framing the tax bill now under consideration.

I assume your objective is to write a bill that will produce as large a return as is consistent with the necessities of the individuals and the vigor and stability of the corporations who will pay the taxes required.

1. *As to individuals.*—The tax should be as high and as broad as our economic safety permits upon every taxable income. But only on true income either from personal earnings or from investments. Specific allowances should be granted for expenses incurred by individuals in obtaining such income. Credits for capital losses and debits for capital gains should be eliminated.

2. *As to corporations.*—Each corporation is primarily a partnership of individuals, of which there are in this country approximately 15,000,000 common stockholders. With few exceptions the taxes paid by the corporation comes out of the pocket of the common stockholder. The earnings paid out to the bond holders and preferred stockholders are largely unaffected. The corporate capital consists of the savings of individuals plus the savings retained by the corporation and these savings should be protected and some recognition given these stockholders who really bear the brunt of the corporate taxes. This can be done in a small measure by relieving common stock dividends from the personal normal tax.

I have no complaint against heavy corporate taxes to the extent of some reasonable basis that would not discourage the highest grade of management and economic operation. The excellence of management should be definitely encouraged. Bluntly, if the taxes are such that it makes little or no difference to the net corporate profits as to the cost of production, waste and extravagance will creep in and increase the cost of the product and the Government will pay this extra cost out of the taxes collected. What we lose in modifying full taxation we will more than make up in the lower costs of products and in volume of reasonable rates.

If the corporation is protected to the extent of reasonable returns on capital invested and sufficient insurance against loss due to governmental conversions, the balance is largely available for tax payment. Specifically the insurance against loss on Government business can be met by some form of reserve. A certain percentage of tax refund has been suggested which I believe is justified in theory but its actual application should be carefully studied. If and when these refunds become payable by the Government we must assume that it will be in a period of reconstruction and that the Federal Budget will be out of balance, consequently the payment of these refunds would be an added burden upon the Treasury.

I venture a suggestion that you require corporate investment in Government bonds of the proposed refund as such refunds accrue. It could be made effective by allowing this refund only to companies which adhere to such investment and only for so long as such investment remains intact in the hands of the company interested. The bonds to be medium term and negotiable. The policy being that each corporation would accumulate such bonds and have them available when peace is declared, to market from time to time as new funds are required.

3. *Sales taxes.*—I favor a broad adequate sales tax collected either by retailers or manufacturers. In answer to the objection that this would fall heavily upon the low income brackets I venture to suggest that the cost of necessary supplies for these brackets would be less with the tax imposed than without it. I firmly believe that the imposition of such a tax would result in a lower range of prices than would obtain if no tax were laid and that the difference in the price level would be in favor of the buyer, which would more than offset the tax imposed.

SUMMARY

1. Broad and high individual taxes upon true income. Allow credit for expense incurred in obtaining income. Eliminate credits and debits for capital losses and gains.

2. Tax corporations heavily, but allow for reasonable profit for incentive and dividends. Provide some form of refund for reconstruction to peace activity. Recognize the tax burden upon the common stockholder of corporate and personal taxation.

3. A broad sales tax which will produce substantial returns and will result in reducing the price of necessities.

Respectfully submitted,

HOMER STRONG.

Dated AUGUST 12, 1942.

STATEMENT OF JOHN HARRINGTON, ASSOCIATE COUNSEL, ILLINOIS MANUFACTURERS' ASSOCIATION

Mr. HARRINGTON. I am appearing for Mr. James L. Donnelly, of the Illinois Manufacturers' Association.

The CHAIRMAN. Mr. Donnelly is not here?

Mr. HARRINGTON. He is not here. I am the associate counsel of that organization, and our matter is largely cumulative to what has been said here before. I think that we will be perfectly willing to file a brief rather than repeat the statements.

The CHAIRMAN. Thank you, very much. You may file your statement and it will go in the record.

Mr. HARRINGTON. We feel that the 45 percent rate is too high and that 40 percent normal and surtax is the very top that a corporation can bear, and that the excess-profits tax rate should not be higher than 80 percent. Our other points are set forth in the brief.

The CHAIRMAN. Thank you very much. Your brief will be incorporated.

(The statement is as follows:)

STATEMENT OF JOHN HARRINGTON, ASSOCIATE COUNSEL, ILLINOIS MANUFACTURERS' ASSOCIATION, ON H. R. 7378

My name is John Harrington and I am the associate counsel of the Illinois Manufacturers' Association. I am here to present the suggestions and recommendations of the Federal tax committee of the association in connection with H. R. 7378 now pending consideration before this committee.

The Federal tax committee of the association is composed of approximately 80 executive of Illinois industrial firms including both small and large manufacturers. The committee has given careful study to H. R. 7378 and respectfully submits their suggestions and recommendations to this committee.

1. The committee recognizes the need for increased taxes for the successful prosecution of the war, and knows that Illinois industry is prepared and willing to assume its fair share of the enormous additional tax burden which the successful prosecution of the war program contemplates. The committee further believes that now more than ever before nonessential Government expenditures should be drastically reduced. The committee unanimously indorses the conclusion of the Byrd congressional committee now engaged in the investigation of Government expenditures that: "Before the war economy in nonessential spending was important; now it is vital. There is no room for nonessentials in a Government stripped for action." Unnecessary nonmilitary expenditures should be eliminated.

2. We recommend that the normal and surtax on corporations with net income of $50,000 be established at 40 percent instead of the 45 percent provided in the pending bill. There are many corporations whose business has not been in any way increased by the war effort. In fact, there are many whose business has been materially decreased. A tax of 45 percent on the net income of these corporations is too great.

3. The excess-profits tax rate should be fixed at a maximum of 80 percent instead of the 90 percent as provided in the bill. Normal taxes and surtaxes of 40 percent and excess-profits taxes of 80 percent are the maximum which should be taken from corporations.

4. There should also be provision for a refund of a portion of the taxes in the post-war period, such as was tentatively proposed by the Ways and Means Committee of the House of Representatives. Practically all corporations will be faced with either obsolete plants or plants which have been kept in a state of disrepair due to lack of necessary materials and skilled labor, and will also be faced with depleted inventories for peacetime production due to the lack of available materials. It is also unlikely that there will be any backlog of capital available to remedy the situation or to meet the enormous problems which will arise in the post-war transition period. The problem of recently formed corporations which have not had any opportunity to accumudate surpluses will be paricularly acute.

5. The capital stock tax and the declared value excess-profits tax should be eliminated. These taxes at best are nothing more than a guessing contest engaged in by corporation officials. While it may be true that in normal times the guesses can be moderately accurate, in the present times it is utterly impossible for corporations to attempt in the middle of the year to determine even approximately what their annual net income will be. The tax has no relation to real excess profits. There is no sound basis whatever for these taxes.

6. The provision that 75 percent of the average of the best 3 years' earnings during the base period 1936–39 may be substituted for the poorest years' earnings in the base period should be restored. The base period was subnormal for many corporations, and the inclusion of this relief measure eliminates some of the inequalities imposed on such corporations. It is true that there are some general provisions for relief of such corporations in the bill, but it is very difficult and burdensome in practice to establish to the satisfaction of the Treasury Department that the cycle of a particular corporation was actually not typical.

7. Losses on sales of buildings and similar real property improvements should be deductible in full in the same manner as similar losses on the sales of ma-

chinery and equipment. They should not be treated as losses on capital assets as they are in the bill. The present bill provides that such buildings and real property improvements be treated as capital assets and therefore impose the application of holding periods, limitations of deductible losses, and loss carry-overs. Previously losses realized on the sale of such assets were deductible in full as ordinary losses. Such treatment recognized the possibility that they might be due to an improper application of depreciation rates, and since depreciation would have been allowed in full in prior years, losses on these assets upon disposition should also be allowed in full. The enactment of such a restrictive provision as contained in the present bill may impose a hardship on many corporations now being forced to dispose of buildings because of lack of materials to carry on normal operation. It would seem logical to treat losses realized on sales in the same manner as similar loss on machinery and equipment.

8. A provision permitting deduction of annual additions to a reserve for inventory losses should be included. The Treasury Department proposed the inclusion of such a provision. The purpose of this provision is to prevent the taxation of inflated profits which may never be realized. Profits realized on the basis of normal prices would be taxed in the usual manner. The inclusion of such a provision in the 1917 and 1918 Revenue Acts avoided—at least in a large measure—inventory price losses such as were sustained during the post-war period in 1919 and 1920.

An alternative method would be to allow losses to be offset against prior years' profits which would result in refunds of previously paid taxes. However, in our opinion, the reserve method would be preferable both from the viewpoint of the Treasury Department and the taxpayer.

9. The provision in the pending bill that fiscal year taxpayers be assessed at different tax rates if the taxable period embraces years with different laws should be eliminated. Thus a taxpayer for the fiscal year ended June 30, 1942, would pay a tax based on 1941 rates for 6 months' income and at 1942 rates for 6 months' income. This provision will work a great hardship on corporations having a fiscal year different from the calendar year. Corporations have been urged for many years by accountants and others to adopt the natural business year for the fiscal year. The advantages of such a method are found in the preparation of financial statements, estimates of tax liability, taking of inventory, and planning and control. The provision in the bill would place a wholly unexpected and unjustified burden on such corporations and would do an irreparable damage to their financial position. It is difficult enough for a corporation not to know the applicable tax rates until late in the taxable year—the situation becomes impossible when the rates of taxation are not known until long after the taxable year is over.

The CHAIRMAN. If there are no other witness who wish to enter their briefs or statements, the committee will recess until tomorrow morning at 10 o'clock.

(Whereupon, at 6:15 p. m., the committee recessed until 10 a. m., Thursday, August 13, 1942.)

REVENUE ACT OF 1942

THURSDAY, AUGUST 13, 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. Senator McCarran, do you desire to appear this morning?

Senator McCARRAN. I desire to appear for a brief statement before the committee bearing on the subject of taxation as it affects the mining of strategic metals and war-essential metals. I shall make my statement quite brief.

The CHAIRMAN. Thank you very much, Senator.

STATEMENT OF HON. PAT McCARRAN, A UNITED STATES SENATOR FROM THE STATE OF NEVADA

Senator McCARRAN. Mr. Chairman, I appear before your honorable committee by authority and direction of the Committee on Silver of the Senate, which committee after having held hearings throughout the West, authorized this appearance.

Briefly, let me say that the Senate Committee on Silver directed that a subcommittee should hold hearings at various places in the West, because silver comes as a byproduct of war-essential and strategic metals that are demanded today by the War Production Board in furtherance of the war effort. For that reason we went into the subject at length, holding hearings in the West—Reno, Nev., Salt Lake City, Utah, and Denver, Colo.

Before leaving Washington, and as chairman of the subcommittee, I requested of Mr. Donald Nelson, the Chairman of the War Production Board, that he should delegate some member of his Board to attend the hearings with the committee and to interrogate, if he saw fit, and to participate as he might see fit.

Mr. Donald Nelson was exceedingly gracious in that respect and sent to attend the meetings with the committee an outstanding mining engineer who is the head of the Mining Branch of the War Production Board, Dr. Wilbur Nelson. Dr. Nelson attended our meetings at all three places and participated in the meetings to some considerable extent and otherwise investigated for himself.

Before leaving Washington, I requested the Secretary of the Treasury that he might send someone whom he would designate from the Treasury and also someone from the Bureau of Internal Revenue to sit in with the Senate committee and attend these hearings, that they might hear first-handedly from the mine operators, the mine executives, and the miners of the West engaged in the production of strategic metals what the problems were that caused the falling off of the production of these metals, if there was a falling off.

The Secretary of the Treasury designated an expert from the Treasury, Mr. Campbell, and an expert from the Bureau of Internal Revenue, Mr. Andresen, and those two gentlemen, together with Dr. Nelson, sat in at the hearings at the various places where we held the hearings.

Before leaving Washington I also requested the American Mining Congress to send representatives to sit in with us at these hearings, and they sent their tax expert, Dr. Fernald, and their executive secretary, Mr. Conover, to attend these meetings, and they too sat in and participated in the meetings.

These hearings were held, Mr. Chairman, commencing at Reno, Nev., on the 16th and 17th of July, and Salt Lake City, Utah, on the 20th and 21st of July, and at Denver, Colo., on the 24th and 25th of July.

These hearings are very recent, and I come representing the committee to present in narrative form and very briefly, if you please, what took place there over some 6 days of hearings held at these various places.

The result of those meetings was this: The meetings were attended by the Governors of the respective States, by the mine superintendents, and mine owners and mine operators and mine foremen, and the miners in each State, and likewise at Reno, Nev., at Salt Lake City, and at Denver, the representatives of the mining industry from the neighboring and adjoining States attended the meetings and testified before the committee—from California, from Washington, Oregon, New Mexico and Arizona, Utah, Idaho, Montana, Wyoming, and Colorado.

All of the Intermountain States were represented by mine operators or mine executives at these hearings.

The object of the hearings was that we might present to this committee the conditions that today, as I state it to be the fact, which are retarding the production of war-essential and strategic metals.

First of all, let it be understood without qualification that the War Production Board is doing everything in its power to urge the mine industry of America to produce, and produce to the limit, war-essential metals.

Mr. Chairman, I make the statement that you can tax or accumulate money by taxation until the end of time, but money accumulated will not win this war. It requires metal to win this war and that metal, by reason of the sinkings that are taking place on the waters surrounding our country has today made it apparent, must come from home production, otherwise there is going to be as there is now, a shutting down of production of war essentials.

We are all interested in what affects the production of war-essential metals such as copper, lead, zinc, manganese, and the like.

With that in mind, we interrogated and had statements made. There are certain agencies that are today retarding these productions. That was disclosed to the Senate committee sitting in these hearings, and I desire to disclose it to this committee. One is the present tax structure, the present tax organization. Let it be remembered that a mine of war-essential metal or a mine producing mineral that will produce in turn war-essential metal is of itself of short life. The average life of a mine producing war-essential or strategic metals in America does not exceed 5 years. It requires the investment of private capital to develop and produce war-essential metals. No war-essential metal has yet been produced excepting perchance on isolated cases by loans from the Federal Government.

Otherwise none has been produced by the Federal Government. Private capital is the one and only thing that will produce these metals, and therefore we must encourage the investment of private capital. The mining industry is one of the most hazardous industries in the world. I say "hazardous" because it is only one mine out of seven that makes good. The other six are liable to be and are, as a rule, failures.

The one mine out of six requires someone who has a venturesome spirit and the courage to hazard his fortune to produce, and so anything that retards private investment in mining retards the production of war-essential and strategic metals.

The present tax structure, the present tax make-up, the present tax law is retarding the investment of private capital in mines producing war-essential metals.

Why? Because, first of all, there is an urge to produce and thus shorten the life of the mining property. That being true, the whole investment comes into a smaller time space. Then when you say to an investor that he will put up a half a million dollars for the development of a mine and that mine has been proven by geologists and experts to have a certain quantum of war-essential minerals, and he is told that when he produces 90 percent will be taken away by way of excess profits, he immediately backs away from the venture, because the venture is 75 percent against him to begin with, and when the other 25 percent is hazarded into an excess-profits bracket that he knows he is going to have the Government take away from him, he immediately backs away from the proposition.

Now, Mr. Chairman, in 1940 the Congress gave promises to those who were engaged in the mining of war essentials that we would not exact an excess-profits tax from them, and with that promise we have the investment of private capital, but Congress, in 1941, went back on its promise to those who invested, and went back on this industry, and again exercised or imposed the excess profits, and today we are confronted with it.

That is one thing specifically that is retarding the production of war-essential metals. Of that, operator after operator, miner after miner, foreman after foreman throughout the mining region of the country, testified.

There are other agencies that are retarding the production of war-essential metals. It must not be said that this one agency of taxation is the only retarding agency, but when you take the other agencies and consider them at the same time that you are examining this retarding influence, then you will look upon your tax activity in a different light.

The labor problem today is affecting the production of metals from the mines. Today we find the Government in competition with the miner. I say the Government because Government money is going into these agencies that are enticing and inducing miners to leave the mines where they are getting perhaps $7 to $7.50 a day, and to go into industries where they can get $14, $15, $16, $20 a day. So when we take the labor situation and the fact that the workers are leaving the mines to go into more profitable walks of life, and then with that, we say we will impose another and an additional burden upon them by way of taxation, you can see the discouragement that now prevails in the mining industry in America.

I return to the subject and return to the statement that unless we do produce metal in this country, we are going to have a shutting down of the industry where war essentials are produced in the way of tanks, ships, planes, and the like.

There is another retarding influence to the mining industry that addresses itself to this committee and that is the excise tax on freight.

I note that the Secretary of the Treasury recommends the elimination of that element. Mr. Chairman, by all means it should be eliminated, because it is a burden on the mining industry that exerts itself on many values.

First of all is the ore that is shipped from the mine to the first treatment plant, which is impressed with that penalty.

Second, the ore that is shipped to the treatment plant is impressed with the penalty of the tax on the freight on the coke and the coal and oil and other instrumentalities that must be brought to the treatment plant for the treatment of the ore.

The ore carries all the burden of that freight excise tax, and that is a discouragement to the mining industry.

All of these things brought together, first of all, the labor, the freight tax, and then your excess-profits tax, together with the hazard that is naturally attendant upon the industry itself is the cause of what was related to the committee of the Senate at Salt Lake when a representative, I think an outstanding representative of the smelter industry of America, testified that their tonnage sent to them for treatment had fallen off nearly 50 percent within the past year. When he stated further that the value of the ore per ton of ore treated by that smelter had fallen off very materially, the reason for that is, first of all, the lack of opening up of new mines because investment will not hazard its money; secondly, the falling off of labor for the production; and thirdly, the fact that by reason of the imposition of your excess-tax policy there is being no money laid away by the mine operators for the development of new ore.

And so the ore bodies in the mines already in existence and working are rapidly falling down in grade, because the production of metal from the smelters is falling off.

Mr. Chairman, in order to bring this matter to a curtailment, because I realize that you have a great number from out of town who wish to be heard, may I say that we join in the recommendation, first, that the mining operations be accorded the same allowance as to depletion as is accorded new oil operations. There could be no reason for saying that there would be a difference. Every ton of ore that is taken out of the mine lessens the value of the mine. It is never restored. That is the end of that ton of ore in its place in the mine. That value of the ore at the mine has just the same value as it has in a ton of oil, and so the same allowance at least should be given for depletion.

Second, that the base period of income of mining operations should be computed on the average of 3 out of 4 base-period years, obtaining such an average by dividing by three.

Third, that adequate allowance be made to a mining operation by which there may be established a reserve fund, nontaxable, for development of new ore bodies now so urgently needed.

That must appeal to the committee and it must appeal to the taxing agencies, because unless development takes place in a mine that is surveyed for new ore bodies and the development of ways to take new ore bodies out goes on it is only a short time until the activity of the mine must come to an end, and so a nontaxable fund should be permitted to be invested in the development of new taxable property, if you please.

Fourth, that special treatment be accorded to those mining operations of strategic materials which were exempt from the excess-profits tax by the Revenue Act of 1940, as well as other mines of short or uncertain life which have been brought into production to meet war needs, and that there be no Federal tax either of the nature of income or excess profits or from the proceeds of such operations until the capital investment is recovered.

That brings me back to the question of the hazard that is ever present in mining operations The mining business itself is of the most hazardous nature, and unless we propose to say to private capital that it will not invest at all in this industry—and that period is rapidly approaching—we should say that if an investor hazards a million dollars in the development of a mine he should be assured of the return of that money, without interest and without profit, before any tax, excess or otherwise, applied.

And then one more point, Mr. Chairman, that I leave with you, and I leave it with you with great urgency, and that is the elimination of the excise tax in freight, because that is the penalty that is ever reaching into every avenue in which the ore or the product of the ore, the product of the mine, goes.

Mr. Chairman, you will not consider a more essential subject during your deliberations, because metal is a thing that is essential to this war. The sinkings that are taking place in the waters around our country are such that we are not receiving ores nor metals from abroad, as we did in times past. We must look for production at home, and in order to look for production at home we must encourage the investment of private capital, and in order to encourage the investment of private capital in this all-essential industry we must lighten the tax burden and relieve them of the intricacies and conditions that now retard their investment.

Mr. Chairman, I am grateful for the opportunity of appearing before you. I have made my statement as brief as I could, considering the field that I had to cover. There is present with me Dr. Wilbur

Nelson, the head of the Mine Division of the War Production Board, who attended our meetings. I have asked the doctor to be present just to present a very brief statement that I ask that he be permitted to make following my conclusion.

I thank the committee.

(The following letter and telegram were submitted by Senator McCarran:)

UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
August 19, 1942.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C.

MY DEAR SENATOR: In keeping with my statement, made before the Finance Committee recently, may I draw your attention to a telegram which I have received from Mr. George B. Thatcher, which telegram is attached hereto. I would appreciate this letter and the attached telegram being made a part of the record in connection with my appearance before the Senate Finance Committee.

Mr. Thatcher is formerly the attorney general for the State of Nevada, and is now attorney for many mining concerns of the West.

The statements contained in Mr. Thatcher's wire are borne out by the many statements and declarations made before the subcommittee of the Committee on Silver of the Senate, of which subcommittee I have the honor to be chairman, and which committee held hearings in three central points in the West, at which hearings representatives of the mining industries were present in large numbers.

Respectfully,

PAT MCCARRAN.

Enclosure.

[Telegram]

RENO, NEV., *August 15, 1942.*

Hon. PAT MCCARRAN,
United States Senate, Washington, D. C.:

We have it here on most reliable authority that United States Vanadium will shortly curtail approximately 30 percent of its production of tungsten at its Pine Creek plant in Inyo County, Calif. This is the largest plant in the United States and now mills 1,300 tons per day. This curtailment will be brought about because of the inability to get and keep labor. The price of tungsten today is less than it was in 1937. Such properties can be kept going only with an increase in the price of metal and relief from taxes if the increased cost of labor is to be met. This same situation applies to the largest producer in the State of Nevada, the Nevada Massachusetts, where they are unable to obtain sufficient labor to carry on a proper development program.

GEORGE B. THATCHER.

The CHAIRMAN. Very well, Senator McCarran, we will be glad to have Dr. Nelson come around. We are pressed for time, but we will be glad to hear you, Dr. Nelson.

STATEMENT OF DR. WILBUR A. NELSON, ADMINISTRATOR OF THE MINING BRANCH, WAR PRODUCTION BOARD

Dr. NELSON. Mr. Chairman and members of the committee, I am Wilbur A. Nelson, Administrator of the Mining Branch of the War Production Board, and I want to say just a word in connection with mine taxation on behalf of that board. I am not a tax expert and I have no suggestions to make as to specific measures in the field before this committee.

The War Production Board is concerned with the output of the Nation's mines and is anxious that nothing be done which will interfere with the production of minerals, essential to the war program. We realize, of course, that you are aware of the importance of increasing mineral production and that you are ready to give the W. P. B. every assistance in its efforts to that end.

My purpose is to emphasize the fact that some tax measures may definitely affect production. Such measures include depletion allowances, the determination of excess profits, amortization, taxes on freight and express shipments.

In the last year we have lost many of the foreign sources for the supply of such strategic minerals as tungsten, chrome, and manganese, metals which were once the subject of special consideration in the revenue law, and we are more than ever dependent on the development of mines yielding these minerals in the Unitel States. The production of copper, lead, zinc, and other metals must be increased.

The complexity of the mining industry is such that I do not believe that it would be practicable for the Government to undertake the exploration and development of these mines. It follows that we must and do rely on the mining companies to find and recover the tremendous quantities of metals that are needed for the guns, tanks, and various other things, factories, and ships.

The position of the Board is simply stated by saying that we want every incentive given to the exploration and development of the Nation's mineral resources, and we ask this committee's expert cooperation in avoiding any action on taxes which will unduly discourage the industry in its efforts to produce for war.

The CHAIRMAN. Thank you very much, Doctor. When this excess-profits tax act was passed this committee and the Senate—I think this committee and at least many in the Senate—were in favor of an exemption from the excess-profits tax of so much of the profits as were derived from mining tungsten, quicksilver, manganese, platinum, antimony, chromite, and tin, and I throw it out as a suggestion now that we might be able to go that far but we were met with the demand to put in gold and tremendous mining operations that were well established, and we were not able to carry that load in conference. If the mining industries of the country will accept that friendly admonition I think something along that line may be done; I think this committee realizes that something should be done.

Dr. NELSON. I am certain the committee agrees with the War Production Board that no action should be taken on taxation which will adversely affect the production of our mines.

The CHAIRMAN. No, sir; you are quite right about that. At least, I am sure that every member of the committee feels that way about it.

Thank you very much, Doctor.

Senator BAILEY. Can you finish with the tobacco people now?

The CHAIRMAN. I suppose it is fair to recall the witnesses who were left off of yesterday's schedule. There were four or five of them, and the first of them is Mr. Lanier. They are at the bottom of today's list, but they were really here yesterday and waited patiently.

Mr. Lanier, will you come around and finish the subject we were on yesterday, and be as brief as you can, consistent with the essential points you wish to present to the committee.

STATEMENT OF J. C. LANIER, GREENVILLE, N. C.

Mr. LANIER. Mr. Chairman and members of this committee, there are only two of us who are here to speak this morning on the subject that I will talk about, and that is tobacco. We had no notice that this matter would come before this committee until about 2 days ago, and we have not had time, nor did we particularly desire to bring a large delegation representing the tobacco growers before this committee. I will be very brief, but I would say for the record that my name is J. C. Lanier; I live in the largest tobacco-growing county in the United States. My business is the gowing of tobacco. I own or operate five tobacco farms in North Carolina.

Senator BARKLEY. You are not the auctioneer, the tobacco auctioneer named Lanier who is on the air?

Mr. LANIER. No, sir; I am on the other side of the row when they sell tobacco, Senator. I don't know him.

Senator BARKLEY. Do you know what your tobacco is being bid at when he is auctioning it off?

Mr. LANIER. Yes, sir.

Senator BARKLEY. Do you understand that Esperanto language?

Mr. LANIER. Yes, sir; I certainly do. And if it is not what I like, I know how to change it.

I would like to say to the committee that I have 70 acres of tobacco this year. I am deeply interested in the growing side of tobacco, and to show that I have a right, I think, to speak for the tobacco grower, I am a member of the State Grange Tobacco Committee in North Carolina.

Of course, I am a member of the Grange. I am State senator from my county, elected by the tobacco growers of that county.

Senator DAVIS. What county are you from?

Mr. LANIER. Pitt County, sir. In 1933 I was called to Washington by the A. A. A. to work for a year with Mr. Hudson on the tobacco question and, without boasting, I will say that the first contract that was written for the protection of the program for the tobacco growers—I wrote it. And the Smith Act, which is the foundation of all protection for tobacco growers, I had a large part in writing that. In 1937, when we had the question of the adoption of the new program under the new Farm Act, for 16 days and nights, I spoke all over North Carolina and Virginia and South Carolina in favor of that program, and so I think I have a right to tell you gentlemen that I represent the tobacco growers.

Last year, over a thousand growers came to Washington before the Ways and Means Committee from Senator Barkley's State and from Georgia and from Florida and from all tobacco-growing States.

Senator BARKLEY. Was that last year?

Mr. LANIER. Yes, sir. About the last of February, I think it was. And I happened to be chosen as the spokesman to present their combined opposition to increased taxes on tobacco, and for several times, including this committee at one time, I have been here before you to oppose any further increase in taxes on tobacco.

I am in the rather anomalous position this morning of having to take the other side of the people who, all these years, have helped me fight an increase of taxes on tobacco, and I don't just believe, could not believe that there were some tobacco growers from my State or Kentucky, or any other tobacco-growing State, who would come here today and say that they now favor an increase in the tax on tobacco when all these years they have opposed it, and have been to Washington to fight it.

I am not interested in the competitive fight within the industry as between the 10-centers and the 15-centers any more than it affects me in selling my tobacco, and I want to be sure that the farmer, those of us who grow tobacco, are not the pawns in this fight within the industry.

Yesterday it was stated by a very fine gentleman who represents a British company that in 1931 the three large companies had a monopoly in tobacco in this country. In fairness to this committee, I want to tell you that that is not the fact. In the flue-cured area covering Georgia, Florida, North Carolina, South Carolina, and Virginia, in all those years, approximately two-thirds of all of the tobacco was bought by English companies, and they were the dominant factor in the price structure of tobacco over all those years, and the records will show that from 1912, when I first had a little connection with tobacco, on through the years, that two-thirds of the flue-cured tobacco has consistently gone abroad—been bought by foreign companies, and shipped abroad—and while I hold no brief for any of the companies, I will say that the fact is that in September 1931 England went off the gold standard and by reason of the dollar exchange between that and the pound, the English got the price on flue-cured tobacco down more than 50 percent and we got the lowest price in the history of the industry, and that was together with the fact that we were in a depression in this country.

Senator BARKLEY. What proportion of the cigarette tobacco—I am not talking of the flue-cured only but all types of cigarette tobacco—in 1931 was purchased by the British interests?

Senator DAVIS. Was that depreciation caused by the rate of exchange between Britain and the United States?

Mr. LANIER. Yes, sir. I am citing that that had a very depressing effect on tobacco. Two-thirds of the flue-cured tobacco, cigarette tobacco over the years, has gone abroad. Very little Burley goes abroad, but there are 2 pounds of flue-cured more than usually to 1 pound of Burley. That is rough. So if you take two-thirds of flue-cured and one of Burley and give flue-cured a weight of 2 and Burley 1, you would get the answer there as to how much went abroad.

Senator BARKLEY. I will get a table and figure it out.

Mr. LANIER. I cannot figure that out in my head.

In 1933, when the 10-cent cigarettes reached the peak of their production, the price of Burley tobacco that was raised in 1933 and sold in late 1933 and 1934 was nearly as low as it was in 1931. It went down below the cost of production and sold for 10.5 a pound in Kentucky, and I was sent to Kentucky when pile after pile of good tobacco, Burley tobacco was selling for a dollar a hundred, and the warehouse got 75 cents a hundred and the farmer got 25 cents, and by reason of an agreement, not with the buying companies, but with the warehouse men, we were able to raise the prices of tobacco in 1933 to $2.75 a hundred.

I give the 10-cent cigarettes credit for filling a definite place in the market, but I don't concede that the well-being of us who grow tobacco will be served when you have to depress the price to a point where they can buy it and sell it at a profit and at the present time, gentlemen, the markets have opened in Florida and Georgia and in South Carolina and in the border of North Carolina, and the price for that end of our crop, the skimmed-milk end, which goes, as they say to the 10-cent cigarettes, is selling so high that my personal observation—and I know the facts will bear me out—is the 10 cent brands are buying less than 2 percent of the tobacco that is now bringing to us farmers, and we hope it will go on up—I sincerely trust—to my section of Carolina and Virginia to where we were getting the best price that we have ever gotten with the exception of possibly 1919 and 1937.

Senator BYRD. What is the price you are getting?

Mr. LANIER. The latest figure I had on the Fairmount Market—that is a large market on the border, was 42 plus—forty-two-and-some-odd cents a hundred.

Senator BYRD. What growth are you speaking of?

Mr. LANIER. That is the average. With the tops at 49 which shows there can't be much cheap tobacco.

Senator BYRD. I understood you to say that the cheaper grades had gone for a very high price?

Mr. LANIER. Yes, sir.

Senator BYRD. They are types 12, 13, 14, and 15?

Mr. LANIER. Yes, sir; the same types of tobacco.

Senator BYRD. What is the reason they have gone up so?

Mr. LANIER. My answer to that is that by reason of the weather conditions that have very definitely diminished the quantity, and by reason of the fact that the Government this year has gone into the market to buy 300,000,000 pounds to turn over to lend-lease, and by reason of the great increase in the domestic consumption of tobacco the crop is a hundred million pounds short of the demand for it. That has made the prices skyrocket.

Senator BARKLEY. Is it true that the price over a period of years of the lower grades has increased by a larger percentage than the higher grades?

Mr. LANIER. Yes, sir; that is true. In the years past, we sold this low-grade tobacco to China. We had a market for over a hundred million pounds of flue-cured tobacco of the very low grades in China and that has been where it has been going until the war between China and Japan broke out.

Senator BYRD. To what extent do you give credit to the 10-cent cigarette for increasing the price of these lower grades of tobacco?

Mr. LANIER. I think that they have had some influence on the price, but this is an industry or a segment of the industry that uses not more than 5 percent of the entire tobacco crop and it could not control the price of the crop.

Senator BYRD. Nobody contends that, but are they not a very considerable factor in the lower grades of tobacco?

Mr. LANIER. Yes, sir; they do.

Senator BYRD. What proportion of the lower grades of tobacco does the 10-cent cigarette consume?

You are putting it on the total, and that is not a fair basis because they do not buy the good grades of tobacco.

Mr. LANIER. They sometimes buy some pretty good grades; they do not buy the lowest grade of tobacco—that goes into chewing tobacco, and then the pipes.

Senator BYRD. The types of tobacco that they buy, as I understand it are numbers 12, 13, 14, and 15, are they not?

Mr. LANIER. 11, 12, 13, and 14. That is the flue-cured.

Senator BYRD. And that is the so-called lower grades of tobacco?

Mr. LANIER. No, sir; that is the type of tobacco as distinguished from burley and air-cured and dark-air cured, and all of that. That is merely a designation of the type of tobacco that is grown and of the grade of tobacco.

Senator BARKLEY. There are some sixty-odd grades of tobacco, as I recall.

Mr. LANIER. They are the Government grades.

Senator BARKLEY. Government grades?

Mr. LANIER. Yes, sir.

Senator BARKLEY. And they are designated by numbers?

Mr. LANIER. BL-3, BL-4, CL-3, CL-4.

Senator BARKLEY. They go up as high as 32 in some grades?

Mr. LANIER. In numbers?

Senator BARKLEY. Yes.

Mr. LANIER. No, sir.

Senator BARKLEY. What is the highest number in any grade?

Mr. LANIER. Senator, they divide the tobacco according to the way it came off the stalk, and they give it a CL-1, CL-2, and CL-3 for the leaf and DL-1, DL-2, and DL-3 for the lugs and LL-3 and 4 for the tops. They don't go up to 32.

Senator BARKLEY. I have seen in a great many of the agricultural reports much higher numbers than those. I don't know that they designate the grades particularly.

Senator BYRD. Are there certain definite grades that the 10-cent cigarettes are bought for?

Mr. LANIER. They buy certain grades of tobacco. They are not exclusive buyers of that grade of tobacco.

Senator BYRD. What I am trying to get at is, What percentage of those certain grades are used by the 10-cent cigarettes?

Mr. LANIER. I would say as an estimate, 20 percent.

Senator BYRD. 80 percent are used in other ways?

Mr. LANIER. Yes, sir.

That would be my estimate.

The CHAIRMAN. Are you objecting to any differential on the great bulk of tobacco?

Mr. LANIER. Yes, sir.

The CHAIRMAN. Because that means an increase in the tax?

Mr. LANIER. It means first that we feel that tobacco is bearing more than its share of even war taxation, that tobacco will pay this year into the Treasury of the United States in excise taxes not counting State and municipal taxes, more than $900,000,000; that the proposed rate of tax—the only farmer's product, aside from grain that goes into alcohol, that bears a tax. And we think that that is an exorbitant tax, but we are not here to fight it; we are merely here to ask that you not raise it higher to cure a competitive situation that exists within the industry because we know that if, by reason of the differential, that there is any considerable shift of smoking from the 15-cent cigarette, the so-called standard brands, to the lower brands, that every time you shift a pound of tobacco from the 15-cent class to be consumed over here in the 10-cent class, you have cost the tobacco growers 15 cents a pound.

Senator BARKLEY. I might ask you this for information.

Why will a differential of 50 cents, or any reasonable amount, shift of tobacco from the 15-cent cigarette to the 10-cent cigarette?

Mr. LANIER. Well, Senator, my answer to that would be that if it does not make that shift it will do the 10 centers no good, and that if it does make that shift the farmers will be the ones to pay the bill.

Senator BARKLEY. Let me ask you this: This is a question of economics and major finance, but is one that has some common sense to it, after all.

Can you continue to increase by a flat rate a tax on any commodity, where there are various prices, without ultimately running the lower price out of business, unless it increases its price to the public?

Mr. LANIER. I would answer that by taking the case of cigars——

Senator BARKLEY. Well, of course, as a matter of fact, tobacco and liquor are the only two commodities taxed by the Federal Government where there is a flat rate on it. Everything else is practically on a percentage basis.

Mr. LANIER. I thought there were others.

Senator BARKLEY. There may be one or two. Let us take automobiles. We put a tax on that, the percentage based according to the sale price. Obviously, it seems to me that if you put the same tax upon what used to be a Ford, and has now become an automobile, if you put the same tax on a Ford that brings five or six hundred dollars, that you put on a Packard that brings $2,000, from the standpoint of consumption, you are automatically injuring the sale of the Ford, aren't you?

Mr. LANIER. I would think so.

Senator BARKLEY. And the same is true of other things. Why wouldn't that same rule apply to tobacco?

Mr. LANIER. That is the very thing that we are up here about.

In that case, of course, by a differential, you would drive more people to buy Fords than you would Cadillacs, and we are fearful that if you put this differential on tobacco that you will drive more people to the 10-cent tobacco class, and out of the class of people who, according to Government figures, can pay us a living price for our tobacco.

Senator BARKLEY. That might depend on the amount, but where under the present tax, the amount left to the 10-cent manufacturer is

$1.15 per thousand, to the manufacturer of the 15-cent cigarette it is $2.15, would a differential of 50 cents really result, as you fear?

Mr. LANIER. Senator, the cigarette people and the wholesalers and the retailers have been able to absorb the two last increases on the standard brands of cigarettes without adding to the cost to the consumer, that is, without being sold at the loss-leader prices by any legitimate cigar and cigarette stands, the last two increases in the price of standard brands of cigarettes have not caused an increase in prices to the consumer. They still sell at 15 cents.

Senator BARKLEY. Let us suppose, just for the sake of argument, that we raise the tax the equivalent of 10 cents per package. When it got to that point, of course, that would be the same as the price of the 10-cent cigarette to the public.

Mr. LANIER. Yes, sir.

Senator BARKLEY. And therefore, it would either have to add that 10 cents or it obviously could not do business, paying a 10-cent tax on a 10-cent article. When that point was arrived at, the other cigarette would still have a 5-cent margin, which may give some general idea of the effect if these taxes still go up on a flat rate applied to the two different classes of cigarettes. That is a subject on which we could all have different opinions.

Mr. LANIER. I would like to state that I am through except for the questions, but that this matter of the differential is not a new question. In 1934, the House Ways and Means Committee appointed a subcommittee headed by that distinguished gentleman from Kentucky, Mr. Fred Vinson, who investigated the question of a differential at length and reported in opposition to any differential in the price of cigarettes, and that is available.

We sincerely believe, the people of my area, that if you gentlemen make this differential in the tax on cigarettes at this time, the price of tobacco which is now selling already in South Carolina, will break 10 cents a pound and will be back below the parity figure that the Government has guaranteed to the tobacco growers, and we would have to come back to this Congress for another subsidy to be paid out of the Treasury when now, under the set-up which presently exists we are out of the dog house and away from the eight-ball.

The CHAIRMAN. Let me ask you, how many standard cigarettes are sold? You have the 10-cent brands and the 15-cent brands, which is the standard cigarette, and then what is there above that?

Mr. LANIER. Very few.

The CHAIRMAN. If you start a differential, if you start the differential game, you are going to run it up and down on all of the grades?

Mr. LANIER. You have to do it on various grades of chewing tobacco and on various grades of smoking tobacco.

The CHAIRMAN. You would have to do the same thing on liquor according to the price.

Mr. LANIER. Yes, sir; it looks like that to me. It was pointed out by the cigar where the differential was originally a tariff to protect American-grown tobacco, because the imported tobacco goes into the high-priced cigars, and the first basis of the differential on cigars was to protect the American grower of cigar tobacco, and the result has been that 90 percent of all of the cigars—88 percent, I believe, they said yesterday—is now in the low-priced bracket, and tobacco is selling at 5 cents a pound.

The CHAIRMAN. Let me ask you one more question. This question has been aggravated for quite a number of years, as you have said. In all of the States that grow tobacco, is there any State outside of Kentucky that makes a differential between cigarettes?

Mr. LANIER. None, so far as I ever heard of—I will state it that way.

Senator BARKLEY. That is no argument against it?

Mr. LANIER. No, sir; I am just stating that I do not know of any.

The CHAIRMAN. I think it is a pretty good argument because the States that grow tobacco know pretty well what effect this kind of a differential would have on their product.

Mr. LANIER. I believe as sincerely as I believe anything, Senator, that I am making a fight for your burley growers, just as much as I am for the farmer in Florida and in Georgia. Out in Mount Sterling and Owensboro and Paducah and Henderson—I have been to all of those markets there—those people came here over a year ago over yonder and appointed a committee and they asked me to come up and make an argument against increased taxes, and if they were here today they would make the same argument and oppose this raise in the tax.

Senator BARKLEY. I have no doubt of your sincerity in this matter. I took that position when a large delegation was brought up here 3 or 4 years ago by a special train.

I have opposed the increase in taxes on tobacco on the very ground that you have mentioned here, and I even introduced a bill reducing the tax on tobacco when tobacco was bearing the only World War No. 1 rates that were being borne by any commodity in the United States, and I am not committing myself one way or the other on this differential. I am trying to find the best thing to do, and what the facts are, and yet I cannot help but wonder how long we can continue to raise the tax on tobacco by a flat rate without ultimately injuring somebody who is legitimately in the business.

That is all I am trying to find out.

Mr. LANIER. Yes, sir; and I have always said that they had a legitimate place in this business.

I would like to close by calling the committee's attention to this fact, and I think that it is within the proprieties, that at the present time the English Government discriminates against our tobacco in that it charges us 49 cents a pound duty extra on our tobacco that goes into England as against the tobacco raised in Canada or in any other dominion; and, to me it does not seem to lie well in the mouth of the British company to come to an American Congress and ask that they be granted a subsidy in this country for the products that they make as against an American institution.

Senator BARKLEY. Of course, we do the same thing with respect to some commodities that come from Cuba and Puerto Rico and the Philippines and the Hawaiian Islands. We have granted a special subsidy to imports into this country from another country for which we are responsible. We did that before Britain made this discrimination against our tobacco. So we have set the example.

Mr. LANIER. Thank you.

Senator DAVIS. How many pounds of tobacco go into cigarettes?

Mr. LANIER. In this country I would say approximately 600,000,000 pounds.

Senator DAVIS. How many different counties in the United States are there that grow cigarette tobacco?

Mr. LANIER. Well, cigarette tobacco is grown in 14 States or more. It is grown in Florida, Georgia, North Carolina, South Carolina, Virginia, Ohio, Illinois, some of it; a little in Missouri, in Kentucky, Tennessee, and a little on the fringes, Alabama, and so on.

Senator BARKLEY. Let me ask you this question, Mr. Lanier. I know you are an expert tobacco grower. I was, as they used to say, raised between two rows of tobacco stalks myself.

On every stalk of tobacco grown, there are at least three grades of tobacco, is that correct?

Mr. LANIER. Yes, sir.

Senator BARKLEY. Maybe more?

Mr. LANIER. There will be more.

Senator BARKLEY. There are more. There are expert growers who say that there may be at least a dozen grades on the same stalk, because there are that many different leaves. The 15-cent cigarette buyers purchase what they call the finer and the lighter grades. I believe that is the description of your friend Lanier down in North Carolina.

Mr. LANIER. I certainly hope you do not get me confused with him.

Senator BARKLEY. I am just being facetious.

Mr. LANIER. I do not know him.

Senator BARKLEY. You will sell the higher grades which may be leaves nearer the top of the plant or stalk, to the finer and high-priced cigarettes. Halfway down the plant, there is another grade, and the closer to the ground you get, the worse the grade is, as a rule, so that it might be that there is some of your tobacco that you grow on your 70 acres that may go into the market for the 10-cent cigarette, is that true?

Mr. LANIER. Yes, sir.

Senator BARKLEY. Now, if the 10-cent cigarette takes 20 percent of that particular type of tobacco, would you say that if it were to go out of the market, that would not affect the price of those grades which they do buy?

Mr. LANIER. I would say that it would affect the price of those grades.

Senator BARKLEY. I thought that was what you would say. It is inevitable.

Thank you very much.

The CHAIRMAN. Mr. Caldwell, and, Mr. Caldwell, will you be as brief as you can this morning, because we have an unusual number of witnesses and, at the rate we are going, we will have to have a night session tonight and another tomorrow and tomorrow night.

STATEMENT OF HARRY B. CALDWELL, GREENSBORO, N. C., MASTER, NORTH CAROLINA STATE GRANGE

Mr. CALDWELL. Mr. Chairman and gentlemen of the committee, I will state for the benefit of the record that my name is Harry B. Caldwell and I live at Greensboro, N. C., and I am master of the North Carolina State Grange.

Mr. J. C. Lanier, the gentleman who just preceded me, is a member of the tobacco committee of the State grange and is the tobacco expert on that committee for the State grange.

The North Carolina State Grange has been particularly interested in this whole tax question for many years. It appeared before the House Ways and Means Committee a few weeks ago in opposition to any increased taxes on tobacco, because we are convinced that tobacco is carrying its fair share of the total tax load.

I want to say that we have two fundamental principles when we come to consider the question of taxation. The first is, we believe that the taxes ought to be collected, so far as it is possible, to cover the extraordinary expenses of the Federal Government in this war effort.

The second principle that we adhere to is that taxes should be collected on the basis of the ability to pay, and when we come to consider the question of taxation, we recognize that tobacco has been carrying a wartime tax since the last World War. Those taxes were not reduced following the close of the last war, but they have since been increased twice, until today, it is taxed at a higher rate than almost any other article that you might wish to compare to the taxes on tobacco.

And so we appeared before the Ways and Means Committee first asking that committee not to impose any additional tax burden upon this particular commodity, not because tobacco growers were unpatriotic or did not wish to carry their share of the tax load, but simply because they were convinced that they are now carrying more than their total share of the tax load based on the ability to pay.

The Ways and Means Committee saw fit to increase the tax rate on cigarettes and other forms of tobacco, and on cigarettes in particular from $3.25 per thousand to $3.50 per thousand, thus continuing a flat rate of taxation on this product.

We opposed a differential in the rate before the Ways and Means Committee, and I might say, for the benefit of this committee that the North Carolina State grange has consistently opposed a differential in the rate of taxation on various forms or brands of cigarettes.

We have taken that position simply because we believe that a tax differential will be reflected in a lowering of the average price that the growers will receive for the tobacco itself.

This question has been considered in recent weeks by the executive committee of the North Carolina State grange and again they unanimously went on record in opposition to any differential in the tax rate as between the various brands of cigarettes.

I would like to say for the record that the State grange is composed entirely of farmers. I suppose our membership is 99 percent home-owning farmers. It is scattered throughout the State of North Carolina. We are organized in almost all of the tobacco-producing counties of the State. We have both flue-cured and burley types of tobacco grown in North Carolina and we represent here today the sentiments, the unanimous sentiment as it has been expressed in the State grange conventions, and through our tobacco committee meetings and through the meetings of the executive committee meetings of our membership, which represents, to a large extent, the tobacco growers in every section of North Carolina.

We are perfectly willing to accept the increased taxes imposed on cigarettes and tobacco by the Ways and Means Committee and by the House of Representatives, I believe, a few weeks ago.

We come before this committee and urge you to adopt the rates that were accepted or approved in the House of Representatives when this question was up before that group for consideration.

There are quite a number of things that have been rather interesting as we have come to consider the matter. As I recall, those who appeared before the Ways and Means Committee in favor of the increased taxes on tobacco and especially in favor of the differential, made the flat statement that there was no relationship between the selling price of tobacco and the consumption.

That statement was made before the Committee on Ways and Means, and I understand that some similar statement was made before this committee, perhaps yesterday. I could not be present because we did not have a notice of the hearing, but I understood that some such statement was made here yesterday.

If such a statement was made here, and I know that it was made before the Ways and Means Committee by those who advocated the differential, then we cannot understand why the differential question is being proposed at this time. If there is no relationship between the selling price and consumption, why bring up the differential question at all? Where does it enter into the picture as you come to consider this particular problem?

As we see it, it is primarily a struggle that is going on within the industry between various manufacturers of certain brands of cigarettes, and we sincerely hope that no action will be taken by this committee that will in any way jeopardize the position of the tobacco growers or farmers throughout the 14 or more States that grow the product.

I would just like to point out that the North Carolina State grange recently went on record endorsing the economy program that this Congress is trying to carry out. We, along with others, have recognized the importance of eliminating as many nonessential and unnecessary expenditures as possible, and we have gone on record to the effect that we will not ask of any Government official for any appropriation that we do not believe is necessary in prosecuting the war.

I would like to say, Mr. Chairman and members of the committee, that the tobacco growers in years gone by have found it necessary to come before the Congress, the Committee on Appropriations, and ask for the appropriation of public funds to keep them from losing their farms and their homes and from starvation, almost, and I would like to say, however, that at the present time tobacco prices have advanced, the outlook for this year is encouraging, and we would certainly not want any action to be taken that might have any depressing influence on the prices that the growers are receiving for their product.

I think I can say to this committee upon the authority of the North Carolina State grange that if action is taken on this question of taxation that will have a price-depressing influence on tobacco and on the average price level paid the growers, should it fall below the cost of production, we will be back here in large numbers before the Appropriations Committee advocating the appropriation of public funds to save the tobacco growers; and we sincerely hope that in the consideration of this question no action will be taken that will in any way tend to retard the progress that we are making in lifting the living standards among the tobacco growers throughout the United States.

This question of a graduated tax has been interesting to us. It has been said that we have a graduated tax on other articles, and yet the tax on liquor and the tax on gasoline and the tax on other items is a flat tax. When we come to consider this particular tax we must remember that it is a sales tax—that is what it is—it is a sales tax, a sales tax on a selected commodity, and certainly if there is no relationship between selling price and consumption there can be no justification for setting up a graduated sales tax for this particular commodity, which, in our judgment, will simply shift a larger part of the consumption to the cheaper brands and result in more manufacturers going into the manufacture of the cheaper brands of tobacco, which can only be made by buying the tobacco at a lower price level than now prevails.

So, on behalf of the Grange members and the tobacco growers, I would like to appeal to this committee that you adopt the schedule of taxation for tobacco that was approved by the House of Representatives when they considered this bill just a few weeks ago.

I might say to you gentlemen also that others would have been present for this hearing today but we did not know about it until just 2 days ago. I learned just 2 days ago, late in the evening that the matter was coming up, and when we appeared before the Ways and Means Committee, the Governor of North Carolina, the commissioner of agriculture of North Carolina, the editor, the associate editor of the Progressive Farmer which covers all of the Southern States, appeared along with others in opposition to increased taxes and in opposition to a differential in the tax rates on cigarettes.

I say to you gentlemen here today that, had we known in advance that this question was coming up, those same persons would have been represented before your committee today to express their opposition to a further increase in the taxes on tobacco and to the adoption of the differential in the rate of taxation as between the various brands of cigarettes.

Senator CAPPER. I understand you accept the bill as it is?

Mr. CALDWELL. The tobacco growers are perfectly willing to accept it as it now stands.

The CHAIRMAN. Any questions?

Senator GUFFEY. Did you say you were president of the State Grange?

Mr. CALDWELL. Master.

Senator GUFFEY. Is your State one of the State granges that endorsed the 120 percent parity bill or the 110 percent parity bill and was not satisfied with parity?

Mr. CALDWELL. I should like to answer that by saying that our State grange would like to have the parity concept accepted, but we recognize that under our present parity formula that there would be gross inequalities between the farm producers, producers of various farm crops, and before the parity concept should be accepted as a ceiling measure on farm prices there should be a new parity formula evolved, modern and up to date, giving the farmer an equitable share of the consumer's dollar on present income.

Senator GUFFEY. You are not satisfied with the present parity situation?

Mr. CALDWELL. Parity means equity, and when we apply the present parity formula to the various farm products, we find that it does not fit the situation in every instance. On some commodities, the prices would be considerably below the cost of production; on other commodities the parity price would be entirely too high—it would be much below levels that had existed in those articles in past years. I would like to see the parity formula at the opportune time considered and modernized and brought up to date so that it will bring to the farmer a proper share of the consumer's dollar.

Senator BAILEY. Something was said about notice. I did not know that the matter was coming up until noon day before yesterday. It was not on the calendar here, but I happened to learn from the clerk that he had a penciled notation that the matter of the differential was coming up and the names of witnesses, and I immediately notified Mr. Lanier and asked that he notify you.

Mr. CALDWELL. Mr. Lanier called me.

Senator BAILEY. We had no notice up here.

Senator BARKLEY. I don't know whose fault that is, and probably nobody's, but Mr. May, who is the commissioner of agriculture of Kentucky and who testified here yesterday, was on the list of witnesses more than 10 days—nearly 2 weeks ago—to discuss this subject, and was postponed by mutual agreement until others could be here so that the whole subject could be considered at the same time.

Mr. CALDWELL. There was no criticism offered, it was simply a statement that we did not know about it, and consequently we did not have an opportunity to arrange to have groups come in.

I thank you.

Senator BARKLEY. Mr. Chairman, I should like to put into the record at this point two or three tables. On yesterday, the Senator from North Carolina referred to an average price of tobacco from 1921 to 1930, inclusive, both burley and flue-cured, and from 1931 to 1940, both inclusive. I would like to have it put into the record at this point, with the year-by-year average price which he has been kind enough to furnish me, taken from the Department of Agriculture figures of flue-cured from 1921 to 1930, both inclusive, and from 1931 to 1940, both inclusive.

The CHAIRMAN. That may be done.

Senator BARKLEY. Also the same sort of table with reference to burley tobacco. Also a table showing prices from 1923 to 1931, inclusive, which makes a slight change in the years involved. I should like also to put into the record a table showing the prices to farmers of the 15-cent leaf tobacco grades from 1931 to 1941, both inclusive, and also the prices of tobacco paid by the 10-cent cigarette purchasers for the same years.

The CHAIRMAN. You may put them in, Senator.

(The tables submitted by Senator Barkley are as follows:)

Average price of Burley and flue-cured tobacco, 1921–30, inclusive, and 1931–40, inclusive, and combined average price, 1923–40, inclusive

BURLEY

Year	Average price	Year	Average price
1921	21.5	1931	8.7
1922	26.8	1932	12.5
1923	20.0	1933	10.5
1924	20.1	1934	16.9
1925	18.0	1935	19.1
1926	13.1	1936	35.7
1927	25.9	1937	20.1
1928	30.5	1938	19.0
1929	21.8	1939	17.3
1930	15.5	1940	16.2
	213.2		176.0
Average	21.32	Average	17.6

FLUE CURED

Year	Average price	Year	Average price
1921	21.9	1931	8.4
1922	27.2	1932	11.6
1933	20.8	1933	15.3
1924	21.6	1934	27.3
1925	20.0	1935	20.0
1926	24.9	1936	22.2
1927	20.5	1937	23.0
1928	17.3	1938	22.2
1929	18.0	1939	14.9
1930	12.0	1940	16.4
	204.2		181.3
Average	20.42	Average	18.13

BURLEY AND FLUE CURED

Year	Average price	Year	Average price
1923	20.0	1932	12.5
1924	20.1	1933	10.5
1925	18.0	1934	16.9
1926	13.1	1935	19.1
1927	25.9	1936	35.7
1928	30.5	1937	20.1
1929	21.8	1938	19.0
1930	15.5	1939	17.3
1931	8.7	1940	16.2
	173.6		167.3
Average	19.3	Average	18.6

Average prices to farmers of Burley, eastern flue-cured, and western flue-cured tobacco, 1931–41, inclusive

From the schedule presented at the hearings before the Committee on Ways and Means, House of Representatives, 77th Cong., found on p. 2817 of Revenue Revision of 1942, testimony offered by H. M. Robertson]

15-CENT CIGARETTE LEAF TOBACCO GRADES

Year	Burley [1]	Eastern flue-cured [2]	Western flue-cured [3]
1931	16.04	22.88	24.83
1932	(4)	27.15	29.08
1933	21.71	28.36	31.27
1934	26.78	37.92	42.37
1935	35.01	31.07	31.58
1936	61.71	35.11	41.50
1937	36.71	34.94	38.42
1938	27.00	31.44	33.33
1939	25.14	24.58	26.88
1940	28.71	28.11	32.25
1941	[5] 42.71	[6] 37.77	[7] 42.75

10-CENT ECONOMY CIGARETTE LEAF TOBACCO GRADES

Year	Burley [1]	Eastern flue-cured [2]	Western flue-cured [3]
1931	5.98	3.20	2.65
1932	(4)	6.70	5.89
1933	10.35	9.10	9.61
1934	15.23	14.88	13.37
1935	15.54	9.91	7.48
1936	38.00	8.71	9.08
1937	20.33	11.43	13.13
1938	16.62	15.58	16.60
1939	15.91	11.68	11.85
1940	17.21	14.31	14.13
1941	[8] 31.33	[9] 26.54	[10] 25.35

[1] U. S. Department of Agriculture type 31 grown principally in Kentucky and Tennessee.
[2] U. S. Department of Agriculture types 12, 13, and 14, grown principally in eastern North Carolina, South Carolina, and Georgia.
[3] U. S. Department of Agriculture types 11A and 11B, grown principally in North Carolina and Virginia.
[4] Government figures not given.
[5] Increase, 1941 over 1931—162 plus percent.
[6] Increase, 1941 over 1931—69 percent.
[7] Increase, 1941 over 1931—72 percent.
[8] Increase, 1941 over 1931—424 percent.
[9] Increase, 1941 over 1931—729 percent.
[10] Increase, 1941 over 1931—856 percent.

Senator GUFFEY. Mr. Chairman, I desire to place into the record at this point a list of the names and addresses of various persons and organizations in the State of Pennsylvania, and elsewhere, who are in favor of the 27½ percent depletion provision in the pending bill, and who have communicated with me to that effect.

The CHAIRMAN. That may be done.

(The list referred to is as follows:)

G. A. Simpson, Bradford, Pa.
Minnick Bros., Bradford, Pa.
N. D. Gibson, oil producer, Bradford, Pa.
C. W. Sharpe & Co., oil producers, Bradford, Pa.
Blaisdell Oil Co. (G. C. Blaisdell), Bradford, Pa.
Hugh Grant, president, Grant & Mohan Oil Co., Bradford, Pa.
J. M. Brooder, Bradford, Pa.
G. G. Bauer, executive secretary, Appalachian Drill Contractors Association, Bradford, Pa.
J. Paul Jones, Bradford, Pa.
A. E. Booth, Bradford, Pa.
R. S. Pringle, Jr., Bradford, Pa.
A. H. Wiborg Property, Bradford, Pa.

Lynn G. Smith, Bradford, Pa.
J. T. Burton, Venture Oil Co., Bradford, Pa.
R. J. Brennan, Bradford, Pa.
Atlas Oil Corporation (F. E. Ernst), Bradford, Pa.
William J. Heale, Healey Petroleum Corporation, Bradford, Pa.
Parker L. Melvin, Bradford, Pa.
D. T. Andrus, Bradford, Pa.
Forest D. Dorn, Bradford, Pa.
Earl F. Smith, Bradford, Pa.
D. B. Tanner, Tanner Oil Co., Bradford, Pa.
J. C. Kelly, Knapps Creek Oil Co., Bradford, Pa.
John H. Kane, Bartlesville, Okla.
Elmer Roeder, Franklin, Pa.
R. G. Rapp, Denver Producing & Refining Co., Oklahoma City, Okla.
W. J. Brundred, Central Pennsylvania Oil Producers Association, Oil City, Pa.
Al Buchanan, San Antonio, Tex.
W. A. Delaney, Jr., Ada, Okla.

The CHAIRMAN. Mr. Baar.

STATEMENT OF ARNOLD R. BAAR, CHICAGO, ILL., REPRESENTING ASSOCIATED STATE CHAMBERS OF COMMERCE

Mr. BAAR. Mr. Chairman and gentlemen, my name is Arnold R. Baar, and I am chairman of the Federal taxation committee of the Illinois Chamber of Commerce. I am appearing here today in behalf of 25 chambers of commerce, 23 State organizations and 2 regional organizations, associated in an organization known as the Associated State Chambers of Commerce. With me delegated to be here is Dr. Leonard P. Fox, manager of the Research Bureau of the Pennsylvania State Chamber of Commerce.

My appearance is the result of a feeling among the State organizations, originating largely in the Pennsylvania State Chamber of Commerce, helped out by Ohio and other States, that you would be interested and be served by an attempt to find out what business men in the State groups, in the State units, thought were the outstanding, fundamental, and primary elements of this tax law.

I cannot say that there is complete unanimity—some things we are not speaking about, because there was division, but the things which I present here, 10 points, do represent a substantial agreement originating in these State organizations, as to what they think fundamentally important in this tax bill.

That program was worked out in this way—I think the method is important. This Associated State Chambers of Commerce is an organization representing 29 States through their State units. They called regional conferences; two were held, one in Milwaukee attended by about four States, and one in Harrisburg, Pa., attended by several States. In each case, they worked out a preliminary program. Then, a general conference was held at Chicago attended by representatives of 13 of these State organizations, and you have before you a sheet which gives the names of those States. I won't repeat them. I will ask leave to have that list incorporated in the record.

The CHAIRMAN. That may be done.

(The supplemental information submitted by Mr. Baar is as follows:)

INFORMATION SUPPLEMENTAL TO STATEMENT OF ARNOLD R. BAAR, CHICAGO, ILL., REPRESENTING ASSOCIATED STATE CHAMBERS OF COMMERCE

President—Karl S. Dixon.
Headquarters—Huntington Bank Building, Columbus, Ohio.

Membership—27 State and 4 regional Chambers of Commerce in 29 States. State chambers represented at the Chicago Conference:

Colorado.
Delaware.
Illinois.
Indiana.
Kansas.
Massachusetts
New Jersey.
Ohio.
Oklahoma.
Pennsylvania.
South Dakota.
Texas (East Texas)
Wisconsin.

Other State chambers which have in the main endorsed the Federal tax program adopted at the Chicago Conference:

Alabama.
Arkansas
California.
Idaho.
Montana.
New York.
North Dakota.
South Carolina.
Texas (South Texas).
Virginia.
Washington.
West Virginia.

Mr. BAAR. Since that conference which worked out this program, it has been communicated to other members of the Associated State Chambers, and 12 more organizations have ratified it—11 State chambers and one regional. So it represents the views of these business organizations, 25 organizations in 24 States. Those organizations were represented at that Chicago conference by various types of people, some of their presidents and executive officers, some of their research directors, like Mr. Fox, and some of their taxation committees' chairmen, like myself, and discussed these problems.

We have not as inclusive a program, for example, as the United States Chamber of Commerce presented yesterday. In many respects we do agree with them. We have one or two additional features that they do not have.

This is not the exclusive action of the various State chambers—you have already heard from the Ohio and the New York chambers; and I have two additional resolutions that I would like to present on behalf of the Illinois chamber, but these are the points upon which these States have agreed in substance.

The CHAIRMAN. Suppose you go right directly to the points.

Mr. BAAR. I will ask leave to file a copy of the program which is in your hands, and some of the points will need no comment.

The CHAIRMAN. Yes.

(The matter submitted by Mr. Baar is as follows:)

FEDERAL TAX PROGRAM AND RECOMMENDATIONS FOR 1942 REVENUE ACT ADOPTED AT CONFERENCE OF DELEGATES OF ASSOCIATED STATE CHAMBERS OF COMMERCE AT CHICAGO, ILL., AUGUST 5, 1942

1. *Reduction of expenditures.*—We commend the work of the Joint Congressional Committee on Nonessential Federal Expenditures, Senator Byrd, chairman, and the reductions in nonwar appropriations thus far effected; and we agree that still further reductions can and must be achieved.

2. *Sales tax.*—Recognizing the absolute necessity for meeting the financial requirements of the war and realizing that American business cannot possibly produce the additional revenue requested by the Treasury and survive, we recommend that the Federal tax base shall be broadened to produce such needed additional revenue. We therefore recommend that a sales tax be included in the 1942 revenue measure. Of the two forms of sales tax proposed, a preponderant majority favors a retail sales tax.

3. *Corporation normal tax and surtax.*—We recognize that business must contribute to the national war effort as large a portion of its earnings as can be given up without permanent impairment of its ability to employ labor and continue to contribute to the support of the war and to the general welfare after the war. Believing that 35 percent is the maximum exaction to which normal earnings can be subjected without risk of serious and permanent damage to the national economy, we urge that the combined maximum rate of corporation normal tax and surtax do not exceed 35 percent of income other than true excess profits.

4. *Post-war credit of excess-profits tax.*—We also recommend that, to facilitate the retooling and other readjustments which business will be required to make after the war and to provide reserves which will help to meet the strains of the post-war period, any excess over 30 percent in the rate of corporation excess-profits tax be covered by a post-war credit, to be evidenced by special Treasury bonds (bearing no interest and being nonnegotiable during the war period, but bearing interest at 2 percent and being negotiable after the war, and being redeemable in five equal annual series commencing 1 year after the termination of the war). If this credit is allowed, the deduction recommended with respect to voluntary investment in similar Treasury bonds may appropriately be reduced or denied with respect to the excess-profits tax.

5. *Determination of excess profits.*—We recommend that the bases of excess-profits tax credits be further adjusted so as more justly and accurately to reflect true normal profits, specifically that—

(*a*) The average-earnings basis be determined by taxing the average of the 3 highest years in the base period, without interfering with the present recognition of the growth principle.

(*b*) 100 percent credit of average earnings be given; and

(*c*) The 8- and 7-percent brackets of the invested-capital basis, prescribed by the present law, be left unchanged.

6. *Capital-stock tax repeal.*—We recommend the repeal of the capital-stock tax and the declared-value excess-profits tax.

7. *Incentive for buying United States bonds.*—We recommend that corporations and individuals be allowed to deduct from taxable income, for all tax purposes, the amount invested during the taxable year in special Treasury bonds (bearing no interest and being nonnegotiable during the war period, but bearing interest at 2 percent and being negotiable after the war, and being redeemable in five equal annual series commencing 1 year after the termination of war), but not in excess of 20 percent of the net taxable income without this deduction.

8. *Life-insurance premiums.*—We recommend that payments of life-insurance premiums, subject to reasonable limitations, be allowed as deductions to individuals for income-tax purposes.

9. *Individual normal tax rate.*—We endorse the increase in the rate of normal tax upon individual net incomes, from 4 to 6 percent, as provided in the bill as passed by the House.

10. *Tax on freight.*—In view of the important, far-reaching, highly variable, and largely unpredictable consequences to business of any disturbance to the interrelations of freight rates and other shipping charges, we urge that no excise tax be imposed upon payments for the transportation of property, such as that prescribed by section 621 of the House bill.

Mr. BAAR. I believe point 1 needs no elaboration.

It states simply the necessity for reductions in nonwar appropriations, and so forth.

Point 2 deals with the controversial question of the sales tax. I think that needs no elaboration. You have heard a good deal about it, but this organization adopted this plank No. 2:

> Recognizing the absolute necessity for meeting the financial requirements of the war and realizing that American business cannot possibly produce the additional revenue requested by the Treasury and survive, we recommend that the Federal tax base shall be broadened to produce such needed additional revenue. We, therefore, recommend that a sales tax be included in the 1942 revenue measure. Of the two forms of sales tax proposed, a preponderant majority favors a retail sales tax.

Senator BARKLEY. Why does your organization favor a retail sales tax instead of a manufacturers' sales tax?

Mr. BAAR. Ohio has been very active in behalf of a manufacturers' tax as a proper procedure after a study based on the Canadian system, but they admit they have not been able to convince the other business organizations. Indiana and Wisconsin took a referendum poll of their members, and of those who voted—about one-third of the membership—about 91 percent in each case favored some sales tax. Of the 91 percent who favored a sales tax, about 75 percent favored a retail tax as against a manufacturers' tax.

And the striking thing is that in Indiana, where they segregated the classes of business, of those retailers who believed in the sales tax, about 75 percent favored the retail sales tax.

Senator BARKLEY. Is your organization made up largely of retailers?

Mr. BAAR. No; we represent all types of business—manufacturers, wholesalers, retailers, utilities, professional men, and business in general.

Senator BARKLEY. Which are in the majority?

Mr. BAAR. I should say it probably varies in the different States.

Senator BARKLEY. I am wondering why a retailer would be in favor of a retail sales tax, because of the additional difficulties that would be imposed upon him from the administrative standpoint, as against the manufacturers' sales tax, assuming that any sort of a sales tax should be imposed.

Mr. BAAR. I understand that a retail tax has been advocated here by two of the largest retail organizations in the country. I think you will find that is so, because it is a sound tax and will be economically better for the country as a whole than a manufacturers' tax, which they seem to feel will be pyramided and inflationary in its effect; in other words, there will be a profit on the tax. It must also be financed during the merchandising process. If it is collected at the time of the ultimate sale, there is no financial burden involved and no pyramiding. The retail sales tax is thus anti-inflationary.

Senator BARKLEY. In the States where there is a retail tax, which is in many of them, it will be necessary for the retailers to keep two separate sets of books, and keep the tax separate, not only in the bookkeeping process but also in the price as it appears to the consumer.

Mr. BAAR. That is true.

Senator BARKLEY. He has to have two separate columns, one for the State or local tax and the other for the Federal tax, so that the purchaser will know how much tax he is paying locally and how much to the Federal Government.

Mr. BAAR. That is a serious consideration. I do not think it is more serious than the problem of accounting for a pay-roll deduction tax.

Senator BARKLEY. Do you think that a retail tax on the part of the Federal Government would involve enormously more in the way of employees to check up and collect it than a manufacturers' tax?

Mr. BAAR. I think it would. It is not part of our program, but my personal idea is that there should be a cooperative program to be worked out with the States. Perhaps some method by which the State agencies would make a report to the Federal Government. It is a serious problem.

Another chamber which acted on this was Oklahoma, where they polled 68 of their directors, and 67 favored the sales tax. Other States have taken action that I won't detail.

I think our most important recommendation is No. 3.

It reads:

Corporation normal tax and surtax.—We recognize that business must contribute to the national war effort as large a portion of its earnings as can be given up without permanent impairment of its ability to employ labor and continue to contribute to the support of the war and to the general welfare after the war. Believing that 35 percent is the maximum exaction to which normal earnings can be subjected without risk of serious and permanent damage to the national economy, we urge that the combined maximum rate of corporation normal tax and surtax do not exceed 35 percent of income other than true excess profits.

I won't elaborate on that in view of the splendid argument made yesterday by Mr. Alvord. I would say to my mind the telling point that he made was the matter of cash. Net income is a bookkeeping matter, but the payment of taxes is a cash matter; and all I have seen emphasizes how difficult it will be for corporations to meet the cash requirements of normal tax above 35 percent. For corporations which are largely in the normal tax class, anything above 35 percent presents a very serious problem of cash financing, interfering with expansion programs and other things which have been mentioned to you.

Our point No. 4 is where we depart from the United States Chamber of Commerce.

Point No. 4 reads:

Post-war credit of excess-profits tax.—We also recommend that, to facilitate the retooling and other readjustments which business will be required to make after the war and to provide reserves which will help to meet the strains of the post-war period, any excess over 80 percent in the rate of corporation excess-profits tax be covered by a post-war credit, to be evidenced by special Treasury bonds (bearing no interest and being nonnegotiable during the war period, but bearing interest at 2 percent and being negotiable after the war, and being redeemable in five equal annual series commencing 1 year after the termination of the war). If this credit is allowed, the deduction recommended with respect to voluntary investment in similar Treasury bonds may appropriately be reduced or denied with respect to the excess-profits tax.

In No. 5, we recommend that the bases of the excess-profits credits be further adjusted so that they will more justly and accurately reflect the true normal profits—specifiaclly:

(*a*) The average earnings basis be determined by taxing the average of the 3 highest years in the base period, without interfering with the present recognition of the "growth principle;"

(*b*) 100-percent credit of average earnings be given; and

(*c*) The 8-percent and 7-percent brackets of the invested capital basis, prescribed by the present law, be left unchanged.

I think they need no elaboration, in view of what you have already heard.

In No. 6, we recommend the repeal of the capital-stock tax and the declared value excess-profits tax, not because it means very much in money; it does not even mean the $288,000,000 that has been estimated as the yield, because the capital stock tax and excess-profits tax are deductible for other tax purposes, and if a company pays an excess profits tax, it does not care how much you take in the capital stock tax because they get 90 percent of it back on their income tax as a deduction. The amount involved there is definitely less than the $288,000,000 but it is a nuisance tax. We believe it is an objectionable tax which should be repealed at this time.

No. 7 is the incentive for buying United States bonds, in which, I think, we adopt exactly the recommendation of the United States Chamber of Commerce. Here I would like to point out the differences between that incentive voluntary deduction and the automatic refund which I have mentioned as our point No. 4. They are somewhat alike. We use exactly the same terms to describe the bonds which would be used, but there are several significant differences.

One, as I said, is voluntary. A corporation can decide of its own free will how much to take advantage of, and it is suggested that there should be a limit of 20 percent of the net income. They may take all or any part of that. Those bonds have to be purchased within the taxable year. If their income is doubled upon later audit, it is too late then to increase that credit. The excess-profits tax refund is automatic. Five years later, or whenever the excess-profits tax is finally determined, a certain fraction of it would be covered by these refund bonds. With the voluntary plan, the money has to be put up within the taxable year, so the Government gets the use of the money several months before it would get the tax money. With the excess-profits credit the money is paid on the tax date, and the bonds are issued as a receipt for the money loaned. It has very substantial differences, and we feel that the automatic refund idea is essential and important if the rates go above 80 percent. Anything above that is so close to the margin that the reserve ought to be applicable for the post-war reconstruction.

Another difference relates to the taxation of the amount received in payment for the bonds. Mr. Cranch in supporting his proposal yesterday said that these bonds should be subject to tax when paid, if I understood him correctly. I think there is a misconception there. That should be so with respect to the incentive bonds, because that is a reduction from income and should be taxed when payment is received. As to the credit bonds that is entirely different—they are not taken out of income, but they represent a portion of taxed income which is loaned the United States, and when they are paid back there should be no tax on that repayment. That is a compulsory loan which should be repaid without tax.

In both cases, these bonds should not be subjected to the very elaborate and very technical and almost impossible strings that were attached in the provisions submitted to the House Ways and Means Committee, that the proceeds cannot be used for this or that or the other purpose. I have never found anyone who would know how to construe or to comply with those provisions. When the money is repaid, it should be repaid without strings.

Of course, this incentive is to be given to individuals as well as corporations.

We do say that if the general incentive provision is adopted, and the refund provision also, they do need a certain relationship. Perhaps the voluntary savings should not apply for excess-profits tax purposes. It would not be difficult, however, to work that out.

These recommendations for these bonds, important as they are in providing reserves for the post-war adjustments, we feel are definitely of secondary importance to the question of rate. These bonds do not provide cash. You cannot pay debts and you cannot buy plants, you cannot install power lines or telephone equipment with nonnegotiable bonds unless, as Senator Taft suggested, some of those bonds might be redeemable to use for debt payments. It is a wonderful cushion for the post-war period, but it does not help the company that cannot find the cash to carry on business, increase production and pay its heavy taxes. For that situation there is no substitute for the maximum 35 percent rate.

Life insurance premiums, our point No. 8, has been mentioned to you. We recommend that the payments of life-insurance premiums, subject to reasonable limitations, be allowed as deductions to individuals for income-tax purposes. The argument has been given here and is presented at some greater length in a resolution of the Illinois Chamber of Commerce which I will ask leave to file.

The CHAIRMAN. That may be done.

(The resolution submitted by Mr. Baar is as follows:)

RESOLUTION BY ILLINOIS CHAMBER OF COMMERCE IN RE LIFE-INSURANCE PREMIUMS

Whereas greatly increased income taxes have been and will be necessarily and properly imposed upon all personal incomes during the present war, and such taxes will require a curtailment of the expenditures of large numbers of persons whose incomes will not be materially increased during the war; and

Whereas such increased taxes and such necessary curtailment of expenditures will make it increasingly difficult for large numbers of persons to maintain programs of life insurance which they have heretofore adopted, and may in many cases require the reduction or abandonment of the protection of dependent widows and children now provided by such life insurance programs: and

Whereas the payment of life-insurance premiums is not inflationary in its effect, but, on the contrary, tends to prevent inflation, since the funds used are diverted from the purchase of commodities and are in large part invested by the insurance companies in Government obligations; and

Whereas it is commonly regarded as desirable for the general national welfare and economic stability of the country, as recognized by various legislative exemptions and special provisions, that individuals should be encouraged and assisted in making appropriate provision for their dependents by means of life insurance, and much of the hindrance and interference of the wartime tax laws with such provision may readily be avoided by allowing the deduction herein recommended;

Now, therefore, by the Board of Directors of the Illinois Chamber of Commerce, upon the recommendation of its Federal income tax committee, it is hereby

Resolved, That it is recommended to and urged upon the Congress of the United States that in the Revenue Act of 1942 (or in any other appropriate legislation) provision be made, in the determination of taxable net income of individual taxpayers, to allow the deduction of amounts paid or accrued as premiums on life-insurance policies, subject to reasonable limitations.

Mr. BAAR. The individual normal tax increase is a step toward broadening the base—we endorse the increase in the rate of normal tax upon individual net income from 4 to 6 percent as passed by the House. It is the general spreading of the burden on all income.

In our No. 10, we oppose the proposed tax on freight. We think it will have a very serious adverse effect on business.

The Illinois Chamber of Commerce, in addition, has adopted a resolution on inventory reserves. It is rather technical and complicated, and I would simply ask leave to file with you the recommendation of the Illinois Chamber of Commerce that the law make provisions for inventory reserves to provide against price declines, when apparent profits turn out to be mere paper profits, represented by inventory which cannot be sold on a declining market.

The CHAIRMAN. That may be filed.

(The resolution referred to is as follows:)

RESOLUTION BY ILLINOIS CHAMBER OF COMMERCE URGING RECOGNITION OF INVENTORY RESERVES IN COMPUTATION OF TAXABLE INCOME

Whereas greatly increased income taxes have been and will be necessarily and properly imposed during the present war upon the incomes of all business activities, and such taxes will result in the diminution of the capital available for continuation of such business activities if the tax rates are in any year applied to a basis in excess of the income actually realized by the taxpayer during such year; and

Whereas the successful prosecution of the war as well as the maintenance of of a sound national economy require the continued efficient operation of business, and that requires the reasonable assurance to owners of capital invested in business that such capital may be continuously used for business purpoes and maintained unimpaired; and

Wherea in periods of rising prices, under the present treatment of inventories for income-tax purposes, taxable income may include profits that result merely from the increase in the value of the inventory on hand, and such profits are not available for the payment of taxes and may be wiped out by subsequent price declines; and

Whereas to the extent that income taxes are imposed with respect to such unrealized profits the taxes must be paid from and to that extent reduce the amount of liquid capital employed in the business;

Now, therefore, by the board of directors of the Illinois Chamber of Commerce, upon the recommendation of its Federal Income Tax Committee, it is hereby

Resolved, That it is recommended to and urged upon the Congress of the United States, in support of the proposal made on behalf of the Treasury Department, that in the Revenue Act of 1942 (or in any other appropriate legislation) provision be made that, in the determination of taxable net income arising from the conduct of a business, deductions be allowed to establish temporary reserves for possible future inventory losses, for the amount by which the inventory price of goods on hand at the end of any taxable period is in excess of a reasonable basic price, such reserves to be availed of as prices decline toward the basic level and in any event to be exhausted within a limited period after the end of the war.

STATEMENT OF DONALD DESPAIN, INDUSTRIAL RELATIONS COUNSEL, CHICAGO, ILL.

Mr. DESPAIN. Gentlemen of the Committee on Finance, in expressing my appreciation for the privilege of this appearance, permit me to state that I have no intention to impose upon your time with a voluminous presentation which may constitute a repetition of data and thought previously submitted.

First. I appear before you in behalf of quite a large number of employers who have honestly and sincerely adopted and initiated profit sharing with their employees with the hope of achieving a relationship of cooperation and harmony between employer and employee, as well as creating benefits which will contribute to the permanent welfare of their employees and to establish an example to others in the accomplishment of industrial peace.

Second. Because it was my privilege and pleasure to serve a subcommittee of your committee during 1938–39 in directing and managing the most exhaustive survey and study of the "experiences and possibilities of profit sharing" ever conducted under official congressional auspices, under Senate Resolution 215, I cannot avoid the consciousness of occupying the status of one who now has the opportunity to report to you as to the results and accomplishments of that survey made during 1938 and 1939.

Briefly, by report can be recapitulated in a few words, namely:

(*a*) That the national investigation which you authorized embraced a study and analysis of more than 10,000 employee relations policies operating in American industry. These plans and policies were of varied character involving profit percentage plans, pension plans, pension and annuity trusts, wage dividend plans, bonus payment policies, stock ownership plans, and all forms of programs which could be classified under the general term of profit sharing.

That survey was conducted strictly as an objective study in pursuit of a formula for industrial peace. Its results can be attested by the fact that, to the best of my knowledge, more than 2,000 institutions, large and small, have since adopted and installed some form of profit sharing. This fact is proof of real social progress and constitutes indisputable evidence of the attention and consideration given to profit sharing as a direct result of the facts, results, and benefits presented in our two-volume report to the Senate, which is a public document available to all citizens.

Third, I wish to emphasize that profit sharing is not a minor subject. It is of major importance. It involves social, economic, and political issues and problems of paramount importance. It is my desire to approach this subject and to treat it, on a much higher ground than that of dollars related to taxation. Its potential possibilities to over 30,000,000 employees.

Yet at the same time it occupies a position in this tax bill which should receive your profound consideration.

May I take this opportunity to remind the members of your committee that until very recently a statue stood at the entrance of the United States Treasury Building. It was the statue of a man who served two Presidents of the United States for 12 years as Secretary of the Treasury. Those Presidents were Jefferson and Madison. The bronze tablet on that statue read as follows:

ALBERT GALLATIN
Secretary of the Treasury

Genius of Finance
Senator and Representative
Commissioner for the Treaty of Ghent
Minister to France and Great Britain
and steadfast
Champion of Democracy

1761–1849

That man, Albert Gallatin, was the father of profit sharing in the United States. He inaugurated the first systematic plan and policy of profit sharing in his Pennsylvania glass works in 1794. In announcing that plan, Mr. Gallatin publicly declared that—

The democratic principle upon which this Nation was founded should not be restricted to the political processes alone, but should be applied to industry

During the more than 140 years since Mr. Gallatin unfurled his flag in behalf of this economic and political philosophy, profit sharing has encountered a rough and stormy road. There are those who indict the principle of profit sharing as being socialistic, but as one of the distinguished members of your committee has so well said—

it is the very antithesis of socialism. It carries the spirit of capitalism to the worker; it is the essence of true cooperation; it represents social-mindedness, and distinctly comports with the American system, because it is a business democracy.

In spite of the criticisms and misunderstanding of profit sharing, in spite of failures due to improper application, the truth of the progress of profit sharing is best expressed by your subcommittee in its letter of transmittal to the Senate, and I quote:

We have found veritable islands of peace, equity, efficiency, and contentment, and likewise prosperity, dotting an otherwise relatively turbulent industrial map, all the way across the continent. This fact is too significant of profit-sharing's possibilities to be ignored or depreciated in our national quest for greater stability and greater democracy in industry.

I refer briefly to this long battle of profit sharing for recognition and acceptance * * * as well as its splendid record of success and beneficial results when intelligently applied * * * in support of my plea and the hopes of several hundred employing institutions * * * that you do not permit new tax measures to discourage these companies and corporations from continuing this far-reaching social-minded principle.

In a very few moments, Senators, I shall attempt to prove to you that you have it in your power, with the approval of the Treasury Department, and possibly with the cooperation of the President of the United States, to utilize the principle or formula of profit sharing to accomplish three extremely vital needs in the job of winning this World War and of preserving the American enterprise system after the war. My hope is to present a sound, practical completely constructive formula for:

(1) Tremendously increasing the sale and absorption of War bonds throughout the Nation.

(2) Establishing a control over wages which will stop the vicious spiral of inflation.

(3) Provide insurance against a socialistic upheaval at the conclusion of the war, when the lag in industrial employment may create an army of unemployed to serious threaten the peace and prosperity of the country.

Before presenting this formula I trust your committee will indulge me a few minutes to describe and outline the injuries which the present tax bill will impose upon existing profit-sharing programs.

UNJUST PROVISIONS OF THE NEW TAX BILL

Section 144 of the tax bill as passed by the House (H. R. 7378) makes extensive revisions of sections 165 and 23 (p) of the Internal Revenue

Code. The stated purpose of these provisions is to prevent tax avoidance through the use of pensions, profit sharing, stock bonus, and annuity plans and trusts. The revisions as adopted go far beyond the stated purpose.

While it cannot be denied that under existing provisions of the code there have been some abuses, nevertheless those abuses have been limited in number. Very few lawyers have been willing to set up plans and trusts of this nature for the primary purpose of avoiding taxes. On the whole, lawyers have not hesitated in bluntly advising their clients that plans having as their primary purpose the avoidance of taxes, were wrong in all respects, and it can be truthfully stated that the lawyers who have been devoting their time to this kind of work have frequently refused to have any part in the establishment of a plan which they felt was desired mainly for selfish reasons or for tax-savings purposes.

The extensive investigations made by the subcommittee of the Committee on Finance of the subject of profit sharing showed that of the thousands of plans in existence there was an overwhelming majority of unselfish plans in which tax saving played a very insignificant part.

The provisions of the new revenue act as passed by the House are subject to criticism in several respects.

Senator TAFT. Why do you say that we tax them? I don't think we do.

Mr. DESPAIN. We have not heretofore. But it is provided in the bill that if an employer contributes more than 5 percent of the pay roll——

Senator TAFT (interposing). We are going to modify that. The Treasury has agreed to that, and it will be modified.

Mr. DESPAIN. That is the principal thing.

THERE EXISTS A LONG-ESTABLISHED POLICY OF CONGRESS IN ENCOURAGING PLANS AND TRUSTS WHICH PROVIDE EMPLOYEE BENEFITS

In 1921 Congress adopted section 219 (f), exempting from taxation profit-sharing and stock-bonus trusts. In 1926 this section was amended to include pension trusts and section 23 (p) was added for the purpose of encouraging employers to establish trusts for the benefit of their employees and granting deductions for tax purposes of money so spent by employers. Thereafter, and until 1939, various amendments were made to these sections from time to time, all for the purpose of encouraging the establishment of these trusts and assuring employees that they would receive their benefits to the greatest possible extent. One such amendment provided specifically that employees should only be taxed upon their actual distributions from the trust, to the extent of the value of the assets at the time they were distributed, rather than the value of the assets at the time they were placed in trust.

Thus, a well-settled policy encouraging employers and stockholders to use corporate earnings for the benefit of employees has been established. Under this long-standing policy enormous benefits are being built up for rank-and-file employees. Under this policy, encouraged by Congress, thousands upon thousands of plans and trusts have been established, most of them on an unselfish basis.

THE PROVISIONS PASSED BY THE HOUSE IGNORE THE ECONOMIC PURPOSES AND THE LONG-RUN BENEFITS TO SOCIETY AND TO THE GOVERNMENT RESULTING FROM SUCH PLANS

The moneys contributed by employers under these established plans and trusts have been of incalculable value in providing both disability and old-age assistance to employees, which assistance would otherwise have had to be furnished by the Government.

Management, in other words, capital, has been educated to the point where responsibility for the welfare of employees upon retirement or in case of disability has been accepted as the usual rather than the unusual.

A progressive social-mindedness—gradual, but definite—pointing to an ultimate industrial democracy so essential to the security of our form of government. Had privately financed plans, in quantity, been in widespread use for some years prior to 1929 the severity of the depression would have been substantially lessened, expenditures for old-age assistance to the poverty stricken by both State and National Governments would have been materially reduced, and unemployment would not have resulted in so many hardships and so much privation.

The funds accumulated under these plans could have been used to take care of temporary unemployment, to furnish incomes as employees reached retirement ages, to provide help in periods of disability, and to enable sons and daughters to care for their aged parents.

By providing for these contingencies, which are not really contingencies, but certainties, through the regular and orderly accumulation of trust funds under private administration, there will be a steadily decreasing demand upon the Federal Treasury for what are generally called social benefits. The drastic provisions of the act as passed by the House, if they are enacted into law, will bring to an abrupt end the establishment of private beneficial plans and will directly result in increased Government expenditures, both immediately and in the future. They will also abruptly stop employer contributions to existing plans and trusts which have been established in good faith and in reliance upon the belief that Congress would not radically change its long-established policy of encouraging such plans and trusts.

WHILE THESE PROVISIONS MAY SERVE TO TEMPORARILY INCREASE GOVERNMENT REVENUES THEY AUTOMATICALLY WILL COMPEL HEAVY INCREASES IN GOVERNMENT EXPENDITURES

A necessary corollary follows if Congress reverses its policy of encouraging the establishment of employee-benefit plans. To a limited extent there will be a temporary increase in taxes collected. This increase will be partially offset by increased need for the support of indigents, a need which Congress cannot ignore.

Far more important will be the fact that in the very near future thousands of employees will be retired upon wholly inadequate incomes. Demands, impossible of refusal, will then be made upon Congress to increase social security old-age incomes, which will mean more and more taxes, and taking the taxes of workers to pay benefits to retired workers.

THESE PROVISIONS DESTROY A MOST SATISFACTORY METHOD WHICH HAS BEEN USED TO REDUCE FRICTION BETWEEN CAPITAL AND LABOR

Whenever an employer transfers or pays over any money for the benefit of his employees, over and above current wages, automatically profit sharing has occurred. This is true whether the employee receives immediate or deferred benefits, since this money must come from the earnings of the employer. It is only within very recent years that employers, in widespread numbers, have felt themselves under a moral obligation to do something for their employees over and above the payment of ordinary wages. By bitter experience many employers have found that the payment of cash bonuses has had disastrous results to both employees and employer. In order to eliminate the payment of cash bonuses, various methods of paying additional compensation in a manner which would defer the receipt of benefits by employees have been developed and were recognized by Congress as early as 1921 as being beneficial to the entire country and deserving of congressional encouragement.

Improved methods have been worked out by employers and the idea of giving additional benefits to employees has gained national acceptance since 1929.

Relations between employers and employees in the United States have swung completely from one end of an arc to the other. Not so many years ago an unscrupulous or greedy employer could and did take advantage of his position to the detriment of his employees. Gradually employees gained the ascendancy, until today we have a complete reversal and a situation under which unscrupulous labor leaders can and do take advantage of employers to the detriment of the entire Nation.

Any fair-thinking person must freely admit that both of these situations are economically wrong and harmful to the progress and well-being of the entire country.

In between these two extremes there has been a steadily and rapidly growing recognition of the fact that employers and employees or, as frequently stated, capital and labor, are not enemies of each other and that if they continue to work at cross purposes the ultimate result is self-destruction.

These middle-of-the-road groups realize that the only proper conception of relations between an employer and employees is a partnership basis with both the employer and the employees working, not only for their own benefit, but for the benefit of each other and cooperating to serve the public, in the best possible manner.

The people in this middle-of-the-road group realize that their very existence depends upon satisfying the public they serve and that if they fail to satisfy that public, there will be no wages to argue about. The author, Napoleon Hill, states that coal-mine operators and miners fought so bitterly and argued so extensively over wages and hours that they built up an enormous business for oil-burner manufacturers and the oil producers.

Under the partnership conception, first consideration must be given to satisfactory working conditions and fair wages, but beyond those elementary factors, recognition is given to the fact that earnings result equally from capital and from labor, whether the labor be mental or muscular and that unless due consideration is given to both elements, the other element cannot survive. The most effective recognition of this partnership has been shown in a division of profits. Actually, labor receives the first call upon the receipts of an employer for the payment of fair wages. A fair return upon capital invested, which creates the opportunities for labor, should have second call, and any earnings above that amount should be equitably shared by both capital and labor.

In this sharing of earnings some method had to be found under which the distribution of these extra earnings would not create a hazardous situation. Many employers tried, and many employers are still trying, to maintain the spirit of cooperation through the payment of cash bonuses. Here and there may be found an isolated instance where cash bonuses have proved to be the proper solution, but the inherent evil of cash bonuses as experienced in so many instances has demanded a different solution. That solution has been found in a method of setting up deferred benefits. Deferment of these benefits has been welcomed by employees of all classes and of all wage or salary groups. Only a pitifully small number of individuals can intelligently save anything from their pay checks, excepting in emergencies such as the present one, when enormous pressure is brought to bear upon them, and even in this emergency the saving through the purchase of War Bonds is being made principally from the abnormally high wages being paid in the war industries.

A plan of deferred benefits results in compulsory savings whether the employee contributes to such a plan or whether all contributions are made by the employer. So long as the money is not placed in the hands of the employee for spending, it must be saved and the investment and accumulation of those savings becomes the responsibility of persons competent to invest and handle savings instead of their being left to the inexperience, ignorance, or whims of the masses.

This is not an autocratic procedure, but it is in keeping with American ideas, the American tradition of thrift, and is a progressive step for the common welfare. Such a formula is the surest method of checking and preventing inflation.

These savings and accumulations will permit vast numbers of employees to retire without becoming a burden upon the State or National Government. Furthermore, during their working years it will permit them to give greater service to their employment by being relieved of worries about their future.

Progress of this kind ought not to be halted by the adoption of unwise punitive laws. The elimination of the use of deferred benefit methods, which will result under the Revenue Act is passed by the House, would be a backward step for this country and would destroy entirely the most effective method yet found for creating harmonious and cooperative employer-employee relations.

CERTAIN OF THE PROVISIONS OF SECTION 144 OF THE HOUSE BILL CONTRADICT EACH OTHER AND CONTAIN REQUIREMENTS WHICH ARE NOT ONLY HIGHLY IMPRACTICAL BUT WHICH ARE ALMOST IMPOSSIBLE OF FULFILLMENT

Under existing law there have been three commonly used methods of providing deferred benefits, namely, a pension trust, a group annuity plan and a profit-sharing trust. As the law now stands an advantage is granted to an employer using a group-annuity plan over the employer adopting a pension trust in the manner of deducting contributions.

The amendment to section 223 (p) made by the House equalizes deductions under both of these methods; however, it also brings profit-sharing trusts under the same strict limitations as pension trusts. Fundamentally, the plans for pension trusts and profit-sharing trusts have entirely different conceptions and should not be treated as being in the same category. A pension trust establishes immediately maximum pensions and requires contributions of a level amount each year to provide pensions for future services to be rendered by employees from the date the pension trust is adopted. On the other hand, a profit-sharing trust ordinarily creates only a minimum retirement income, the annual contributions by the employer are not fixed but are dependent upon the annual profits of the company, and the ultimate amount to be received by employees is fixed by the results of profitable operations and successful conduct of the business furnishing the employment. In some plans there is a fixed percentage of profits which the employer agrees to contribute, in other plans certain formulas have been developed to determine the amount of profits to be contributed, and in still other plans, the share of profits is fixed annually by the board of directors of the employing company. In all of them there must be profits if the employees or stockholders are to benefit.

Profit-sharing plans and trusts of this nature provide a specific stimulating incentive for both employers and employees to work together in harmony and to render the greatest possible service to the public they serve, or, in other words, to their market. It is the application of the profit motive that has been the basis of American growth, wealth and power.

Placing an arbitrary limitation upon the amount an employing company can pay into such a trust will completely destroy the present incentive for harmonious and cooperative efforts.

Here is presented an ideal and logical situation for the application of incentive taxation to encourage larger and more generous contributions, rather than the imposition of punitive taxes for contributing to the security and welfare of a group of employees. It would be indeed regrettable if Congress were to take such a backward step after having encouraged the establishment of such plans for over 20 years.

The limitation of employer contributions to 5 percent of the pay roll of employee-beneficiaries, plus a small percentage of excess profits, will immediately destroy all of the painstaking and unselfish efforts which have been put forth through many years and which have resulted in the establishment of large numbers of bona fide, unselfish profit-sharing plans and trusts. The authority granted now to the Commissioner to deny the deduction of any amount which constitutes unreasonable compensation is considered ample protection against the abuse of profit-sharing plans and trusts.

As to pension trusts and group annuity plans the same 5 percent limitation is contradictory of the language in the report of the Committee on Ways and Means. In general, the report states that the legislation is intended to prevent discrimination in employee benefits, but almost in the same breath the report says discrimination in favor of lower-paid employees is permissible. It is respectfully submitted that if discrimination is to be prevented, it must exist all the way through any plan.

It is submitted that the committee might well have said that certain minimum pensions shall be considered permissible, and that beyond those minimum pensions no discrimination shall be permitted, and that the language of section 144 of the bill might have been worder correspondingly. The 5-percent limitation is in itself discriminatory.

The language of the bill is ambiguous in that it does not clearly define whether the 5-percent limitation is applicable to the compensation of each employee-beneficiary, or to the aggregate compensation of all employee-beneficiaries. Whether treated as an individual or a combined limitation, discrimination still exists because of the varying ages of employees.

The following schedules of benefits will illustrate both the discrimination resulting from the 5-percent limitation and the inadequate amounts of retirement incomes resulting therefrom.

SCHEDULES OF BENEFITS AVAILABLE

Plan No. 1 is a company investment plan where the expected incomes are based upon actuarial computations only. It is well known that such factors as investment losses and temporarily uninvested assets may reduce the incomes shown on this schedule. Current interest rate of 2½ percent is used.

Plan No. 1

Age at time of entering plan	Annual contribution	Monthly retirement income at age 65	Death benefits
30	$100	$52.27	None.
35	100	40.99	None.
40	100	31.16	None.
45	100	22.65	None.
50	100	15.35	None.
55	100	9.94	None.
60	100	4.09	None.

Plan No. 2 assumes incomes guaranteed under a group-annuity contract issued by a life-insurance company, based upon future service contributions.

Plan No. 2

Age at time of entering plan	Annual contribution	Monthly retirement income at age 65	Death benefits
30	$100	$48.09	None.
35	100	37.71	None.
40	100	28.66	None.
45	100	20.83	None.
50	100	14.13	None.
55	100	8.46	None.
60	100	3.75	None.

Plan No. 3 assumes the use of an individual annuity contract issued by a life insurance company on the life of each employee-beneficiary.

Plan No. 3

Age at time of entering plan	Annual contribution	Monthly retirement income at age 65	Death benefits
30	$100	$39.70	None after income payments are started.
35	100	31.17	Do.
40	100	23.81	Do.
45	100	17.40	Do.
50	100	11.90	Do.
55	100	7.27	Do.
60	100	3.23	Do.

Examination of these schedules shows that a limitation of 5 percent of compensation (1) discriminates harshly against the older employee and (2) fails to provide a reasonable amount of pension.

The contribution of $100 per year is 5 percent of an annual compensation of $2,000, which is above the average compensation. If the contribution were reduced as to younger employees and increased as to older ones the total limitation would still create a discrimination and prevent payment of reasonable retirement incomes.

The privilege of deducting one-fifth of excess amounts is a carry-over of a part of the 1926 act and has no general applicability. It was intended by Congress to permit the deduction over a period of years of money previously placed in a reserve upon which taxes had been paid. (See reports, Ways and Means Committee.) Under a ruling of the Commissioner of Internal Revenue, I. T. 2910, purchasers of group annuity contracts, ignoring section 23 (p), have been especially favored in deductions, and that part of the proposed amendment of 23 (p) which places group annuity purchasers on a par with those who establish pension trusts, is recommended for adoption.

No plan of deferred employee benefits is complete if it merely guarantees a retirement income. An employee's worries and fears are not limited to his own individual situation, but include a constant worry as to the future maintenance of his wife, children, and dependents. A well-rounded plan must, therefore, include provisions for benefits to be paid in the event of the death of an employee, both before and after he retires from active work. If, under the figures shown, some death benefits are to be available from the total contributions, whether invested with an insurance company or otherwise, and a well-rounded program of benefits is to be had, the incomes shown would be greatly decreased under the first and second schedules, but would remain about the same under the third schedule. Some of the plans where the funds are company or committee invested are not solvent today. Limiting employer's contributions to these plans will prevent them from ever becoming solvent.

Suggestions regarding proposed amendments of section 165 (a).—In general no criticism can be offered of a requirement that employee trusts shall be broad enough in their coverage to include 70 percent of the permanent employees. However, the definition of an employee who may work more than 3 months in a year as being a permanent employee is unreasonable. It should be expanded so as to exclude any employee who works less than 6 months in any calendar year. As now written the bill provides that a plan or trust must "benefit" 70 percent or more of the permanent employees. There has been and will be many instances where an employer establishes a bona fide plan and makes it available to 70 percent or more of the permanent employees, but enough employees may temporarily fail to avail themselves of the benefit of the plan so that possibly 69 percent would be actually benefited. The language should be changed to provide that the benefits of the plan and trust should be available to 70 percent or more of the permanent employees.

This 70-percent requirement would be objectionable were it not for the provision that plans with smaller coverage will be deemed bona fide upon approval by the Commissioner, because there are in existence hundreds of plans which are entirely unselfish and nondiscriminatory even though they do not cover 70 percent of the permanent employees. Under many of these latter plans the scope is being constantly widened to eventually include steadily increasing proportion of the total employees and such plans should be encouraged.

The provision for approval by the Commissioner is objectionable in one respect, namely, in that it gives final authority to the Commissioner without the right of appeal to either the Board of Tax Appeals or the courts. The authority so conferred upon the Commissioner will probably be exercised by various of the Internal Revenue Bureau men, to whom authority is delegated, and whose final decisions will be based to some extent upon their personal beliefs and prejudices. It is recommended that this provision of the bill be changed to correspond to the methods commonly used in all tax matters, whereby a final determination of the bona fides of any plan will rest with the courts. In the only instance where final power has been conferred upon the Commission, which was the three-man Board established under the law providing for a tax upon unjust enrichment, it is a notorious fact that over 90 percent of the decisions were against the taxpayers, from which decisions no appeal could be taken. To deny a taxpayer the benefit of an appeal to the courts is highly un-American, and such a provision would be most inopportune at a time when we are sacrificing and fighting to preserve the American way of life.

In the statements which have been made to your committee there is no desire to argue for retention in the law of any provision which will permit widespread abuse, or which will permit the continuance or establishment of employee plans and trusts solely for the sake of avoiding the payment of taxes, or for the purpose of benefiting a few favored individuals. However, it is urged upon your committee that the entire country would be vastly benefited under the provisions of existing law, even though there were some abuse, but not under the prohibitive and objectionable restrictions and limitations in the bill as passed by the House.

Exemption from all income taxes of payments to employees from profit-sharing retirement funds or trusts.—The Federal Government today recognizes the public benefits of life insurance by granting special tax exemption. In addition to the Federal Government, practically all of the States allow the insurance payment to be exempt from the tax whether the proceeds are paid direct or in trust.

In essence and logic, a corporation which creates and develops a profit-sharing fund in the form of an irrevocable trust is, for all practical purposes, building endowment or life insurance for the benefit of the worker or his beneficiaries in the event of his death. The same attitude should be assumed by the Government to such a profit-sharing retirement fund as it now maintains toward life insurance.

Such reward and encouragement as would be extended by such an exemption can be well founded upon the basis of the benefit to the common welfare. Such a retirement fund is insuring the independence, comfort, and security of the worker in his or her old age. It is removing that worker from the shoulders of the Government in old age. An inviolate and irrevocable retirement trust fund is in reality a life-insurance contract. If insurance benefits are exempt, then payments to the beneficiaries (the workers) of such a fund should also be exempt. The savings of the worker contributed to the profit-sharing fund are identical to the annual premium paid on a life-insurance contract. The only difference possible of contention is that the corporation is contributing a portion of the fund ,which builds the retirement fund. Accepting this as a difference, Government should recognize that the corporation is contributing to the general welfare by such contributions.

A six-point program for victory in the war and for the protection of a sound national economy.—In conclusion, Senators, I submit to you in all sincerity and seriousness of which I am capable of expressing, a program which is within your power to vitalize by tax encouragement and present for the approval of the executive departments of the Government and the acceptance of business and industry.

Permit me to preface this program with four vital factors which should control your consideration of a tax law such as is now before you for consideration?

First. We must win this war at all costs, but primarily by maintaining a unity of management, men, and money.

Second. We must pay the enormous cost of the war without destruction of our productive enterprise by ruinous and devastating taxation. Our industrial machine is our first line of defense and offense.

Third. We must prevent the economic collapse of the Nation by the vicious effects of inflation while fighting the war to its successful conclusion.

Fourth. We must safeguard the rehabilitation and reconstruction of America after the war by insuring readjustments from a wartime to a peacetime economy through the preservation of the American enterprise system.

Here in brief is my proposal:

Encourage in every way possible the inauguration of profit-sharing retirement fund trusts under the general formula—

(*a*) Joint contributions of employees and employers.

(*b*) Accumulated funds or estates.

(*c*) Discretion as to payment and liquidation of the employee's share in case of discharge or unemployment for reasons beyond his control.

(*d*) Permission to the corporation to extend hospitalization and medical care.

(*e*) Payment to the family of the employee in case of death before date of retirement.

Advantages.—Such a formula universally adopted throughout American industry, or accepted and inaugurated by a substantial proportion of the Nation's industry, would:

(1) Create a tremendous impetus to the sale of war bonds; an increased contribution to the support of the war cost which would subordinate in marked degree the difference between the amount to be be gained by taxation of trust funds, and the nation-wide sale and absorption of several billions of war bonds.

(2) By the accumulation of these war bonds in retirement fund trusts, the Government would not be called upon for payment of such bonds for many years, thereby relieving the Government of one of its most serious future problems.

(3) Stop the spiral of inflation by governing wages in the manner of letting the employee decide whether he wants increased wages today, or an estate guaranteeing financial security and independence later at the time of retirement. Employees in hundreds of institutions have demonstrated their preference for future security.

(4) Insure harmony and peace in the industrial field which means (1) increased production, (2) better product, (3) efficiency, and (4) loyal cooperation.

(5) Bring employees throughout industry to the consciousness of their real partnership in the industrial operation, whereby they participate in profits, forget the demanding of increased wages, and unite for the winning of the war and the preservation of the American free enterprise system.

(6) Provide for the cushion against mass unemployment in the post-war period. Do something now to provide financial subsistence for those who will suffer unemployment when the let-down from maximum war production occurs. Provide the bridge-over financial help for the change from wartime to peacetime operations.

Gentlemen of the committee, the foregoing objections combine all the factors and features essential to a united America; to a greater financing of the war by greatly increasing the amounts to be gained by taxation of these employee trust funds; relieves the Government of early redemption of bonds, and is the most practical and constructive program for the cure of social unrest which is the greatest menace to the preservation of our American enterprise system.

The CHAIRMAN. Thank you, sir.

Mr. H. E. Bowman, of Boeing Aircraft Corporation.

STATEMENT OF H. E. BOWMAN, TREASURER, BOEING AIRCRAFT CO., SEATTLE, WASH.

Mr. BOWMAN. Gentlemen, I greatly appreciate the opportunity of being here. I am the treasurer of Boeing Aircraft Co., the designers and builders of the Flying Fortress which General Arnold says is the guts and backbone of our world-wide air offensive. I am here to plead to you for the life of that company because in our opinion this tax bill, if passed in its present form, will probably effectively end its existence. I say this with all seriousness. I was urged to come here by some of the members of the Truman committee, who visited our plant and were able to see what effect this bill would have on the war effort—how it would in our case effectively stop further development which is so essential to winning this war.

It is curious that I should be here to plead for the life of this company at a time when in Seattle the company and its employees are being given the Army-Navy production efficiency award. Boeing is the first airplane manufacturer to be so honored and in the words of Under-Secretary Patterson, it "is your Nation's tribute to the patriotism and production effort of your plant."

It is ironical that the events which lead up to the granting of this award are the same events which will cause the proposed tax bill to be so disastrous in effect. Boeing suffered heavy losses during the base period, largely because of the fact that it was developing the Flying Fortress, the Trans-Atlantic Clipper, and the Stratoliner. Thus the company has substantially no income or invested capital credit and the 90-percent rate applies to an excessive amount of its income.

Further, the company is the victim of the fact that its Flying Fortress was regarded so highly by the Air Corps that we were not permitted to sell it abroad. So far as we are aware, this was the only American military airplane in this category. Furthermore, we were requested by high Government officials not to sell the design rights of one of our largest commercial airplanes to a foreign buyer and we refrained from doing so even though there was not then in existence any law by which the sale could have been prevented. Thus the company is now being penalized for having developed outstanding airplanes and for having cooperated with the Government.

Attention is also invited to the fact that Congress recently enacted a renegotiation statute which directs the Secretaries of War and Navy to renegotiate any contract which in their opinion will yield an excess profit. I understand the services have rather drastic ideas on this subject. We have shown in a brief submitted to your committee that even without renegotiation Boeing would retain under the proposed tax bill less than one-half of 1 percent on the gross volume of business done. Any renegotiation downward would, therefore, be extremely serious, if not disastrous. Inasmuch as renegotiation is a form of taxation it appears that the limit of bearable taxation has been exceeded in the case of those companies whose contracts are subject to renegotiation and whose remaining profits are subject to a 90-percent excess-profits tax.

I would like to say at this point that I noticed in his testimony that Mr. Davidson said that the aircraft industry had the largest percentage of its income subject to excess profits, and that it was 82 percent. According to our computation, 96.6 percent of the Boeing income will be subject to the 90-percent rate.

Senator TAFT. What are you under?

Mr. BOWMAN. Invested capital.

Senator BYRD. Is that your high bracket?

Mr. BOWMAN. 96.6 percent of all of our profit will be subject to the 90-percent rate.

Senator BYRD. What percentage of all of your profits will be paid in taxes?

Mr. BOWMAN. All of it.

Senator BYRD. Do you mean you will take your taxable income and pay 96 percent of that?

Mr. BOWMAN. No; that is not quite what I meant to say. Ninety-six and six-tenths percent of it will be subjected to the 90-percent rate.

Senator TAFT. It makes about 85 percent of your total?

Mr. BOWMAN. About 88¾ percent will be our average tax.

The CHAIRMAN. Your whole effective tax, both normal and surtax, will be 88¾ percent?

Mr. BOWMAN. Yes, sir.

Senator BYRD. You will pay 88 percent of your net income?

Mr. BOWMAN. Yes, sir. Our lawyers don't believe this, but it is barely possible that some of the relief provisions could be construed to cover such cases as ours. We are certain, however, that we could not establish by evidence any constructive normal income basis. It must be remembered that we build large airplanes, some of which cost approximately a million dollars each and which take more than 2 years to develop, and the development costs about $4,000,000. No criteria exists upon which to establish a constructive base earning for such items. It has got to be an arbitrary one giving consideration to what Boeing has contributed to the people of America. Boeing did not develop one product—it produced an era—the four-engine era. That era is here to stay. Most of the airplane money in this war will go for four-engine airplanes. That is true of cargo planes as well as battle planes and this is all traceable back to Boeing's pioneering at a time when Boeing and a small group of Air Corps officers were about the only ones who had the vision to see the absolute necessity for this type of airplane.

Furthermore, it appears that the procedure of paying most of the tax and then petitioning for the return of a portion will defeat the very purpose of the relief provision. Boeing will need its money currently if it is to continue development work whereas under the House bill it will very possibly take years to recover it and that can only be accomplished at considerable cost not only in cash but in executive time. It would seem that some simple direct method could be found whereby those companies which find themselves in the same position as does Boeing could pay a lesser portion of the tax and only have to prove to the board that they qualify under that relief provision. The amount of relief should be automatic. We have offered a form of relief which we believe is equitable. If the method suggested does not meet with the committee's favor, we have several alternate suggestions which I will be glad to discuss with anyone the committee may designate.

In connection with the award to us by the Army-Navy for production efficiency, we were extremely interested in noting an editorial in Collier's magazine of recent issue wherein they suggested that your committee might well give consideration to granting some small tax relief as a reward to companies who are granted the award for producing effectively and efficiently as this means that these companies are not only doing a good job in assisting in the war effort but by reason of the fact that they are producing efficiently, they are producing at a lower cost.

My attention has been called to an article which appeared in the latest edition of Time magazine about our president, P. G. Johnson, in connection with the Army-Navy award. In this article Time implied that Boeing would have "whopping" profits. We cannot, of course, be responsible for any statement which a magazine may make but I am giving consideration to writing them a letter calling their attention to the fact that most of Boeing's business is on a 5 percent fixed fee basis. O. P. A. at this time is writing a regulation covering aircraft. Many items of necessary cost are disallowed. We believe it is apparent, therefore, that after a 5 percent fixed fee is reduced by O. P. A. ceiling requirements, by disallowed items of cost, by renegotiation and by an 88 percent over-all tax rate, profits will not be "whopping."

I think I might take just one moment to impress upon the committee, if I may, the burden which the aircraft industry is carrying now. Not only are we having to produce very largely ourselves but we are having to develop new products, and we have had to bring in other industries, such as the automotive industry. The Big Three of the automotive industry are now in the airplane business, and we are teaching them everything we know about it, we are giving them our designs and they have announced that they are going to be our competitors after this war. That is one reason we should not be sacrificed, so that after the war is over the entire airplane industry will not be in the hands of the automotive industry.

Boeing, I think, is typical. Seven companies in the United States are building our airplanes. One of them, Bell, I believe, has opened a big plant in the chairman's home State to build one type of our planes. I don't know much about Bell, but I think they are perhaps in the same position as we are, from their published statements, in that they were developing airplanes in the base period.

We have prepared a statement which has been mailed to each member of this committee and to the committee as a whole. In this statement we have set forth facts not included in my discussion here today. We also included photographs of the airplanes developed in the base period. We realize fully that you are extremely busy men, that you have many weighty and complex problems to solve. However, our life is in your hands and we feel that our record of accomplishment justifies the request that our plea be read. We feel sure if the facts are known, Congress will grant relief for the sake of the war effort, if not for the sake of this company.

The CHAIRMAN. Thank you. Would you like to have entered in the record—we cannot put in the photographs—the statement to which you referred as having been sent to all members of the committee?

Without objection, the statement from the Boeing Aircraft people will be incorporated in the record, omitting, of course, the photographs which you cannot reproduce.

(The statement referred to is as follows:)

STATEMENT OF H. E BOWMAN, TREASURER, BOEING AIRCRAFT CO., SEATTLE, WASH.

Congress has under consideration a new tax bill. We are fully conscious of the fact that during time of national emergency tax rates must of necessity be high. However, the proposed 90 percent excess profits tax rate, when combined with the proposed method of computing the amount of exemption, will adversely affect the war effort and may well result in ruination to certain companies. This conclusion is based upon a careful study of the proposed bill as passed by the House and the reasons leading to this conclusion are set forth herein.

The bill as passed by the House does contain a relief provision and without doubt it was the intention of the House that relief should be granted in all cases where the other provisions of the bill resulted in inequities and hardships. However, there are certain meritorious cases deserving of consideration which apparently would not come within the relief provisions in the bill as passed by the House.

Particular attention is invited to the case of those companies which are contributing so much to the success of the war effort by reason of their foresight in developing in peacetime those products which are essential to the war effort and yet, because of this very development work, had little or no net income during the base period which is used in computing excess profits tax credit. Boeing Aircraft Co. is an outstanding example of such companies. It is proud of the fact that in the face of discouragement and lack of incentive it conceived and developed (largely at its own expense) the flying fortress, which Major General Arnold has called the "guts and backbone of our world-wide air offensive" and which Brigadier General Tinker said was "the outstanding development of the war." Valiant pilots, upon returning victorious from the Midway Island battle, said of the flying fortress, which was a most important factor in that battle, "the B-17 will win this war for us." Not only did this company conceive and develop the flying fortress, but it also developed at great loss, the trans-Atlantic clipper—"the trans-Atlantic lifeline"—and the stratoliner the four-engine high altitude transport which is doing such yeoman service. While the latter two airplanes were originally commercial developments, it will be shown later that many features so dearly learned are now incorporated in our military airplanes. In addition to conceiving and developing these airplanes, the company has done during the past year, and is doing, such an outstanding job of building and delivering flying fortresses that it has now been awarded the only Army and Navy "E" pennant for production efficiency thus far awarded to aircraft companies.

Furthermore, Boeing currently has under way two military development projects on which it is estimated that losses in excess of $3,000,000 will be sustained and is now engaged in constructing at its own expense an advanced type wind tunnel for use in research work.

As a result of its development program, the company sustained severe losses during the "base" period which had the dual effect of causing it to have practically no "average base period net income" and also prevented it from building up its invested capital. Thus the company has virtually no excess-profits tax credit. This lack of credit makes the 90 percent rate practically confiscatory *and will so limit the remaining cash funds available that Boeing will be effectively precluded from contributing so materially to aviation progress and to the improvement of the Nation's air arm.* The excellence of the equipment which our armed forces have had has been instrumental in whatever successes they have achieved to date, and it is our opinion that the continued development of new and improved military aircraft is imperative to the war effort.

The proposed tax law in addition to curtailing vitally needed research and development will result in discriminatory taxation which is neither equitable nor to the Government's best interest. In the final analysis a high tax rate is a profit-fixing device in the case of Government contractors. The standard of permitted profit on a Government contract under the proposed tax law is determined largely by the company's earnings during the base period. Thus through the proposed tax law the Government permits Boeing to make only nominal profits from Government contracts because Boeing served its country well by developing these sorely needed airplanes, while at the same time it sets a higher and more reasonable profit standard for other companies similarly engaged on current Government contracts simply because several years ago the other companies were engaged in more profitable business of another nature.

We wish to specifically illustrate this point. In this illustration we make comparisons of the net profit after tax. Naturally, we do not have access to the tax returns of any other company, but we do have annual published reports of such companies and we believe that the conclusions drawn from such reports are reasonably accurate.

Boeing Aircraft Co., as pointed out above, has developed to a high point of excellence the four-engine bombardment airplane. At the request of the United States Army Air Forces, Boeing has entered into agreements with several other companies wherein Boeing agreed to furnish the necessary information to enable these companies to build Boeing bombers. At least one of these companies had not previously been in the airplane business. To draw a comparison of the effect of the proposed tax law on Boeing (which conceived and developed these airplanes), and the newcomer (which will build a Boeing-designed airplane), we assumed that Boeing and the other company would have the same gross profit per airplane and we have further assumed that both companies would have the same amount of profit before taxes in 1942 as in 1941 (after making necessary adjustments for nonrecurring and nontaxable items). We then applied the proposed tax law to both companies. It revealed that Boeing would be permitted to retain 11.17 percent of its net taxable profits, while the other company would be permitted to retain 26.51 percent of its net taxable profits. In other words, the other company would be permitted to make net, 2.37 times as much profit on a Government contract to build Boeing planes as would Boeing.

Recently one company advertised that it had contracts to produce 10 percent of all war munitions, including airplanes, motors, etc. These include several new lines of endeavor in which it is participating by invitation. The established companies in these lines have furnished the designs and "know how." The company in question has announced that it intends to remain in certain of these fields after the war. Due to the inequities in the proposed tax law, it is doubtful if many of the companies which pioneered and developed the products in these fields will be able to survive. The proposed tax laws give this newcomer a great advantage by prmitting it to retain fair profits simply because years ago it made substantial profits in other lines of endeavor. The majority of Boeing's contracts are based on cost-plus-a-fixed fee of 5 percent. The fee does not represent contract profit for the reason that disallowed items of contract costs (which are substantial in amount) must be paid out of the fee. Boeing, due to past development losses, has a relatively small invested capital credit, and a 90-percent excess-profits tax, together with a 45-percent normal and surtax, will produce an effective over-all rate of taxation in excess of 88¾ percent. The remaining 11¼ percent of the 5 percent (less disallowed costs) means that Boeing would retain less than one-half of 1 percent on the volume of business done. Thus it can be seen that Boeing's net retention after taking care of taxes will not permit it to provide reserves to meet the post-war return to normal operations and compete with this entrenched newcomer.

Attention is invited to the fact that the proposed law makes no provision for recognizing as an element of cost before determination of profits the expense incidental to returning the physical properties and organization to a normal basis. A construction contractor is permitted to tear down the scaffolding, remove his construction shack, clear up the debris, and put the grounds in order. Defense industry today has the same problem, but no allowance is made for it. The Boeing office and factory buildings are painted a drab green. The windows are painted black on the outside with a green overcoat. Inside they are covered with plywood. The interior of the factory is cut up with splinter-proof parapets. The roofs are covered with lookout houses and guns. The factory is crowded with machines not required for ordinary operations. The organization is geared to a three-shift 7-day week operations of a magnitude unheard of prior to the war. Under these circumstances we submit that it is fallacious and unjust to refer to any figure as being taxable profit until adequate provision has been made to provide for the inevitable expense of returning the factory and organization to a normal basis.

There is another very important factor to be considered in reviewing the probable effect of the proposed tax law on companies currently engaged in military development work. The airplanes which Boeing has under development are so vital to the war effort that military authorities insist that Boeing's entire engineering staff devote its full time to these projects. Other companies with less important military airplanes under development are permitted and encouraged to devote considerable engineering time to developments which are fundamentally commercial. Rewards for services cannot be measured by the immediate cash received. Boeing's reward will be limited to profits from Government contracts (which, as previously pointed out, will largely be taken away under the proposed tax bill), while the competitors' reward will consist not only of the retention of a larger proportion of cash from current profits but also of emerging from the war with a strangle hold on the commercial market. The loss of competitive position is a real and severe loss which cannot be presently estimated in dollars and cents, nor can it be taken as a deduction on tax returns. This situation is exceedingly important for the reason that it costs several million dollars and takes at least 2 years to develop a large airplane. It is therefore inequitable to tax Boeing so severely that it cannot reconstruct its competitive commercial position.

In conclusion we wish to reiterate that an excess-profits tax rate of 90 percent, together with the low exemptions which many companies in the aircraft industry particularly will have, will be harmful to the war effort, result in inequitable taxation, and may result in ruination for many companies. The proposed law will be particularly harmful to the war effort by precluding many established companies in the aircraft industry from continuing with comprehensive research and development programs. This research and development can only be successfully done by the established companies for the reason that they alone have the trained, organized, and integrated technical staffs with the necessary experience to carry on such a program. The proposed law will result in inequitable taxation because for years the profits and business of the Government contractors in the aircraft industry have been controlled and limited. They have largely been kept during peacetime on a development basis so the country would have a basic industry to meet a war challenge. The industry has met that challenge. It has carried the war burden while the newcomers' plants and organizations were being converted and they were being supplied with the "know how" by the industry. These newcomers are now being allowed to make reasonable profits from aircraft contracts because they have a reasonable exemption base while the established industry will face possible insolvency due to a relatively low base arising from the pre-war restrictions. Also one of the inevitable results of the tax law will be the further concentration in the post-war era of business in the hands of a few corporations. We do not believe that it is desirable for America to emerge from the war with a comparatively few corporations controlling business. We especially do not believe it is desirable for the Government to make a gift of the aviation industry to a few powerful corporations without regard to merit on their part. The proposed law may well result in ruination to certain companies in that they will not be permitted to retain sufficient funds to meet post-war reconversion costs to normal operations and to regain their competitive commercial positions.

In order that the war effort be not harmed, and to assure equitable and just taxation, we suggest that the relief provisions in the proposed law include the following paragraph:

"If during the base period the taxpayer was to a substantial extent engaged in research and development work which contributed materially to the improvement or development of articles manufactured for the United States and which articles are used in or are necessary in the war effort, and by reason thereof the average base period net income of such taxpayer does not provide a reasonable base for the measurement of the excess-profits tax credit in the taxable year, the taxes (normal income tax, surtax, and excess-profits tax) payable by such taxpayer during such taxable year shall in no event exceed an amount equal to 75 percent of the taxable net income of such taxpayer for such tax period."

There are attached hereto photographs of the airplanes, the development of which caused the company to suffer heavy losses. These photographs reveal several of the many features of design developed on the commercial airplanes that are now incorporated in military airplanes. Other features which cannot be discussed for military reasons are also being incorporated.

We would welcome the privilege of discussing this matter further with you as we are certain that the proposed law, if not amended, will bring about undesirable results which are not intended or contemplated by the Congress.

BOEING AIRCRAFT CO.,
H. E. BOWMAN, *Treasurer.*

Senator BYRD. I should like to insert in the record a memorandum on smoking tobacco, Federal taxes, also a statement of the Larus & Bros. Co., of Richmond, in favor of the differential on cigarettes.

(The memorandum and statement referred to are as follows:)

A MEMORANDUM ON SMOKING TOBACCO—FEDERAL EXCISE TAXES

On July 23, 1942, Mr. Morgenthau, Secretary of the Treasury, appeared before the Senate Finance Committee and suggested that the present excise tax of 18 cents per pound be increased to 36 cents per pound in the 1942 Revenue Act. This increase is estimated to produce $26,800,000 additional revenue.

We believe it is desirable to call the following pertinent facts to your attention:

(1) *Pipe smoking is the most economical form of smoking.*—It has long been recognized that the most economical form in which tobacco can be smoked is in a pipe. There are many who cannot afford to purchase cigarettes. In our opinion we should first exhaust all other possible sources of revenue before placing this additional burden of 18 cents per pound on these people.

(2) *Due to the present economic conditions an increase in cigarette taxes will not drive consumers to smoking tobacco.*

A CURRENT EXAMPLE

On July 1, 1940, the Federal excise tax on cigarettes was increased from $3 to $3.25 per thousand. Since this date the production of pipe-smoking tobacco shows a downward trend as follows:

Pipe-smoking tobacco, United States total production

	Pounds
1940	205,101,032
1941	197,622,203
A decrease of	7,478,829

This decrease occurred in spite of the fact there was an increase on July 1, 1940, in the Federal excise tax on cigarettes from 6 to 6½ cents per package, or from $3 to $3.25 per thousand. Unanimous opinion was that an increase in the cigarette tax would cause a "switch" to pipe-smoking tobacco. The reverse has happened. Due to our war effort, which is steadily increasing purchasing power of the consumer, cigarette consumption increased while pipe-smoking tobacco consumption decreased. (See attached exhibits A and B for more data.)

(3) *The per capita consumption of smoking tobacco was smaller in 1941 than it was 10 years earlier.*—

	United States population	Smoking-tobacco production	Per capita consumption
		Pounds	Pounds
1932	124,657,565	190,986,528	1.53
1941	132,818,005	197,622,203	1.49

Thus with a constant tax of 18 cents per pound, the per capita consumption of smoking tobacco has decreased 0.04 pounds per person during the past 10 years.

(4) *Smoking tobacco now carries the equivalent of a 20-percent Federal sales tax.*—If, as the Treasury suggests, an 18-cents-per-pound tax is superimposed upon a tobacco classification which has lost ground during the past 10 years, unquestionably the results will be a sharp decrease in smoking-tobacco consumption. Based on retail prices, the 18 cents' proposed tax increase would have almost exactly the effect of a 20-percent sales tax. It is very difficult for an industry which has lost ground during the past 10 years to survive if an additional 20-percent sales tax is added. Let us not forget, prior to World War I, the Federal excise stamp tax on smoking tobacco was 8 cents per pound. This was increased to 18 cents per pound in 1919.

(5) *The proposed increased tax on smoking tobacco will in all probability limit the farmer's market.*—Smoking tobacco furnishes the domestic consumer outlet for those grades of leaf tobacco too heavily bodied for cigarettes and too light-bodied for chewing and are naturally produced in burley and flue-cured types. It is impossible to grow a plant of tobacco, either burley or flue-cured types, without producing a large percentage of strictly pipe tobacco which is unsuitable for either cigarettes or chewing. If increased taxes drastically reduces pipe smoking, the farmer will have trouble marketing his surplus pipe tobaccos. Smoking also accounts for an outlet for certain grades of dark air-cured, dark fire-cured, Louisiana perique and Maryland types of tobacco. The consumption of pipe-smoking tobacco is very essential in order to afford the farmer-producer of these types of tobacco a complete market outlet for their entire production of tobacco.

EXHIBIT A.—*Total production of manufactured tobacco and snuff for calendar years 1938 to 1941, inclusive*

Calendar year	Plug	Twist	Fine cut	Scrap chewing	Smoking	Snuff	Total
	Pounds	*Pounds*	*Pounds*	*Pounds*	*Pounds*	*Pounds*	*Pounds*
1938	54,494,646	5,658,854	4,572,346	42,775,966	200,693,591	37,173,135	345,368,53[illegible]
1939	51,262,796	5,732,777	4,701,102	41,350,992	202,289,118	37,969,933	343,306,71[illegible]
1940	48,758,919	5,605,287	4,176,364	42,909,979	205,101,032	37,871,628	344,423,209
1941	50,207,089	5,619,163	5,148,749	44,162,579	197,622,203	39,716,195	342,475,978

NOTE 1.—This data was prepared from reports of the Commissioner of Internal Revenue.

NOTE 2.—The present Federal stamp tax on each of the above classifications is 18 cents per pound. The Secretary of the Treasury has proposed to the Senate Finance Committee that the tax on smoking tobacco classification be doubled or increased to 30 cents per pound. From the above table, you will observe the smoking-tobacco classification shows a decrese in production since 1940.

EXHIBIT B.—*Collections of internal revenue from tobacco taxes, fiscal years ended June 30, 1941, and 1942*

Sources of revenue	Receipts from July 1, 1941, to June 30, 1942	Receipts from July 1, 1940, to June 30, 1941	Increase or decrease
Cigars (large)	$14,877,828.15	$13,900,527.60	+$977,300.63
Cigars (small)	104,051.62	1[illegible]3,969.87	−9,918.25
Cigarettes (large)	15,981.44	12,059.83	+3,921.61
Cigarettes (small) [1]	704,933,504.61	616,745,234.31	+88,188,270.30
Snuff of all descriptions	7,440,212.25	6,899,820.62	+540,391.63
Tobacco, chewing and smoking	52,138,924.73	54,927,764.18	−2,788,839.45
Cigarette papers and tubes	1,960,557.77	1,431,315.35	+529,242.42
Leaf dealer penalties, etc	6,049.82	11,814.90	−5,765.08
Cigarette floor tax	5,105.35	4,534,384.21	−4,529,278.86
Total	780,982,215.72	698,076,890.87	+82,905,324.85

[1] 10-cent and 15-cent cigarettes.

Source: Form 7094, Treasury Department, Internal Revenue Bureau, Accounts and Collections Unit.

RICHMOND, VA., *August 12, 1942.*

Senator HARRY F. BYRD,
Senate Finance Committee,
Washington, D. C.:

Please insert into the record that we as manufacturers of economy cigarettes wish to recommend the adoption of the cigarette tax differential as we feel this is necessary to preserve competition for the benefit of the farmer as well as the consumer.

Economy cigarettes are fast going off the market due to present tax inequalities.

W. T. REED, Jr.,
Larus & Bro. Co.

The CHAIRMAN. Mr. Hess.

STATEMENT OF BEECHER HESS, WASHINGTON, D. C., REPRESENTING PEOPLES COMMITTEE TO DEFEND LIFE INSURANCE AND SAVINGS

Mr. HESS. My name is Beecher Hess, of Washington, D. C. I appear today as a representative of the Peoples Committee to Defend Life Insurance and Savings for the purpose of offering for the record a letter from the chairman of that committee, Mr. C. Vivian Anderson.

The CHAIRMAN. It may be entered into the record.

Mr. HESS. Thank you, sir.

(The letter referred to is as follows:)

PEOPLES COMMITTEE TO DEFEND LIFE INSURANCE AND SAVINGS,
Cincinnati, Ohio.

SENATE FINANCE COMMITTEE,
Washington, D. C.

PREMIUM DEDUCTION FROM INCOME TAX

GENTLEMEN: A very large percentage of all men leave nothing at death for their families except life insurance. If it were not for the large amounts of money paid out for death claims and matured endowments by the life insurance companies during the year there would be a great deal more required of the public for orphans' homes, poorhouses, old-age homes, and for all types of charity in general.

Since the Government allows a deduction for amounts paid to charitable organizations, it seems reasonable that the Government should allow a deduction for life insurance premiums paid, because the more insurance a man can leave his family the less likelihood there is that they will have to depend on charity in any sense of the word. Thus through the medium of life insurance the necessity for some of the charitable organizations is lessened.

Due to the scarcity of consumer goods because of the war effort, there is bound to be a lot of surplus cash in the hands of the people for a number of years to come. Some of this money will go into Government bonds, savings banks, and life insurance; and as soon as it is possible to again buy consumer goods, bonds will be redeemed, money withdrawn from savings banks and life insurance either borrowed upon or cashed. Giving a liberal exemption for premiums paid on life insurance will be an incentive for men to continue to carry protection for their families and their own old age, thus creating a very effective brake on inflation.

Securities in the hands of individuals and banks are very likely to be turned in to the Government for cash; whereas securities in the hands of the life insurance companies for the most part will remain there until the maturity date of the bonds. Thus you would get a stabilizing effect from money paid into insurance companies from which Government bonds are purchased.

Anything the Government might do in the way of allowance on income tax for premiums paid on life insurance will have a tendency to stimulate thrift, and the premiums received by the life insurance companies will be doing a threefold job; furnishing adequate protection for old age and the family in event of premature death of the insured, helping finance the railroads and industrial plants which are very essential during the war and which will be just as essential in the reconstruction period after the war, and furnishing a large reservoir of money for the purchase of Government securities.

The allowance on income tax should be on both old and new insurance purchased because there is a greater demand during times of stress and because of the threat of inflation, for protection for the family than in normal times. Practically all the premiums which would be paid on new insurance would be immediately put in Government bonds by the insurance company, whereas the individual may not feel that the could put more of his income or savings into Government bonds than he is at the present time, and the insurance which he purchased would give his family far more protection than if the premiums were put into Government bonds individually.

EXEMPTION OF INSURANCE FROM ESTATE TAX

For a good many years the insuring public have been receiving an exemption of $40,000 on any insurance payable to named beneficiaries in addition to $40,000 on their general estate. The present income-tax bill provides for $60,000 general exemption. This would mean that a man who had very little insurance would have a $20,000 additional exemption on his estate than under the old law which would mean that the Government would collect less tax on the present estate than under the present law.

It seems, therefore, logical that the law should contain the same feature of exemption, namely, $40,000 on estate and $40,000 on life insurance as at present.

FEDERAL SALES TAX

Some months ago this committee made a very extensive survey in regard to Federal sales tax, ceiling on wages, ceiling on farm prices, abolishment of

Work Projects Administration, Civilian Conservation Corps, and National Youth Administration, limiting incomes to $25,000 net per annum. In the thousands of replies received from all over the United States, there was a demand for Federal sales tax, ceiling on wages and farm prices, and abolishment of Work Projects Administration, Civilian Conservation Corps, and National Youth Administration, and the very great majority of the people answering our inquiry stated that although they did not receive $25,000 net income, they felt it was not democratic to consider such a procedure which in the last analysis would raise a very small amount of tax. If the Federal Government will adopt a Federal sales tax similar to that in Canada the reduction in income tax for life insurance premiums would be offset. Also a very large reduction in the corporation taxes could be written in the present bill under consideration.

From the circularization and correspondence with more than 15,000,000 life-insufrance policyholders in the past 18 months, we think the vast majority of these policyholders feel that they should have a reduction of their life-insurance premiums from income tax because it is money which is being put aside unselfishly for the protection of their family rather than being used in any selfish way on themselves at the present time. They also feel that the sales tax would be fair to everyone because it would have a tendency to hold down inflation and would raise the required revenue easier and at less cost than is being done at the present time.

Therefore, because of our survey, we urge that Congress make a provision for the allowance of life-insurance premiums from income tax and retain the $40,000 general exemption and $40,000 exemption for the life insurance in the estate tax and enact a Federal sales tax which will offset any loss in revenue from the above exemptions.

Respectfully submitted.

C. VIVIAN ANDERSON,
Chairman.

The CHAIRMAN. Dr. Hugh Magill, American Federation of Investors.

(No response.)

The CHAIRMAN. Senator Capper offers this telegram for the record with a brief statement.

Senator CAPPER. Mr. Chairman, I present for the information and consideration of the committee, and ask to have incorporated in the printed record of the hearings on the pending bill, the accompanying telegram from Hon. Jeff A. Robertson, chairman of the State Corporation Commission of Kansas, in which he urges on behalf of the commission that the existing provisions governing depletion allowances on oil and gas wells for income-tax purposes be retained in the bill and in the Internal Revenue Code. I should like to join heartily in the views expressed by the chairman of this important State commission, and I hope the recommendations made in his statement may be followed by the committee in taking final action on this feature of the tax bill.

(The telegram submitted by Senator Capper is as follows:)

[Telegram]

TOPEKA, KANS., *August 8, 1942.*

Hon. ARTHUR CAPPER,
United States Senator:

On Monday, August 10, the revenue bill of 1942 will come up for discussion before the Senate Finance Committee. This commission concurs with the representatives of the oil industry of Kansas in urging the retention of the percentage depletion allowances on oil and gas wells for income-tax purpose. We urge that the revenue bill of 1942 not amend the present Internal Revenue Code on the question of percentage depletion for oil and gas wells. We believe this allowance encourages development and wildcatting, now so necessary to the war effort and to the future of Kansas. The present percentage depletion provision tends to

balance the profit years against the loss years. Since the issuance of Conservation Order M-68 by W. P. B. and O. P. A., which requires the wider spacing of wells, the percentage of dry holes has increased materially, and this is additional reason for the retention of the present percentage of depletion provision as it now reads in the Internal Revenue Code.

JEFF A. ROBERTSON,
Chairman, State Corporation Commission of Kansas.

Senator BAILEY. Mr. Chairman, what do you say to limiting the talks to 10 minutes?

We will have to do something of that kind if you wish to get through today, and you have a great number on the list.

The CHAIRMAN. The committee may have to limit. I hesitate to put an absolute limit of time on, but we will probably have to restrict the witnesses to 10 minutes each.

Senator BAILEY. We won't get through otherwise.

The CHAIRMAN. No; not today nor tomorrow. I wanted to get through today, if possible.

Senator BAILEY. I suggest that. That is a matter of kindness to all of them, because that will enable us to hear all of them.

The CHAIRMAN. We will ask the witnesses to observe that, Senator Bailey. Thank you for the suggestion.

Now, we have reached the witnesses that were assigned especially for today. Mr. Harry Cooper is the first witnesses. I should like to continue until 12:30 unless the members of the committee desire to go to the floor.

Senator BYRD. I have a matter that I would like to bring up on the floor.

The CHAIRMAN. We will finish with this witness, then, and recess.

STATEMENT OF HARRY P. COOPER, INDIANAPOLIS, IND., SECRETARY, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. COOPER. My name is Harry P. Cooper, of Indianapolis, Ind. This is my thirty-sixth year as executive secretary of one of the 86 Indiana farm mutuals and my twenty-ninth as executive secretary of the National Association of Mutual Insurance Companies.

I am appearing here in both capacities.

More than 90 percent of the 958 members of the National Association of Mutual Insurance Companies are farm mutuals or similar mutuals operating principally in one State, or a few counties, or townships, or in some cases only in one city or town. These member companies report 9,459,716 policies in force. A similar number of nonmember farm and other small mutuals look to the National Association to represent them in Washington. Most of these mutuals, both member and nonmember, operate upon the assessment plan, some assessing after the loss but many assess in anticipation of the loss so ready money may be available when loss occurs. Consequently, for the most part, the income of these mutuals consists largely of fees, dues, and assessments used or held for the purpose of paying losses and expenses. It is on behalf of these companies that I wish to speak.

These mutual insurance companies and associations are nonprofit organizations. They constitute an organized method of preventing and sharing misfortune. The class of property covered and the hazards insured against, generally determine the safe territorial limits and indicate the need and size of the safety fund. Probably the windstorm mutual has a greater fluctuation of losses from year to year than most classes of mutuals. One windstorm mutual reports $38,000 loss one year and $950,000 another. At least a State-wide basis is desirable for the safe operation of a windstorm mutual because of the catastrophe hazard. One windstorm mutual suffered a $100,000 loss in a single township. That amount in a county or adjoining counties is not unusual. Another collected $535,000 more than it paid out during that year. Two years later it suffered 30,000 losses costing $700,000 more than it took in that year. Today most mutuals collect more than needed in light years that they may tide safely over the heavy years. This is particularly true with hail and windstorm mutuals.

From a few pioneer mutuals a hundred years ago these numbers have grown to nearly 2,500. They are found in almost every State of the Union. They have always brought lower insurance cost. Even today the States having no farm mutuals have a cost per $100 for farm insurance of from 5 to 10 times that of States covered by such mutuals. The 2,000 farm fire and windstorm mutuals cover more than 50 percent of all the insurable farm property of the Nation according to Governmental statistics and at approximately 50 percent of the rate charged by commercial insurance companies.

Subsection 11 of section 101 of the present income-tax law exempts most of these mutuals from that tax because they are not operated for profit, but their income "is used or held for the purpose of paying losses and expenses." It reads as follows:

SEC. 101.—The following organizations shall exempt from taxation under this title * * *

(11) Farmers or other mutual hail, cyclone, casualty, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses.

This provision was the culmination of 17 years of difficulties experienced by these mutuals beginning with the Excise Tax Act of 1909, aggravated by the Income Tax Act of 1913, and by inadequate wording of subsequent acts, disturbing interpretation and rulings until in 1926 when the present provision was enacted by Congress. To make sure such troubles were ended a retroactive amendment was enacted cleaning the slate back through 1909.

With subsequent interpretations and rulings this provision now represents the experience of nearly a third of a century. Its meaning is established. A change may result not only in confusion in the minds of the officers of these mutuals but may change the status of many of them under the social security and unemployment taxes. Exempt mutuals do not now have to report on occasional adjusters, temporary employees or others receiving not more than $45 in any one quarter.

Moreover, the construction of the new provisions of this subsection may be more far-reaching than we can anticipate. If past experiences may be relied upon as a guide many difficulties encountered in the past will again rise to plague us. What is the meaning of "writing insurance contracts solely on a mutual basis"? Does this mean on an assessment basis? If so, would it include contracts on an advance assessment plan? Or an advance premium plan? Would it include a mutual providing for the levying of assessments annually or oftener? Would it include a mutual assessing approximately the same rate in good years and bad? Would it include only those having little or no investment income? How about the ones owning their own office building? Or those writing insurance at a fixed premium? Would the exemption apply only to those "operating as a community neighborhood activity"? These and other questions come from past experience where troubles arose. Probably one of the most annoying of these troubles was that all money carried over the end of the year was "taxable income."

The $100,000 provision of the House bill in this subsection indicates the desire of Congress to exempt many. However, the nonprofit basis of exemption is overlooked. The $50,000 deduction later provided is a further indication of the desire of Congress to exempt many. This, however, makes no distinction between the assessment mutual with no legal reserves to deduct and the advance premium mutual required to maintain such reserves which are deductible. Nor does it recognize that excess assessments, dues, or fees collected in a light year do not constitute profit but provide a cushion for heavy years.

In 4 of the years during the last 10-year period 3 of the larger windstorm mutuals collected sufficient excess assessments, fees and dues to constitute taxable income under the $50,000 deduction provision as I understand it. In the other six each paid out more than they took in or had a comparatively small excess. The deficiences ran from $24,000 to $700,000 while the excess ran from $4,900 to $535,000. These windstorm mutuals operate largely in Ohio, Michigan, Indiana, Illinois, Wisconsin, Minnesota, Iowa, Missouri, Arkansas, Texas, Kansas, Nebraska, South Dakota, and North Dakota. Is it the intention of Congress to tax these assessments in the years they exceed the expenditures by more than $50,000 under the new Income Tax Act?

Naturally, the farm mutual fire, cyclone and similar mutuals are anxious to retain 101 (11) as it is under the present law. At least they would hate to see changes made that would again involve them in years of difficulty and confusion.

These mutuals are willing to pay their share of the war burden as a war-emergency tax. In some State conventions of these companies, as well as in national groups, resolutions have been passed favoring a war emergency tax if the revenue needs of the United States Government require it. Such a tax was imposed during the last World War. Such a tax is fair and equitable, works a hardship on no one, is simple, will confuse no one, and brings in a steady flow of funds. Even though the rate were double or triple that of the other World War tax these companies would gladly pay it during the war in preference to changes in the principles recognized in the farm-mutual provision section 101 (11). The loss prevention work of these mutuals will enable them to pay such a tax without increase in cost to their members. The farm company with a million at risk would have an annual tax of less than $100 and the great majority would not exceed $50 even at double the rate of that of the last war.

These companies know what section 101 (11) means. Changes mean confusion, construction, changed rules and regulations. These companies gladly will pay their fair share of the war burden. They feel the only satisfactory plan is a war-emergency tax.

Senator HERRING. Of the 2,500 companies you represent, how many will pay tax under that provision?

Mr. COOPER. Under this $50,000 provision?

Senator HERRING. Yes.

Mr. COOPER. A good many of the windstorm companies would.

Senator HERRING. The large companies. You do not contend that this will tax the little farm mutual, do you?

Mr. COOPER. I don't think it would, unless this change in the wording: "writing insurance solely on a mutual basis" would do that.

Senator HERRING. That does not affect your buildings or any other basis?

Mr. COOPER. I don't know what it means.

Senator TAFT. I think it meant that every man who wrote insurance and participated in the returns and the profit, and so forth. That is true of all companies, I think. I would not think there would be any possibility of misinterpretation of those words.

Mr. COOPER. Anyway there were a good many things that arose in past years that we did not think would.

Now, finally, gentlemen, I want to say this, that I think almost to a company, we farm mutuals are willing to pay. They feel that this is a great emergency, and if the finances of our Nation are such that these companies ought to contribute, they will do so gladly, but they feel that it would be under a war-emergency tax which ends with the war.

Nearly 3 years ago our association sponsored a campaign to cut losses 25 percent. These losses have been cut 10 percent, and the cutting of the lo es that have occurred will enable these farm mutuals to pay a tax equal or treble the war tax of the last World War, without increasing their cost, but they hope that no change will be made in section 101 (11) that will need interpretation or that will bring about the difficulties that they encountered during the first 17 years.

I thank you very much, and I want to say this further, that if I can be helpful to you in working out—if my experience will be helpful to you in working out a basis that is fair and equitable, I assure you that I shall be happy to do it, and I will spare no one, and I will help you get the money.

The CHAIRMAN. Thank you very much.

Senator TAFT. Could you get the figures for us so as to show how many of the 2,500 mutuals are not exempt under these two provisions with assets of $100,000 and $50,000 exemption? Have you any basis for telling us that?

Mr. COOPER. It would only be a guess right now, but I could check that.

Senator TAFT. If they are all exempt there is no use in coming in and telling us how to tax them.

Mr. COOPER. I would be glad to furnish that information.

Senator TAFT. I think it would be helpful if we could get those figures.

The CHAIRMAN. Thank you very much, Mr. Cooper. There is one witness who desires to get away. Mr. Stokes, what is the length of your statement?

Mr. STOKES. Less than 5 minutes.

The CHAIRMAN. We will hear you for less than 5 minutes to accommodate you, because we are taking you out of your order.

Mr. STOKES. Thank you very much.

STATEMENT OF EDWARD L. STOKES, PHILADELPHIA, PA.

Mr. STOKES. My name is Edward L. Stokes, and I am a bond dealer from the city of Philadelphia; I appear here to recommend the taxation of municipal and State bonds.

The CHAIRMAN. Are you in favor of taxing them?

Mr. STOKES. Future issues of municipal and State bonds; yes, sir. I fully concur in the wisdom of the recommendations made by Presidents Roosevelt, Hoover, and Coolidge, as well as Secretaries Morgenthau and Mellon, that these bonds should be taxed. Mr. Mellon, 18 years ago, said that the existence of a mass of tax-exempt securities constitutes an economic evil of the first magnitude.

In my opinion, it would make very little difference to the cost to the States or municipalities whether their bonds were free of tax or not. United States Government bonds have just been made fully taxable, and they are selling at practically the same prices as they did before. The bond buyer or the investor wants high-grade security, and if the city or municipality is willing to economize, they can get a very good price for their bonds.

For example, Philadelphia had just paid off $18,000,000 of its debt from its surplus without any additional borrowing, which means that its credit is very high.

Understand me, gentlemen, I do not recommend the taxation of issues that have already been placed with the public and who have bought them in good faith as tax exempt.

Answering Mayor LaGuardia's statement that "if you tax my bonds I will tax your property," I say that the United States Government must deal justly and not permit a large amount of wealthy people to pay no tax, and who are prefectly willing to pay it if need be.

Senator TAFT. Are you a dealer in municipal bonds yourself?

Mr. STOKES. Yes, Senator, I am.

The CHAIRMAN. Thank you, Mr. Stokes.

Without objection, this telegram from Mr. Joseph J. Klein in which he says he seems to have overspoken himself or else was incorrectly reported in the press may be put in the record.

Senator TAFT. I suggest that in the final record it can be put in the record with his remarks.

The CHAIRMAN. The clerk will give it that disposition. (See p. 1530.)

The CHAIRMAN. I will put into this record this statement of James P. Hatch, of New York City. It deals with a subject that the committee will desire to explore in full.

(The statement referred to is as follows:)

STATEMENT OF JAMES P. HATCH, NEW YORK, N. Y., ATTORNEY FOR PAUL J. CHRISTOPH CO.

The writer is counsel for the Paul J. Christoph Co., a corporation of the State of New York doing its entire business in the United States of Brazil. This company is agent in Brazil for many manufacturing concerns in the United States. Its principal function is the retailing and wholesaling of American manufactures in Brazil, including some reprocessing of American goods to adapt them to tropical and subtropical conditions, and the manufacture in Brazil of some American pharmaceuticals under formulas suited to the Tropics. It has a diversified line, including electrical goods, radios, oil products, pharmaceuticals, and some food articles.

The writer maintains that the proposed income-tax laws and allied legislation will create undue hardships on companies such as this and may result in bankrupting them and the American foreign trade.

POINT 1. THE FOREIGN EXCHANGE SITUATION

Under the present tax law the taxable income is arrived at by including so-called exchange losses and exchange gains. The exchange factor is introduced by valuing current assets and liabilities at the beginning and end of the tax year in dollars at the exchange rates obtaining at the beginning and end of the year. This conversion often causes appearance of profit or loss, which is nonexistent or at least unrealized. This is why. The company, since it operates wholly in Brazil, must of necessity operate according to Brazilian laws. One requirement of Brazilian law is that all accounts and inventories must be expressed solely in local currency. In addition the company buys with dollars and sells for milreis. Profits necessarily are milreis items.

Accordingly, let us suppose the company purchases two identical articles for $100 apiece from an American company to be sold in the market in competition with similar articles manufactured by foreign states. Let us suppose at time of purchase $100=2,000 milreis. The article now has a cost of 2,000 milreis on the company books The company later sells one article at 50-percent markup, and for argument forgetting merchandising cost, etc., the company now has 3,000 milreis. The exchange at the time of sale is 10 milreis to the dollar and so remains to the end of the year. The company by present law has made a profit on this article of $200 and is taxed accordingly. Has it made $200? In all likelihood, no. This profit is figured upon immediate conversion to dollars and transmission to the United States. Foreign trade cannot and does not operate this way. In all likelihood the proceeds remain in milreis to be converted to dollars only for the purpose of buying more goods or to distribute profits as it appears safe and wise to do so, or perhaps dollar exchange is partially blocked, or, what is most likely, the sale is on long-term credit or conditional sale (duplicato). South America is notorious for long-term credit and in a competitive market such credit must be granted. Many factors peculiar to foreign trade prevent liquidation. Brazil, because of its need of capital, lays many stumbling blocks in the way of withdrawal of either capital or profits. The tax nevertheless to the United States is, let us say, 40 percent of profit of $200, or $80. Before conversion and transmission to the United States exchange does another gyration back to starting point. We have 3,000 milreis worth $150 of which $80 is tax. Result, $70 of original capital left—$30 lost on the transaction.

The other article was not sold in the year, but, since it carried a milreis price tag, the exchange rate gives it a value of $200 for tax purposes. Again $40 tax to the United States.

Next year the exchange returns to beginning value. Next year the company will show a $250 loss on these items if still in milreis. That ought to make everybody happy—but does it? The company has dollar commitments to meet and depreciated money to pay with. The company is losing money hand over fist. Adding red figures to red figures does not put back into the company till the $120 in tax paid the previous year on profits that were never realized, tax, in fact, paid out of capital or accumulated surplus. Furthermore, the American producer may have to restrict its sales to this company because of its losses or may have to write off a bad debt to the direct loss of the United States Government in tax collections from the producer.

The examples are not farfetched. They represent the everyday headache of foreign trade. The alternative basis of figuring profits entirely in milreis and then converting to dollars for computation of tax is just as fallacious. The milreis profits mean nothing, for the company may be losing heavily on falling exchange. Remember, the market price of the goods in Brazil does not fluctuate with dollar exchange. All the factors of demand and supply, prices of competitive currencies, and the local state of business and buying power enter into the actual selling price of the article.

The plain fact is that the method of tax is fundamentally unsound, and given certain conditions can be vicious and confiscatory. The mitigating circumstances have been these: In doing business abroad in industrialized countries credit for local taxes has generally absorbed the United States tax. In doing business abroad in raw-material countries, such as Brazil, the local exchange has for many years been depreciating in terms of the dollar because of unfavorable trade balance. While in such countries tax rates are generally lower than in the United States, the exchange losses have resulted in low tax or no tax to the United States.

The trend of Brazilian currency appears to be about to reverse. Brazil is enjoying a favorable trade balance, and the war is giving it a new-industrial development. Brazil is not suffering the terrific expense of war. We tend to inflation while Brazil's exchange tends upward. Brazil is having a war boom. The disastrous effects on American foreign trade are obvious if the tax continues to be laid on unrealized profits. Much of the realization on present sales because of time lag between sale and collection will occur from 3 to 6 years, hence when exchange trends may well be in reverse. The company could weather the storm if allowed to keep its position strong by husbanding its resources, but the present tax law and proposed tax law is in effect a compulsory distribution. It collects a tithe before the crop is in, and the tithe may well exceed the crop.

The nearest parallel to the treatment now received by foreign trade would be a tax law valuing the investments of an individual citizen of the United States at the market price at the beginning and end of the year, whether actually sold or not, and taxing the unrealized gain or loss. The theory of the tax would be that such price might have been realized if the investment had been sold. Exactly the theory which compels the artificial conversion of milreis assets to dollars in the case of the corporation engaged in foreign trade. The individual under such law would find his little nest egg taxed each year of market rise and he would have a loss to offset against his income, if any, in years of declining market. Furthermore, in increase years he pays in progressively higher brackets and in loss years he has a set-off against his lower bracket taxable income. It is obvious that nothing short of a miraculous continuous upward price trend would enable recovery of the original investment.

The sheer gamble in which the individual would be engaged under such a law is self-evident. Why treat foreign trade in such manner simply because by necessity its assets are not realized in dollars during the artificial tax years?

POINT 2. CORPORATION NATIONALITY

It is often argued that a corporation organized in the United States, and, therefore, a domestic corporation no matter where it does its business, must, as an American corporation, bear its equal and fair share of American taxes. The principle on its face seems to be fair and reasonable. Unfortunately the principle does not take into account factors peculiar to foreign trade, which make it impossible for a company such as the writer represents to act entirely as American corporation. Such a company cannot warp business and accounting practices into the groove the tax law assumes it follows. In the first place this corporation is doing a merchandising business entirely outside the United States and since the merchandising business is done in Brazil it must conform to Brazilian laws.

When such laws are in conflict with American corporate law and practice it must, nevertheless, act in the way required by the Brazilian law or else stop doing business. As a foreign concern in Brazil, the company acts in Brazil under the usual disabilities of a foreigner and at least under the present tax laws, is given no compensating special privileges by the country of its domicile. It has been said: "Why not, under such circumstances, become a Brazilian corporation," which suggestion is usually made with the additional statement that such a change would contribute to "a good neighbor policy." It is true that if the company became a Brazilian corporation it would be exempt from American taxation. However, if it became Brazilian, its directors, under Brazilian law, would have to be Brazilian citizens or permanent residents. Furthermore, under Brazilian law and custom a director is the active and dominant force in the company and usually, in fact, its owner. This would hardly be fair to the Americans who have contributed the capital of the company. These Americans are entitled to have Americans in control, in whom they have confidence or whom they know personally. The writer fails to see why the step of becoming a Brazilian corporation either adds or subtracts from the good-neighbor policy. Brazil wants and needs American capital and Americans who have placed their eggs in a basket should have the right of watching the basket.

In American trade abroad, particularly in raw-material countries where capital is relatively scarce or is not in liquid form, two things are essential; first, the goods must be manufactured and shipped, and, secondly, it must be merchandized. Both of these phases of foreign trade require capital. The United States Government is already receiving its full and equal taxes from the producers in this country who ship abroad. Producers' profits are indisputably within America's tax domain. If the tax is extended to the merchandizing end of the business, the United States Government is laying a tax on the portion of the business which is domestic to Brazil and it would appear to the writer that the United States Government could be charged with exploiting our good neighbors to the south. The charge of exploitation becomes particularly pointed when the tax is laid as set forth under point 1 hereof upon unrealized or fictitious profits. Under some conditions the United States Government is in effect taxing the Brazilian buying power by taxing credit reservoirs.

POINT 3. CREDIT AND CAPITAL

To give the credit necessary for a developing country such as Brazil to buy from us, capital is essential, and this is one of the functions of the company the writer represents. This capital is right at the point where it does the greatest amount of good in advancing foreign trade, for the credit is given directly from the seller to the buyer. No intergovernmental loans or subsidization of foreign trade will create buying power in Brazil as directly or as efficiently as the direct grant of credit from the seller to the buyer. Any proposal of intergovernmental loans or private loans to Government to create buying power ought to bring to mind at once the fiasco of the war debts and of various South American bond issues which mulcted the American public without great advantage to the borrower, There is no quicker way of losing a friend than to loan him money which he is unlikely to be able to repay or which will encourage rash spending. The United States Government ought to avoid, as far as possible, such types of loan because they are so closely associated with sovereignty and national pride that upon default the Government must either use armed force to collect or indulge in the fiction that the loan really does not have to be repaid but it would be very nice if it were repaid. The type of credit advanced by this company in foreign trade does not fall into such classification since it involves purely private debt and is advanced upon strictly business terms. The fear of the writer is that the present proposal for taxation of corporations in foreign trade will have the effect of diminishing reservoirs of credit available to keep such trade flowing.

POINT 4. TAX PROPOSALS

It would seem to the writer that the wisest way of treating corporations such as the Christoph Co would be to add such corporations to the list of corporations already treated as foreign, under section 131 (g), since it operates 100 percent abroad, and to extend the benefits of treatment as a foreign corporation to all taxes except the capital-stock tax, which should be based on the dollar par value or stated value of the shares of stock. By so treating the American corporations doing business abroad any dividends paid to American stockholders would be taxed just the same as dividends by an American from an actual foreign corporation. Neither the British nor the Canadian Government tax corporations in foreign trade until such time as profits are brought back to Canada or Great Britain, as the case may be. The American corporation doing business abroad would have the same status. In cases where American corporations do their business partly in this country and partly abroad adequate provision for taxation of the business done in the United States could be made through the machinery set up by section 119 of the present Internal Revenue Code.

If it were feared that such a law would permit an American corporation doing business abroad to keep too large a portion of its profit in its surplus, it should be remembered that (*a*), the stockholders are not going to sit idly by receiving little or no dividends while surpluses are impounded, (*b*) any surpluses built up will be credit reservoirs for the increase of foreign trade, (*c*) the American corporation is unlikely to keep out of the country surpluses not needed in its business, because such surpluses would be a definite temptation to the foreign country in which such corporation is doing business.

In closing, the writer wishes to say that he believes many Americans have a false impression of foreign trade. It is frequently viewed as a lush business engaged in by arch exploiters. It is seldom viewed from the standpoint of the hardships implicit in such trade. Foreign trade has grown up; it is no longer a hit-and-run proposition. The company in foreign trade is a foreigner in a foreign land, with all the disabilities that such a foreigner has; yet it must foster goodwill for itself and its products. Its business methods are distorted by the need of conforming to laws of more than one sovereign power, laws which, in effect, whipsaw the company. The company can work well and efficiently and appear to make profits only to lose profits overnight in an unfavorable turn in the exchange. It is subject to expropriation, losses due to foreign wars, vindictive legislation arising from the stresses and strains engendered in relationships of sovereign states. In taxing such trade, the risks of the participants should be considered and the peculiarities which set foreign trade apart from domestic business should be given due consideration. Finally, tax should be so laid that American foreign trade can continue without dread of expropriation by badly advised American tax policy. In foreign trade you cast your bread upon the waters but you cannot count your seven loaves until they come floating back from over the horizon to shore and the tax policy should recognize this fact.

Respectfully submitted.

James P. Hatch,
Attorney for Paul J. Christoph Co.

The Chairman. The committee will now recess until 1:30.

(Whereupon, at 12:15 p. m., a recess was taken until 1:30 p. m., of the same day.)

AFTERNOON SESSION

(Whereupon at 1:30 p. m., the committee met pursuant to recess.)

The Chairman. The committee will come to order, please.

The Senate session is continuing somewhat longer than anticipated. Senator Byrd, who is interested in and a member of the subcommittee having to do with mutual insurance companies, requested that the mutual insurance witnesses on that question be not called until he could return to the committee room. I understand that is agreeable to those who are appearing on the question of mutual insurance. Therefore, we will skip below that group and call first Mr. McWain.

STATEMENT OF L. J. McWAIN, CHICAGO, ILL, TREASURER, UNIVERSAL PAPER PRODUCTS CO.

The Chairman. Mr. McWain, you may proceed. You may take the chair or stand, just as you see fit.

Mr. McWain. Thank you, Senator.

Mr. Chairman, members of the Senate Finance Committee: For the record, I represent the Universal Paper Products Co., Chicago, treasurer.

My name is L. J. McWain. I have a prepared report, gentlemen. I will read it. We wish to save time.

The Chairman. Yes, sir. It seems to be brief.

Mr. McWain. It is brief.

If an excess-profits tax is really to tax excess profits, some fair method must be devised for determining normal profits. We do not feel that the bill contains that method as far as businesses started during or since the base period are concerned.

We make paper drinking cups. In this industry heavy investment is not so important as merchandising skill. We started late in 1936, and lost a little money that year; 1937 was our first full year, and we lost plenty. We weren't surprised. That often happens in new businesses. In 1938 we broke about even, and in 1939 we made money.

We were just really starting to get over the hump. Obviously, under those conditions we didn't have very good average earnings during the base period. Relief provisions so far have helped concerns like ours, but they haven't equalized the tax burden.

Under this new tax bill, our taxes will be about 80 percent of earnings. We have some large competitors who have been in business for a long time. Some of them publish their figures. They made good profits during the base period. Consequently, they have substantial exemptions. We don't know how much money they are making this year, but our estimates indicate that the percentage of our earnings going for taxes will be much greater than theirs only because their exemption is so much greater.

Senator TAFT. I should thing that that was just what this relief section took care of.

Mr. MCWAIN. Senator, it did endeavor to take care of it.

Senator TAFT. I mean if you had examples in industry of other people who had base periods, it seems to me that this provision would give you a corresponding exemption.

Mr. MCWAIN. It doesn't give us a corresponding exemption. It goes part way, but it doesn't equalize the burden. Our best estimates indicate that our competitors might pay under the proposed tax somewhere around 60 per cent.

Senator TAFT. I should think, under the relief provision, you would get in your business correspondingly the same base that they have. What is there in the relief section that doesn't take care of you?

Mr. MCWAIN. We doubt very much if, under the constructive-base idea, that we will get relief which will put us on an equality basis.

Senator TAFT. Do you object to the language of the relief section or the fact that the Treasury may not be liberal enough?

Mr. MCWAIN. The Treasury may not be liberal enough. As a matter of fact, we wonder if the Commissioner in our locality would accept the wording of the law which will give us relief comparable so that our tax will be comparable to our competitors.

The CHAIRMAN. You do have some relief under the existing law.

Mr. MCWAIN. And it helps.

The CHAIRMAN. Now, then Senator Taft is referring to section 72; I believe it is a new section. I don't know whether you would be included—from that section, I don't think you are—but I would think you would have some additional relief.

Mr. MCWAIN. We have some additional relief, Senator, but it would be difficult for us to establish, under the constructive-base formula of section 72 that would put us on an equality basis with our competitors.

Senator TAFT. I was interested in knowing if there is some change that should be made in that relief section, if you would suggest what it is.

Mr. MCWAIN. I follow it here in my testimony, and I would like to elaborate briefly on it when I get to that point.

We go on to say: Now, that doesn't seem exactly fair. We don't want to ask for any advantage, but neither do we feel that advantages should be give to larger competitors. We merely want equality.

One way to get equality might be the way we understand they get it in Canada. The thing to do is put in a relief provision that will allow us to go before a board of review and have them set exemptions for companies like ours that will result in our paying out, in taxes, no higher percentage of our earnings than our larger competitors do. The present bill doesn't provide for that, and we think that it should.

Does that help, Senator?

Senator TAFT. Do you mean just a wide open provision that they can grant any relief they want to?

Mr. McWAIN. Not particularly, but to make it more in line with what our competitors are paying, for example. That situation does exist in Canada under their relief section in the case of new or growing companies established during the base period, they provide for your filing with a board, of review of your case.

Senator TAFT. Of course, this can go to the Board of Tax Appeals, can't it?

Mr. McWAIN. I am not certain of that, Senator.

Senator TAFT. I think there is an appeal to the Board of Tax Appeals under the relief section.

The CHAIRMAN. If administered by the Board, it is.

Mr. McWAIN. The point I make there is that under the constructive base theory it would be very difficult for us to put ourselves on a competitive basis, Senator.

The CHAIRMAN. I think we understand your point. We were just interested in seeing whether or not some change might be made in the section that would more nearly reach the case. You may proceed.

Mr. McWAIN. We think that the provision should also apply to those concerns started after the base period. We have an interest in those concerns starting after the base period.

Senator TAFT. They are not covered at all by the relief section.

Mr. McWAIN. That is true.

A small concern has to be alert to hold its own against big competitors. We have tried to be alert. We have, for example, developed a collapsible paper tube which seems to hold promise of doing the job now being done by tin and lead tubes like containers for tooth paste, shaving cream, and other items. We would like to go ahead with it, but just how can we with this tax bill staring us in the face?

Obviously, if our present company made the new product, any profit we made from it would come in the very top brackets. Excess profits and corporate income taxes would take 94.5 percent of the profits. Realizing that under those conditions we could lose all of the money that we put into the venture, but could keep only 5.5 percent of any profit we might make if we were successful it doesn't look like a sensible business risk. We would need new capital, but no one would lend it to us if we had to pay out 94.5 percent of any profit in taxes. We would never be able to pay back the money. No investor would want to buy stock, either, because our tax bill would make the investment seem to be a poor one.

Senator TAFT. Why 94.5 percent?

Mr. McWAIN. If you want a 90 percent basis and we paid a 90 percent excess-profits tax and the normal and surtax, it would amount to roughly 94.5.

Senator TAFT. They don't duplicate each other—90 percent would be the outside figure, I should think.

Mr. McWAIN. The way I calculated that, Senator, was that giving yourself a 90 percent credit, you would be paying your normal and surtaxes, too, or the over-all would be about 94.5.

Senator TAFT. But you don't pay normal or surtaxes on anything that you pay excess-profits tax on. On one sum you pay one and on another sum you pay the other, so I don't see how in any event it could be over 90 percent.

Mr. McWAIN. If the surtaxes and the normal did not apply it would be the whole top bracket of 90 percent. That is true. But suppose we started in as a new business? That wouldn't help much either, because the new company would have a very small exemption, too. We have developed the item in such a way that not much machinery would be required. We did it that way because we, too, want to help conserve vital materials. The investment in machinery would be low, so there wouldn't be much exemption on the invested capital basis.

If some older concern which had been making tin tubes had developed this idea they could profit by it because of the earnings exemption they had built up during the 1936-39 period. Why shouldn't a new concern be able to profit similarly? Again, it seems that it would be only fair to allow that new concern a special exemption, to be determined by a board of review, based upon the figures of competitors who had been in the business of making tubes long enough to have established exemptions during the base period.

We are not arguing that new concerns deserve better treatment than old ones. We think, however, that they are entitled to equal treatment. They don't get it under the bill as now written. They should get it in a definite way through the right to go before a board of review to establish a special exemption that will put them on an equal basis with larger and stronger competitors.

The CHAIRMAN. Thank you.

Mr. McWAIN. Thank you.

The CHAIRMAN. Mr. Noyes.

Mr. KELLY. Mr. Chairman, for the purpose of the record, I am Ralph Kelly and I am speaking for Mr. Noyes.

STATEMENT OF RALPH KELLY, EXECUTIVE VICE PRESIDENT, BALDWIN LOCOMOTIVE WORKS, EDDISTONE, PA.

Mr. KELLY. I am executive vice president of the Baldwin Locomotive Works.

The CHAIRMAN. Yes, sir.

Mr. KELLY. The Baldwin Locomotive Works urges that provision be made in the revenue act which you have under consideration for post-war refund of part of the tax imposed on corporation income during the war period.

Without attempting to define such provision precisely, it is our opinion that the refund should cover at least any excess-profits tax in excess of an 80-percent rate, and any combined normal tax and surtax above a 40-percent rate.

This refund should become available to the taxpayer upon termination of the war, and its use should be unrestricted, except that no payment of dividends therefrom should be permitted.

We recommend that the refund be made by issuance to the taxpayer of Government bonds which would become negotiable and interest bearing after the end of the war.

The Baldwin Locomotive Works emerged from reorganization under section 77B of the Federal Bankruptcy Act on September 23, 1938. The company was forced into this reorganization because of the business depression of the earlier nineteen thirties and its debt service charges and capital structure which it could no longer support. It emerged from reorganization with an improved capital and debt structure, but with small working capital.

As business conditions improved, the company somewhat improved its working capital position, but the entry of our country into the war found this company still with too little working capital for an undertaking of its size. No dividends have been paid since July 1, 1931, except on a small amount of preferred stock issued under the reorganization in payment of certain funded debt interest.

The name and history of the Baldwin Locomotive Works immediately identifies it with steam locomotives, but this company also makes other equally important heavy goods, such as Diesel locomotives, Diesel engines for the industrial and marine fields, hydraulic turbines, hydraulic presses, testing machines, ferrous and nonferrous castings, of large size, and steel forgings.

In the manufacture of heavy engineering machinery, constant research and development must be carried on. During the depression of the nineteen thirties, one of the severest handicaps experienced by companies in the heavy goods industries, was the necessary drastic curtailment of research and development. In Baldwin's case, work of this character was further restricted by the reorganization proceedings already mentioned.

After its reorganization, Baldwin again became active in progressive developments, of which a few examples are cited for illustrative purposes.

Recognizing the trend toward high-speed passenger service, Baldwin, in 1939, began the development of new designs of modern steam locomotives to suit this service. Two streamlined steam locomotives were built for the Pennsylvania Railroad which have an increased thermal efficiency of more than 15 percent when compared with the average steam locomotive of today. They are equipped with lightweight reciprocating parts which reduce rail stresses, thus permitting smoother riding and longer rail life. Steam locomotives, as a whole, have great possibilities for modernization in the field of higher pressures, welded boilers, and the extensive application of the many alloys that are being developed in this war.

A steam turbine utilizes steam more efficiently than a reciprocating engine. Following this fundamental, a turbine driven locomotive has been designed which has many advantages over the present-day steam locomotive. This turbine locomotive has been held up due to scarcity of materials, but should be built in the post-war period.

A new Diesel engine is being developed with a weight of 15 pounds per horsepower as compared with previous weight of 28 pounds per horsepower. This engine will be used in many places in transportation and in marine work. An important application will be its use in driving a 6,000 horsepower Diesel road locomotive with all the driving equipment in one cab. Other types of Diesel road locomotives now in use require four cabs for an equivalent amount of motive power. This type of Diesel engine will have application in submarines, where lightweight, high-speed engines are required.

Baldwin manufactures hydraulic turbines of every size. All of its capacity for the production of large water-wheel hydraulic turbines is now being used for Government projects, such as T. V. A. and Boulder Dam.

A large amount of continuing experimental work is required to determine the best characteristics of water wheels, turbines, draft tubes, and so forth, to produce the greatest possible amount of power from falling water under the particular conditions.

In the Baldwin Southwark division extrusion presses are now being built as large as 3,500 tons, some of them for Russia. Presses are made for plastic products, airplane parts, and many other miscellaneous applications, all requiring large expenditures for development.

These are but a few examples of development effort in the six divisions of our company. Most of our peacetime research work has been arrested by the declaration of war, the scarcity of critical materials, and the need of devoting all of our manpower and facilities for the manufacture of tanks, guns, and other materials of war.

It requires a substantial amount of cash to conduct development programs on locomotives, Diesel engines, hydraulic machinery, and so forth. We are unable at the present time to improve our cash position sufficiently to provide the necessary cushion for post-war adjustments or for continuing to finance the program that we were conducting prior to the entry of the United States into the war, for the following reasons:

1. Expense of major rearrangements of our plant, some of which are paid for out of Government funds, but a great deal must come from Baldwin working capital;
2. The need of training large numbers of workmen in advance of production; and
3. Large payments for taxes.

A number of adjustments will be necessary at the end of the war. Factories must be converted back to manufacture peacetime products. Competition will be keen and development programs must be scheduled which will take months before there is any return. Such progressive development policies, with the continuity of employment that they provide, cannot be carried on without adequate working capital. A company without capital cannot produce goods and furnish employment, and is of little benefit to the community in which it is located. A company with progressive development policies and adequate finances to support these policies is an asset to its community and to everyone in its employ.

It is our firm belief that a post-war refund is necessary to implement the transition from a wartime to a peacetime economy.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you.

Mr. Oehler, what is the length of your statement?

Mr. OEHLER. Not over 3 or 4 minutes.

The CHAIRMAN. You may be heard now.

For the benefit of the Senators who have just come in, we have skipped the witnesses on mutual insurance until after the Senate recesses.

STATEMENT OF I. C. OEHLER, ATTORNEY, ST. PAUL, MINN.

Mr. OEHLER. My name is Ira C. Oehler. I am a lawyer in St. Paul, Minn. Tax practice is part of my work. My clients are all individuals. The subject of my discussicn is taxation of individuals having income from a partnership that has a fiscal year different from the taxpayer's year.

This subject has no relation to corporations.

The revenue acts consistently have required that an income from a partnership be reported by the individual partner in the year in which the partnership ends, so that if the partnership has a fiscal year starting in 1941, and ending in 1942, under the law, as it came from the House, the entire earnings of 1941 would be taxed at the '42 rates.

Before the 1934 act, the acts of 1924, 1926, 1928, and 1932, each had a provision which I am asking this committee to put back into the law. That is, earnings of a partnership year falling into 2 taxable years should be prorated and the amount of the tax—the proportion of the income should be taxed at the rates applied in each of the 2 years.

Now, in 1934, all machinery for equalizing or adjusting rates applicable to a taxpayer falling into 2 years were dropped from the law.

Section 129 puts back part of the machinery, but the provision applying to partnership income is omitted.

Now, the hardship that is produced by this situation can be shown by assuming that a taxpayer has a surtax income of $5,000. If his partnership year ended with the calendar year 1941, he would pay at the 1941 rates, $598.

If, however, the year ends January 31, 1942, then the 1942 rates would apply to all of the income, and his tax would be $1,062.

In other words, he suffers an imposition of an extra tax of $460 by reason of the partnership fiscal year.

Now, under the machinery that was in the law from 1924 to 1934, and which this committee is asked to return, the tax of that man, if the fiscal year ended with January 1942, would be $636. That is, he would pay on eleven-twelfths of his income at the 1941 rate and he would pay on one-twelfth at the 1942 rate.

Senator TAFT. Have you figured how much less he would pay than if he was a corporation?

Mr. OEHLER. I am not going into that. I am keeping away from corporations.

Senator TAFT. It occurs to me that a partnership is not such a tremendous advantage that the relief of partnerships doesn't seem a very serious problem.

Mr. OEHLER. A partnership ordinarily is a smaller business than a corporation.

Senator TAFT. I understand that.

Mr. OEHLER. Two or three men combine their assets and their working ability and they have a small partnership.

No tax is imposed on the partnership. It is on the individuals.

Senator TAFT. I understand that.

Mr. OEHLER. Now, that formula applied to fiscal year ending in November, would result in the paying of a 1942 rate on eleven-twelfths of the income and only pay the 1941 rate, the low rate, on one-twelfth of the income.

Now, if this committee and the Senate will add the proposed amendment, which is copied verbatim from the 1928 law, then injustice and inequity that now falls upon an individual taxpayer will be avoided and the committee can give relief to thousands of taxpayers all over the country, and if the committee will have in mind that there is no tax on a partnership, the tax is on the individual who helps earn the money, and if the committee will add the equivalent of section 128 of the Revenue Act of 1928, which was in the law, and which operated satisfactorily for 10 years, many, many people will wake up next spring and find that they have had some relief.

On the other hand, if it is not done, they will wake up and find that it cost them hundreds of dollars more than the Government intended to tax them.

I thank you.

The CHAIRMAN. Thank you very much.

(Document submitted by Mr. Oehler is as follows:)

STATEMENT BY I. C. OEHLER, ST. PAUL, MINN., RELATING TO TAXATION OF INDIVIDUALS HAVING INCOME FROM A PARTNERSHIP THAT HAS A FISCAL YEAR DIFFERENT FROM THE TAXPAYER'S TAX YEAR

H. R. 7378, by not qualifying the provision of section 188, Revenue Act of 1938, imposes an inequitable, unnecessary burden on an individual who is a partner in a partnership reporting on a fiscal-year basis.

The revenue acts consistently require a partner to return partnership income in his tax period in which the partnership accounting ends. See section 188, Revenue Act, 1938.

This requires an individual to include in his 1942 return income earned in part of 1941 and in part in 1942 when the partnership fiscal year ends in 1942. All such income then is taxable at 1942 rates.

Before the 1934 Revenue Act, the acts of 1924, 1926, 1928, and 1932, each had a provision similar to section 128 of the 1932 act apportioning the tax to each of the years in which the earnings were made. A copy of this section 128 is attached.

When section 129, H. R. 7378, was put in the present bill, a section similar to section 128, here attached, was omitted, perhaps from oversight. This omission, if not corrected, will result in obviously a wholly unintentional tax burden on thousands of individuals.

A few figures demonstrate this hardship:

An individual who had a $5,000 surtax income in 1941, all from a partnership reporting on a calendar-year basis, would pay a 1941 tax of $598.

If, instead, his $5,000 surtax income came from a partnership reporting on a fiscal year ending in 1942, though the fiscal year ended as early in 1942 as January 31, and so was made up from earnings of the partnership almost wholly earned in 1941, his tax would be $1,062, not $598.

If, in these circumstances, the individual's surtax income is $10,000 the calendar-year basis would result in a tax of $1,708 while the partnership fiscal year would require a tax of $2,602.

The amendment here suggested proposes a return to the provisions in the revenue acts for 10 years prior to 1934.

These, while a part of the law, adjusted fairly variances based on the incident of whether a partnership accounting period ends with the calendar year, or at some other time during a year.

On the assumed $5,000 income, if the opposed amendment becomes law, the tax so equalized would be

(598 x 11/12) plus (1062 x 1/12) = 636.67 tax

Then, on the $10,000 income the tax so equalized would be

(1708 x 11/12) plus (2602 x 1/12) = 1782.00 tax

If, however, the partnership fiscal year ends on November 30, 1942, the $5,000 income would be taxed

(598 x 1/12) plus (1062 x 11/12) = 1023.83, and the $10,000 income would be taxed

(1708 x 1/12) plus (2602 x 11/12) = 2527.50

The addition of an unnecessary tax burden on individual partners reporting partnership income on a fiscal year basis is not justified.

By adding the attached proposed amendment to H. R. 7378 the relief the Treasury asks for is had and yet injustice to thousands of individuals is prevented.

The Committee should give relief from the burden imposed by H. R. 7378 on individual taxpayers in every State in the Nation.

This can be done by including in the Senate 1942 Revenue Act the amendment attached to this petition.

Respectfully submitted,

IRA C. OEHLER,
Endicott Building, St Paul, Minn.

REVENUE ACT 1928

SEC. 182. TAX OF PARTNERS

(a) GENERAL RULE. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. If the taxable year of a partner is different from that of the partnership, the amount so included shall be based upon the income of the partnership for any taxable year of the partnership ending within his taxable year.

(b) PARTNERSHIP YEAR EMBRACING CALENDAR YEARS WITH DIFFERENT LAWS. If a fiscal year of a partnership begins in one calendar year and ends in another calendar year, and the law applicable to the second calendar year is different from the law applicable to the first calendar year, then

(1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and

(2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.

In such cases the part of such income subject to the rates in effect for the most recent calendar year shall be added to the other income of the taxpayer subject to such rates and the resulting amount shall be placed in the lower brackets of the rate schedule applicable to such year, and the part of such income subject to the rates in effect for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to such year.

STATEMENT OF CHARLES DANA, TOLEDO, OHIO, REPRESENTING SPICER MANUFACTURING CORPORATION

The CHAIRMAN. I am skipping here a little bit, gentlemen, for reasons that have been made known to me.

Mr. Dana, I understand you have a brief statement.

Mr. DANA. Very brief; yes, sir, Senator George.

The CHAIRMAN. Yes, sir.

Mr. DANA. Senator George and committeemen, my name is Charles A. Dana, and I am chairman and president of the board of Spicer Manufacturing Corporation, a company that has five plants in America, five in England, two are in occupied France, and we make various parts for automobiles, trucks, and busses throughout the United States.

Throughout the United States for practically all companies like Ford, General Motors, Chrysler, and others; we are the largest suppliers of transmissions for tanks and we manufacture half of all the jeep axles and other gear devices for mechanized services of either the Army or Navy, and the clause which is in the Ways and Means Committee bill changing the tax year and the fiscal year becomes very onerous.

We have been in business 40 years. We have always been successful. We have never had any financial troubles, and about 4 years ago President Roosevelt requested that the automotive year be changed to the early fall. He thought it would assist in selling, and consequently we changed our fiscal year from the calendar year to the 31st of August in order to accommodate his theory of selling automobiles, busses, and trucks.

We adjusted our fiscal year and paid taxes accordingly. We have published our statements accordingly to the public, and during this current year we have already published three quarterly statements showing our earnings at a certain figure after adjustment of what we thought was the law, namely, the 1941 tax law, and now there are rumors that the bill will change our accrued taxes so that the representations we have made to the public and to our stockholders are false representations.

I don't think, in view of our having changed our year, it having been accepted by the S. E. C., it having been accepted by the New York Stock Exchange, for all that, we should be forced in the position of having this very heavy burden which will amount to over a couple of million dollars to us to pay here in August.

In addition to that, the Secretary of the Treasury asked us to buy tax-anticipation certificates. We went all-out into this war effort. We increased our plants under letters of intent from Judge Patterson and Mr. Knudsen, who, at that time, was head of the O. P. M., and we have invested $12,000,000 in our own facilities and have been given certificates of necessity by the War and Navy Departments, and have been buying tax anticipation certificates because we believe, with Mr. Morgenthau, that the principle of pay-as-you-go is right. And consequently we have been buying tax-anticipation warrants as he requested, trying to do just what was requested.

Now we find that we are in the hole to the extent of a couple of million dollars because of the fact that the law that we bought our tax certificates under, it is suggested be changed.

We have gone into this war effort in an all-out way. We have not requested any support from the Government in funds to be advanced to us at any time. We are operating on our own working capital, and we have made our program and laid it out in such a way that we could finance our own necessities and those of the War and Navy, as they release orders to us.

Two years ago we were a small company doing $10,000,000 of business a year and now we are operating at the rate of $120,000,000 a year, and the result is that if we are forced to pay at this time an unexpected sum, one that has never been intimated to us before, as of the end of our fiscal year as provided by the present tax law, as we have understood it up to this time, and therefore it is going to create such a big burden to us that we will be forced to come to the

War Department or the Treasury and ask them to advance money for our working capital to go ahead.

Otherwise, we have made out our plans, we have borrowed such money as we have needed. We have laid in such materials and we are ready to go and carry our own burden and ask nobody's help, but if we are forced, under the amendment, as it appears in the Ways and Means bill, to change our tax bill, we can't go forward and do our job in the way we feel we should in behalf of the armed services to whom we are supplying these devices of every sort of mechanical means that are used in defense and offense at the present time.

The CHAIRMAN. Thank you very much.

In this connection, I would like to put in the record, for a witness who desired to appear on this same point, a brief statement, and I especially call the committee's attention to it.

Mr. Donald Comer of Avondale, Ala., or Birmingham, Ala., is the head of several cotton mills in Alabama, and he has this system of paying a bonus on each previous month's net income. That is to say, that after taking out 5 percent of earnings, the balance is divided equally between all of the employees and the company, and is distributed monthly. He is on the fiscal year basis, and Mr. Comer very strongly insists that in his case bonus payments having been made up to and including July of this year, that the change of the fiscal-year program really constitutes a capital levy.

(The document submitted by Mr. Comer is as follows:)

SOUTHEASTERN COTTONS, INC.,
New York, August 12, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SIR: I am here before this committee in opposition to section 129 of the revenue bill of 1942. I am not here to oppose in any way the general purpose of this bill; as a matter of fact, I think that the cost of this war should be paid for, as far as possible, as we go. I think the very safety of the thing we are fighting to preserve will be in jeopardy if we proceed on any other course. My concern is that we have the American way, or, if you please, the old goose sound and strong after this war is over rather than more golden eggs now.

Dealing with the people as human beings and dealing with the matter realistically, I would like to see a revenue bill that would tax the profits of industry at a rate that would get the most money. I would like to make a part of my statement a copy of a letter that I wrote to our President in October in which I outlined some of my views on this general question. My appearance here today is not for or against any part of this bill because it may or may not produce more revenue—my concern is only as to a question of fairness of one section, section 129, of the bill.

Section 129 was written into the bill on June 23, 1942, after public hearings had closed on April 17; therefore, there was no opportunity whatsoever for public hearings on this highly controversial section before the Ways and Means Committee, and the only way the citizens have to present their views is to the Senate Finance Committee. This seems to me to call for more thorough consideration by the Senators of this section than would be the case if there had been ample opportunity for public hearings before the bill was reported out by the Ways and Means Committee.

Section 129 is a revival of that procedure in the 1931 act which was abandoned on the ground that it was too complicated. The Ways and Means Committee stated in its report accompanying the proposed 1934 bill, "This complicated rule has been eliminated in the proposed bill for the purpose of simplicity and ease of administration." In 1934 there was not the excess-profits tax, no corporate surtax, and certainly if the rule was too complicated in 1934, consideration should be given to the much greater complication that would result from a return to that rule under present tax conditions.

There is not merely the complication of two tax computations but the further complication of two income computations under different revenue acts for the two parts of the fiscal year. The 1941 act is applicable to the first part of the fiscal year, and the 1942 act to the second part of the fiscal year. Moreover, there is a manifest unfairness to fiscal year taxpayers in that while they are taxed for the 1942 months of the fiscal year at the new and higher 1942 tax rates, they are denied certain advantages given by the 1942 act. This unfairness results from the "exceptions" enumerated in section 108 (b), providing that certain benefits of the Revenue Act of 1942 shall not be applicable to fiscal year taxpayers.

I realize that when the Ways and Means Committee reported the bill to the House on, I think, July 14, that I then had the opportunity of knowing what was then the tax bill; however, I knew nothing about the provision under section 120 until after the bill was before your committee. Further, I think there are a great many taxpayers today affected by this section who are still unaware of the change. As a matter of fact, I talked to two manufacturers yesterday who operate under fiscal years, one I think closes March 31 and the other June 30, and neither of these gentlemen knew about this proposed change in the revenue law. Every taxpayer who operates under a fiscal year has been making calculations based on the old tax law and not until just recently have we known about the proposed change. Some taxpayers whose fiscal year closed earlier in the year have closed their books, computed their taxes, and published their financial statements. Others, like the companies for which I am speaking, Avondale Mills of Sylacauga, Ala., and Cowikee Mills, of Eufaula, Ala., whose fiscal year closed on July 31 operated practically their entire fiscal year under the belief that they were operating under the old tax law.

Our two companies pay employee bonuses monthly, based on our estimated earnings for the previous month, and in estimating these earnings, we naturally allowed for accruing taxes and, of course, at last year's tax rate, which we understood was applying right along.

If section 129 is enacted, corporations whose fiscal years have closed earlier in the year, no doubt have made up their income tax reports and have paid their first installment of taxes; they would be now delinquent in payment of taxes and subject to interest thereon. In this case, they would not only have retroactive taxes, there would be interest to pay, notwithstanding the fact that the taxpayer has paid all the old law required him to pay when his return was due and filed.

To pursue this thought further, fiscal year corporations may find they have paid dividends which under State laws they could not legally pay. There might also be cases where fiscal year corporations have been liquidated.

If Congress for sufficient and good reason thought it desirable that all taxpayers should operate on the calendar year basis, it would only be fair that they give the fiscal year taxpayer reasonable notice of such intent. As the matter now stands, for some, this would be a retroactive tax,, while for others it would really be a capital levy.

I think that section 129 as proposed would be changing the rules after the game started.

Some time ago when the question came up of abandonment of the time and one-half for overtime principle in the interest of economy and in the fight against inflation, our President himself was reported as speaking out in defense of the maintenance of the time and one-half principle on the ground that the rules should not be changed after the game started. In maintaining this principle of time and one-half for overtime (all above 40 hours) undoubtedly several billion dollars a year of labor cost have been maintained in the things that we are making in this country, the majority of which things the Government itself buys. The money involved in section 120 is just a fraction of the above.

Surely, with some of us, this will be changing the rules after the game has started; for many of us, it will be changing the rules after the game is over.

Yours truly,

DONALD COMER,

Chairman of the Board of Avondale Mills, Sylacauga, Ala., and Cowikee Mills, Eufaula, Ala.

[Copy]

SOUTHEASTERN COTTONS, INC.,
New York, October 10, 1941.

Hon. FRANKLIN D. ROOSEVELT,
The White House, Washington, D. C.

DEAR MR. PRESIDENT: The delayed intention to write you was prompted into action by a speech delivered in Birmingham on Wednesday by Dr. George S. Benson, president of Harding College of Searcy, Ark. I mentioned his name because I understand he recently made this same speech before the House Ways and Means Committee.

As one citizen, I am writing to urge a taxing of profits and income to the limit at this time. I am terribly concerned over what we shall have in this country at the end of this emergency and at the end of the second World War. My concern is that whatever changes come to our democratic way of living here in America shall come under our pattern of government and through orderly procedure.

Surely those who are in charge of billions and billions of dollars of investment in industry in this country should be more concerned in a policy that protects and guarantees this property for the future than in profits the very accumulation of which and the spending of which will cripple and may destroy the very defense effort itself. I am thinking more about having the old goose herself when it is over than more golden eggs now.

The defense program today is being protected as best it can from the spending of profits for consumer goods, luxuries and otherwise and we are not going to have a united effort for defense until we abandon and get entirely away from gouging efforts during this emergency for increased profits, at every point where salary, wage, or dividend enters in.

With the growing national income, it is conceivable to me that a tax structure can be built that will pay for this defense program as we go, tremendous as it is. There is one thing, though, that would stand in the way of such a program, that would create a rebellious feeling on the part of the man who pays the tax and that would be unnecessary and wastful spending of this tax money by government itself.

If such a tax program were to be inaugurated, it would have to come coupled with the most drastic economy on the part of government at all levels from the city right on up to national Government. If this Nation is not willing to approach this matter in times like this and pay for this cost right now, I do not believe we will ever pay for it and when I think of a government that does not pay its debts, I can think of just one result and that is revolution and chaotic conditions leading to repudiation of debt and dictatorship. The way to preserve our democratic way in America is to be honest and pay our debts right now for the expense of defense right now with the profits of right now.

If the gathering of all profits above 6 percent today, as Mr. Morgenthau has suggested, means greater security for the American way after this war is over, it would be very cheap insurance. With such limitations to profits there will be less consumer dollars to compete with defense needs and there will be one less incentive for strikes.

The more orderly we can keep industrial operation in this country today in relation to employment, wages, and earnings, the more we can pay for our defense program as we go, the less difficult will be our problem when the emergency is over.

Yours very sincerely,

DONALD COMER.

Senator CONNALLY. Mr. Comer represented to me that he paid out $400,000 in bonus up to the 1st of July or whatever his year was, and that if he had had the 1942 tax rates now contemplated in effect, he probably wouldn't pay any bonus at all, because he wouldn't have had profits enough to do it. I just suggest that point.

The CHAIRMAN. Yes.

Well, it is in the record there. That is a very clear, concise statement, and I thought the committee ought to consider it.

Mr. Mylander.

STATEMENT OF CHARLES H. MYLANDER, VICE PRESIDENT, HUNTINGTON NATIONAL BANK, COLUMBUS, OHIO

The CHAIRMAN. Have you a brief statement you can make at this time?

Mr. MYLANDER. I hope I can finish in 5 minutes, Senator.

The CHAIRMAN. We will hear you so that you may be able to go home.

Mr. MYLANDER. Mr. Chairman and members of the committee, my name is Charles H. Mylander. I am vice president of the Huntington National Bank at Columbus, Ohio, and I am chairman of the committee on taxation of the American Bankers Association.

I desire to speak to you this afternoon solely on supplement U which is found on page 159 of the House bill, and to direct my remarks entirely to the provisions of supplement U, having to do with the withholding of taxes on bond interest and dividends.

As you know, practically all bonds are issued under indentures, of which banks are the trustees, and the banks are, for the major part, the paying agents of those corporate bond issues. Consequently, the entire burden which is provided in this bill for the giving of receipts and the making of withholding tax returns would fall upon the shoulders of those banks which are trustees.

The withholding agent, as defined in the bill, is the person or corporation which is required to withhold the tax.

Provisions of the bill which allow individual taxpayers who own bonds to file a statement with the paying agent of the interest as to whether or not the individual owner is an income taxpayer, means a perfectly tremendous amount of work for those paying agents. If a man is not an income taxpayer, the paying agent does not withhold on his bond interest. If he is an income taxpayer, the paying agent does withhold on the bond interest.

If he is an income taxpayer and the trustee withholds on the coupon, then the trustee must furnish him a receipt for the amount withheld. You gentlemen have some broad general idea, as I have, as to the number of bond coupons that pass through the banks of the country every year and that will give you some idea as to the volume of receipts and such things that will need to be furnished.

Senator TAFT. How many is it?

Mr. MYLANDER. How many?

Senator TAFT. Yes.

Mr. MYLANDER. I haven't the slightest idea, but it is way up in the billions of bond coupons that pass around the country during the course of a year.

We do have some idea, as I will show you in a moment, on the question of dividends.

That, in brief, is the problem that we are facing, in giving of millions, if you want to be more conservative, of receipts to these various individuals who present coupons for payment at the bank.

There is a very definite legal question involved which I think is going to require some amendment to the bill as it passed the House. I think I should say that we have been talking with the Treasury and with the Bureau of Internal Revenue about this problem. They have listened to our story. We understand that they are going to suggest some changes, but we feel that the changes which they are going to suggest are not to relieve the situation which we are facing.

They have been most cooperative and we have tried our best to work with them and to get this thing worked out.

Coming now to the question of dividends, the same problem is involved. Under the bill as it passed the House, it is necessary for the dividend-paying agent to furnish a receipt for the amount of tax withheld which goes out with every dividend check. There we have some knowledge of volume. We estimate that there are about a hundred million dividend checks go out in the country during the course of a year which would mean a hundred million receipts if only one is furnished. But, of course, naturally the paying agent of the dividends will want to keep a copy of the receipt that he furnishes for his records, since, under the terms of the bill, the individual taxpayer who receives this receipt must preserve it carefully and attach it to his own individual income-tax return to get credit for the tax thus paid at the source. If I were the income taxpayer I would ask the dividend-paying agent to give me two receipts so that if mine happened to get lost from the return I filed with the Government, I at least would have the evidence that I had gotten the receipt attached to the return in my own personal file.

There is a very large question involved in the provisions of the bill as to the continuation of the so-called nominee registration of securities. I don't want to take the committee's time to go into denial on that, because it is covered fully in the memorandum which I have handed to you, and which I would ask, Mr. Chairman, be added to my remarks at the end in the record, if it may be.

The CHAIRMAN. It may be substituted. Do you want it in addition or substitute this statement for your oral——

Mr. MYLANDER. I would like, if I may, I would like the entire memorandum added to what I am now saying.

The CHAIRMAN. All right.

Mr. MYLANDER. Because I am just hitting the high spots, as it were.

The CHAIRMAN. All right.

Mr. MYLANDER. Suffice to say only that the nominee in the registration system of securities has grown up over a long period of years, and it seems to us that it would be a rather difficult thing to surmount at this time.

We are merely laying these difficulties in your lap in view of the fact that we feel that as the bill is written and as the proposals are drawn, that it would be impossible with present restrictions on the purchase of office machinery, on the present restrictions, on the inability to get skilled help for the banks of the country to carry on the tremendous burden of minute detailed accounting that would be necessary by the withholding. We, therefore, suggest as a substitute for the proposal in the House bill, that withholding on dividends and on interest coupons be in gross, that the withholding be on all dividend coupons and all interest coupons and all dividends without the possibility of individual taxpayers being exempted from that withholding tax.

Thank you very much.

The CHAIRMAN. Thank you, sir.

(The document submitted by Mr. Mylander is as follows:)

MEMORANDUM BY CHARLES H. MYLANDER, CHAIRMAN, COMMITTEE ON TAXATION, AMERICAN BANKERS ASSOCIATION, REGARDING THE ADMINISTRATIVE DETAILS TO BE REQUIRED OF BANKS UNDER THE PROPOSAL TO WITHHOLD TAX COLLECTED AT SOURCE AS RELATED TO DIVIDENDS AND BOND INTEREST

With the general philosophy that part of the income tax should be collected at the source as the income itself is paid or accrued, there can be no serious criticism.

Collection at the source benefits Government in that it obtains needed revenues earlier. It benefits the taxpayer in that part of his heavy tax burden is paid as his income is earned.

Particularly, it aids Government's effort to keep wartime wages and commodity prices from causing that situation best described by the one word "inflation."

But in planning for collection at the source, Government should be practical as well as philosophical.

If, for example, collecting taxes at the source is more expensive to Government or to taxpayers, it is self-evident that, in the long run, Government will lose. Or, if collection at the source will have a bad effect upon other plans of Government for financing the war, Government again will lose.

It is with this background that the committee on taxation of the American Bankers Association has examined the proposals made by section 153 of H. R. 7378, the proposed Revenue Act of 1942. This section provides that during 1943, 5 percent of wages and salaries, dividends, and bond interest shall be withheld by the payor and paid quarterly into the Federal Treasury. Beginning January 1, 1944, the withholding shall be at the rate of 10 percent.

If the proposal stopped there, there could be little criticism. An employer during 1943 would deduct from the wages and salaries 5 percent on each pay day. A corporation paying dividends likewise would deduct 5 percent of the amount of the dividend from each check sent to its stockholders. In paying bond interest, whether such interest was paid by check (as would be true where bonds are registered), or paid upon presentation of an interest coupon, the paying agent similarly would deduct 5 percent.

Ascertainment of the total amount of wages and salaries paid during the year by any employer would be comparatively simple. If he then did not remit the 5 percent to the Federal Government, he could be suitably punished. Likewise, each corporation's record of dividends paid could be examined to see whether proper withholding and payment had been made, and similar examination would reveal the correctness of the amounts withheld from bond interest payments.

The bill as it passed the House of Representatives, however, does not provide for such withholding "in gross." Instead, each employee may file with his employer a certificate which sets forth his personal exemption status. Thereupon, a portion of his wages or salary depending upon the amount of his personal exemption, shall not be subject to withholding.

The bill provides that similar certificates of exemptions may be filed by owners of stocks and of bonds who expect to receive dividends or interest during the taxable year. If the owner of stocks files a certificate stating that his income will not be large enough to subject him to income tax liability, the corporation shall not withhold any tax from dividend checks sent to him. Similar certificates also may be filed by the owner of registered bonds. Ownership certificates required when coupons are presented for payment also will contain a statement whether the owner will be subject to Federal income tax.

The partial withholding thus provided for wages and salaries does not present serious administrative difficulties for banks. If an individual is not married and is receiving a weekly wage of $20, the tax withheld is based, not upon $20, but upon the difference between $20 and $11, or $9. If an individual receiving a $20 weekly wage is married, then no withholding is required, since withholding of the wages of a married man does not begin until his weekly wage exceeds $26. Such computations and adjustments can readily be made upon the pay-roll records of employers and proper withholding made.

But when exemptions of any kind from withholding on dividends or bond interest paid are allowed administrative difficulties pile up until they seem almost insurmountable.

Let us look first at the difficulties attending the payment of bond interest. It will be necessary for at least three certificates of ownership to be prepared in the case of each interest coupon, or group of coupons from a single issue. This introduces a serious situation in connection with public acceptance of Government bonds.

Ever since World War I, coupons from Government bonds have been accepted universally as cash. Throughout the Nation a person can deposit them for immediate credit in his bank account, or he can present them at any teller's window in any bank in the United States and obtain currency for them. Under the bill as it passed the House, this procedure must be changed. Instead of Government bond coupons being taken as cash, they will be forwarded to the Federal Reserve bank, accompanied by three copies of the certificate which reveals whether the owner expects to make an income tax return on March 15 of the following year. The Federal Reserve bank then will have to issue its check in payment, either of the face amount of the coupons if the owner is not an income taxpayer or the face amount of the coupons less 5 percent if the owner is an income-tax payer. The Federal Reserve bank also will have to give its receipt for the amount of tax withheld. It takes little imagination to see the tremendous confusion, delay, and irritation which will be caused by this change in procedure. Is it going too far to say that lack of faith in the stability and worth of an investment in Government bonds will come into the minds of many individuals, unskilled in handling investments, who now are their owners?

Whether the Federal Reserve banks are prepared in machinery and personnel to undertake this added burden, we do not assume to say, but we believe that it will be extremely difficult for them to do this job.

Three national banks in Columbus, Ohio, in the 30 days from June 15 to July 15, 1942, forwarded 13,297 coupons from Government bonds to the Federal Reserve Bank of Cleveland. The owners of these bonds had been given cash, or immediate credit for them. When these coupons reached the Federal Reserve bank, it was necessary only to check the amount of the coupons with the amount shown on the ownership certificates, Form 1000. The amount of the coupons then was charged to the Government's account and the coupons sent to the Treasury for cancelation.

But under the new tax collection plan, each coupon or group of coupons will be accompanied by three copies of the ownership certificate. This certificate will need to be examined to see whether the owner is an income tax payer. If he is not, then the Federal Reserve bank will send him a check for the full amount of the coupon, and will send one copy of the certificate to the Bureau of Internal Revenue along with its quarterly report of taxes withheld. If he is, then the Federal Reserve bank will withhold the tax, send a check and one receipted copy of the certificates to the owner, one to the Bureau, and keep one for its files.

How much this extra work will cost the Federal Reserve banks is not known, but it will not be inconsiderable. We do know that the costs of handling Government bond coupons in the chartered banks will double, if not triple, since each coupon will be handled "for collection" and not as cash.

What has been said about withholding from Government bond coupons applies with equal force to corporate bond coupons. While the practice of accepting corporate bond coupons as cash is not so universal as the acceptance of Government bond coupons, in many cases they are used as cash subject to final payment by the debtor corporation or its paying agent. Here again it seems necessary that this procedure be changed and that all corporate bond coupons be handled by banks "for collection" and not as "cash."

It is our understanding that the Treasury proposes that the amount of tax to be withheld from all bond coupons, both corporate and Government, should be withheld by the first bank to which they are presented and that such bank should issue its receipt for the amount of tax withheld. This seems impractical if not illegal. The bill places the duty of withholding the tax and of issuing the receipt on the "person having control of the payment of such bond interest." The first bank to which the coupon is presented is not the "person having control of the payment." Therefore the first collecting bank could not properly issue the receipt. If this be the case then all bond coupons with the certificates in triplicate must be forwarded to the debtor corporation or its paying agent in order that the receipt for the amount of the tax may be given by the person legally responsible therefor.

The burden of examining the ownership certificates, of withholding or not withholding the tax, of issuing the receipts, and of writing checks in payment of corporate bond coupons, will fall for the most part, upon the banks, since most corporate bonds are issued under indentures with a bank as trustee and paying agent.

Today, by far the majority of both Government and corporate coupons are paid by bookkeeping entries between banks and between banks and their customers. This well-established practice all will be junked if the bill, as it passed the House, becomes law.

Instead, bank collection departments will expand, their detail work then be increased. Banks which are paying agents will need added machines and personnel to keep the multitudinous records required and to prepare the billions of checks and receipts which will be required. No accurate estimate of the amount of office machinery which will be needed could be made in the short time at our disposal since the details of the bill have been made public, but we do know that under present restrictions on the manufacture and sale of such machines not enough of them would be available, nor could the banks find and hire sufficient intelligent personnel to operate the machines if they were available.

The bill also provides that each recipient of dividends who is subject to withholding (that is, who has not filed a certificate stating that he is exempt) shall receive, in addition to his dividend check a receipt for the amount withheld. This receipt must contain the name and address of the corporation paying the dividend, the name and address of the stockholder to whom it is paid, the total dividend declared in respect of the stock he owns, and the amount of the tax withheld. A copy of this receipt must be retained by the dividend paying agent in order that it may be prepared to furnish a duplicate thereof to the stockholder in case he loses or misplaces his copy during the taxable year, for he likewise must file this receipt with his Federal income-tax return. It is highly probable that many stockholders will demand that these receipts be furnished them in duplicate so that they may retain a copy in their files for use in case of controversy with internal-revenue agents who audit their returns.

Thus, it is easily possible that in place of the single check to go to a stockholder, the corporation, or its dividend-paying agent, will need to prepare the check and at least three and possibly five copies of the receipt. It is estimated that corporations issue about 100,000,000 dividend checks a year. While these checks are prepared for the most part by machines, the addition of so tremendous a burden as the preparation of 300,000,000 to 500,000,000 receipts will be beyond the capacity of these machines. Since new machines of this particular type are not readily available at present, the doing of this job, as has been said before, seems to be almost impossible.

Four of the larger banks in New York, however, have made a hurried survey of their needs in machinery, equipment, and personnel if the present bill becomes law. They will need:

94 Fan fold typing machines.
58 Combination typing and adding machines.
8 Multiplying punching machines.
60 Canceling machines.
1 Standard register.
4 Tabulating printers.
2 Tabulating collators.
3 Bookkeeping reproducers.
6 Bookkeeping machines.
7 Stencil machines.
4 Stencil cutting machines.
45 Fireproof steel filing cabinets.
50 Typewriters.

The estimated aggregate initial cost of these new machines is $190,000. The estimated aggregate annual cost of additional personnel and machine rental is $835,000. There are grave doubts as to availability of these new machines. Moreover, many of the types required are not standard but of special design normally requiring many months to construct and deliver. Furthermore, present experience indicates it will be most difficult if not impossible to secure competent additional personnel required, especially machine operators. In addition, all banks would have to provide, and in many cases acquire, additional working space at considerable extra cost.

Nor are the objects outlined above the only objections to the withholding of income tax from the recipients of dividend income. The entire structure of the "nominee" and "street name" systems of registration of corporate stocks and bonds will have to be wholly reconstructed if the system of withholding proposed in the bill is enacted into law.

Certificates of stock of corporations whose issues are listed on recognized securities exchanges when sold must be "good delivery." As a result, large amounts of corporate stock continually are registered in the names of brokerage firms and whereas the actual ownership of the particular certificate may change a dozen times in a single day, the registration is not changed.

When dividends are paid to the owner of the stock represented by such a certificate they are, of course, paid to the brokerage firm in whose name the certificate is registered. The broker in turn credits the amount of the dividend to the owner or gives him check for the amount of the dividend. It can readily be seen that the actual owner of stock represented by such a certificate would not receive the receipt for tax withheld in such a case, since the receipt would go to the brokerage firm and not to him.

About 25 years ago, when the holding of corporate stocks became more widespread in the United States, the difficulties of effecting transfers of ownership of such stock began to increase. This was particularly true in the case of stock registered in the names of corporations and fiduciaries. Transfer agents demanded resolutions of boards of directors, evidences of authority of officers to sign, etc. Likewise, many individual owners of securities who were away from their homes for varying periods of time found that the requirement that the actual stock certificate be endorsed, the signature of the owner guaranteed by a bank or broker, and all of the other complexities involved in stock transfers, seriously hampered his dealings in securities.

As a result, banks which act as fiduciaries and custodians have caused so-called nominee partnerships to be organized and stocks which are owned by these banks as fiduciaries or which are held by them as custodians, customarily are registered in the name of these nominees. In some of the larger banks it is not uncommon that such a nominee partnership will hold registered in its name certificates calling for 100,000 shares of the stock of a single corporation. This stock actually may be owned by 1,000 different owners, but so far as the stock books of the corporation are concerned, it has only a single owner and only a single dividend check need be issued when dividends are paid.

Under the terms of the bill it seems necessary that the nominee notify the corporation of this diversity of ownership. Certainly it would be necessary for it to do so if any of the owners are exempt from income taxation or have incomes so small that they need not file an income-tax return.

But once this notification is on file with the corporation, the entire nominee system breaks down. The corporation no longer will pay the dividend upon the stock belonging to such an owner to the nominee, nor will it allow the stocks to be transferred out of the name of the nominee without a consent evidenced by power of attorney of the actual owner.

No figures are available as to the number of shares of stock which are held in nominee names, but it is well known that they represent a large percentage of the shares of corporate stocks now outstanding. If the system of nominee registration must end because of a requirement of the tax laws, the increased number of stock certificates to be issued by corporations, the increased work involved in such issuance, and the increased expense to the corporations for such transfers will further reduce their taxable income. One bank alone estimates that in order for it to go through the complex legal procedures necessary to transfer the stocks which it now holds in nominee form to the actual owners would require the services of a crew of 12 men for a period of at least 12 months.

It is our understanding that none of this detail of exemption certificates and receipts would be necessary if the law provided for the withholding "in gross" of taxes from recipients of dividends and bond income. We believe that the number of persons who will receive dividends and bond interest and who also will be exempt from Federal-income tax will be greatly in the minority when compared with those who will receive such income and pay income tax. It seems apparent, therefore, that the added burden and added expense of carrying out all of the details imposed by the bill is too great a payment for the benefits which will accrue from earlier collection of the tax.

To sum up, therefore, we feel that the method proposed in the bill is unworkable:

1. Because of the provision for exemption certificates for a relatively small number of stockholders and bond owners;

2. Because of the requirement that each stockholder and each bond owner be given a receipt for the amount of tax which may be withheld from him upon payment to him of dividends and bond interest;

3. Because of the fact that adoption of the system proposed in the bill will destroy the "street name" and "nominee" systems of registration of corporate securities;

4. Because to prepare the receipts and other detail will require much additional machinery and equipment which is not now available to corporations and their paying agents; and

5. Because of the difficulty, under present conditions, of obtaining adequate trained personnel to operate this machinery.

In order to make a practical suggestion for overcoming these difficulties in the bill, we submit that withholding "in gross" is the proper procedure.

Objection will be raised that without the receipt the taxpayer will not be able to prove that the tax has been collected upon the dividends or interest he receives and thus will be unable to obtain credit therefor in his income-tax return. This objection will not stand, however, when it is realized that dividends and bond interest are reported separately by the taxpayer in his income-tax return. If he should attempt to claim a credit for more than 5 percent of the gross amount of dividends and bond interest which he includes in his gross income, a prima facie case of an attempt to defraud the Government is made. The other objection to the gross withholding of all dividends and bond interest is that the citizen whose income is not large enough to subject him to income tax would be penalized. For this minority, it is suggested that a simple form of application for refund of the tax withheld be provided and that refunds be made upon such applications promptly. If a Form 1099 or Form 1000 is filed by all corporations covering the payment of every dollar of bond interest and dividend income, such forms would be in the hands of the collector of the district in which the recipient of the income resides early in the year following the year in which the tax was withheld. If the taxpayer then files a claim for refund of the tax withheld, listing thereon the names of the companies from which he received dividends or bond interest on which tax was withheld, the Form 1099's and Form 1000's to support his claim would be available and upon this showing, the refund should be allowed promptly. In the first year, 1943, the gross income of such a citizen would be reduced but in succeeding years his income would be augmented by his tax refund and he would be none the worse off.

Second, if this plan does not seem feasible, then it is urged that the method proposed in the bill for sole proprietors, professional men, et cetera, be adopted for accelerating the collection of taxes on bond interest and dividend income; that is, that there be no withholding at the source of any percentage tax on bond interest and dividends, but that the taxpayer be required to pay on March 15, in addition to one-fourth of the tax computed upon his total income, a tax of at least 5 percent in 1943 and 10 percent in 1944, and thereafter upon his bond interest and dividend income. As a matter of fact, since the initial burden of normal and surtax is placed by the bill at 19 percent, it might be possible to compel the recipient of bond interest and dividends to pay more than the percentage collected from the recipient of wages, at the March 15 payment.

The CHAIRMAN. We will go back now to the witnesses on the mutual insurance companies.

Mr. Gruhn.

STATEMENT OF A. V. GRUHN, GENERAL MANAGER, AMERICAN MUTUAL ALLIANCE, CHICAGO, ILL.

Mr. GRUHN. Mr. Chairman and gentlemen, my name is A. V. Gruhn and I am general manager of the American Mutual Alliance, of Chicago. As general manager, I am speaking today for more than 100 mutual fire and casualty insurance companies.

These companies range in age from 7 to 190 years; in size from small companies with a surplus as low as $28,000 to some of the largest companies in the mutual field.

I am here today to state the vigorous objection of these companies to some features of section 207 of H. R. 7378 commencing on page 131 of the bill and discussed in the report of the Ways and Means Committee beginning at page 113.

Before stating our specific objections I want to make certain that the members of the committee understand how a mutual fire or casualty insurance company is organized and its general method of doing business.

Mutual insurance companies are conducted entirely for the benefit of their policyholders. They provide an organization through which a group of people may protect themselves against the losses and risks to which they may be subject in their daily life or business. Mutual companies are organized without capital stock and have no stockholders.

The policyholders who insure in a mutual company pay for their protection at a rate no higher, and, indeed, frequently less, than that charged by other types of insurance companies.

The money received from these payments constitutes the funds with which the mutual insurance operation is conducted. This money is used to pay the expenses of running the business, to pay the losses which occur, and to provide the necessary reserves to insure the safe and solvent operation of the company.

All funds which are not needed for these purposes are returned to the policyholders. The funds collected belong to the policyholders and to no one else, for the policyholders own the companies.

In other words, the mutual operation is designed so that safe and adequate insurance protection is afforded to the policyholders at as low a cost as possible.

Without exception all savings from the operation are returned to the policyholders, and no third party shareholders or other nonpolicyholders' group skims off any of the cream.

Needless to say, the mutual form of insurance protection has, beginning over 190 years ago, been recognized as a proper and efficient method of providing insurance protection.

They are regulated and recognized by the State insurance authorities.

Because of the nature of their operation they provide the least expensive form of insurance. That they are operated on sound and businesslike principles cannot be questioned.

It is because of the very nature of their operations that mutual fire and casualty insurance companies have traditionally been exempted from the Federal income-tax laws.

Indeed, with few exceptions, the companies I represent have never paid any Federal income tax, because the law has always recognized the principle that they should not be taxed.

The reasons for this exemption become apparent if a study is made of section 101 of the present revenue law. This section, which in substantially the same words has appeared in past tax laws for many years, exempts by specific terms certain types of companies.

These companies are, in the main—like the mutual fire and casualty insurance companies—nonstockholder, nonprofit organizations, you will find included in the list mutual savings banks, mutual building and loan associations, fraternals, mutual benefit life associations, mutual telephone companies, mutual ditch and irrigation companies, coöperatives, business leagues, and other similar groups.

These various classes of companies which have been traditionally exempted from the income-tax law have in common the fact that they return to the members who use their services the fruits of their operations. They have been properly deemed non-profit-making and consequently entitled to tax exemption.

One of our principal objections to the new tax proposal before you is that it results in singling out the mutual fire and casualty insurance companies for discriminatory treatment. If you examine the bill before you you will find that all companies which have had the benefit of the section 101 exemption continue to have that exemption except the mutual fire and casualty companies. No sound reason has been given; in fact, none can be given, for changing the status of this one group and placing it arbitrarily into the so-called profit-making classification, while allowing other companies in the exempt group to remain exempt.

Senator TAFT. Mutual life companies have always been taxable, havent they?

Mr. GRUHN. Yes; on a portion of their interest income.

Senator TAFT. But substantially the same now as the stock companies?

Mr. GRUHN. Mutual and stock life are on the same basis at the present time under this bill.

Senator HERRING. The mutual life companies agreed to accept that provision and pay a tax this year.

Mr. GRUHN. So I understand, but I am not connected with the mutual life companies.

Senator HERRING. Do you have any agreement where they get revenue for salaries?

Mr. GRUHN. I have none. I am an association manager and I have no agreements of any kind.

Senator HERRING. I mean any of the officers that you know of.

Mr. GRUHN. None that I know of. We challenge anyone to show that the mutual fire and casualty insurance companies have characteristics, either by way of size, number, income, or method of operation, which justify treating them differently than the other principal classes of financial organizations traditionally exempted by section 101.

If, because of the need for revenue, the status of all nonprofit groups had been changed under a plan in keeping with their organization and objective, such action would not at all have been unexpected.

However, this was not done. Only one nonprofit group was singled out of a large number for arbitrary reclassification. The principle underlying the exempt status of nonprofit enterprise was not repudiated. Its validity, on the other hand, is reaffirmed by reason of the fact that the status of every one of the other nonprofit groups remains unchanged under this bill.

This arbitrary reclassification of mutuals is not primarily a revenue-raising idea. It never pretended to be for the purpose of raising revenue. Today it remains nothing more than an alleged attempt to equalize the competition between mutual and stock companies.

Obviously, if the need for revenue were controlling, all nonprofit groups would have been asked to make a contribution. Under such circumstances I have no doubt but that all of such groups would have been willing to discuss a means whereby a fair contribution to the war effort could be secured from these groups.

I know this to be the situation as far as our own companies are concerned; yet the approach to the matter blocked any consideration on such a basis.

We think it very significant that in the recent rigid and all-inclusive tax legislation enacted in Canada, the Canadian mutual fire and casualty companies continue to receive a complete exemption from the income-tax law because of their fundamental characteristics of mutual operation.

We would like next to turn to a consideration of this specific proposal in an effort to point out some of its gross inequities. The time allotted to me, while generous, is not sufficient to even read to the committee the proposal and the abstruse and complicated explanation, let alone to discuss the numerous questions which are raised.

We must confess that, while the actuaries and other technicians of our companies have given this provision the most careful study, they are not yet able to understand it in all its detail, nor are they in a position to foretell with absolute certainty the precise way in which this tax would be applied if it ever was enacted into law.

We urge that the members of this committee read this provision carefully. We believe it is so complicated and so involved that you will find it difficult to understand and incapable of only one interpretation.

The provisions in the bill, section 147 on pages 130 to 139, completely revamp the existing law as to this one nonprofit mutual group. The new provisions are presumed to exempt companies with less than $100,000 of assets; and as to others, the first $50,000 of net income is not to be taxed.

As to the remainder, it is claimed that they are to be taxed on the same basis as stock companies with certain allowances for dividends returned to policyholders and additions to apportioned surplus, which is perhaps completely nullified by the contradictory character of the provision which would permit this deduction.

The exemption provision is unique and without precedent. It does not follow a pattern heretofore established for special treatment of small enterprise.

Emphasis is laid upon the claim that it is a very generous exemption which should be gratefully acknowledged by those who are presumed to be the beneficiaries of it. If it is so much more generous than similar treatment to other small business, why the departure in this one instance? A reduction of the number on whom unfair and unjust treatment is to fall in no way strengthens the case against the rest. Certainly, we believe nonprofit enterprises should be exempt.

It never has been shown that there is a point—whether assets, premium volume, amount of risk, number of members, area covered, kinds of risk insured, surplus funds, or some other yardstick be used—at which a mutual company ceases to be a nonprofit organization and automatically becomes a profit-making enterprise.

If such a point exists, it would be instructive to have explained in detail the exact nature of the changes which take place—the changes which convert the company from a nonprofit to a profit enterprise.

Certainly, if it is sound policy to exempt from income taxation a nonprofit company, which furnishes an essential consumer service to 100 or 1,000 members at cost, the same treatment should not be denied to a larger nonprofit company rendering the same essential consumer services at cost to a larger number of consumers. The public interest is served in both cases, for both companies have precisely the same objective—to give satisfactory insurance coverage, service, and protection, to the public at cost.

The bill is said to be applicable only to about 20 percent of the companies, but the unfair result falls on more than 80 percent of the mutual policyholders. The number and proportion of policyholders affected are surely of more importance than the number and proportion of companies.

However, these companies are singled out not only from the thousands in the other nonprofit groups, but from the hundreds of companies in the mutual nonprofit groups for especially harsh treatment, solely because they are in competition with proprietary stock companies who desire to put the dead hand of monopoly on 100 percent of the premiums instead of the 83 percent of the fire premiums and the 73 percent of the casualty premiums which are under stock company control at this time.

Let us call attention to the type of situation with which we are confronted in attempting to figure out what this tax is all about. The mutual fire and casualty insurance companies are, under the provisions of the law, subject to the excess-profits tax.

The question naturally arises, how is the excess-profits tax to be computed? The mutual companies are not profit-making, they have no invested capital, and they never before have been subject to the provisions of the excess-profits tax. Nowhere in the bill is there any definition or explanation of what is to constitute invested capital in a nonstockholder, nonprofit mutual company, nor is it explained on what basis average earnings are to be computed.

Thus, in the application of this very important provision, the mutual companies are left at the mercy of those who will be charged with the interpretation and application of the legislation.

Rules and regulations, and not law, will govern this most controversial and important question, and in the promulgation of those rules the officials administering the tax law will not be able to find in the reports of the committee or in the bill the slightest indication of what is the congressional intent. We submit that this is no way to proceed in enacting tax legislation.

Another criticism of the proposal is that no deduction is allowed for the full amount which the companies are required to set aside in surplus or reserves to meet the requirements of the various State laws and regulations of the State insurance commissions.

Reserves required to be set aside by the laws and the regulations under which these companies operate are not fully recognized. The consequence of this serious omission from the tax proposal is that in many cases companies will find it most difficult to maintain that standard of safety which is properly required under State law.

Finally, as you are aware, the Treasury has offered this proposal on the theory that it will tax mutual companies on the same basis as stock companies, and that the disparity which is said to exist between taxation of mutual and stock companies will be eliminated.

We do not wish to be understood for a moment as granting that any disparity does exist or that the public interest will be served by taxing mutuals on the same basis as stock companies.

Passing over this question for the moment, however, we are in position to prove that the proposed tax does not simply equalize the alleged difference between the tax treatment of stock and mutual companies. As a matter of fact this bill would tax mutuals far more heavily than stock companies, and in so doing it would place a premium upon inefficient, uneconomical management. This, of course, is wholly undesirable and very unsound.

Before I present the proof, in the form of an exhibit, as to how this formula works it is necessary to discuss the difference between the operation of a stock company and a mutual company and the difference in the expense ratios of the two classes of organizations.

Stock companies are operated primarily for the benefit of private stockholders who invest money in the company for the purpose of profit. The substantial excess of premiums paid by policyholders goes to stockholders, in the form of stockholder dividends and into funds which belong to the stockholders and not to the policyholders.

These excess funds can be withdrawn by the stockholders at any time through their control of stock-company directors.

In a mutual, the excess of premium is returned to the policyholders and the reserves and surplus, increased from time to time in keeping with the increased amount at risk and increase in liabilities, are held for the protection and security of policyholders. There are no stockholders or anything resembling stockholders' dividends.

The expense ratios of mutual companies are much less than the expense ratios of stock companies. For example, the underwriting results of 190 stock casualty companies—Spectator Reports of 1941—show an aggregate adjustment and underwriting expense of 50 percent. This means that 50 cents of every premium dollar paid by the stock company policyholder was used for expenses. For the same period the expense ratio of 100 mutual casualty companies was less than 32 percent. Some mutual companies have still lower expense ratios than this average. For example, the largest mutual casualty company has an expense ratio of less than 23 percent.

However, the formula to tax these mutual companies very strangely penalizes companies which are economically managed and which return the amount saved by reducing expenses to the policyholders who pay the premiums.

Please refer to the exhibit which accompanies this statement. This exhibit is based on the Treasury's analysis of its formula as applied to the "Z" Mutual Fire Insurance Co. It is set out on page 117 of the report of the Ways and Means Committee.

In this example, the committee assumed a $2,000,000 dividend refund to policyholders. Since the average of such dividends is 20 percent of the gross premium, we have accordingly, necessarily assumed a premium of $10,000,000, and have used the recognized loss and expense ratios which fit the two classes of companies.

The result shows that the "Z" Mutual Co., with an expense ratio of 25 percent, paying the $2,000,000 dividend in the way of refunds to policyholders at the rate of 20 percent of the premium paid, would be taxed $612,975 under the proposed bill.

If, on the other hand, the "Z" Mutual Co. returned no dividends to policyholders, but instead used that money for expenses and operated at an expense ratio of 45 percent instead of 25 percent, the 45 percent being comparable to the expense ratio of stock companies, the application of the formula would result in a tax of only $259,500.

It is readily to be seen, therefore, that this bill would exact a penalty of $353,475 from a company which commits the crime of operating economically and returning refund dividends to its policyholders. Stated another way: The bill would offer the "Z" company $353,475 as an incentive for not giving its policyholders a break.

Lest there may be a little doubt about this, we have taken the precaution to apply the formula to the figures of several stock companies, taking actual investment income, actual losses, actual expenses, and all the rest. We have applied this formula to the annual statement of the St. Paul Fire and Marine Insurance Co., on file with the insurance departments of the States, for the taxable years 1940 and 1941.

Based on the tax rates in this bill, operating as a stock company, the result is a tax of $689,526 for 1940 and $381,739 for 1941. Operated as a mutual company and changing only one figure, namely, a reduction of expenses to the level of the average mutual company, thereby allowing for a 20-percent refund to policyholders, the taxes would jump to $1,396,705 for 1940, and $1,147,920 for 1941. In other words, the bill would actually tax a large mutual, comparable to the St. Paul company, more than twice as much as the stock company.

Senator TAFT. I thought the dividends returned to policyholders would be deducted just like expenses; is that not so?

Mr. GRUHN. No, sir; it is not so. This bill would not allow mutual dividend deduction; only partially; and that results in overlapping taxation of investment income, as I shall show hereafter.

We have applied this formula to the actual annual statements of companies to determine the result, and in every case of a dividend-paying company the tax on the dividend-paying company is considerably higher than it would be if, instead, the dividends were used for expenses.

As we understand it, Secretary Morgenthau has been deploring the amount of the expenses deducted by corporations in their tax returns under normal conditions. The Government has been considering the development of a plan to limit the expenses which could be deducted.

Under such circumstances, how inconsistent this mutual tax proposal becomes. Here, using exact figures, you have a formula propounded by the Treasury which would reward extravagant management by allowing full credit when the policyholders' money is dissipated in expenses and which would discourage and penalize economical management by allowing only partial credit for the amount that a mutual company saves and refunds to its policyholders.

I grant this is hard to believe, but facts are facts, and here they are. We believe they will challenge your attention and your consideration.

How does this amazing situation come about? By an overlapping taxation of the investment and interest income in the hands of a mutual company. Instead of allowing full credit for the dividend refund which a mutual company makes to its policyholders and which results from a saving in the expense of administration and management, such refund deduction must be reduced by the total of:

(a) All wholly exempt interest

(b) 79 percent of partially exempt interest (total less 21 percent surtax),

(c) The exempt portion of dividends (85 percent) from domestic corporations,

(d) 55 percent of all taxable investment income.

This tricky formula results in a tax on all taxable investment income at 45 percent plus another tax of 45 percent on the remaining 55 percent of the taxable investment income, an aggregate tax of 69.75 percent; plus a tax of 48.7125 percent on the dividends received on the stock of other corporations; plus a tax of 56.25 percent on partially taxable income; plus a tax of 45 percent on all wholly exempt income.

The following is a comparison of the tax percentage applicable to the investment income of a stock company and a mutual company under the bill:

	Stock	Mutual
	Percent	*Percent*
Nontaxable investment income	0.0	45
Dividends received from stock investments	6.75	48.71
Partially taxable investment income	21	56.55
Wholly taxable investment income less investment expenses	45	69.75

This graphically illustrates the discrimination against mutual insurance companies. Furthermore, the rates applicable to the stock companies are those at which all ordinary corporations will be taxed on investment income under the bill. Thus the discrimination becomes all the more pronounced.

You will readily perceive that this is not only taking a second bite out of the taxable investment income, but it is an indirect method of placing a tax upon interest received from tax-exempt securities, which the law provides shall be free from taxation.

I do not need to remind you that you have already had several arguments with the Treasury on the question of the taxation of tax-exempt income.

A stock company which has a tax-exempt investment income of $1,000,000, would retain complete corporate financial control thereof and could use it to pay profit dividends to stockholders or to increase the surplus or pay it out for expenses.

However, a mutual company with the same tax-exempt investment income, making refunds in the form of dividends to its policyholders, would not retain complete financial control of it.

The mutual company would have to deduct it from the refunds paid to policyholders—a device which is equivalent to a tax of 45 percent on such tax-exempt income.

Furthermore, a stock company enjoying a taxable investment income of $1,000,000, would pay $450,000 in Federal taxes on it, but it would retain complete control of the remaining $550,000. On the other hand, a mutual company would have to apply that $550,000, after normal and surtax payments, as a deduction from the refunds returned to policyholders.

Therefore, it is to be seen that after first having paid a tax of 45 percent, or $450,000, the mutual company would be indirectly taxed and would pay another 45-percent tax on the remaining $550,000.

When you take a second bite of the same investment income, at the same tax rate, in the same tax return, in the same tax year, from the same taxpayer, you are on the road to confiscation.

Where is there any equality of treatment under such a scheme? A disparity in tax treatment is not being removed; one is being created instead.

This is punitive taxation directed against low-cost nonprofit operation which would be penalized because it is rendering an essential consumers' service on an at-cost basis.

It would seem that if the real intention had been to tax a mutual company on the same basis as a stock company—a wholly unsound theory—that result could have been attained very simply by applying the tax basis applicable to stock companies under section 204 of the present law and simply providing for deduction of amounts refunded to policyholders in the form of dividends. Such an involved complex formula as appears in the proposed bill, would not be needed.

Because of its complexity, there are other important objections to the bill. The tax burden on mutual companies may be far greater than that which we have shown it to be by these examples. You have only to read the sections and the elaborate explanation in the report which accompanied the bill to appreciate how difficult of understanding they are.

We are not sure that the mutuals will get the same general deductions for reserves, for unpaid losses, and other credits to the same degree that the stock companies enjoy them under section 204.

The very fact that different language is used to describe the same deductions invites wholly different interpretation.

The Internal Revenue Bureau, which makes the rules and regulations and interprets acts passed by Congress, will naturally assume two different things must have been meant when different language is used to describe the same deductions.

If this proposal passes, the tax which must ultimately be paid by the mutual companies is not definitely determined. It is left in the hands of those who are charged with its administration. The rules and regulations will make the law. This bill, as far as the taxation of mutual insurance is concerned, will not do it. The opportunity for doubt and uncertainty, for disagreement and difficulty, is unlimited. The provisions would be expensive to administer, not only to the Bureau, but to the companies as well.

The report of the Ways and Means Committee makes much of the fact that an allowance is presumed to be made for an addition to surplus apportioned to policyholders. This provision is meaningless as to most companies, because it is contradictory and unworkable.

Even if made workable by clarifying amendments, only a very few companies, namely, those writing a limited number of large risks, would be able to gain anything in the way of substantial relief from it.

The deduction is predicated on an absolute promise to the member in his contract or in the bylaws that the sum so deducted will be returned to him within a period of 5 years after the termination of the policy. Under such a provision, the board of directors charged with the management of the company would be absolutely prohibited—and that is in specific terms in the bill—from exercising any discretion in determining subsequently as to whether or not the amounts so deducted and set aside were actually needed to pay losses or to meet the requirements of some State law, which are the conditional alternatives in the wording of the section.

Aside from the somewhat contradictory statements of the Treasury, support for this tax proposal has come from only one source. It has come from the stock fire and casualty companies.

These stock companies have done everything in their power to urge the enactment of this legislation. Their objective has not been the public interest nor the interest of the Government, but to enhance their own competitive position. It seems clear that these provisions are not designed primarily to raise revenue. They were frankly introduced for the purpose of lessening mutual competition.

We are forced, therefore, to discuss the competitive situation which exists in the fire and casualty field and to point out to you some of the forces which have been at work stirring up support for this feature of the bill.

The mutual companies account for only 16 percent of the fire premiums written, and about 22 percent of the casualty premiums written. The stock companies write more premiums and have more assets, and enjoy huge profits.

We have established a position in the industry because we provide an essential consumer service at the lowest possible cost. The stock companies can reduce the cost disparity by taking a cut in their large profits. Instead, their efforts are directed toward reducing the differential by an unwarranted increase in the costs of mutual insurance by such measures as this.

It is small wonder that Mr. William B. Joyce, of New York, a prominent stock insurance official, in a letter to the Insurance Advocate, which I offer in evidence, stated with regard to that publication's efforts in favor of this tax proposal—

> The campaign you are putting on will be worth hundreds and hundreds of thousands of dollars to stock insurance companies, and I have no doubt they will so recognize your activities.

Now, I don't know where those hundreds and hundreds of thousands of dollars are coming from, but I assume from the public in the way of increased costs if competition in this manner can be curbed.

Senator GERRY. Mr. Gruhn, did you say Mr. Joyce is an executive of your company?

Mr. GRUHN. He is a prominent stock insurance broker of New York, but I believe he was the president of the National Surety Co.

Senator GERRY. He is not now?

Mr. GRUHN. No, sir; the National Surety isn't what it used to be, either.

It is the stock companies, not the public, which stand to gain if this proposal is enacted into law.

We cannot take the time of this committee to discuss in any detail the long campaign of vilification and misrepresentation which has characterized the efforts of the stock companies to eliminate mutual competition. Certain allegations have been made, however, by the stock company representatives, in their effort to promote this tax proposal, which must be answered.

First, it is said that the mutual companies are financial giants, no longer mutual and clearly proprietary and profit-making. This is a false statement. The mutual insurance companies are still mutual in organization and in fact. We need only point to the low-cost insurance which the mutuals provide, to the extremely low expense factor which characterizes their operations, and to the continued confidence and support which they receive from State authorities and policyholders alike.

Second, it is said that the mutual companies are accumulating unduly large surpluses which should be distributed to the policyholders. This is likewise a false statement. The surpluses accumulated by the mutual companies are in large measure surpluses required by law and State regulation. Where they exceed requirements of law, they are made necessary to assure safe operations. There is absolutely no way that these surpluses can be used except for the benefit of the policyholders. They cannot be dissipated or withdrawn by the management.

The fact is that the surpluses of the mutual companies are not as great proportionately as those accumulated by the stock companies. It is difficult for us to understand how the stock companies, with their tremendous surpluses which have been accumulated by the sale of extravagantly high-cost insurance, can argue that the moderate surpluses of the mutual companies are excessive.

It is further significant that the stock companies in talking to the public, and not to congressional committees, emphasize in sales campaigns that mutual surpluses are entirely too low for safe operation.

Third, it is said that the managements of mutual insurance companies are withdrawing exorbitantly high salaries and enjoying other improper perquisites at the expense of the policyholders. This, likewise, is false.

In the entire mutual field of approximately 2,600 companies there are only 16 officials who receive salaries, commissions, and other emoluments in excess of $25,000 a year.

You can take almost any two of the large stock companies and find in those two companies alone more men with salaries and commissions above this figure than in the entire mutual field.

Fourth, it is said that the mutuals have constructed extravagant office buildings. While we cannot see what this has to do with the question of whether or not the mutuals should be taxed, we again assert that the statement is false.

It is true that many of the smaller companies operating in the rural districts have found it necessary to construct office buildings, but these buildings have been moderate and have proved eventually to effect a saving for the policy holders. None of the larger mutual companies has placed any unreasonable portion of its assets in office buildings and here again these buildings have been reasonably constructed and the annual cost has often proved lower than reasonable rental.

In 1940, the mutual companies saved policyholders $110,000,000 out of a premium income only one-forth as large as that of the stock companies.

We contend that approximately 75 percent of this $110,000,000 was taxable in the hands of the policyholders of mutual companies.

It is reasonable to assume that on the average the Government received a tax on most of this money at the normal rate. Figured at 24 percent, this tax would have amounted to $19,800,000. By taking into account other factors, it is probably reasonable to reduce this amount another 25 percent. This would leave Federal income taxes aggregating $14,850,000 paid by commercial mutual policyholders on those mutual dividends.

This compares very favorably with the $18,000,000 Federal income taxes paid by the stock companies on four times larger premium income.

In other words, the Federal Government already is getting more tax revenue out of each thousand dollars going through mutual insurance channels than it gets out of a thousand dollars going through stock insurance channels.

It is difficult for me to restrain myself in discussing these and other charges by our stock competitors. They are far from being in an invulnerable position themselves. They have enjoyed several special tax advantages. They have paid handsome dividends, in some cases dividends well above 25 percent after taxes. They have made inconsistent and misleading statements before the committees of the Congress. It does not seem to us that their actions justify giving the stock companies much voice in the deterimnation of the Nation's tax policy toward mutual companies.

We know from long experience that the stock companies would like to see mutual insurance destroyed.

They seek to force all buyers of insurance to pay a tribute to their appetite for profit. They have tried to destroy mutual competition by means of boycott, to bully buyers of insurance by using the reciprocity racket, by rate manipulation—this is well indicated by the fact that the stock fire companies are now subject to an antitrust action—and they have engaged in pressure politics, of which their long campaign in favor of this bill is a good example.

It seems to us that there is something wrong with this picture, that a thorough investigation of the situation should be made.

We would like to see the subcommittee, which has been appointed to give further attention to this matter, go into all the ramifications which bear upon this situation.

We don't believe that an adequate factual study of it has been made. We don't believe that a case has been made for the allegation that an unfair disparity exists in the present law between the tax treatment of stock and mutual companies.

We stand ready to aid the subcommittee in every possible way.

Thank you very much.

Senator CLARK. What do you say about the proposition that they advance that since the large mutuals are in direct competition with the stock companies, they should be subjected to approximately the same tax treatment?

Mr. GRUHN. I don't think that proposition is based upon sound principle. The income-tax law, as applied to corporations, is a tax on profit, and those corporations not engaged in business for profit and not making profit have for a quarter of a century always been regarded in the nonexempt, nonprofit class. Mutual savings banks are in direct competition with commercial savings banks. Mutual building and loan associations are in direct competition with commercial private building and loan associations; cooperatives are in direct competition with merchants. Yet there is no intention of changing their tax-exempt situation. The difference is that in a stock company, the money that you and I and the other policyholders contribute for insurance protection is not held there and retained for our protection, but becomes the property of a third party proprietary interest, which makes a huge profit out of the transaction. A small, comparatively, capital investment in a fire and casualty insurance company, permits the complete control of millions and millions of dollars of policyholders' money by the third party stockholders' group for the privilege of making profit out of this essentially mutual transaction.

Senator TAFT. We get the profits when the stockholders get them. That is, we get a very large proportion of them. I don't think the profit question makes much difference. I can't see that distinction. I think it is most important that there should be no discrimination. I agree with that thoroughly, but I don't see quite why a large organization—after all what we are doing in this thing is taxing business. We are not taxing profits. We get the profits. This is a business tax today as a convenient means of raising money for the Government, and that is true of all corporation taxes, and I can't quite see why it shouldn't apply to a large mutual.

Mr. GRUHN. Or a large mutual savings bank or a building and loan association?

Senator TAFT. That is right. We tax building and loan mutuals exactly the same way as we tax the banks and the other building and loans.

Mr. GRUHN. I shall point out in a moment that in our opinion the Government loses no money by reason of the funds channeling through mutual companies as compared with what it gets from the funds which channel through the stock companies in the way of profit.

Senator TAFT. I feel it is a tax on the business process, and that you are just as much a part of the business process as a stock company.

Mr. GRUHN. Well, that becomes a privilege tax rather than a profit tax.

Senator CONNALLY. Let me ask a question.

Mr. GRUHN. Yes, sir.

Senator CONNALLY. The right to do business as a mutual without paying any tax is a valuable privilege, isn't it? You regard it, don't you, as a fine thing to be able to engage in this business tax free?

Mr. GRUHN. Well, from the policyholders' standpoint, I think the policyholders should be permitted to combine in their own company for their own benefit instead of paying tribute to a profit-making group which takes a substantial slice out of every premium dollar which is paid.

Senator CONNALLY. You might say that as to any cooperative or mutual concern, but why shouldn't they—it is a privilege and an especial benefit—why shouldn't they pay something in the way of taxes?

Mr. GRUHN. I made the point, sir, that under war conditions, nonprofit enterprise, I felt sure, would willingly submit to a proper tax with due recognition of the character of the enterprise and the fact that it is not engaged for the profit of third party proprietary interests, but this bill doesn't do that.

Senator CONALLY. Have you submitted an amendment that will do that? Would you mind drawing one and leaving it with us, that will do that?

Mr. GRUHN. We have attempted——

Senator CONNALLY. You say this doesn't do it, but will you draw one?

Mr. GRUHN. I will draw one which, in my judgment, as a war measure is a fair basis of tax treatment of nonprofit enterprise as compared with profit-making enterprise.

Senator CONNALLY. All right.

Mr. GRUHN. I shall be glad to do that.

Senator CLARK. Coming back to my first question, Mr. Gruhn—in actual practice, has this difference in taxation put the stock companies at an unfair competitive advantage? They claim that it has.

Mr. GRUHN. Well, of course, I am very sorry for them. But they do not deserve or need any sympathy. They ought to be thankful. If I made three and a half times the rate of return on my investment for the 14 years ending 1939, including the depression, that other profit-making businesses made, and if I controlled 83 percent of the fire business and 73 percent of the casualty business, and if I made profits of 40 and 50 percent, as some stock companies have been making in recent years, which have complained to you, it would seem to me that I would be very much ashamed to complain about competition.

Senator DAVIS. Are the rates just the same for the mutual as for the stocks?

Mr. GRUHN. Not necessarily in all cases. In the case of the mutual companies we are considering here, the rates are no higher, but they are frequently less, but the net result is a 20 to 50 percent lower cost to the policyholder. There is no element of profit, sir, in the mutual set-up except it has been contended at times in the Bureau that perhaps there is an element in the investment income. The money set aside for reserves and surplus is a reasonable amount necessary for the safety of the insurance operation. It is not held there for somebody else who has not paid it in.

Senator DAVIS. It is just more or less, then, a cooperative organization?

Mr. GRUHN. In a sense, it is cooperation in the mutuality of the group out of which the losses of the unfortunate few are paid. Now, under the State laws, certain surpluses are required, and there is a constant effort to increase those surpluses. We have opposed those efforts from time to time. They are supported by the stock people mainly, who contend that organization and administration requirements for existing companies should be raised. They have raised them in the State of New York to the point where certain classes of companies, in order to perform full service to their policyholders, must have as much as $1,500,000 to do business. There are only 3 percent of the mutual companies which have more than a million dollars of surplus. A much smaller percentage of large units than in the mutual savings banks or the mutual building and loan associations or the mutual fraternals, and yet under this bill these additions to mutual surplus which are required by the State law would be subjected to an extremely heavy and discriminatory tax.

The CHAIRMAN. Mr. Gruhn, you have been speaking for 30 minutes.

Mr. GRUHN. I am sorry. I am trying to answer the questions.

The CHAIRMAN. Are you speaking for the whole group?

Mr. GRUHN. I am speaking for a hundred of these companies.

The CHAIRMAN. You are not speaking for the other witnesses?

Mr. GRUHN. No, sir.

Senator BAILEY. I would like to ask Mr. Gruhn a question or two.

The CHAIRMAN. Yes, Senator.

Senator BAILEY. What effect would this taxation have upon the premiums of your companies?

Mr. GRUHN. This tax would increase the cost to the policyholders of the mutual companies because of its punitive effect.

Senator BAILEY. To what extent?

Mr. GRUHN. Well, I can't say. The Federal Government already realizes from our business, through the tax on the dividends returned to policyholders, at least ten to eighteen million dollars annually. To the commercial policyholders of these mutual companies the reduction which it might be necessary to make in the dividend return as a result of these taxes varies with different companies. I understand from some companies that if this tax had been in force during the period of the depression they would have had to close up shop for the simple reason that they would not be able to build the surplus which was needed for the protection of the policyholders after it had been depleted. Because of the punitive nature of this tax—45 cents of every dollar would first have to be paid as profit for the money that would have to be built up which doesn't go to anybody as profit.

Senator BAILEY. As I understand, the surplus of stock insurance companies is, in a sense, property of the stockholders, but, after all, it is a reserve.

Mr. GRUHN. Yes; it is a reserve, but, on the basis of the stock spokesman formula to this committee, it is a redundant reserve.

Senator BAILEY. What is the difference between the stock companies' reserve or the mutual reserve?

Mr. GRUHN. The stock company is engaged for profit and that reserve belongs to the stockholders. They are holding at the end of 1941, $393,000,000 excess surplus.

Senator BAILEY. You have surplus and reserve, don't you?

Mr. GRUHN. Yes, sir. Certain reserves are required by law to take care of incurred and unpaid losses and the surplus is needed for unusual and unexpected losses in excessively heavy years.

Senator BAILEY. In the nature of capital?

Mr. GRUHN. In the nature of capital, but the capital of a stock company is not taxed. They are not taxed—they do not pay taxes under the capital stock declared value excess profits tax.

The CHAIRMAN. Thank you, Mr. Gruhn. You can file your brief and it will have, of course, the consideration of the committee. We will be glad to consider it.

Senator BARKLEY. I am sure that the chairman and the staff have made every effort to eliminate duplication of witnesses. I notice from the calendar that there are seven witnesses on this same subject. It seems to me impossible that there should be seven different phases of this question, and I was wondering whether some suggestion might be offered to the witnesses not to cover the same ground that is covered by previous witnesses in talking about this subject.

Mr. GRUHN. There are many types of mutual insurance companies, and we do not represent them all. I notice there is one stock spokesman on mutual insurance.

Senator BARKLEY. It is all the same question in the main, though, isn't it?

Mr. GRUHN. It is the same question, but it varies in results with different types of companies, with assessment companies, with small companies.

The CHAIRMAN. Well, I will say that the number of witnesses on this question was reduced from about some 10 or 12 or 15 to this number, but I assume that there will be spokesmen, that you have covered the main part of the ground and that there won't be duplication.

Mr. GRUHN. Thank you very much.

(The letter submitted by Mr. Gruhn is as follows:)

[From Insurance Advocate, January 10, 1942]

WILLIAM B. JOYCE, VETERAN SURETY LEADER, COMMENDS OUR CAMPAIGN FOR TAX EQUALIZATION

WM. B. JOYCE & CO., INC.,
New York, October 27, 1941.

Mr. C. S. ROSENSWEIG,
Managing Editor, Insurance Advocate,
New York City.

DEAR MR. ROSENSWEIG: I have noted, with much interest, your editorials on taxation of stock insurance companies, and featuring the difference between stock insurance and mutual insurance taxation.

To all intents and practical purposes nonassessible mutual companies are little, if any, different from stock companies, and I feel you are inaugurating a meritorious campaign so that the tax inequality will end.

The campaign you are putting on will be worth hundreds and hundreds of thousands of dollars to stock insurance companies and I have no doubt they will so recognize your activities.

Very truly yours,

WM. B. JOYCE.

[From Report No. 2333 of Ways and Means Committee, p. 117]

EXAMPLE 1

The Z Mutual Fire Insurance Co. has wholly taxable investment income of $550,000, dividends of $200,000, partially exempt interest of $100,000, and wholly exempt interest of $300,000, a total of $1,150,000. Investment expenses are $150,000, leaving net investment income of $1,000,000. The amount subject to both normal and surtax rates is $430,000 ($1,150,000 less $150,000 less $100,000 less $300,000 less 85 percent of $200,000), and the tentative tax at 45 percent is $193,500. The amount subject only to surtax is $100,000, and the tentative surtax is 21 percent of this amount or $21,000. The amount of investment income available for distribution is then $785,500 ($1,150,000 less $150,000 less $193,500 less $21,000). If dividends paid to policyholders were $2,000,000, then of this amount $1,214,500 ($2,000,000 less $785,500) would be allowed as a deduction for dividends paid out of premiums or surplus apportioned to policyholders.

	Z Mutual Insurance Co.			Z Stock Insurance Co.		
1. Investment income		$1,150,000			$1,150,000	
2. Less investment expense		150,000			150,000	
7. Net investment income (1−2)			$1,000,000			$1,000,000
12. Premiums received (net)		10,000,000			10,000,000	
Less:						
13. Net losses paid	$3,800,000			$3,800,000		
14. Underwriting expenditures paid	2,500,000			4,500,000		
15. Adjustment expenditures paid	350,000			350,000		
16. Portion of dividends deductible	1,214,500			....		
17. Deductions (sum 13 to 16, inclusive)		7,864,500			8,650,000	
18. Net amount, unearned income (12 to 17)		2,135,500			1,350,000	
19. Unearned premiums, increase	500,000			500,000		
20. Unpaid losses, increase	750,000			750,000		
21. Surplus apportioned to policyholders	....			....		
21. Reserve increases		1,250,000			1,250,000	
22. Net underwriting income			885,500			100,000
23. Total income (7+22)			1,885,500			1,100,000
Less:						
24. Net operating loss (after 1942)		....			....	
25. Deductions authorized by law		....			....	
26-29. Wholly exempt interest [1120—(1) (2) (3) (4) (6)]		300,000			300,000	
30. Partially exempt interest [1120—(5)]		100,000			100,000	
31. 85 percent dividends, domestic corporations		170,000			170,000	
32. Deductions (24 to 31, inclusive)			570,000			570,000
33. Net normal tax income			1,315,500			530,000
35. Normal tax (24 percent, line 33)			−315,720			−127,200
38. New normal tax income (33)			1,315,500			530,000
39. Plus partially exempt interest (30)			100,000			100,000
40. Surtax income (38+39)			1,415,500			630,000
41. Surtax (21 percent, line 40)			−297,255			−132,300
44. Total tax (35+41)			612,975			259,500

Calculation of dividends deductible

A. Dividends paid to policyholders			$2,000,000
B. Net investment income (7)		$1,000,000	
Less:			
C. Wholly exempt interest	$300,000		
D. Partially exempt interest	100,000		
E. 85 percent dividends	170,000		
F. Deductions (sum C, D, E)		570,000	
G. Net investment income less deductions (B to F)		430,000	
H. 45 percent of G	$193,500		
I. 21 percent of D	21,000		
J. Investment income not available for dividends (H+I)		214,000	
K. Investment income available for dividends (B−J)			785,500
L. Portion of dividends deductible (A−K)			1,214,500

The CHAIRMAN. Mr. Gross.

STATEMENT OF HARRY F. GROSS, DES MOINES, IOWA, REPRESENTING IOWA MUTUAL TORNADO INSURANCE ASSOCIATION

Mr. GROSS. Mr. Chairman, I briefly want to say, realizing the importance of time to this committee, I will waive the time that has so kindly been allotted to me and I will further add that the statement made by the secretary of the National Association of Mutual Insurance Companies substantially agrees with my views.

I thank you one and all.

Senator TAFT. Do you say that the Farmers Mutual Tornado Companies usually have more than this exemption?

Mr. GROSS. I don't get you, Senator.

Senator TAFT. It was stated by Mr. Cooper that the tornado companies could not get within this exemption.

Mr. GROSS. They couldn't certainly, because they cannot confine their business to a small zone.

Senator TAFT. In other words, they are usually State-wide?

Mr. GROSS. State-wide and in our State we supply the tornado and windstorm insurance to about 150 county mutuals, but our losses, as Mr. Cooper told you—he referred to possibly our company—that 1 year we had over $950,000 in losses and in another year we have less than $50,000. Does that answer your question?

Senator TAFT. Yes.

Mr. GROSS. The same thing is true in Michigan, Ohio, Illinois, and Indiana, and other States of the Middle West.

The CHAIRMAN. Mr. Hurst.

STATEMENT OF O. E. HURST, LEXINGTON, KY., CHAIRMAN, LEGISLATIVE COMMITTEE, KENTUCKY MUTUAL AND COOPERATIVE FIRE INSURANCE ASSOCIATION

Mr. HURST. Mr. Chairman, members of the committee, Senator Barkley, my name is O. E. Hurst. I am chairman of the legislative ecommittee for the Kentucky Mutual & Cooperative Fire Insurance Association—instead of corporation—secretary and manager of the Hurst Home Insurance Co., a farmers' mutual insurance company operating in 12 counties only in central Kentucky.

From the viewpoint of the farm mutual company, and from 30 years' experience of being a football in our State, and called Communists and Bolshevisks for writing nonprofit insurance, and the arguments that have been placed against mutual insurance, the local farm mutual company feels that here is a dangerous change in the revenue laws affecting those companies.

Under the original act it was kindly endeavored to exempt the local farm mutual company, qualified exemptions were written, and arguments were made that these companies, because of peculiar practices that grew up among them, did not fall under that exemption.

It is our belief in Kentucky that the attempted exemption under this measure for the companies puts the companies supposed to be exempted in far more dangerous condition and unhealthy condition than the companies taxed.

We do not know what form of human logic would bring us to a conclusion that a cooperative protective association, or mutual insurance company, should be favored by its Government so it would not be taxed at all provided it did not have $100,000 in mean assets, and if it had $1 more than the minimum in this bill it comes under certain taxing provisions that undoubtedly in some cases will prove fatal to these companies.

For 30 years in my work among the farm mutuals and in Kentucky we only covered one-third of the State. There are no local farm mutuals in Senator Barkley's immediate neighborhood.

The savings we make are not great, compared to the effect we have upon the commercial rate.

There are certain governmental agencies making loans that have minimum requirements for accepting policies above $100,000.

I hate to see the farm mutual companies placed in the position of begging the Congress of the United States to set them aside in a special class where they will bear no part of the war cost, because I know this propaganda that has been used against us so terrifically—within a very few months the word "slacker" and the outcast idea that has been handed toward the builders of cooperative enterprise will be used again and again.

However, in our own State, where this same stock company trust is attacked again and again, and has said that they favored farm mutuals, we know, if the sentiment all over this country and the conflict between these two classes are as bitter as they are in the South where we are on the border line of mutual insurance, that any stock company man who favored a local farm mutual company would be an outcast among his own. We know that the savings of farm mutual companies in Kentucky have brought the cost of insuring a barn where tobacco is fire-cured down to $48 per thousand, where the local mutual company carries about $8 and includes windstorm.

We know that a few years ago a farmer in Kentucky paid a rate for fire insurance for a tobacco barn with a stripping room attached of $30 per thousand, or with a stripping room detached of $13 a thousand to the commercial companies, and because those growing mutual companies there did not make that surcharge it has been withdrawn.

We know that in the five States in the deep South where the farm mutual companies have not been allowed to grow, that the insurance cost under this insurance trust is beyond the ability of the farmer to pay, and we see, or think we see, in this changed wording in this bill, which attempts to exempt the majority of the farm mutual companies, that it would stop their growth and limit their ability to build a solvency that will allow them to meet their honest promises, for there is only one alternative: If the company knows it takes a hundred thousand surplus to safely cover a certain amount of risk, it must stop there or build itself into insolvency.

There is one other thing I would like to call to the attention of this committee particularly: That the assessment mutual companies cannot be taxed under the same provisions and the same law that the commercial companies are taxed and the same results be achieved, for the assessment company does not and is not required to build an unearned premium reserve and under the same tax that would tax the commercial companies each dollar that would be added to the surplus would be taxed, but we think we see here a danger.

An assistant attorney general of the State of Kentucky once ruled that the Mutual Fire Insurance Co. of Covington was no longer a mutual company because it had too much surplus, and members of the board of that State argued that a mutual company was not mutual in principle, or purely mutual, if it had any income other than from premium and assessments, and that ruling was made. It has been afterward rescinded. It has been argued before the Treasury that unless a cooperative or mutual company paid anything for services for an agent bringing new business into that concern it destroyed the mutuality, that a mutual company was an institution where people voluntarily came together, almost without persuasion, and every farm mutual company who remembers the inquisition in the old tax law, when they thought they were exempted for 7 years, were penalized, and afterward it was refunded, and some of them were threatened their very existence.

He fears this language which states "companies that write policies solely on a mutual basis," when the mutual basis is not established.

The old law established that basis by making it certain where the income of these companies must be used or held solely for the purpose of paying losses and expenses.

That was a broad enough definition to cover the farm companies, but there have been such narrow arguments made and propounded that no farm mutual company in the United States could rest securely under the expected exemption.

One more thing: A farm company carrying fire alone, or isolated property, is allowed the same surplus as the company carrying fire and tornado.

The little company I represent has had a hard struggle. It is 51 years of age. In 1912, in one county, the total losses paid was $17 and ninety-odd cents, the next year over $10,000—$50 per thousand.

In 1913 the company was compelled to assess its members $12 per thousand and then ran a deficit.

These losses fluctuate greatly. If a hundred thousand dollars surplus is a safety fund for a given amount of insurance, then, by putting this type of exemption into your bill, you say: This is a good thing—so good that it must not be taxed whatsoever, but, if it raises its surplus above that, it is an evil thing and must be discriminated against, and in so doing you limit the good thing's growth, and you render the greatest service to the stock insurance trust that has ever been rendered in a tax bill.

These farmers are not beggars; they are not unpatriotic; they are putting their surpluses—our own little company has put one-fifth of it into your bonds this year, and has voted to put every dollar into bonds, not as a matter of investment but as a matter of support, and I know these 55 directors in Kentucky, if they thought their country needed it, would vote to give every single dollar of their surplus and assess their membership in support of their Government.

But they do ask of you: If it is necessary to tax losses under the present emergency, to make that tax certain, simple, and so it cannot be interpreted and not build a trap for 80-odd percent of these farm companies, so that they may go thinking that they are not required even to make a return, and later on be brought up under an inquisition, as they were following the World War.

Senator HERRING. What do you call a little farm company?

Mr. HURST. My company happens to be the largest farmers' insurance company in Kentucky. It has a right to cover 20 counties.

Senator HERRING. Then yours is a large company; it isn't a little farm company then?

Mr. HURST. It covers 12 counties. I presume it is large compared to some.

Senator HERRING. We have hundreds of little farm companies, Mr. Hurst.

Mr. HURST. But others are much larger than ours.

Senator HERRING. You don't contend that a little company that is really a little farm company will pay any tax under this bill?

Mr. HURST. I claim it is the most dangerous tax that could be devised.

Senator HERRING. That isn't an answer.

Mr. HURST. I don't think they will make a return at the present time at all. I think they will feel they are out from under this bill.

Senator HERRING. They will be out from under, won't they?

Mr. HURST. I don't think so.

Senator HERRING. Little farm companies who have $50,000 profit?

Mr. HURST. That is my belief, they will not.

Senator HERRING. Then give us an amendment that will correct that, because that is the intention, to entirely eliminate the little company.

Mr. HURST. That is the intention; I know that; I appreciate that. But in principle any law that limits the growth of a healthy institution is keeping that institution from functioning, and that is our principal objection.

That is what we think is very bad, because it keeps mutual insurance companies from growing, and we think it is the greatest weapon the competitors ever had.

Certainly, it is lunacy of logic to lead us to say that, if a company has $99,999.99, that it is tax free, and if it gets another penny into its surplus it should be taxed.

Senator BARKLEY. Would you make any qualification at all as to surplus? Would you fix any line at all?

Mr. HURST. If you would leave your old wording, Senator, in the bill, I think it would accomplish your purpose, that mutual-insurance companies the income of which shall be used or held solely for the purpose of payment of losses or expenses, you would accomplish what you are trying to accomplish, but I believe the attempt to accomplish that thing will drive the farm mutual companies out of the tornado business.

In our State, where one-county companies are the companies that I have associated with, those are the companies that for 30 years have elected me to the nonsalaried position of chairman year after year.

We will pay the taxes until we are insolvent, without a squawk, but they are the companies I am worried about here today.

One of the companies carried insurance 3 years without an assessment.

But they have great difficulty in securing tornado insurance.

The stock companies don't give it to them, and we have no tornado company in the State, and the tornado company can not safely cover a large amount of insurance with $100,000 surplus, but the objection is the principle of this thing, for it is our opinion that this bill is merely the start.

If you put a $50,000 limit it will be lowered to 5 and 10, but the principle of this thing, of the United States rewarding companies for holding down their size and solvency, when they could serve more people by natural growth, I think is a weapon being used against those smaller companies, and I think the smaller companies, under the provisions of the bill as it is here today, are in far more danger than any other companies being taxed.

I thank you.

Senator BARKLEY. How many policyholders do you have, Mr. Hurst?

Mr. HURST. 6,300. There are about 60,000 policyholders of mutual cooperative companies in Kentucky. There are companies in Louisville with perpetual policies, and when their State rating law was made effective they were called up before this rating board.

They were not subject to it; it was argued they were, but the board itself was new and the secretary came up and he said, "We don't know what you want about our rates, but here is policy No. 1 written 50 years ago that has never paid but one premium. What do you want to do with the rates?"

Those companies are deserving of consideration, too, and they have more than a hundred thousand dollars surplus accumulated over many years of thrift and saving, but it is my absolute belief—and I think it is the belief of the farm boys who suffered from the honest attempt of Congress years ago to put them in a special class, but I believe in this emergency, putting them in a special class is not right and will place them in a very awkward position later on when they are told that they haven't borne any part of the load.

I thank you.

The CHAIRMAN. Thank you very much.

Senator CONNALLY. Mr. Hurst, just one question.

Mr. HURST. Yes, sir.

Senator CONNALLY. Suppose you allowed them $100,000 and then taxed the surplus above that: Would that be just as harmful as the present bill is?

Mr. HURST. I think, Senator, that honest mutual insurance should be taxed the same all the way through.

Senator CONNALLY. Well, there is an advantage, though, when it gets spread out?

Mr. HURST. There may be some advantage—some additional advantage—and there may be some fairness there.

Senator CONNALLY. It is an additional security, though, when you have got a big spread?

Mr. HURST. That is necessary, and that is the reason that we object to this retarding of the growth. You have to have a certain spread to meet a certain type of risk, and the thing that we are objecting to here is the restriction on the growth of these mutual companies.

On the other hand, if it comes to penalizing some of the big boys in a tax bill, that is very difficult, because, if you go out and try to review the Henderson case in Missouri, which was penalized for that, there is no telling where the taxes would go on the stock fire-insurance company.

Thank you.

The CHAIRMAN. Thank you very much.

Mr. Reporter, will you please include in the record the brief of Hal G. Sours, director of highways for Ohio, who is present, but who has agreed in the interest of saving the committee's time, to appear by brief.

Senator TAFT. I might add, in opposition to any increase in the gasoline tax.

The CHAIRMAN. Yes, sir; thank you, Senator Taft.

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

BRIEF OF HAL G. SOURS, DIRECTOR OF HIGHWAYS, STATE OF OHIO, IN OPPOSITION TO INCREASE IN GASOLINE TAX

Mr. Chairman and members of the committee, my name is Hal G. Sours. I am a highway engineer by profession and director of highways for Ohio. I am appearing here today as a director and past present of the American Road Builders' Association. The association, a scientific and educational organization, was formed in 1902, almost 40 years ago, and it represents a cross-section of the Nation's highway industry and profession.

It is my purpose to direct your attention to the effect which an increase in the Federal tax upon gasoline would have upon the fiscal situation in many of the States and upon the highway program of the States both during and after the war. I shall be as brief and concise as possible.

I know that I need not dwell upon the obvious fact that automobile operation will be reduced month by month as cars and their tires wear out, but I do feel that I should point out the effect this will have upon the revenues of the various States.

The report of the Public Roads Administration on gas-tax collection for June 1942 in 26 States shows 17.17 percent less collected than in June 1941. The report includes 6 rationed States in the East the average decrease in those States being 26.64 percent, leaving a decrease of 13.53 percent in the 20 nonrationed States. Nation-wide rationing, if it comes, will naturally speed the decrease to all States. Furthermore, as tires and cars wear out there will be a still greater decline on that account.

Every reduction in aggregate mileage of American motorists will be reflected in reduced income to State and local treasuries. Thus, the conservation which will help ease the rubber shortage and alleviate the petroleum transportation problem may at the same time force State and local governments either to reduce expenditures below levels of needed maintenance and some essential replacements to carry on transportation in the war effort or to seek other sources of revenue.

Just how the States can adjust their finances and appropriations to reduced automotive revenues is a problem. Taxpayers, facing heavier Federal income taxes, are campaigning vigorously for reduction in their State payments. In some States, notably New York, I understand they have gained the support of State officials and have successfully reduced State levies. But motor-vehicle fees have more often been increased than reduced. Under present crises conditions many States may be forced to increase gasoline tax rates even though this course is ill advised.

This is not the whole story. State sales taxes, personal property levies, toll charges and other imposts harvest another large sum each year from the motorist. The aggregate is almost impossible to estimate with any precision. The automobile produces more than twice the revenues of the general sales tax, three times the total of special taxes levied on business, three times the combined income taxes on individuals and business, and more than six times the total of State income taxes alone.

I believe it is evident from the facts that many States as a result of the loss of the various incomes from motor vehicles may face a fiscal crises. This is especially true of the ones which have large highway bond issues outstanding or which annually divert a sizable portion of the receipts of motorists to nonhighway purposes. Florida, for example, will find this revenue source cut very severely. Florida has outstanding $90,000,000 in county road bonds. An important part of the gasoline tax receipts are the real security for the credit of the

State. Arkansas has pledged its gasoline tax revenues to the payment of outstanding bond issues. In the current fiscal year $7,175,000 out of $11,500,000 remaining in the State treasury, or 62.4 percent, is earmarked for bond payments. The fact is that bond interest and retirement has taken such a large share of the 6½ cent State gasoline tax that Arkansas has not been able to match its Federal highway aid allotment for a decade.

West Virginia became alarmed and made a survey sometime ago of the decline in automotive use. By personal interviews with 6,000 car owners State officials estimated that their motor-vehicle registration could readily decline in 1943 to approximately 40 percent of the January 1, 1942, registration.

Inasmuch as recent annual debt service requirements are more than $8,000,000, West Virginia obviously faces a fiscal crisis in 1943 when revenues will fall abruptly. Many other States are in similar financial plight due to their dependence upon automotive revenues not only for the payment of highway indebtedness and highway maintenance, but also because some States diverted highway revenues to a variety of nonhighway uses.

In my own State, Ohio, a careful survey by the highway planning survey has shown some interesting predictions.

According to this survey the State will receive $11,124,000 less than in 1940 for each of the years 1942, 1943, and 1944 from the sales tax on automobiles alone. Gasoline and liquid fuel receipts will be off about $4,500,000 in 1942, $13,600,000 in 1943, and $22,700,000 in 1944. Such a decline is, I believe, obvious in the light of Nation-wide tire rationing. Furthermore, motor license fees will inevitably decline as cars go off the road and are not immediately replaced, approximately $2,200,000 for 1942, $6,500,000 in 1943, and $11,000,000 in 1944.

Truck traffic will undoubtedly continue, perhaps at increased volume as our war production advances. Indeed, I doubt that we in Ohio will be able to get along without trucks and busses during the war years. We are located at an industrial crossroads. We have many war industries to and from which we haul enormous tonnage of materials. Furthermore, we are geographically located so that our highways carry large tonnage across the State. We must always bear in mind that in the reduction of traffic facing us the smallest decrease will be in the type of traffic which does the most damage to the roads, namely, that of heavy hauling. Consequently, the States and their subdivisions which are charged with the responsibility of maintaining highways will have a continuing problem of maintenance and some essential replacement. But the elimination of automobile sales and the absence of replacement of tires and parts will inevitably bring great losses in revenue based upon extensive civilian use of the highways. It is just as important in the war effort that we keep transportation lines feeding the war industries open and functioning as it is to keep the industrial assembly lines in good order. With the normal dependence on the States upon gasoline tax revenue it would be unjust for the Federal Government further to invade this tax field.

Permit me to cite the meritorious adjustment of highway revenue in Canada. Each of the nine Provinces has levied a gasoline tax for many years. Under the war revenue act of last year the Dominion Government imposed a tax on gasoline for the first time. When just recently the Dominion Government placed restrictions on tires and rationed gasoline, the Provinces called attention to the effect that this would have upon the annual level of gasoline tax revenues. The nine Provinces had collected $55,000,000 from this source in the previous year. The Dominion Government was sympathetic to the difficult financial position imposed upon the Provinces and agreed to reimburse them each year in amount sufficient to make up the difference between actual collections and $55,000,000. This program is now in effect for the duration of the war or as long as gasoline rationing is continued, provided that the Provinces do not increase their gasoline tax rates.

The gasoline tax is in effect a sales tax. State gasoline taxes are classed generally speaking, as a use or privilege tax levied and used for a specific purpose, that of building and maintaining highways. There is no complaint on taxes of this type when levied and used for the benefit of the user of the road. It follows a pay-as-you-go plan, and might be considered as a toll or metered charge. The amount paid varies directly with the amount the payer uses the road.

When we transfer the use of such taxes to something other than a special use for the direct benefit of the payer of that tax, then it becomes another form of tax and should be considered in the same light as any of the several other forms of taxes which we pay. When we consider taxes on gasoline as something other than a use tax it becomes an excessively high tax compared with other taxes which we pay.

It cannot be considered a luxury tax. The car and truck is not now a luxury. It is being used principally as something essential. There are some forms of luxury taxes as well as taxes on nonessentials. They do not, however, usually run nearly as high as the gasoline tax. Generally speaking, the total gasoline taxes now amount to approximately a 50 percent tax. The 1½-cent additional tax proposed would amount to an increase of 100 percent on the Federal tax. It can scarcely be said now that the present 1½-cent tax is a use tax. The Federal Government has practically shut off Federal-aid highway projects, about the only new construction going on being that of access roads in certain areas.

After all, then, the gasoline tax is fundamentally a sales tax levied on an essential commodity. It is an extremely high one by comparison with the ordinary form of sales tax.

Much of the gasoline taxes now being paid are on the transportation of war materials. This tax will only tend to increase the cost of the materials which the Government in turn must pay for. Furthermore, gasoline consumption, as I have stated before, will decrease. We would be taxing a product which will show a diminishing return.

When the Federal gasoline tax was originally put on it was supposed to be an emergency or temporary tax. However, part of it went for Federal aid for roads and there was no objection to its continuance. It was, however, at that time recognized as being somewhat of an invasion of the field of taxation which the States depended upon for their highway revenues. To add to, or to double these taxes, would be a serious crippling of the taxing ability of the States.

I recognize your problem in providing taxes to meet the abnormal conditions of the moment and I further realize that we should not oppose your methods unless there is an adequate remedy. I believe there are remedies which would be less painful and more equitable. If we are considering a sales tax, and after all tax on gasoline is essentially a sales tax, it would seem more logical to make the tax on sales a more equitable one rather than to overburden any single essential commodity. Taxes are unpleasant. They cause distress when we pay them and they cause distress to you when you are called upon to set up a means to provide for them. They must, however, be faced and the more equitable our taxes may be the more cheerfully they will be met. We cannot enjoy the privileges which our taxes buy for us if we do not provide them and we must now pay the cost of preserving and protecting the form of government which does and will give us such privileges.

I trust that what I may have said in my remarks may contribute something in the way of respectfully bringing to your attention the objections to the proposal for increasing Federal taxes on gasoline.

I appreciate the opportunity of appearing before this committee and wish to thank you for your attention.

STATEMENT OF HERMAN L. EKERN, CHICAGO, ILL., REPRESENTING THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

The CHAIRMAN. Mr. Ekern.

Mr. EKERN. Mr. Chairman, my name is Herman L. Ekern, of Ekern, Meyers & Matthias, at 1 North La Salle Street, Chicago, Ill.

I appear for various mutual insurance companies other than life—that is, the fire and casualty companies—and I have had some contacts with these various associations, which date back to the time I left the commissioner of insurance in Wisconsin in 1915.

At the present time I am engaged, with my partners, in advising on insurance-company management.

I shall try to hit a few of the high spots, to help the chairman out on the time, and I will try not to duplicate, as far as what has been gone over is concerned.

I endorse what Mr. Gruhn and Mr. Cooper and Mr. Hurst have presented here.

I am personally familiar with it. I know that the facts they have given you are absolutely the facts with regard to the operation of these mutual insurance companies.

Let us make this one thing clear at the outset: This is not a question of an amount of tax at all. These mutual companies are American companies. The insurance business in the United States was born with American companies, dating back to Ben Franklin, 190 years ago.

They stand ready, in this emergency, to do their full share, in every way, in contributing financially to the needs of the Government.

There is no question about that. They are ready to waive any exemption or any exclusion for any tax that Congress sees fit to prescribe, that does not try to transfer them into a profit-making institution; that is all. They are not standing on this exemption or exclusion at all. They want to pay a tax.

I have attended several meetings of these companies recently.

We have had conferences on it, and I have had this expression universally from these meetings. I want to take that out of the minds of anyone who thinks that these companies don't want to pay.

But there is a serious question involved in this bill.

All through the revenue acts, down to this very hour, these mutual companies have uniformly been classified as nonprofit, and it doesn't make any particle of difference whether it is the large or the small company; they are in the same position; they are nonprofit, because the money that they get from their policyholders is collected for the sole purpose of paying losses and expenses, and it is carried for that sole purpose; it never becomes a profit.

The United States Government today gets, from every dollar of business premiums paid to a mutual company, a tax 1½ times as large as it gets from the same dollar if it were paid to a stock company, including not only the tax paid by the stock company, but every dollar of tax paid on the dividends that are received by the stockholders of that stock company.

That is the fact. It is easily demonstrable. Let me give it to you:

I take my figures from the Spectator, 1941, reports on fire and casualty companies. This is a compilation in two volumes. It is the oldest publication institution in the United States, a recognized authority.

These mutual companies, during that year, on the average, paid their policyholders about 20 percent in dividends on their policies.

In other words it cost the policyholder 80 cents on every dollar for what insurance they took, as compared with the dollar that would have been paid to a stock company.

Either they got a check back from the company for the $20 on a hundred or their premiums were reduced by that much or approximately that, in advance.

There is no exemption in the present revenue act, and it is not proposed to grant any here, of savings that are made by policyholders in mutual companies.

Hence every dollar of this 20 percent handled by the mutual company pays a tax to the extent the policyholder pays a tax.

There is no deduction to this policyholder for the part that comes from exempt interest no matter how much exempt interest the company has.

There is no deduction to corporation policyholders for dividends, the 85 percent of dividends. They pay on every dollar, the same as if they got the money from any other business enterprise.

What do the stock companies pay? These same statistics show that these stock companies had in 1940 an underwriting and investment income, which they call an operating income, of 7.8 percent of their premiums. That is 7.8 cents on the premium dollar, the same dollar that the mutuals had 20 percent savings on.

The stock companies obviously did not pay any tax on any more than those 7.8 percent.

These stock companies paid back to their stockholders 6 percent on the same stock company premiums. Add that together.

That is 13.8 percent of their premiums, which is the entire basis of tax on that dollar of premium that went to the stock companies.

Now, these mutual companies' policyholders are farmers of the type that you have had here, all over these United States. They are the best class of farmers.

They are the fellows that are looking after their business and looking for the savings.

Now, what about the big companies—the big policyholders of these bigger companies—that are complained about here? The biggest businesses in the United States are insured in these mutual insurance companies.

The mutual companies in the factory mutual association that is represented here insure manufacturers all over the United States, and the large stores.

And then you have the large general writing mutuals. They insure all over these United States—the largest manufacturers and merchants and other business enterprises. Seventy-five percent of their business is of that class—some of them—and they pay dividends to policyholders, and many of them are stock corporations that get those dividends.

They pay the highest rate of a stock corporation on that. So that by and large it is a safe assumption that there is just as high a rate based on every dollar that is received by a mutual-company policyholder as there is paid on any of the profits of the stock insurance companies—or on any of the dividends paid to their stockholders, in the hands of their stockholders.

Senator TAFT. I am afraid I can't follow you. I can't understand that argument at all.

Mr. EKERN. Well, that is the truth.

Senator TAFT. It can't be true. They may reduce the expenses of some business corporations. If they pay it back to individuals it makes no difference in their income tax. If they pay it back to some corporations they may thereby make more earnings, and thereby have to pay a tax, but on the other hand the dividends paid out to stockholders by them bring in a very large income tax from those stockholders.

Mr. EKERN. They do.

Senator TAFT. So that I can't see the argument. I don't see that there is any difference.

Mr. EKERN. Just a moment, Senator Taft. If the stockholder is a corporation receiving a dividend from a stock company he only pays on 15 percent. The stock corporation only pays on 15 percent of that dividend. He pays much less in the case of a stock company dividend, but in the case of the mutual policyholder——

Senator TAFT (interposing). But most of this stock is owned by individuals.

Mr. EKERN. That doesn't follow as a matter of course at all.

Senator TAFT. It is a fact, though, as I understand it, Mr. Ekern.

Mr. EKERN. I have studied recently the situation with regard to these holding companies of the fire insurance companies, and the interrelationship of holding companies, whereby they make the capital stock of the parent company carry a lot more load, which is something that the insurance commissioners have been fighting.

Senator TAFT. Whatever it is, it is an investment trust.

Mr. EKERN. Whatever it is, it is a stock corporation. Let us get back to this policyholder. That is what I am interested in, because this policyholder is the man who carries this mutual insurance company, and he gets a return averaging 20 percent; not a dollar of that is exempted or excluded from his income.

He pays on all of it, and there is 20 cents out of every dollar that passes through a mutual company, against 13.8 percent of the dollar that passes through the stock company and 20 percent——

Senator TAFT. An individual insurer—a farmer insuring his home—doesn't pay more or less tax because he gets a dividend from a fire company.

Mr. EKERN. Why not?

Senator TAFT. Because it isn't that kind of dividend, as I understand it.

Mr. EKERN. It may be. He is conducting a business. He is entitled to deduct that.

Senator TAFT. Not on his home.

Mr. EKERN. No; not on his home; but on his buildings, barns, and everything else, and that is the big business of the farmers, and he is entitled to deduct that, and does deduct it, and hence you have the same application.

There is no difference between the stock-company stockholder and the stock company, on the one hand, and the policyholder in a mutual company, on the other hand, and 20 cents on the dollar in the case of the mutual company is just about one and one-half times, a little over 13 percent in the stock company.

The fact of the matter, therefore, is that today the United States Government gets half again as much from every dollar handled by the mutual company.

Why should the mutual company, then, pay a tax—and they haven't paid any all the time during the time these revenue acts have been in force. They have been exempted in part. A large part of them have not been exempted, but have had the mutual deductions which leave no net income subject to tax.

Senator HERRING. Don't you think a lot of people who haven't been paying taxes are going to have to pay taxes in this situation?

Mr. EKERN. Yes, sir; and these companies are going to pay taxes.

Senator HERRING. All right.

Mr. EKERN. You and I have no quarrel on that.

Senator HERRING. You bet they are going to pay taxes.

Mr. EKERN. Let me get this straight: These companies are entitled to this exclusion from tax as operating these mutual companies.

They are not entitled to get away from any tax that goes to the proportion of the business they do, or to the volume of their business, and any tax that you impose that doesn't make these companies profit-making companies will be accepted by them, and not only that, but they will sit down and help you work it out, and they will pay it, and anybody that doesn't like it in those companies will be brought to book and will like it before these companies get through with their policyholders, if there is anybody going to kick, and I haven't heard of anybody.

The bill was drawn, and, unfortunately—Senator, I am going to take a minute, I am going to analyse this bill—the bill was drawn, unfortunately, undoubtedly in a hurry, and the report was drawn in a hurry.

The evidence of that is contained in the report of the Committee on Ways and Means, who obviously got their information from the people who drew this bill.

That report indicates to anyone who knows the mutual-insurance proposition that these men didn't understand what they were dealing with; they didn't have the facts.

I don't blame them. Anybody can go wrong, but—if you will indulge me just a moment—I just want to present this, because I think the committee will be vitally interested in this, and then I am going to leave this memorandum with you, Mr. Chairman, to go into the record. I have also followed this up by a careful analysis of every provision in this bill, which vitally changes everything about the mutual insurance company taxation and does not do what the report says—put this tax on a basis of stock companies at all.

They say that dividends returned by mutual companies to their policyholders are made up of two components: Part is a distribution of the investment income earned by the company on its investments, and the part from underwriting income.

The report also states:

> Surplus accumulated by mutual insurance companies is also of two kinds: Surplus apportioned to policyholders, which is to be distributed to policyholders within a reasonable period in equitable proportion to the amount which the policyholders severally contributed to this surplus * * *

The trouble with that is this: There are no two kinds of surplus. There never have been, and in actual practice the machinery proposed to be set up for handling this and which really prescribes a regulation of the way these insurance companies are going to do their business, is impossible to comply with by the companies.

If they should attempt to do so they would run afoul of every insurance department in the United States, because the insurance departments of the United States will not stand for the issuance of a policy which promises to the policyholder in advance the payment of a certain amount of dividend.

They will not stand for a bylaw to that effect, and consequently this goes directly contrary to the recognized law, the regulations, and the insurance practice, throughout, so far as I know, every State in the United States.

They say that there is to be an unapportioned surplus concerning which there is no such expectation that it will be returned to those by whom it was provided.

Here is an apportioned surplus that is tied up under an absolute liability under this bill to the policyholder from the day that the company gets it. What about the unapportioned surplus?

The report further states:

Additions to apportioned surplus are analogous to additions to the capital or paid-in surplus of a stock company in that the surplus will eventually be distributed to the policyholder.

Now, there is no such analogy at all.

The additions to surplus paid in by a stockholder are paid in not as a policyholder but as an investment by a proprietor sharing in the ownership of the stock company and its assets in the expectation of profits.

There is no such situation as to a policyholder in a mutual company.

He isn't an investor for profit. He puts that money in to assure himself of getting a safe, sound insurance, with a desirable loss-prevention service, at the lowest cost that he can get with the 20 percent savings.

That is the average for all mutual fire and casualty companies in the United States.

These mutual companies do one-sixth of the total business in the United States—17 percent. They have only 14 percent of the assets held by all the companies doing the same kind of business.

I am feeding my stock friends here something they will like to use, because they will say these companies aren't sound; they are publishing broadcast circulars and advertisements that these mutual companies carry too little assets.

They are only 14 percent. That is one-seventh.

And then, when we get to the surplus in these mutual companies, what is the fact?

I am quoting the same authority I quoted before. You get the same thing from the Alfred M. Best Co., of New York, which is the largest insurance authority in the United States.

In surplus they only have about one-eighth, or even down to one-ninth, of the assets and margin that is carried by all the companies doing this business.

In order that these companies shall be able to put up the kind of surplus that these stock companies would insist they should put up, they would have to add to their present surplus somewhere between 4 and 6 percent of the total surpluses of all the companies, including the stock companies.

But they have been getting along pretty well by careful management, by a careful selection of the kind of business they write, and by writing insurance for people who couldn't get it otherwise because it is too expensive for these stock companies to write it.

We have a farmers' mutual insurance company which was organized for the specific purpose of giving insurance protection against liability to farmers, on a basis of so low a cost that these farmers could afford to carry it, and still that company, over 20 years, 2 years ago, had by a careful calculation saved its policyholders, in the difference between what their policyholders had paid and what they would have had to pay in a stock company, more than $40,000,000.

Is that the kind of a company you want to put out of business?

We stand ready to help you work out any tax you want, but do not adopt this kind of tax, that is designed to handicap—I will take that back; strike out the word "designed"—that would handicap these companies, that would ultimately put them out of business.

I wish I could go through this analysis with you, of the provisions in this draft of this bill, which in my judgment are so impossible that it would impose on these companies an absolutely prohibitive expense, and these small companies would have to do it just the same as the others, because they would have to comply with these requirements, if they come over the hundred thousand dollar mark. They would clearly have to show that they have no income over $50,000.

If the term "issuing its policies on a mutual basis" should be construed to mean something more than the word "mutual" at the beginning of that exempting section, then there is an opportunity to do, in the Treasury Department and in the Bureau of Internal Revenue, exactly what was attempted by them for years, under the old provisions. Even now occasionally some examiner comes in and raises the very questions that were discussed here by Mr. Hurst.

If there is no intention here to have the words "mutual basis" mean anything different from the word "mutual" at the beginning of that section in this bill, then, in all fairness and decency, that section of the law should be allowed, in that respect, to remain just as it is, because mutual basis doesn't mean anything different, unless it means as a mutual company.

If you strike this out and then you put back "the income of which is used or held for the purpose of paying losses or expenses," you have a definite statement. You can ascertain, by examining the company, whether the income has been so held, and that is all there is to it.

From a legal standpoint, everyone knows that it is presumed that every word put into an act means something, and there is danger—and I think all lawyers on this committee will agree with me—that any court would have to say that "mutual basis" means something different from mutual.

And then they will scour the field to find anything that they can hang their hat on to say this company is not exempt. Then what happens if the company is not exempt? If the company should take an exemption, and let it go by over the years, and then finally, after a good many years, it grows into something, the Treasury Department overturns that and says, "You weren't exempt, this was improvidently issued," the company would be penalized.

There is a decision over here in Maryland that, in that kind of case, the statute of limitations does not run, and you can go back just as far as the company has been in operation.

I do not believe that that was the intention of the Treasury Department. I don't believe that they were familiar with this.

I don't see how they could have been. I have lived with this since 1916, and before that as commissioner of insurance of Wisconsin for a great many years, and I know there are a lot of things I don't know about this.

Mr. Chairman, I trust you will pardon my taking as much time as I have. I want to ask that this memorandum be printed as an addition to my remarks here, informal as they are—I ask that these also be printed as a part of the record.

The CHAIRMAN. All right. Thank you for your appearance, Mr. Ekern.

Mr. EKERN. Thank you, sir.

(The prepared statement of Mr. Ekern is as follows:)

STATEMENT OF HERMAN L. EKERN, OF EKERN, MEYERS & MATTHIAS, CHICAGO, ILL.

I am appearing on behalf of various mutual insurance companies other than life, and with Harry P. Cooper, secretary, on behalf of the National Association of Mutual Insurance Companies, on the proposed amendments affecting the exemptions and deductions of these companies, as set out in the pending bill, H. R. 7378.

Those amendments apply to the companies designated in the present exemption provisions as farmers or other mutual hail, cyclone, casualty, or fire insurance companies, and designated in the present deduction provision as mutual insurance companies other than life, all of which are classified by the State insurance departments, and in the insurance publications as mutual fire and mutual casualty insurance companies.

These amendments are objected to because: (1) The amended section 101 (11) would introduce uncertainties in, and largely deprive these companies of, their classification as nonprofit organizations; and (2) the amended section 207 proposes largely to take away from these companies a recognized nonprofit classification, to prescribe for these companies a prohibitive regulation of their insurance business and their relations with their policyholders, and to impose upon these companies an excessive, unjustifiable tax.

These mutual companies are not unmindful of the urgent need of the Government for revenue in this emergency and of the obligation of each organization and each citizen to pay its full share. They are ready and willing to do this on any basis that will not handicap and ultimately destroy their plan of operation and their companies.

They believe that the amendments have been proposed without a full knowledge of the plans and methods upon which these companies operate and the service they are rendering to their policyholders and the public and the income-tax revenue which now accrues to the Government from the increased taxable income from the savings or dividends returned to them by these mutual companies.

Until now no opportunity has been afforded the mutual companies to present objections or suggestions with regard to specific proposals for amendments to these sections. We appreciate the courtesy here extended to enable us to give to the Senate Finance Committee the facts for such action as will make it possible for these companies to continue successfully and at the same time fully serve the public interest.

The relative proportion of the business of these mutual companies to the total fire and casualty business in the United States is important in this connection Figures for the year 1940 published in the 1941 yearbooks of the Spectator Co., a recognized authority, show that these mutual fire and casualty companies had 17 percent of the business done by all fire and casualty companies in premiums written, premiums earned, and losses paid. The mutual companies had 14 percent of the admitted assets, held 15 9 percent of the Government bonds, 13.3 percent of net surplus, including voluntary reserves, and 11.2 percent of surplus to policyholders, including voluntary reserves and capital stock. The mutual company expenses incurred were 11.3 percent of the total expenses for all fire and casualty companies.

Compared to premiums earned, the mutual companies' net from investment and underwriting income was 21.9 percent, out of which they returned to policyholders in dividends 2C.7 percent.

The mutual companies transacting one-sixth of the total business thus had accumulated but one-seventh of the total assets and about one-eighth of the surplus to policyholders. They had expenses of less than one-eighth of the total for all the companies.

These mutual companies clearly had no excess of assets or of surplus in proportion to the business they handled. Likewise, the low proportion of expenses shows where the saving largely came from to pay dividends to policyholders on the average reducing their cost by about 20 percent. This percentage takes no account of large savings made in the reduced rates of non-dividend-paying mutual companies.

The taxes which it has been suggested are to be required from these mutual companies other than life appear to be very much out of proportion to the amounts to be required from other classes of insurance companies. The Treasury Department has indicated a figure of $16,000,000 from these mutual companies and it was recently stated before this committee the tax would be just short of $10,000,000 a year.

The taxes estimated to be paid by the life companies, which have assets of more than $30,000,000,000 and premiums of about $4,200,000,000 a year, are estimated by the Treasury Department at about $26,000,000.

Best's Fire and Casualty Aggregates and Averages, 1942 (pp. 1, 53, and 94), show that for the taxable year 1940 the stock fire companies paid in Federal taxes 0.66 percent on $917,201,000 of premiums written, which would total about $6,054,000, and the stock casualty companies paid in Federal taxes 1.1 percent on $869,600,000 premiums written which would total about $9,566,000, a total fire and casualty company 1940 Federal taxes of $15,620,000 including Social Security. Assuming that on a business equal to one-fifth of the stock company business, the mutual companies on the same basis for 1940 would have paid about $3,150,000, and assuming that the 1942 rate would be increased seven-eighths over that of 1940, the mutual company tax could not exceed $6,000,000.

The pending bill does not place these mutual companies under the stock company section and recognizes, in part at least, as to the deductions, the nonprofit character of these mutual companies and of any participating business, in the deductions proposed to be allowed for all dividends paid to policyholders in excess of investment income, including tax-exempt income.

The Spectator reports show that mutual fire and casualty companies in 1938 had an underwriting income of $71,998,991 and returned $70,949,241 in dividends, that the 1939 underwriting income was $76,583,011 and they returned $70,566,868 in dividends and that the 1940 underwriting income was $73,758,902 and $72,429,843 were returned in dividends. The Spectator figures are available for 1940 only for the fire companies and show that the mutual companies had an underwriting income of $37,381,891 and returned $38,625,868 in dividends to their policyholders.

There is no justification for the changes proposed to be made in the exempting provision to make this read:

"(a) EXEMPT COMPANIES.—Section 101 (11) is amended to read as follows:

"(11) Farmers, or other mutual hail, cyclone, casualty, *liability*, or fire insurance companies or associations (including inter-insurers and reciprocal underwriters) ~~the income of which is used or held for the purpose of paying losses or expenses.~~ *writing insurance contracts solely on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000.*" (The material added by the amendment is printed in italics and that omitted is stricken through.)

The amendment retains only the list of companies in the present subsection, and omits "Farmers or other," and the present specific single condition of exemption, "the income of which is used or held for the purpose of paying losses or expenses," and inserts two new conditions, one requiring "writing insurance contracts solely on a mutual basis" and the other limiting mean assets to $100,000.

The wording of the present section 101 (11) has been the same since last amended by the Revenue Act approved February 26, 1926.

The House Committee on Ways and Means report (No. 2333) on this bill states that the present exempting section 101 (11) has been revised to limit the exemption to mutual companies "writing insurance contracts solely on a mutual basis" with mean ledger assets not exceeding $100,000. The report further states t[illegible]:

"Practically al[illegible] of the farmers' and other small and local mutual companies have ledger assets of less than $100,000 and accordingly will not be required to file income-tax returns or pay any income taxes. It is estimated that over 80 percent of all companies will be exempt from filing returns under this provision."

There are about 500 companies or 20 percent of the total of about 2,600 that have mean assets of more than $100,000, leaving all the 80 percent having less assets exempt. If these companies with assets of less than $100,000 are all exempted by reason of that fact, there is no occasion for the insertion of the additional condition that to be exempt they shall be "writing insurance contracts solely on a mutual basis."

This language is very indefinite. If the words "mutual basis" are not to mean something different from the word "mutual" introducing the sentence there is no occasion for adding this language. If they are to mean something different it should be a factual statement as under the present section. Under the rule that an exemption is to be strictly construed it offers opportunity to any Federal tax employee to interpose his opinion as to whether or not the company complies with the condition. Thus, questions may be raised as to the contents of the contracts, with regard to the manner of payment of assessments or premiums, the accumulation of reserves, the accumulation or distribution of surplus, or the payment of dividends, or the kind of business to be transacted, and other matters affecting rates, reserves, investments, and management and control.

In reference to "writing insurance," questions might be raised as to whether a company might employ persons on a salary, on a policy fee, or on a commission basis to secure insurance and within what territory, sometimes called "strictly local" such as a town, township, city, county, adjoining counties, or a State, and whether persons writing the insurance are or are not required to be licensed.

In the use of the term "solely on the mutual basis" any or all of the foregoing questions might be suggested, as well as the question with regard to the accumulation of assets of various kinds and the investment of such assets, and the receipt of interest, dividends, or other return upon assets and the disposition of such assets and all matters relating to the statutory or charter powers of the company.

The suggestions of these questions is not fanciful. The history of the provisions with regard to the exemption of mutual insurance companies indicates that these questions and many others have been raised or attempted to be raised within the Bureau and in legislation and proposed legislation. If it is not proposed to use these indefinite, uncertain terms for the purpose of depriving mutual companies of the exemption, there is no occasion for inserting this condition and it should be stricken from the bill.

The condition drawing a line between companies having assets of less, and those having more, than $100,000 has no sound basis. The reasons for the exemption is that these companies are not operated for profit and they stand on the same footing as the farmers' and other cooperatives, the building and loan associations, mutual or cooperative savings banks, farmers' sales organizations, civic leagues, business leagues, chambers of commerce, real estate boards and boards of trade, cemetery companies, labor, agricultural and horticultural organizations, fraternal, religious, charitable and educational organizations, and community chests. These mutual insurance companies have no stockholders or other proprietary interests, and they are owned, controlled, operated, and conducted solely by and for their policyholders to furnish the desired insurance protection with the greatest efficiency and economy for the benefit of their members. No such limitation is drawn as to the amounts of assets or of business transacted by the mutual savings banks, building and loan associations, or any of the labor, farmers', or other cooperative organizations, some of which have assets and transact a volume of business greater than that of the largest of these mutual companies.

The provisions of the amended section 207, as interpreted in the report of the House Committee on Ways and Means, are very different from the provisions under the present section 204 relating to nonparticipating stock fire and casualty companies, called insurance companies other than life or mutual.

The facts with regard to the operation of these mutual companies and the conclusions to be drawn are also entirely different for those set out in the report.

It is inevitable that in some instances this would be the case in view of the distinctly technical nature of the business and the great mass of material to be dealt with in the brief time allowed for the preparation of the bill and the report.

The following statements in the report are not supported by mutual insurance company law, regulation, or practice:

"In case of mutual insurance companies other than life which are not granted exemption under section 101 (11), it is proposed to subject such companies to income tax on the sum of their investment and underwriting income in a manner somewhat similar to that used under section 204 (relating to insurance companies other than life or mutual).

"The chief difference between the present section 204 and the proposed section 207 is that provision must be made for two new deductions for which no occasion arises in the operations of the ordinary companies subject to the tax imposed by section 204. These are the deductions for dividends returned to policyholders and additions to surplus apportioned to policyholders.

"Dividends returned by mutual companies to their policyholders are made up of two components: Part is a distribution of the investment income earned by the company on its investments, and the remaining part is considered variously as a return of an excess premium charge, as an adjustment of the price paid for the insurance coverage, or as a return of a deposit made by the policyholder to increase the security of the company and insure full payment of claims. Your committee has provided that only this second part is to be allowed as a deduction.

"Surplus accumulated by mutual insurance companies *is also of two kinds: (a) Surplus apportioned to policyholders, which is to be distributed to policyholders within a reasonable period in equitable proportion* to the amount which the policyholders severally contributed to this surplus, and *(b) unapportioned surplus, concerning which there is no such expectation that it will be returned to those by whom it was provided. Additions to apportioned surplus are analogous to additions to the capital or paid-in surplus of a stock company in that the surplus will eventually be distributed to the policyholder* by whom it was contributed or to his assigns, *in the same manner that the stockholder is entitled to the return, tax free, of his share of the paid-in capital and surplus on dissolution, or in the meantime may realize on this interest by selling his stock.* On the other hand, additions to unapportioned surplus constitute taxable income to the company. There is no assurance that they will ever be paid out. The only probable occasions for such a distribution are a catastrophic loss or the dissolution of the company; in either case the recipients will be others than those who contributed to the surplus. That is, the policyholders receive this distribution in their capacity of proprietors rather than in their capacity of patrons. For many companies even these contingencies are extremely remote, and for practical purposes the unapportioned surplus becomes an autonomous fund accumulating in perpetuity. Your committee has accordingly provided that the addito surplus apportioned to policyholders shall be deductible in computing net income, and hence exempt from tax, but that additions to unapportioned surplus shall be taxed as income to the company." [Italics ours.] H. Rept. No. 2333, pp. 113–114.)

This clearly errs in the designation of the above as principles applicable to mutual companies. The statement as to what happens to a stock company and its stockholders is correct. The rest of the statement implying that the situation is the same with respect to a mutual company and its policyholders is not correct.

Referring to (*a*) in the above discussion of surplus, this is wholly new.

There is not, and there never has been any recognition of a division of mutual company surplus; (*b*) nor is there or has there ever been any such division of such surplus. There is no surplus as to which in a mutual company there is or can be no expectation that it will or will not be returned.

There is no such analogy as suggested. The additions to surplus paid in by a stockholder are paid in not as a policyholder, but as an investment by a proprietor sharing in the ownership of the stock company and its assets in the expectation of profits. Where the stockholders paid in capital and surplus is returned to him the company pays no tax and pays no tax on it. On the other hand any surplus returned to a policyholder increases his net taxable income by just that amount.

There is no such thing in practice as having a policyholder assigning an interest in the surplus on a policy separately from the policy of insurance.

Additions to surplus of a mutual company do not constitute profits or taxable income to the company. These are merely the property not of a stockholder for profit but of a policyholder to be held and used for payment of losses and expenses and so far as the directors may find any amount not needed to be returned to the policyholder, the effect being that of increasing his taxable net income.

There is no assurance that surplus will not or will ever be paid out. The records of practically all insurance companies indicate that there is every probability that over the years the additions to surplus will be paid out. Nearly all the insurance companies, stock and mutual, had reductions in surplus during 1 or more of the past 10 years.

The State laws under which these mutual companies operate, do not recognize a policyholder, receiving a return of a saving from premiums paid to and held in the assets of a mutual company, as a profit making proprietor, but only as a policyholder patron. He shares in a cooperative enterprise in which there are no profits to stockholder proprietors and no continuing interests other than those connected with the policy of insurance carried by him.

The amended section 207 would deprive their directors of a discretion always heretofore recognized with respect to surplus and the return of increased savings. It prescribes entirely new and unprecedented methods of accounting and for dealing with their policyholders. The requirement that a company shall, in the policy or a bylaw, without any discretion by the directors, contract in advance for the return of specified amounts of savings or dividends to policyholders is contrary to the law, regulation, and insurance practice recognized throughout the United States.

The Spectator Co. year books, heretofore quoted, show that for the year 1940 these mutual companies returned to their policyholders in dividends more than 20 percent of their premiums. The same figures show that the stock companies had an operating income from combined net underwriting and investment income of 7.8 percent of their premiums out of which they paid cash dividends to their stockholders equal to 6 percent of the same premiums. The combined total maximum possible taxable net income of the stock companies and their stockholders from such dividends was thus 13.8 percent of their premiums as compared with 20 percent of the premiums of these mutual companies.

This understates the relative tax paid in case of the mutual policyholders. All these amounts returned to the mutual policyholders are in effect included in the gross income and in any net income as subject to tax. In the case of the stock companies the same is the case as to the operating income except that their part derived from tax-exempt and partially tax-exempt income is not subject to tax. A corporation stockholder of the stock company is also exempted from tax on 85 percent of such dividends.

Assuming that in both cases on the average, the rate of tax and the ratio of the net taxable income was the same, the net income and the tax return to the Government on each dollar of premium handled by the mutual companies was 20 percent, and that of the stock companies was 13.8 percent, on each dollar of premiums handled by each. In other words, the proportionate tax income to the Government from the mutual companies at the least was nearly one and one-half times that from the stock companies and from the dividends of their stockholders.

In the final analysis this is not a question of the amount of a tax, or adjusting an erroneously alleged disparity, claimed by competitors who for purposes of their own have advocated this amendment. There is no disparity. If there be one, it is against these mutuals. This bill would put on these companies a burden in the uncertainties and expense of operation that with an unjust and possibly prohibitive tax would injure and ultimately deprive their policyholders and the public of the savings and service which they afford all who insure. That the Government gets much more revenue out of each dollar in premiums paid to these mutuals than out of each dollar paid the stock companies is not open to question.

The following is a comparison, paragraph by paragraph, of provisions of the amended section 207 and the present section 204. From this it appears that these are almost wholly different in wording and in effect.

In the case of an insurance company subject to the tax imposed by this section:

(Sec. 207 (b), p. 133, H. R. 7378)

This is the same as present section 204 (b):

"Gross income" means the sum of (A) investment income as defined in paragraph (2); (B) underwriting income as defined in paragraph (4); and (C) all other items constituting gross income under section 22.

(Sec. 207 (b) (1), p. 133, H. R. 7378)

This differs from present section 204 (b) (1), which reads:

"'Gross income' means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National

Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under section 22."

"Investment income" means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in section 117, less (A) losses from sales or exchanges of capital assets to the extent provided in section 117, (B) investment expenses, (C) real-estate expenses, (D) depreciation, and (E) interest paid.

(Sec. 207 (b) (2), p. 133, H. R. 7378)

As used in this section the terms "investment expenses," "real estate expenses," "depreciation," and "interest paid" shall have the same meaning, and shall be subject to the same limitations, as in section 201 (c) (7) (B), (C), and (D), section 201 (c) (6) (A), and section 201 (d) (relating to life insurance companies), but shall be computed as if the word "paid" wherever it appears therein were "paid or accrued."

(Sec. 207 (b) (3), p. 133, H. R. 7378)

The foregoing two sections differ from present section 204 (b) (3), which reads:

"'Investment income' means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows:

"To all interest, dividends, and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year."

"Underwriting income" means net premiums received during the taxable year, on insurance contracts plus any decrease during such year in any of the items specified in subparagraph (C) less * * *."

(Sec. 207 (b) 4, p. 134, H. R. 7378)

This differs from present section 204 (4) and (5) which read:

"(4) 'Underwriting income' means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

"(5) 'Premiums earned on insurance contracts during the taxable year' means an amount computed as follows:

"From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

(A) Losses paid in excess of salvage and reinsurance recoverable.

(Sec. 207 (b) (4) (A), p. 134, H. R. 7378)

This differs from present section 204 (6) which reads:

"'Losses incurred' means losses incurred during the taxable year on insurance contracts computed as follows:

"To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year."

(B) Underwriting expenses and loss adjustment expenses paid or accrued.

(Sec. 207 (b) (4) (B), p. 134, H. R. 7378)

This differs from present section 204 (7) which reads:

"'Expenses incurred' means all expenses shown on the annual statement approved by the national convention of insurance commissioners, and shall be computed as follows:

"To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by subsection (c) of this section."

(C) The increase during the taxable year in any of the following items: (i) Unearned premiums; (ii) unpaid losses; and (iii) surplus apportioned to policyholders.

(Sec. 207 (b) (4) (C), p. 134, H. R. 7378)

(Present secs. 204 (5) and (6) in effect correspond to this reference in the bill as to unearned premiums and unpaid losses. Iitem (iii), "Surplus apportioned to policyholders," is new and is not found in any present or former revenue act.)

(D) Dividends and similar distributions paid to policyholders out of premium income and surplus apportioned to policyholders.

(Sec. 207 (b) (4) (D), first sentence, p. 134, H. R. 7378)

(No such provision is found in present sec. 204 or in any part of former revenue acts. It should be noted that dividends to policyholders may only be paid out of "Premium income and surplus apportioned to policyholders." Apparently no dividends can be paid out of unapportioned surplus mentioned in (6) or any surplus unincludible under (B).)

Dividends and similar distributions paid to policyholders shall be considered to be paid out of premium income and surplus apportioned only to the extent they exceed the sum of the investment income of the taxable year available to pay dividends and similar distributions in that year plus the investment income of the preceding taxable years (if beginning after December 31, 1941) available to pay such dividends and similar distributions in such years but not so used.

(Sec. 207 (b) (4) (D), second sentence, p. 134, H. R. 7378)

(Present sec. 204 and no part of any former revenue acts, contain any such provisions. The investment income referred to is defined in (7) and, reducing the deductions for dividends paid to policyholders by this investment income, in effect, subjects such investment income to the tax.)

(5) "Net premiums received during the taxable year on insurance contracts" means gross premiums (including premium deposits and assessments) written or received on insurance contracts less return premiums and premiums paid for reinsurance.

(Sec. 207 (b) (5), first sentence, p. 135, H. R. 7378)

This is, in effect, the same as the second sentence of present section 204 (5).

Amounts returned where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (4) (D).

(Sec. 207 (b) (5), second sentence, p. 135, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. The contrary of this is contained in (6) (B) and would indicate that apportioned surplus might be included in return premiums.)

(A) In general, "Surplus apportioned to policyholders" means such portion of the surplus of the company as is held for distribution to policyholders before the expiration of 5 years after the termination of their policies in equitable proportion to the amount of the surplus contributed by each policyholder or group of policyholders and includes amounts set aside for the payment of dividends and similar distributions to policyholders.

(Sec. 207 (b) (6) (A), first sentence, p. 135, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. (1) This proposes to set up an entirely new method of operating the business of these mutual companies. (2) For this method there is no precedent in any Federal or State law or department regulation or company practice. (3) It proposes to constitute the Federal tax employees the judges as to what is the equitable proportion of surplus contributed by a policyholder or group of policyholders. (4) If this requires setting up and carrying forward individual policyholder accounts, it will be wholly impracticable, prohibitive in expense, and in many cases impossible.)

The amount of surplus apportioned to policyholders shall in no case be considered to exceed an amount which would leave unapportioned surplus equal to or less than the unapportioned surplus as of the beginning of the first taxable year which begins after December 31, 1941.

(Sec. 207 (b) (6) (A), second sentence, p. 136, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. This not only prohibits any surplus being apportioned to policyholders from the surplus at the end of 1941, but also prohibits any surplus being so apportioned thereafter unless any loss or shrinkage in the unapportioned surplus is first restored. This would prevent a company from paying dividends to policyholders, possibly for a number of years, while it would be actually making a surplus justifying a dividend and be able to make a gradual increase of its surplus.)

(B) For the purposes of subparagraph (A) no amount shall be included in surplus apportioned to policyholders unless, under the provisions of the insurance contract, or by the bylaws of the company, the distribution of such amount is specifically required and the distribution is not at the discretion of the directors of the company.

(Sec. 207 (b) (6) (B), first sentence, p. 136, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. The requirement that, for the inclusion of any amount in surplus apportioned to policyholder, the policy or the bylaws must specifically so require without any discretion on the part of the directors would make such apportionment automatic. It would immediately be a fixed liability of the company to policyholders which the commissioners of insurance would be compelled to refuse to recognize as surplus. Under the last sentence of (5) amounts so set apart would clearly be return premiums and not dividends when paid policyholders.)

The fact that the distribution of an amount can be withheld in order to comply with requirements of State law, or may be subjected to lien or assessment to meet abnormal loss or decline in market value of assets, shall not prevent the inclusion of such amount in surplus apportioned to policyholders.

(Sec. 207 (b) (6) (B), second sentence, p. 136, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. The right to subject such apportioned surplus to a lien or assessment to meet abnormal loss or decline in market values of assets would not make it less a liability to the policyholder. What is an abnormal loss or what is to be recognized as a shrinkage in values, whether to be a realized loss or merely a bookkeeping loss, and what duty there would be to restore the original apportioned surplus would, no doubt, involve endless controversy and possible litigation.)

In no case shall an amount held for more than 5 years from the termination of the policy be included in surplus apportioned to policyholders.

(Sec. 207 (b) (6) (B), third sentence, p. 136, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. What charges or credits are to be required or made during the 5 years after termination of the policy, and what is to happen at the end of the 5 years? Many mutual companies have issued hundreds of thousands of policies on the great mass of which such apportionments would be very small, and there would surely be great difficulty in settling the exact amount payable and in finding the persons legally entitled to payments.)

(C) For the purposes of subparagraph (A), for taxable years beginning after December 31, 1941, and before January 1, 1945, an amount shall be included in surplus apportioned to policyholders if includible under subparagraph (B), or if payable to policyholders under the established normal practice of the company.

(Sec. 207 (b) (6) (C), p. 137, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. This provision recognizes the impracticability of complying with the rule laid down in (6) (A) and (B) for apportioning surplus to policyholders giving the taxpayer 3 years after 1941 in which to learn how to do it. The wording raises questions: (1) Whether during these years the apportionment is compulsory and automatic; (2) whether the dividends theretofore paid have anything to do with the amounts and method; and (3) whether a taxpayer who has not paid dividends in cash but has, in effect, made like returns by giving policyholders a reduced rate of premium has thereby established a normal practice, entitling the taxpayer to have a recognized surplus apportioned to policyholders.

(If a question is to be raised as to the apportionment of increase in surplus by a deviated or reduced-rate, non-dividend-paying company as under the established normal practice, further questions would be raised as to whether a bylaw enacted in 1941 would conform to the requirements of the first sentence of (6) (B) for the year 1941, and if there is any question as to this, whether such a bylaw would constitute an established normal practice which would permit the establishment of a surplus apportionment for the year 1943.

(A refusal to recognize the right to apportion a surplus increase, either by bylaw action or recognition as an established normal practice, would result in great hardship and injustice to the deviated or reduced rate, nondividend paying companies and a discrimination against these in comparison with dividend-paying companies on tariff or bureau rates.)

(7) "Investment income available to pay dividends and similar distributions" means investment income for the taxable year (computed without regard to section 117 (d) and (e)) less (A) an amount equal to 21 percent of the interest on obligations with respect to which a credit is allowable under section 26 (a) (relating to interest on certain obligations of the United States), and (B) an amount equal to 45 percent of so much of the investment income (computed with regard to section 117 (d) and (e) as exceeds the sum of (i) the interest on obligations with respect to which a credit is allowable under section 26 (a), plus (ii) the interest on obligations described in section 22 (b) (4), plus (iii) the credit provided in section 26 (b) (relating to dividends received on stock of domestic corporations).

(Sec. 207 (b) (7), p. 137, H. R. 7378)

(Sec. 204 and other parts of the present and former revenue acts contain no such provision. This provides a distinctly different rule for determination of investment income available to pay dividends from that prescribed for the determination of investment income for the purpose of computing the tax on investment income. Keeping in mind that the dividends paid to policyholders authorized to be deducted under (4) (D) are to be reduced by the investment income under (7), the effect of reducing this deductible investment income only by the taxes on the exempt and partially exempt interest and stock corporation dividends results in the mutual companies being deprived of the tax exemption and partial tax exemption on such tax-exempt bonds held by them. These mutual companies hold United States Government securities which proportionately constitute a ratio about one-fourth greater than that of other companies transacting fire and casualty insurance. At the end of 1941 out of total assets of $366,000,000 the mutual fire companies held $103,000,000 or 28.06 percent of United States Government bonds as against $624,000,000 or 23.22 percent held by other fire companies out of assets of $2,687,000,000.)

(8) "Net income" means the gross income as defined in paragraph (1) of this subsection less the following deductions:

(Sec. 207 (b) (8), p. 138, H. R. 7378)

The deductions following are different but this wording is substantially the same as present section 204 (b) (2), which reads:

"'Net income' means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section."

(A) All deductions as provided in section 23 to the extent not otherwise allowed.

(Sec. 207 (b) (8) (A), p. 138, H. R. 7378)

The corresponding wording in section 204 (c) (10) reads:

"Deductions (other than those specified in this subsection) as provided in section 23."

(B) The amount of the net operating loss deduction provided in section 23 (s) except that in computing such deduction the terms "third preceding taxable year," "second preceding taxable year," and "first preceding taxable year," as used in section 122 shall not include any taxable year beginning before January 1, 1942; and

(Sec. 207 (b) (8) (B), p. 138, H. R. 7378)

(This is new and there is no corresponding provision in present sec. 204 and apparently refers to former sec. 122 relating to a net operating loss carry-over with a proposed amendment shown on p. 49 of the bill. By its terms as to mutual companies this does not have any effect for any year before 1942.)

(C) The amount of interest which under section 22 (b) (4) is excluded for the taxable year from gross income.

(Sec. 207 (b) (8) (C), p. 138, H. R. 7378)

(Sec. 204 has no corresponding specific provision for deduction of wholly tax-exempt interest. The insertion of this as a special deduction raises the question as to whether it is intended to be a substitute for and deprive the mutual companies of this and any other exclusions from gross income which are given under sec. 22, or whether this is an added deduction from net income still permitting the exclusion from gross income of the same item to offset the inclusion of this exempt income, in effect for taxation, by its deduction from dividends under (4) (D) as construed in (7).)

(d) Nothing in this section shall be construed to permit the same item to be twice deducted.

(Sec. 207 (d), p. 138, H. R. 7378)

(The corresponding provision is found in present sec. 204 (e) and is worded exactly the same. This prohibition of a double deduction with a doubt raised as to the construction of (8) (C) and (1) (C) with its effect on (4) (D) and (7) (A) and (B) leaves the whole situation confused as to what is intended by the wording of the act. If it is intended that this final provision with regard to double deductions is to be applied to the exclusions under (22) and to enforce the attempt to tax the exempt interest of these companies by including such exempt interest as an exclusion from the deduction of dividends paid, it would do a gross injustice to the mutual companies in taxing their wholly exempt interest where this is not taxed in the case of other fire and casualty insurance companies If it is not intended to make this distinction, the wording would clearly result in great confusion, controversy, and litigation. In any event the wording does not dispose of the injustice and confusion with regard to other insufficient deductions from the exclusion of the investment income as defined in (7) from the dividend deductions provided by (4) (D).)

STATEMENT OF HOVEY T. FREEMAN, PROVIDENCE, R. I., CHAIRMAN, LEGAL COMMITTEE, ASSOCIATED FACTORY MUTUAL FIRE INSURANCE COMPANIES

The CHAIRMAN. Mr. Freeman.

Mr. FREEMAN. Mr. Chairman, my name is Hovey T. Freeman. I am president of the Manufacturers Mutual Fire Insurance Co., of Providence, R. I., and chairman of the legal committee of the Associated Factory Mutual Fire Insurance Companies.

I have a prepared statement, but much of the ground has already been covered.

I don't think it is needed to take the time of you gentlemen.

There are two or three items I would like to discuss, and it will take me just a matter of 2 or 3 minutes. I think the others have covered the field, and I support all they say.

I would like to state that the position of the factory mutual companies—and we are the largest mutual insurance company in the business—are perfectly willing to pay a tax.

We are not trying to avoid a tax in any way, but we do want to be taxed on a fair basis, and therefore what I have done in this statement—which I will ask to be made a part of the record—is to outline, first, the errors or inadequacies or fallacies of the House bill, proposing certain amendments which I think will correct them, and then go on to show a different type of tax, which will get you gentlemen a lot more money, and I think that is what you are after.

It will cost my company more money than the House bill, but I realize that the country needs it, and we want to do our part.

I would like to call your attention to the table that accompanies my statement—it was taken from the New York Journal of Commerce of July 28—because much has been made about the taxes paid by our competitors, the stock companies. If you will look at the statement which is attached to these copies, which I have had the clerk distribute, you will notice that there are many stock companies who did not pay any tax for the year 1941.

I think that that ought to be noted, because, from what has been said here, some would think that the stock companies all paid a tax.

I would propose that, instead of trying to mix apples and oranges—that is, mutual companies and stock companies—that you exempt all fire and casualty insurance companies from the provisions of the House bill, and instead tax them on their net premiums.

If you will do that, gentlemen, you will get $26,000,000 for each 1 percent tax on net premiums. You will get probably double or three times what you will get under the House bill, and you will really be getting somewhere.

That is all I have to say.

The CHAIRMAN. Thank you very much.

Senator TAFT. Just one question, Mr. Chairman.

The CHAIRMAN. Yes, sir.

Senator TAFT. Mr. Freeman, your proposal is that the mutual companies be taxed that way and the stock companies be left on the same basis?

Mr. FREEMAN. I don't want to keep hearing this talk of inequity.

Senator TAFT. You propose the same thing on everybody?

Mr. FREEMAN. Yes, sir; the same tax on everybody. That is, take us all out—both stock and mutual—from the income-tax laws and tax us on a net-premium basis just as the States do.

Senator TAFT. It would be a very much simpler tax.

Mr. FREEMAN. There is nothing to it. You can determine your tax in 2 minutes. Any Treasury Department auditor can come in and see what we filed under a sworn statement, as to the different States.

It is all right there. It is a very simple thing, and it will give you more money.

The CHAIRMAN. Thank you very much.

(The prepared statement of Mr. Freeman is as follows:)

STATEMENT REGARDING THE PROPOSAL TO IMPOSE INCOME TAXES UPON THE BUSINESS OF MUTUAL FIRE INSURANCE COMPANIES, BY HOVEY T. FREEMAN OF PROVIDENCE, R. I., PRESIDENT, MANUFACTURERS MUTUAL FIRE INSURANCE CO., AND CHAIRMAN OF THE LEGAL COMMITTEE OF THE ASSOCIATED FACTORY MUTUAL FIRE INSURANCE COMPANIES

Mr. Chairman and gentlemen of the committee: I have the honor of appearing here today on behalf of the Associated Factory Mutual Fire Insurance Companies to discuss with you certain of the provisions of the bill, H. R. 7378, which is now before you and commonly referred to as the Revenue Act of 1942.

STATEMENT OF POSITION

That there may be absolutely no misunderstanding of my position or that of my associates, I want it clearly understood that we in the mutual fire insurance business fully appreciate that every activity must pay its fair share of the cost of the war effort. Our only request is that such taxes as are imposed upon us are on a fair and equitable basis and recognize the peculiar nature of our business.

DISCUSSION OF THE HOUSE BILL

The bill which is now before the Senate for consideration for the first time definitely places an income tax on the business of mutual fire insurance.

I call your attention to my memorandum filed with the House Ways and Means Committee and which appears in the "Hearings before the Committee on Ways and Means, House of Representatives," volume 2, page 2328. I shall not take your time in repeating what I said then as it is already in the record, except to point out to you that the proposal to tax mutual insurance companies is not a new idea. It has been repeatedly urged on Congress in the past that a tax be placed on mutual companies, other than life, and each time Congress in its wisdom, after having been presented with the facts, has legislated not to tax such companies. Purely mutual fire insurance companies are operated without purpose of profit and have no profits and therefore to endeavor to collect an income tax from them is erroneous whether or not a company is small and operates only locally, or large and operates on a Nation-wide basis. It has been our understanding that Federal income taxes on corporations were deemed to be taxes on profits. In the case of the factory mutual companies the savings that result from our method of operation are reflected in the increased income tax of our policyholders.

The sections of the House bill which affect our companies were drafted we understand by the Treasury Department for the purpose of removing, we are informed, what the Treasury had referred to as a "serious disparity" in tax treatment between mutual insurance companies and stock insurance companies.

Unfortunately the House bill, if enacted into law in its present form, would very seriously injure, if not destroy, certain mutual insurance companies. It would in many cases place a tax on such companies which would be prohibitive, for the tax in some cases would amount to as much as 50 percent of the total loss payments of a given year. In other words, 25 percent of the amount we charge our policyholders for their insurance. This is practically equivalent to a sales tax of 25 percent. Certainly no business could stand such a tax. The House bill fails to recognize certain peculiarities of the insurance business, particularly the mutual insurance business. We in the factory mutual companies have no desire to have any tax advantage and I shall therefore later on point out to you how you can tax insurance companies on a fair and equitable basis and obtain a much greater revenue than you will under the House bill and at the same time treat all companies alike.

However, before doing so let me first point out to you the fallacies in the House bill as it affects our business and suggest to you certain amendments so in case you do decide to adopt the House bill it will at least allow the mutual insurance companies to remain in business, although I am sure if it is revenue you are after and not the correction of an alleged disparity, which, in fact, does not exist, that the Treasury Department next March will be disappointed in the amount which they shall have collected from all insurance companies as against what they could have collected under the suggestion which I propose to make.

The four principal items in the House bill which must be corrected in order to treat insurance companies fairly are as follows:

(1) The House bill proposes that as regards insurance companies other than life, losses from the sale of securities be allowed as a deduction only to the extent of gains from the sale of securities. Under existing and prior laws all insurance companies have been permitted to take full deduction for losses from sales of certain types of securities. Under this bill only life companies and banks are permitted this deduction

Since the maintenance of adequate reserves requires the maintenance of investment portfolios, it is an extremely important and necessary part of the insurance business, whether life insurance or any other kind, that all insurance companies be permitted to take full deduction for the losses from sale of securities and should not be limited to the deduction of losses only to the extent of gains from the sale of securities. This can be readily accomplished by amending section 117 (i) of the House bill to make the provisions of that section apply to all insurance companies and to all types of investment securities.

(2) The second amendment that is necessary to avoid the very discriminatory treatment accorded mutual insurance companies under the House bill involves a change in the amendment proposed in the House bill in section 207. In that amendment, subsection (7) restricts the right of mutual companies to take full deduction for the so-called dividends or similar distributions made to policyholders. This provision introduces a very serious disparity of treatment between stock insurance companies and mutual insurance companies. It should be borne in mind that mutual insurance companies operate with a much smaller expense ratio than do stock insurance companies and that whatever savings are made are returned to the policyholders as co-called dividends, or, in the case of the factory mutual companies, as unabsorbed premium deposits. The mutual insurance companies use the investment income to pay a portion of losses or expenses and by so doing are able to increase the amount of return premium paid to policyholders. They should obtain full credit for this return. If we take two companies, one stock and one mutual, with identically the same amount of investment income and premium income and with the same deductions for all items except that the total of expenses of operation and of dividends to policyholders of mutual company equals the expenses of operation of the stock company, we find that the stock company will pay a materially lower income tax under the House bill than will the mutual company. This appears entirely unfair and unprecedented.

As a matter of fact, the section of the House bill to which we are referring actually results in double taxation of investment income. Such income is included in the taxable income of the mutual insurance company and is also included in the taxable income of the corporations insured by factory mutual companies because of the fact that the lower insurance cost possible in the factory mutual companies results in lower operating costs for the manufacturer and therefore increases the income subject to income tax.

The theory behind this provision, as it has been explained to us by representatives of the Treasury Department, is that the business of mutual insurance companies is considered to be in reality two separate businesses—one, that of an investment trust, and the other, that of an insurance company. We firmly believe that there is no justification for the Treasury's theory. We therefore ask that the provision of the bill should be changed so that mutual companies may be permitted to deduct all returns to policyholders except for losses in order to correct the inequity and remove the possibility of double taxation.

(3) The third amendment is in the nature of a clarifying amendment required to prevent misinterpretation of "surplus apportioned to policyholders" as those words are used in the House amendment of section 207. The term in question is not one used in the insurance field except possibly in the life insurance field. Therefore if it is to be applied to other kinds of insurance companies the law should be explicit as to its meaning.

(4) The fourth amendment which I suggest if the House bill is to be adopted by the Senate would be a clause inserted somewhere to the effect that in no case shall the total tax liability in any year exceed 10 percent of the total amount of all losses incurred by an insurance company during such year.

The amendments suggested are all of importance yet they do not touch upon the very important fact that mutual insurance companies made subject to an income-tax law such as that proposed, would find it practically impossible to accumulate the contingency and conflagration reserves which are so necessary to protect the stability of companies engaged in a business in which losses of a catastrophe nature are always possible. The insuring public, which includes practically everyone in this country, requires that insurance organizations be financially sound. Unless those organizations can build up reserves during good years against catastrophe losses in bad years it will be very difficult for them to develop that soundness. A practical manner in which some provision could be made for the development of proper reserves would be to allow credit in the determination of taxable income for contributions to reserve not in excess of some small percentage of the annual premium income until such time as the reserves so accumulated amounted to a predetermined maximum, the maximum to be specified also as a percentage of annual premium income. If a provision of this sort is not included in the income-tax laws applicable to insurance companies, the companies will find it a very long and expensive process (because of the high tax rate) to rebuild their reserves after a bad loss experience or to increase their reserves as their liabilities increase as a result of growth.

I have presented these suggestions in an effort to be of help and not because I believe the House bill is a correct basis of taxation.

PROPOSED BASIS OF TAXATION

I make the following suggestion as a better basis for the taxation of all insurance companies, other than life, because I know it will bring in more revenue to the Treasury and I take it that that is what Congress primarily wants and that the alleged disparity as mentioned by Mr. Randolph Paul is simply an argument advanced by our competitors, the capital-stock insurance companies, in an effort to embarrass the mutual insurance companies who have shown a steady growth and which growth is causing the stock companies no little concern.

In connection with my proposal, I would like to present a tabulation which appeared in the New York Journal of Commerce under date of July 28, 1942, and call your particular attention to the column headed "Federal taxes." You will note in the first place that as regards the mutual companies they paid no Federal taxes. That is because Congress so legislated. You will notice in the second place, as regards the capital-stock fire companies, that many of them likewise paid no taxes, whereas others paid only a small percentage of their earned fire premiums. I therefore say to you that if I were in your position and were looking for revenue, I would exempt all insurance companies, other than life, from the operations of the income- and excess-profits-tax laws, and I would tax them all just as they are taxed by the 48 States in which they operate, and that is on a percentage of the net premiums retained by them. If you do this, then there can be absolutely no charge of disparity in tax treatment between the mutual companies and the capital-stock companies. The Treasury will receive, in my estimation, a much larger total income, provided the tax on the net premium is at least 2 percent. My suggestion would be that a tax of 3 percent of the net premiums retained be levied.

Such a tax as a war measure in my opinion will not hurt any of the companies. It will result in almost twice the revenue which we are informed it is expected will be received under the House bill. It is very simple in operation because all the Treasury Department has to do in auditing the tax return of the company is to examine the sworn report that each company files with each State in which it is licensed to do business. Such a tax is equitable to all concerned. It is a method of taxation with which all companies are familiar because they have been paying such taxes to the States for many, many years. Such a tax would be in the nature of an excise tax and not a sales tax as some have thought it might be since it would be paid by the company as one of its items of expense and not assessed directly against the policyholders.

I have purposely excluded from my proposal the inclusion of life-insurance companies in this premium-tax suggestion because their problem is different and I do not feel qualified to speak for them. I do know that a premium tax on the basis which I propose will fit the picture for all fire-insurance companies and I believe all casualty insurance companies.

Totals of the fire and casualty business—1941

Class and type of company	Premiums	Estimate of tax at—			
		1 percent	2 percent	3 percent	4 percent
Fire:					
Stock	$1,051,526,000	$10,515,260	$21,030,520	$31,545,780	$42,061,040
Mutual	195,000,000	1,950,000	3,900,000	5,850,000	7,800,000
Reciprocal	13,702,000	137,020	274,040	411,060	548,080
Lloyds	385,000	3,850	7,700	11,550	15,400
Total fire companies	1,260,613,000	12,606,130	25,212,260	37,818,390	50,424,520
Casualty:					
Stock	997,395,000	9,973,950	19,947,900	29,921,850	39,895,800
Mutual	363,934,000	3,639,340	7,278,680	10,918,020	14,557,360
Reciprocal	45,777,000	457,770	915,540	1,373,310	1,831,080
Lloyds	5,867,000	58,670	117,340	176,010	234,680
Total casualty companies	1,412,973,000	14,129,730	28,259,460	42,389,190	56,518,920
Total fire and casualty companies	2,673,586,000	26,735,860	53,471,720	80,207,580	106,943,440

(A table entitled "Experience for 1941 on fire insurance only of companies entered in New York," which was printed in the Journal of Commerce and Commercial, New York, N. Y., on Tuesday, July 28, 1942, is on file with the clerk of the committee.)

As to how Congress might legislate in this matter I propose that at the proper place in the bill a paragraph substantially as follows be inserted:

"In lieu of all taxes imposed upon corporations under sections —— and —— having to do with income and excess-profits taxes, all insurance companies other than life, shall annually pay a tax of 3 percent on the net premiums retained by them during the calendar year ending on the 31st day of December next preceding. The term "net premium" means the difference between the gross premiums or premium deposits received from all policyholders during the calendar year and the aggregate amount of premium or premium deposit returned to policyholders other than for losses, during such calendar year."

I hope from my remarks that it is evident to you that I have appeared here in a spirit of cooperation in an effort to arrive at a form of taxation which will be not only equitable but will assist the Government in its war efforts. Permit me to add that if our knowledge of this business as a result of years of experience will be of any assistance to you, we want to know that our time is at your disposal.

Respectfully submitted.

HOVEY T. FREEMAN, *Chairman*.

Legal Committee of the Associated Factory Mutual Fire Insurance Companies;
Manufacturers Mutual Fire Insurance Co., Providence, R. I., Hovey T. Freeman, president;
Firemens Mutual Insurance Co., Providence, R. I., F. T. Moses, president;
Blackstone Mutual Fire Insurance Co., Providence, R. I., C. E. Rigby, president;
What Cheer Mutual Fire Insurance Co., Providence, R. I., C. C. Stover, president;
Boston Manufacturers Mutual Fire Insurance Co., Boston, Mass., M. B. Dalton, president;
Arkwright Mutual Fire Insurance Co., Boston, Mass., E. V. French, president;
Worcester Manufacturers Mutual Insurance Co., Worcester, Mass., M. B. Dalton, president;
Fall River Manufacturers Mutual Insurance Co., Fall River, Mass., M. B. Dalton, president;
Cotton & Woolen Manufacturers Mutual Insurance Co., Boston, Mass., E. H. Williams, president;
Philadelphia Manufacturers Mutual Fire Insurance Co., Philadelphia, Pa., H. G. Griffin, prsident;
Protection Mutual Fire Insurance Co., Chicago, Ill., J. L. Wilds, president.

(The following letter was received from Mr. J. D. Smart, president, New Hampshire Fire Insurance Co.:)

NEW HAMPSHIRE FIRE INSURANCE CO.,
Manchester, N. H., August 17, 1942.

The Honorable CHARLES W. TOBEY,
United States Senate, Washington, D. C.

DEAR SENATOR: No doubt you are giving a great deal of thought to the tax situation and I desire at this time to call your attention to this subject insofar as it effects the business of fire and marine insurance.

Insurance does not show a known fixed profit when sold. We are obliged to retain so-called profits in order to make good our promise to pay claims when called upon to do so.

Conflagrations, a widespread windstorm, or heavy marine losses may at any time call for large payments of money, and if the management were foolish and failed to conserve so-called profits to meet such a call, then it is going to be just too bad for their policyholders.

As fire insurance is really the backbone of business it seems to me that the insurance companies should be given wide latitude, not only to develop but to conserve their funds without being subject to the excess-profits tax.

I believe insurance companies as a whole are willing and desirous of paying their fair share of taxes, but I do feel that due to the nature of our business we should be exempt from the excess-profits tax.

Our losses this year on marine business alone run close to 300 percent. If in past years we had paid out all of our profits, we today would find ourselves in an unenviable position. Many companies so far in 1942 have paid marine claims far in excess of their profits for the last 20 years. We, therefore, feel that we should be allowed to build up our profits without excessive taxation for just as sure as day follows night there will be conflagrations, windstorms, and marine losses in the future as in the past.

May we ask that you give this letter your most favorable consideration.

Very truly yours,

J. D. SMART, *President*.

The CHAIRMAN. Mr. Chapelle.

STATEMENT OF C. C. CHAPELLE, CHICAGO, ILL., REPRESENTING AMERICAN FARM BUREAU FEDERATION

Mr. CHAPELLE. Mr. Chairman, my name is C. C. Chapelle, from Chicago.

I wish to state, first, that I am perhaps the only one here this afternoon who is speaking adversely to the predecessors here.

I am from the American Farm Bureau Federation, and I am appearing before you favoring the provision in the House bill (H. R. 7378) and to reaffirm the position of the American Farm Bureau Federation in regard to taxation of the mutual and casualty insurance companies.

In addition thereto the farm mutual companies sponsored by the farm bureaus of the State of Illinois, Iowa, Indiana, Kansas, Kentucky, New Hampshire, and Wisconsin, have independently expressed their endorsement of the position on this subject.

I wish to outline that position briefly.

I might say that representatives of the foregoing organizations have previously consulted with the Treasury Department, and have appeared before the House Ways and Means Committee.

It is our position, first, that the local mutual companies which, for the most part, serve rural people on a county or district basis, rendering truly a nonprofit service, and which number more than 2,000, should be entirely exempt from income tax.

The proposed revision of section 101 (11), which provides that companies whose mean ledger assets do not exceed $100,000 are exempt, would make it unnecessary for most of the local county and district mutuals to file an income-tax return.

The proposed revision of section 207, which provides further that such companies shall not be subject to tax in the event that their corporation surtax net income is less than $50,000, would probably exempt the balance of such local county and district mutuals. This appears to be entirely proper.

Next, I wish to say that we maintain the generally recognized principle that when a mutual company maintains in its operations all the elements of mutuality, and is truly a nonprofit organization, it would yield no taxable income.

We realize, however, that in practice, mutual insurance companies accumulate over long period of time a certain portion of the policyholders' premiums not required to pay current losses or operating expenses, since it is necessary that such companies have certain capital funds with which to carry on their operations.

It might be claimed that when the dividends to policyholders are unduly withheld to provide such funds, a certain degree of mutuality is lost.

We have, therefore, concluded that under these circumstances mutual insurance companies other than life should share in taxation to the extent that they may be adding amounts to unallocated surplus funds in excess of the necessary minimum.

While there is always some question of the interpretation which may be placed upon the involved language necessary in statutes relating to income tax, it is our opinion that the proposed revision of section 207 provides in general a tax formula upon the above basis.

I wish, therefore, to express again, on behalf of the American Farm Bureau Federation, and the following State-wide farm bureaus, which have definitely taken action in support of H. R. 7378—Illinois Agricultural Association, Iowa Farm Bureau Federation, Indiana State Farm Bureau, Kansas Farm Bureau Federation, Kentucky Farm Bureau Federation, New Hampshire Farm Bureau Federation, and Wisconsin Farm Bureau Federation—our support of the revision of sections 101 (11) and 207 of the Internal Revenue Code which has been adopted by the House of Representatives.

It is our opinion that the basis suggested is fair and equitable to a real mutual company.

Now, here is a point that has been stressed greatly here this afternoon:

If a local mutual company has accumulated assets of a hundred thousand dollars, it is no hardship to that company to make a return and give evidence that its operations have been truly mutual and that no taxable income has resulted. It is merely a method of determining whether or not the mutual insurance company is to make a return.

The fact that they have a hundred thousand dollars in assets does not necessarily mean that above that they have to pay a tax, but if they have over the hundred thousand dollars it is quite apparent on the face of it that some examination should be made as to whether or not that insurance company is in a profit operation or whether they are truly mutual.

Even the large mutuals have the means whereby the amount of tax that they will pay can be practically controlled by policy dividends, and yet the exemption provided will serve to supply them with the necessary capital for expansion and place them in a position at least comparable to stock companies.

A study of the history and regulations of section 101 (11) indicates that it was the clear intent to limit the exemption to mutual insurance companies whose operations were purely mutual and local in character.

The definition as to what constituted local was so expanded that State-wide and finally Nation-wide companies were claiming the exemption.

In conclusion, I wish to say that it is the considered opinion of the American Farm Bureau Federation that the study that has been put in this bill merely states the position which they are recommending to their constituents in support of this bill.

I thank you very much.

The CHAIRMAN. Thank you.

(The following memorandum was submitted for the record:)

MEMORANDUM FILED WITH HOUSE WAYS AND MEANS COMMITTEE IN 1936 HEARINGS ON THE UNDISTRIBUTED SURPLUS TAX

STOCK COMPANIES UNDER INCOME TAX LAW

The stock companies likewise were free from the undistributed surplus tax law during the years it was in effect. The reasons for this were given in a memorandum filed with the Congress by a representative of the New York Insurance Department, which follows:

Taxation of surplus of insurance companies

"I represent the Insurance Department of the State of New York and have been authorized by Superintendent of Insurance Louis H. Pink to make these representations on the subject of the caption.

"The interests of State supervision of insurance would be adversely affected by any tax which would encourage the depletion of insurance companies' surpluses held for the security and protection of policyholders. The insurance supervisors of State departments feel that the protection of the public, who look to the insurance companies for the payment of losses of the various kinds insured, is best served by the accumulation of sizable surpluses for various reasons, some of which are enumerated below:

"1. The assets and investments of insurance companies are subject to wide fluctuation, as evidenced by conditions that prevailed over the past 10 years. Taking the year 1928 at an index of 100, stock market prices fluctuated between 228 and 32, while bond prices fluctuated between 101 and 57, during subsequent years. It became necessary for the National Convention of Insurance Comsioners to adopt average values for financial statements of insurance companies, but in spite of this action many members of the public insisted upon viewing these financial statements in the light of actual market prices and it became impossible to save a number of insurance companies that had insufficient surpluses to absorb these market fluctuations.

"2. The loss ratios of insurance companies fluctuate widely. This is true even in normal periods, so that what has been put in surplus out of apparent underwriting profit during good years is consumed by excessive losses of bad years. The specter of conflagration and marine disaster hovers constantly over the fire and marine companies and the danger of catastrophe and the collapse of financial institutions bonded by them constantly threatens the casualty and surety companies.

"The State supervisors in the interest of the public encourage the maintenance of substantial capital and surplus for the purpose of making insurance security more certain. Companies have been criticized for the payment of stockholders dividends when they have exceeded the excess of investment earnings over any underwriting loss, or, in any event, when they have exceeded investment earnings even where there is an apparent underwriting profit. The states look upon a substantial surplus over and above outstanding capital as important to any insurance company. As a matter of fact, the New York statute requires a surplus equal to not less than 50 percent of capital upon the organization of an insurance company. Small surplus would necessitate frequent release of capital funds to surplus in the event of an adverse market or a bad loss ratio. This involves considerable red tape and delay and is disturbing to the peace of mind of the policyholding public. The definite financial condition of many insurance companies is impossible to determine shortly after the closing date of any year, by reason of the fact that incurred and outstanding losses must be appraised, and where these are subject to litigation or protracted negotiation the actual value cannot be determined for several years. It is comforting to the policyholder, the public and the state insurance departments to know that a sizeable capital and surplus act as a cushion to absorb adverse fluctuations in the loss reserves. Many successful insurance companies have had to make substantial contributions from their surplus account for the support of less successful subsidiary insurance companies.

"I respectfully urge that no tax be imposed which would discourage the maintenance of security by insurance companies through the creation of surplus."

LOUIS H. PINK, *Superintendent.*

STATEMENT OF RAY MURPHY, NEW YORK, N. Y., REPRESENTING THE ASSOCIATION OF CASUALTY AND SURETY EXECUTIVES

The CHAIRMAN. Mr. Ray Murphy.

Mr. Murphy appears later on in the schedule, but he seems to be on the same general subject.

Mr. MURPHY. Mr. Chairman and gentlemen of the committee, I am Ray Murphy, assistant general manager of the Association of Casualty and Surety Executives.

I am sure that I shall not be persona non grata to this committee merely because I represent capital-stock companies which are engaged in business for profit.

It was my privilege to appear before this committee on August 20, last year, upon the subject of taxation of mutual companies other than life, and at that time I believe it was the opinion of this committee that it was an important subject, one that should have time for consideration, and I believe the distinguished chairman indicated that the matter would be given consideration at the time the expected administrative amendments bill was proposed by the Treasury Department.

So a year has elapsed since this proposal for equalization of tax, or of some tax upon mutual companies, has been made to this body.

In the meantime the matter has been considered by the House of Representatives through its Ways and Means Committee, and nearly all—if not everyone—of the representatives and spokesmen for mutual companies who have appeared before this committee today or last April 9th appeared before the House Ways and Means Committee and said, before them, almost exactly the same things they have said today, but at that time there was one marked difference: The spokesmen at that time would not concede that mutual companies should pay any tax whatsoever.

Now, I think it is well known to the members of this committee, who are much more familiar with legislative proceedings than I, that the record will show that, for 30 years there has been an attempt, beginning, I think, at the time that the Honorable Cordell Hull was a member of the Ways and Means Committee, to make these commercial mutuals pay some tax to this Government for the privilege of existing and doing business in these United States.

But for one reason or another—and principally because those spokesmen have been enabled to put on a hippodrome and a three-ring circus before committees—they have thus far successfully evaded taxation.

I submit to you that, with one or two frank and notable exceptions which have appeared before you today, those same spokesmen are using exactly the same tactics that they have used successfully for 30 years, and I submit to you that, if for the first time this bill had not passed the House of Representatives, and if for the first time they had not been threatened with the payment of a tax, their attitude would not have been altered in the slightest.

Now, you may say that I am in a somewhat anomolous position—perhaps in an embarrassing position—in appearing here suggesting that a tax be put on a competitor.

I say to you frankly that it is not a happy position for me to be here urging a tax upon anybody.

There are just perfectly natural human considerations which make it embarrassing for me to do that, but for 30 years these large commercial mutuals have been growing and thriving.

They have been taking business away from us. There can be no question about that.

Frankly, I don't have time, nor do you, for rebuttal of all that has been said here today, and frankly I am sure you will never have time to wade through all that has been handed to you.

In that connection, I ask, however, that I be permitted to insert in the record two pamphlets; one, entitled, "The untaxed profits of mutual casualty insurance companies," and the other entitled "Taxation of mutual insurance companies other than life," same being a statement which I made to the House Ways and Means Committee on April 16, 1942, and I ask that they be made a part of my remarks to this committee.

The CHAIRMAN. Your statement may be, but is the other a printed pamphlet?

Mr. MURPHY. Yes, sir.

The CHAIRMAN. If it were sent to the committee for the use of individual members it would be better than including such a voluminous document in the record.

Mr. MURPHY. Of course, I would be glad to insert it on whatever basis the chairman indicates.

The CHAIRMAN. I don't want to put in too lengthy a statement, but if you will furnish them to the clerk we will be glad to have them.

Mr. MURPHY. So many confusing statements were made that I am confused, but I know one statement was made to this effect: That on the basis of this bill the mutual companies would pay, I think, five times as much tax, proportionately, as the capital stock companies.

That just does not happen to be a statement of the fact. For example, last year, I believe it was, casualty companies wrote about a billion dollars in premiums. The mutual casualty companies wrote about $300,000,000 in premiums.

Under this bill they would pay an estimated $5,000 in taxes, and under this bill our companies would pay an estimated $45,000,000 to $50,000,000 in taxes.

The Treasury Department, of course, has those figures available, and I am certain they will substantiate largely what I have said.

So I would simply like to leave this thought with the committee: That at no time have we ever proposed that any action be taken by the Congress of the United States which would tax the small local or purely mutual company, but always before, the large commercial mutual companies have been enabled to crawl in under the same tent with these little companies, and therefore have escaped payment of any tax.

We have proposed a generous exemption, and I may say that—Mr. Ekern made reference to whoever wrote this bill—I may say, with equal frankness, that I don't know ho wrote the bill.

Certainly, I never saw it. I am sure no one ever saw it, outside of those entitled to know, until it became a public record.

But I suppose that is a matter for inquiry, if it seems to be pertinent to this committee.

There may have been the intention to imply that capital stock interests wrote this bill.

I assure you that that is not the case.

We had absolutely no inkling or knowledge of what was going into it until it became a matter of public record.

I wish to thank you gentlemen and assure you that I would like the time to answer many of the things I have heard today, but I know that it would be not only infringing upon your courtesy, and that, though answers are feasible, at this time it would be utterly impossible for you to grant me the time required for detailed reply.

Thank you.

The CHAIRMAN. You may include the brief that you have, which I presume deals with the question, and if you will furnish us with a copy of the other document we will be very glad to use it.

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

STATEMENT OF RAY MURPHY, NEW YORK, N. Y., ON BEHALF OF THE ASSOCIATION OF CASUALTY AND SURETY EXECUTIVES

TAXATION OF MUTUAL INSURANCE COMPANIES OTHER THAN LIFE

I am Ray Murphy, assistant general manager of the Association of Casualty and Surety Executives, on behalf of which I appear. This association is composed of 31 principal stock-casualty insurance and surety companies doing business in the United States. The principles expressed herein apply equally to all mutual-insurance companies other than life.

On March 3, 1942, Mr. Randolph Paul, tax adviser to the Secretary of the Treasury, in his appearance before the Committee on Ways and Means, House of Representatives, made the following statement:

"*Mutual insurance companies other than life.*—Many of the mutual casualty insurance companies, large as well as small, are given an outright exemption from taxation under section 101 (11), although that section was originally designed to exempt only small and local mutual companies. Other mutual companies, while nominally subject to tax, ordinarily pay no tax under the present method of computing their income. This has resulted in a serious disparity in tax treatment between such mutual companies and the stock-casualty companies.

"It is suggested that the exemption in section 101 (11) be confined to those mutual-casualty companies whose net taxable income does not exceed $25,000 and which do not write insurance on any property having a value of more than $50,000, regardless of whether reinsured. It is further suggested that the remaining mutual companies be taxed on the sum of their investment income and the additions to their surplus which are free from claims of policyholders."

Such statement was made by Mr. Paul as a part of the Treasury's recommendations for "Removal of special privileges." We concur in Mr. Paul's statement that there is "serious disparity in tax treatment" between stock and mutual insurance companies other than life. Such disparity can be explained in these simple terms:

(*a*) Mutuals are permitted exactly the same deductions as stock companies.

(*b*) In addition they enjoy the following deductions which are not permitted to stock companies:

(1) They are permitted to deduct dividends paid to policyholders.

(2) They are permitted to deduct amounts of premiums which are retained and added to surplus.

Therefore, the mutuals have never paid any tax either on their investment profits or their underwriting profits. This, despite the declared intent of the Congress to impose a tax upon both stock and mutual companies.

Applying to actual figures these special deductions allowed to mutuals we find a mutual company with $46,000,000 of net premium writings in 1940, showing

$11,000,000 underwriting and investments profits, paying nothing into the Federal Treasury for income taxes. From 1940 business this same company added $2,300,000 to its surplus. By this same process 23 leading mutuals earned $42,000,000 in 1939 and paid nothing or nearly nothing as Federal income taxes.

During the continuation of these special privileges the mutuals have accumulated over the years not less than $150,000,000 in surpluses which belong to the companies free from claims of policyholders.

We wish now to clarify one extremely important point, concerning which the large commercial mutuals for many years have successfully confused the issues and the facts. That point is the claim repeatedly made by mutuals spokesmen that there is no distinction between a small farmers mutual and the largest commercial mutual in the United States, and that both therefore should be exempt from taxation. We will summarize briefly the character of income and the methods of operation of these wholly different types of mutual companies, believing this will dispose of the claim upon which the large commercial mutuals have consistently based their plea for tax exemption.

Classified according to character of income and methods of operation, the two principal types of mutual casualty companies are:

> *First group.*—Those operating on the assessment or premium deposit basis and
>
> *Second group.*—Those which collect a fixed, cash premium equivalent to that charged by other companies generally.

First group.—Usually the income of companies in the first group consists almost entirely of assessment or premium deposits collected from members either in advance or after occurrence of the loss. No dividends are paid to members, amounts refunded to members, if any, represent a return of the unused portion of the assessment or premium deposit. These mutuals do not with a few notable exceptions, maintain extensive organizations nor employ commercial methods of conducting their operations, such as widespread advertising and other forms of soliciting business from the general public. It is doubtful whether the entire number of mutuals operating on this basis have any profits of consequence. In this group fall the several hundred true farmers mutuals which the Congress has heretofore exempted as a matter of tax policy. Under the recommendations of the Treasury made to this committee on March 3, 1942 by Mr. Paul, every small farmers mutual would continue to be exempt.

Second group.—In contrast are the commercial mutuals in the second group, many of which operate on a national and, in some cases, international scale. Their policies provide the same coverage as those issued by the stock companies. A flat, final, fixed premium is charged as distinguished from collection of an assessment or a premium deposit. Mutuals have sought and secured authority in every State to issue nonassessable policies, the issuance of such policies is now their common practice. This constitutes an abandonment of the fundamental concept of mutuality.

The wholly commercial nature of these companies is emphasized by the methods and vigor with which they seek their business.

Like many other large commercial enterprises, they spend hundreds of thousands of dollars annually in advertising. Their national advertising is directed not to individuals alone, but to industry and commerce as well. Their advertisements are carried in the largest periodicals and newspapers in the country, such as Fortune, Time, Newsweek, Saturday Evening Post, Nation's Business, Collier's, New York Times, and Wall Street Journal.

The policyholders of commercial mutuals now include many of the largest industries in the United States. One mutual advertises that it is the leading writer of compensation insurance in America. Another advertises that it is the largest exclusive writer of automobile insurance in the world.

The commercial mutuals employ conventional methods of solicitation—some through agents, others through branch office employees, and still others through both agents and branch offices. The larger companies have offices in the principal cities throughout this country; some maintain offices in foreign countries.

Many of these companies maintain large home office buildings staffed by hundreds of employees.

In 1940 the 203 mutual casualty companies doing business in the United States had premium and investment income of more than a quarter of a billion dollars. Forty-three of these companies, each with an annual premium income of more than a half million dollars, wrote 92 percent of the total business. Those 43 companies, therefore, wrote more than ten times the volume of business written by the other 160 companies. Six of these 48 wrote 59 percent of the total mutual casualty business; each of these 6 companies in 1940 had premium income ranging from $11,000,000 up to $46,000,000. These 6 biggest companies are members of the American Mutual Alliance for which a spokesman appeared before the Ways and Means Committee on April 9, 1942.

It should be transparently clear that the true farmers and local mutuals are not the real parties in interest represented by the spokesmen appearing before this committee. The true farmers and local mutuals have either no profits, or profits of no importance from a tax standpoint. Furthermore, under the Treasury's proposal, those mutuals having net income not in excess of $25,000, and not insuring risks in excess of $50,000, would be exempt. The real parties in interest represented by the mutual spokesmen are the small number of large mutuals whose methods of business we have herein described, wholly commercial in nature, parallel in operation in all respects with the operations of the stock companies.

A principal contention made by the mutual spokesmen is that their accumulations of surplus are held in trust for their policyholders. This cannot be demonstrated. At this time the largest mutual casualty company is resisting in court the claim of a former policyholder to a pro rata share of the company's surplus which was accumulated during the long period that it was a policyholder. Very probably all other commercial mutuals would resist similar claims by policyholders. With no constancy of policyholders, with policyholders coming and going and ever changing, with intermingling of funds, with no records of proportionate accumulations from the premiums of individual policyholders, with a fixed practice of resistance to policyholders' claims thereon—the commercial mutuals cannot in good faith contend that their accumulations of surplus are in fact held in trust. They are in fact the property of the company, free from any claim of the policyholder for participation therein. The hoary myth of trusteeship has long been a favorite device of the commercial mutuals in their successful resistance to Federal income taxation. The records will amply prove that palpable fact.

Now a few words concerning the Federal tax history of stock casualty and surety companies. Since 1909—the date of the original Corporate Excise Tax Act which taxed corporations on their net income—they have remained subject to tax on their net income at approximately the same rate applied to corporations generally. The rates on stock casualty and surety companies are now identical with those of other corporations. Under successive Revenue Acts since 1909 the stock companies have paid millions of dollars of Federal taxes based on net income. Under the rate increases proposed for 1942 their Federal taxes will be drastically increased.

What is the tax history of the mutual casualty companies? According to the testimony of their own spokesmen here last week, they have paid nothing or nearly nothing into the Federal Treasury by way of income taxes. They will continue to pay nothing, regardless of rate increases, so long as the present situation maintains.

Neither the time allotted, nor your patience, will permit a detailed verbal reply to the various points raised by the mutuals' spokesmen in support of their plea for tax exemption. I shall, therefore, cover in quick summary the principal points advanced by them and I ask leave of the committee to insert in the record additional data, statistics, and other information touching upon these points, as well as other pertinent matter.

Four points were listed at the committee hearing of April 9, by the spokesman for the American Mutual Alliance, in opposition to the Treasury recommendations presented by Mr. Paul. We shall summarize here the answers to these points, requesting that the committee, if it desires, consult such additional exhibits, as we are permittted to file for the record, for more complete information.

The first point alleged was—

(1) That no disparity exists in tax treatment between stock and mutual casualty companies, and that the present difference in tax treatment between the stock companies, and the mutual companies, two wholly different types of companies, is fair and reasonable.

In one breath the spokesman stated that no disparity existed and in the next breath stated, in effect, that the disparity which does exist is justified. When one set of corporations—the stock companies—pays several million dollars a year in Federal taxes and another set conducting exactly the same kind of business—the mutual companies—pays nothing, disparity cannot be doubted.

As to the pretended justification for this disparity, we believe that our previous statements herein made, showing the methods and practice of the commercial mutuals, constitute a wholly sufficient answer. Such statements are supported by the matter filed for the record.

The second point alleged by a mutual spokesman was—

(2) That the stock companies are not in a serious competitive difficulty, because of the tax law, as the record of their earnings will show.

We are confident that this committee has no interest in any competitive issue, as such, between the stock and mutual companies. We are equally confident that this committee will not knowingly continue any serious tax disparity, nor permit the Federal tax laws to be employed as a competitive weapon. We believe the existing disparity was never intended. Now that it has become serious by reason of increased tax rates, and can become more serious as such rates increase, we trust that the Congress will implement by appropriate legislation the proposals for elimination of such disparity.

Our view finds support in the statement of the Treasury made by Mr. Paul on March 3, 1942, pertaining to tax-exempt corporations which engage in trade or business not related to their exempt activities. On this subject he commented:

"In this way sources of considerable tax revenue are withdrawn from the scope of the tax. At the same time privately owned businesses are forced to compete with other businesses not subject to an income tax."

We submit that the exemption of the commercial mutuals from Federal taxation withdraws a considerable revenue from the scope of the Federal income tax. At the same time the stock companies are forced to compete with companies conducting the same type of business but not subject to income taxes.

In attempting to minimize the importance of Federal income taxes as a competitive factor, a mutual spokesman appearing before the Ways and Means Committee quoted a newspaper statement purporting to deal with the differential in expense ratios of stock and mutual companies. The illustration is irrelevant and grossly misleading.

First, Federal taxes are not a permissible factor in arriving at expense ratios. Second, the spokesman artfully sleected for his example a line of insurance (workmen's compensation) on which few companies are fortunate enough to make a profit. Obviously, any ratio of taxes paid on extremely low-profit business, in relation to expense ratios, or any other element of the premium dollar, will not accurately reflect the general, and the true over-all situation. Incidentally, there is no compulsory or uniform accounting method prescribed as respects the treatment of Federal income taxes in various published statistical exhibits. This is immaterial since there is no allowance in insurance rates established by rate-making authorities for such taxes. Hence, any published average may be wholly meaningless, indicative of nothing.

The important fact is that if the recommendations of the Treasury Department are enacted into law the stock companies will, for 1942 and doubtless future years, be subject to income and surtaxes totaling 55 percent and to excess-profits taxes as high as 75 percent, and that unless existing law and practice are changed with respect to them, the mutuals will continue free from any Federal taxes based on net income.

It is estimated that if the proposed rate increases are enacted into law the stock companies will be required to pay in Federal income and excess-profits taxes of at least 60 cents out of each dollar of taxable net income. By reason of their heavy investment in Federal obligations, the incidence of the corporate surtax is far heavier on the stock companies than on ordinary business corporations.

The third point alleged by a mutual spokesman was—

(3) That the capital-stock insurance companies have enjoyed and are now enjoying special tax privileges not available to other profit-making concerns; and that consequently their profits are greater and taxes less.

This statement is false in its implications. We have hereinbefore outlined the past and present tax status of stock casualty companies, under the successive revenue acts since 1909 (see p. 7 herein, and exhibits filed). The records of the Treasury Department are the best source from which to determine whether the stock companies have enjoyed or are now enjoying special tax privileges. Inasmuch as such records are not available to us, we respectfully invite the attention of the committee to them, that they may satisfy themselves on this point. We are completely convinced that such records will effectively refute the mutuals' point, and that they and other Government records will establish definitely that stock companies are not only given no favored treatment, but, as heretofore herein stated, are given far less favored treatment than is now accorded the mutual companies.

Important facts are that the stock casualty and surety companies are required to compute their net income on a basis comparable to that of corporations generally; the rates of normal tax and surtax are the same as imposed on corporations generally; they are subject to the same provisions of the excise-profits tax as are other corporations generally.

The fourth point alleged by a mutual spokesman is—

(4) That the Government does not lose revenue because of the nonprofit nature of the mutual companies.

The point is fallacious. On the one hand, their spokesmen extolled the mutuals as the benefactors of the farmers; on the other hand, the mutuals' spokesmen frankly claimed for the purposes of their point that from 75 to 100 percent of the mutuals' dividends are paid to policyholders engaged in corporate business. It must be assumed that the dividend recipients to which the mutual spokesmen referred are not only corporations, but are sizable corporations, since the 24-percent rate was used by such spokesmen, and such rate applies only to those corporations having taxable net income in excess of $38,000. We believe the mutual spokesmen in this regard are guilty of a violent assumption indeed, but, if not, and their statement is true, then their claim of service to the farmer and the little man is quite exploded.

Moreover, the Report of the Commissioner of Internal Revenue for the fiscal year ended June 30, 1941, page 18, reveals that in 1940 540,935 corporations filed Federal income-tax returns, of which 340,220, or 64 percent of all corporations, paid no tax. In 1941 535,525 corporations filed returns, of which 328,342, or about 65 percent, paid no tax. It is fair to assume that an unknown, but possibly substantial, number of corporate policyholders to whom the commercial mutual companies returned dividends were included in the great majority of nontaxpaying corporations. If so, the mutual spokesman's estimate of Federal income taxes paid by recipients upon dividends from the commercial mutuals becomes even more fantastic.

In laboring their point the mutual spokesmen have chosen to disregard the fact that Federal income taxes, undoubtedly substantial in the aggregate, are paid by the many thousands of stock-company commissioned producers.

We believe it to be the desire of the Treasury Department and of the Congress that loopholes be closed so that all unwarranted tax exemptions shall be eliminated. We trust that whatever legislation is enacted it will effectively close the loopholes through which the commercial mutuals have escaped tax-free.

However, great anxiety was expressed by the spokesmen for the mutuals over the possibility that the Treasury's recommendations would result in a tax upon mutuals substantially higher than the tax paid by stock companies—"two and one-half to four times more than a similar profit-making stock company"—to quote the spokesman verbatim. Please note the spokesman's perhaps inadvertent use of the word "similar," for at the outset of his statement to this committee he alleged that the stock and mutual companies are "two wholly different types of companies."

We are sure that no one will take seriously the pretense of anxiety. In the light of the past and present tax history, the spokesman's tears are reminiscent of the crocodile. We do not feel that we are presumptuous in saying we are certain that the Treasury will not advocate, nor the Congress permit the mutuals to be taxed at a greater rate than the rate applied to stock companies. Certainly we have not asked it. We ask equality only.

We are frankly astounded at the attitude of the mutal spokesman appearing before this committee. One has attempted to prove that the taxes paid by the stock companies are not a competitive handicap. If this were true, it would necessarily follow that similar taxes upon the commercial mutuals would not be a competitive handicap. One mutual spokesman, out of step for the moment, told you that the statement submitted by the Treasury does not "appear to be urged as a means of raising any substantial revenue." Why, then, are the mutual spokesmen opposing the Treasury's proposal so vigorously?

In refreshing and encouraging contrast is the attitude of a witness who appeared before the Ways and Means Committee, on April 10, on behalf of Acacia Mutual Life Insurance Co. He said:

"Our company appreciates the nature of the situation confronting our Government and fully recognizes the necessity for greatly increased revenues. We appreciate the fact that life-insurance companies, along with all other corporations and citizens, must pay additional taxes. We have no fixed ideas as to what tax formula should be adopted by Congress this year to apply to the life-insurance industry."

In response to questions from a member of that committee this witness frankly stated:

"I believe all life-insurance companies expect to pay more income tax. The question, as I stated, is to determine what the fair amount would be and to determine a basis for equitably distributing the tax among the different life-insurance companies."

Parenthetically it may be stated that the tax basis for stock life-insurance companies and mutual life-insurance companies under present law is identical. No reason exists why the same parity should not exist between stock and mutual companies other than life. No reason exists why life-insurance companies, stock and mutual, should be taxed, while the commercial mutuals go tax free.

We, too, expect to pay additional taxes. The Nation has never needed them so much as now. We ask only parity, equality, justice.

The CHAIRMAN. Mr. Cowdin.

STATEMENT OF J. CHEEVER COWDIN, NEW YORK, N. Y., REPRESENTING THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. COWDIN. My name is J. Cheever Cowdin. I am chairman of the Committee on Government Finance of the National Association of Manufacturers.

The revenue bill of 1942 is one of the most important single measures ever to come before Congress. A bad tax bill can lose the war.

Every man, woman, and child in the United States is directly and vitally affected by this tax bill, upon which may depend—

1. Whether or not the United States will win this war of production; and

2. Whether free enterprise, after the war will be able to provide employment not only for all present workers but for the men and women in the armed forces who will be returning to peacetime pursuits.

These objectives require the highest order of statesmanship and leadership in government and in industry.

We urge you in Congress, in these critical days, to give us a courageous and long-range program of war financing.

We respectfully submit a comprehensive program which we urge be placed in effect for the duration of the war.

This program will yield estimated revenues to the Federal Treasury of $33,200,000,000 in 1 full year at current levels of business activity and $37,200,000,000 at levels anticipated for 1943, and is as follows:

1. Industry will be left under this program with the absolute minimum consistent with national safety. Under the plan, corporations will pay taxes of $11,900,000,000 out of estimated 1942 earnings of $18,000,000,000. We believe such corporate taxes for the coming year would raise $13,500,000,000. These taxes are far beyond the corporate payments anyone in Government has so far estimated or asked for.

2. High rates on individual net incomes are also necessary to meet the costs of war. We submit for your consideration the schedule

of surtax rates graduating from 8 to 79 percent we submitted to the House Ways and Means Committee earlier this year.

These less-harsh rates on individuals are the maximum we believe fair and practicable when taken into consideration with other aspects of our suggested program.

These recommended new rates will raise an estimated $8,000,000,000 from individual incomes of this year and $9,000,000,000 from those of next year.

3. A wartime consumption tax is urgently needed as a major source of Federal revenues.

A majority of people outside of Washington accepts the need for such a tax. Those in Congress who oppose it, because of the November elections, misread the minds of the American people. Our suggestions on wartime consumption taxes would have returned to the Federal Treasury, at minimum estimates, $4,800,000,000 on the 1942 level of consumption, and should return $5,200,000,000 next year.

4. Existing excises, employment taxes, customs, miscellaneous, and all other taxes should yield an estimated $6,500,000,000 from 1942 and $7,500,000.000 from 1943 transactions.

5. We urge Congress to cut every dollar wasted in nonmilitary, Federal expenditures. A minimum of $2,000,000,000 can be saved for war in this way.

CORPORATION STUDIES AND RECOMMENDATIONS

To get a definite answer to the question, "How much can the American people raise from business without impairing the war effort and without destroying the free-enterprise system for which we are fighting?" the N. A. M. did these things:

1. We made a complete and factual study of manufacturing companies' earnings for the 20 years up to 1940; and

2. We made a Nation-wide questionnaire survey of the 1942 earnings, profits, and financial requirements of thousands of businesses, of every kind and character, in every State of the Union; and

3. We talked to over 3,000 business leaders and war manufacturers in every important industrial area from coast to coast. They represented every State and all types of business, large and small.

These first two studies are being submitted to you today.

OUR STUDIES PROCEEDED ON TWO MAJOR PREMISES

1. That the Government must now be given every dollar in taxes that industry can stand;

2. That companies must be left enough earnings to keep war materials flowing, pay some dividends to their 11,000,000 stockholders, and have left reserves enough to reemploy our fighting forces, retool, and make new goods after the war.

The questionnaire we sent out has developed what is probably the most authoritative and comprehensive information in existence today about current business earnings, taxes, and financial requirements. The executives of more than 3,000 companies, representing all kinds of businesses in all sections of the country, gave us estimates of the business conditions and earnings of their companies for 1942. The study reveals two highly significant facts which bear directly upon the tax program:

1. It indicates an aggregate corporate net income in 1942 will be $18,000,000,000.

This figure, as you will note, is substantially higher than that used by Treasury and other authorities in calculating the revenues to be derived under corporate tax schedules.

2. Corporations will need to retain after taxes about 2.7 percent of their total receipts. They must have this to maintain present operations and to continue the expansion necessary to win the war, to pay minimum dividends to investors, and to set up protective reserves. This would mean that out of an estimated business volume of $226,000,000,000 in 1942, $6,000,000,000 would be needed for additional working capital, for increased inventories and receivables, for maturing indebtedness, and for the expansion of plant facilities to meet war-production needs.

Industry today is producing far above its normal output and is asked to produce even more. It cannot do this increased-production job with less than it had to work with in 1939 and 1940.

In March we recommended to Congress a combined normal and war surtax of 40 percent and a 90-percent excess-profits tax. This was to be computed on the method contained in the 1940 law—a method already approved by Congress and your committee after long study.

The rates in part are now in the bill before you. The results of our questionnaire show that under the House bill the effective rate of these taxes would be 75 percent.

We recommend most earnestly that the combined normal and war surtax not exceed 40 percent.

A higher rate will ruin a vast number of smaller and medium-sized companies which are not sharing in war work and which, because of priorities, labor difficulties, and loss of markets have great difficulty in keeping themselves financially sound.

In addition, the method has been replaced by another untried method—one that, if the bill be passed at proposed rates, will be disastrous to many companies. In other words, we urge that the normal tax and base credit be allowed to be deducted before the excess-profits tax is computed. We believe that when a tax has been in effect for over 30 years it is so much a cost of doing business that there can be no excess profit until that liability has been satisfied.

We urge the Congress to reestablish the 1940 method in the 1942 tax bill.

We do not say that any one plan of corporation taxation is the only fair method.

However, we maintain that any sound corporate tax plan must meet the requirements of this four-point formula:

1. A sufficient amount, after taxes, must be left to carry on and expand war production and to emerge solvent after the war. The 1940 formula of applying a 40 percent on normal earnings and 90 percent on excess profits will leave corporate business less than 3 percent of gross earnings for these purposes.

2. The combined normal and war surtax must not exceed 40 percent since any higher rate is bound to cripple the many thousands of companies which are not directly engaged in the war effort.

3. In all fairness, if we are using the base credit to measure normal earnings, we should allow companies to earn and retain it before levying excess-profits taxes.

4. Adequate relief provisions must be made for hardship cases so that a fair base credit is assured for all companies.

TALKS WITH BUSINESSMEN FROM COAST TO COAST

In addition to the 20-year study of manufacturing and the survey of current business earnings and financial requirements, our recommendations to you are based, as I have said, upon recent discussions with thousands of businessmen in every section of this country.

We are proud to tell you that wherever we traveled, from coast to coast, in the North, and in the South, we found businessmen ready and willing and anxious to pay taxes to the very limit of their resources.

But we found general agreement that the House bill would be dangerous and many of them felt that even the tax proposals of the association approached the danger line.

Most disturbing to us, and I am sure it would have been to you, was the discovery that there was widespread feeling on the part of businessmen that there had crept into the tax bill definite restrictions on business which would change the free system we have in this country.

This feeling has been accentuated by the widespread and continuous unjustified attacks upon the patriotism and integrity of business. This raises a suspicion that the war effort is being used to undermine the foundation of free enterprise in America. However, we found that the inherent patriotism of the American businessman was the principal driving force behind the tremendous momentum that American war production has attained. Today, they are producing a volume of essential war materials beyond that ever dreamt of by any country in the world. By this time next year, industry will be producing a volume greater than that produced in all of the enemy countries combined, if they are not harassed and hamstrung.

The American public, for example, cannot form a proper judgment on the fairness of a tax bill when the Treasury's public statement of the amount to be raised through corporate taxes is billions less than the actual probability.

It is suggested that in the future, the facts should be given the American public as to what total income corporations will earn, what dollar volume the total taxes will take, the over-all effective rate, and what will be left them after taxes, just as is now done for individuals. This should help to eliminate confusion.

At the same time that it underestimates receipts from corporate taxes, the Treasury talks of business profiteering and builds a picture of profits which are nonexistent. It attributes to business unpatriotic motives which are without foundation.

Actually, the present bill would take from corporations owned by 11,000,000 citizens, some 13½ billion dollars or 45 percent of the entire Federal tax bill. These 11,000,000 stockholders, in addition, have to pay taxes as individuals, if and when they receive these corporation earnings. These 11,000,000 people are thus taxed twice.

We find businessmen particularly chagrined at the discrimination which is being shown against stockholders at a time when full consideration is being accorded the income requirements of labor and agriculture.

Actually, there is no dispute of substance between the honest workingman, the farmer, and management—it is mostly manufactured. The American people are completely aware that to provide full employment, industry must be allowed to survive.

TAX CREDIT TO AID POSTWAR REHABILITATION

The drastic taxes proposed for business in this war period require that a tax credit be established both to provide Government with the necessary funds to finance the war and to cushion business and employment against the difficult readjustments which will follow.

We earnestly recommend that companies be allowed to purchase Government bonds in an amount up to 10 percent of taxable net income, the money paid for such bonds to be allowed as a tax credit. These bonds should be issued immediately to the companies buying them to be held by them as an aid for postwar rehabilitation and conversion back to peacetime production. These bonds should be nonnegotiable and noninterest-bearing during the war. At the termination of hostilities, they should become negotiable, bear interest at 2 percent, to be repayable one-tenth each year in the following 10 years.

The businessmen of this Nation tell us that without such a provision it will be impossible to effect postwar rehabilitation and provide full reemployment.

The CHAIRMAN. Mr. Cowdin, how much longer will it take?

Mr. COWDIN. I would say about 6 or 7 minutes.

The CHAIRMAN. Can't you brief it?

Mr. COWDIN. I will try, if you want me to.

The CHAIRMAN. Many of these subjects have been gone over by various witnesses in the last 5 weeks, and the committee is fairly familiar with them. Of course, we don't want to cut off a witness. I just suggest that you shorten it as much as you can.

Mr. COWDIN. All right, sir. I will do the best I can, sir. There are some rather important provisions. Let me see if I can pick them out, sir.

CORPORATION CREDIT FOR EITHER PAYMENT OF DEBTS OR THE PURCHASE OF WAR BONDS

Our discussion with businessmen confirmed the findings of our survey which shows that 90 percent of companies have a debt problem. Debts can be repaid only out of the margin of earnings left after taxes, and if taxes take too large a portion of these earnings, unnumerable companies will have to default on their obligations.

We, therefore, recommend that corporations be granted a tax credit up to 10 percent of their taxable net income for the repayment of noncurrent debt obligations contracted prior to January 1, 1942, or, the extension thereof. Or, if they have no debt, for the purchase of Government bonds.

These bonds should be the same type as recommended for issuance to aid in postwar rehabilitation, and be delivered to companies immediately.

Such a provision for meeting debts in the new tax bill will help companies facing serious debt difficulties without discriminating against other companies, and at the same time protect business solvency which is the backbone of Government revenues.

FISCAL YEAR COMPANIES

We urge this committee to strike from the pending bill the provisions which, retroactively applies unexpected new rates arbitrarily. This provision works a hardship on the vast numbers of companies on a fiscal year basis. This section of the new bill was adopted without benefit of public hearings.

Great numbers of companies have made irrevocable plans and commitments based on the reasonable assumption that their tax liabilities would be those contained in the 1941 Revenue Act.

They have expanded their plants, extended their credit to the limit, and even paid out dividends on the basis of completed years for which tax reports had already been filed.

On our recent trip, large numbers of businessmen told us that the retroactive effect of this fical year provision would seriously jeopardize their solvency.

In all fairness, each company should be allowed a full year's operation under each tax law.

BROADENED RELIEF PROVISIONS

The bill now before you soundly recognizes the need for protecting companies from unfair application of excess-profits tax as by setting up various relief provisions.

We urge this committee to broaden the relief provisions for hardship cases to give all companies adequate and proper base credits.

We recommend that these relief provisions establish an additional yardstick of appraising base credits for those companies using their own capital to carry on expanded production programs. Such companies should be allowed a 25-percent increase in their base credit for each 100-percent increase in the dollar value of production over and above the average in the base period.

We also recommend that the so-called automatic relief provision at one time contemplated by the House Ways and Means Committee be reestablished by the Senate. This relief provision will allow companies to use 75 percent of the average of their 3 best years in the 1936–39 period as a substitute for a year of low earnings or of deficit operations.

We also urge that companies be allowed the option of substituting 1940 for the year 1936 in the growth formula set up to help young and growing companies. If this is done, and if the limitation of section 713 (f) (6) is made anplicable to young, growing companies, you will have a growth formula which will give these companies a base far more representative of normal earnings.

LOSSES ON PHYSICAL PROPERTIES

We also recommend that the changes in the capital-gains-and-losses provisions established by the pending bill be revised so that capital losses in the case of physical properties may be offset against business gains by corporations.

ABNORMAL DEPRECIATION

The extremely high rate at which production facilities are being used during this war requires complete equity in allowing operating concerns fair amounts of depreciation, obsolescence, and depletion. The loss in capital investment reflected by such depreciation, obsolescence, and depletion is as much a cost of doing business as the purchase of materials and the payment of wages.

Most of the businessmen we have spoken to recently feel that the Treasury is requiring difficult, if not impossible, burdens of proof from taxpayers for the justification of depreciation allowances established in good faith and in sound business judgment. We recommend that your committee study means of properly protecting companies meeting today's demands for all-out production by the enactment of a provision to broaden the law to care for abnormal depreciation, so that companies using their facilities at greater than normal rates receive adequate and proper depreciation allowances.

Many companies are risking the future of their plant and equipment by around-the-clock operations and are deserving of a proper allowance for the abnormal depreciation of their assets.

DEFERRED MAINTENANCE

Many companies explained to us that priority restrictions, combined with general lack of labor and material, make it impossible for them to keep their plant and equipment adequately maintained. This deferred maintenance cannot be shown, as an expense for tax purposes although it is a real cost of carrying on current business.

We urge this committee to study ways of giving due consideration to companies which are unable to make current repairs and maintenance.

INVENTORY PROBLEMS

Modern bookkeeping is such that the rise in the cost of goods held in inventory results in a taxable profit, although a real profit may never be realized.

In these days of rising prices and volume and increasing costs, thousands of companies will have to pay cash taxes on inflated inventory values.

Most businessmen we have spoken to fear that a great part of the bookpeeping profits contained in today's inventories will disappear at the end of this this war as they did in the early 1920's.

An important factor, often overlooked, is that taxes have to be paid in cash, while an important part of a company's current earnings are nothing more than bookeeping profits, existing in inflated inventories and similar noncash items.

We urgently recommend that this committee give serious consideration to establishing a fair method of protecting companies against inventory losses and to offset existing inflationary price levels by providing for tax-free inventory reserves.

The matter of adequate inventory reserves is of such importance that it may be desirable to appoint a special committee of businessmen, accounting experts, and other authorities to cooperate with your committee and other governmental bodies in an effort to find the adequate and fair solution.

We shall be pleased to cooperate with you in establishing such a committee if you so desire.

DECLARED VALUE TAXES

We reiterate our opposition to the unsound capital-stock tax and declared value excess-profits tax.

These taxes are nothing more than a gambling device set up between the taxpayer and the Government.

They should be stricken from the law.

CHANGES IN RATES ON INVESTED CAPITAL

We oppose the provision in the pending tax bill which would establish a new schedule of rates allowed as a return on invested capital.

These new rates are discriminatory against the great number of small stockholders in large enterprises.

We vigorously protest this discrimination because of size of company.

Certainly stockholders should not be subjected to one kind of treatment as contrasted to another just because they have become investors in so-called large companies, which have created large employment.

We recommend this committee study a provision to allow companies to include in their base credit the same percentage of earnings reinvested by those companies that is allowed for capital additions.

Retaining earnings is equivalent to putting new capital into the business. This fact is recognized in the formula for the credit based on invested capital.

Since the earnings base credit is now reduced by capital distributions and is increased by other kinds of additions to capital, it is only logical to include retained earnings as an addition to capital such as to increase the earnings base credit.

MERGER OF COMPANIES

We recommend this committee give full and careful consideration to the provisions of the pending tax bill relating to mergers so that fair and complete credit bases will be established in the case of merged companies which would equitably reflect base period earnings and the true amount of invested capital.

Similar consideration should be given to the fair application of the capital-stock tax and declared value excess-profits tax for such merged companies, if such taxes are retained in the law.

CAPITAL GAINS

We recommend that proposals to eliminate the distinction between short- and long-term transactions and to tax all capital gains at 10 percent be seriously considered.

RENEGOTIATION OF WAR CONTRACTS

The sound method of recapturing war profits, in our opinion, is through a properly framed excess-profits tax law. With the enactment of this bill the arbitrary and difficult renegotiation law is unnecessary and should be immediately repealed.

It is detrimental to all-out war production, as well as completely unfair to subject corporations, to arbitrary renegotiation of profits from war contracts and at the same time have these same profits subject to unknown amounts of heavy normal and excess-profits taxes.

Pending the repeal of the unsound renegotiation law, it is essential that—

1. Renegotiation be on the basis of earnings after income and excess-profits taxes;
2. Renegotiation apply to over-all contracts and not to a single contract.
3. Renegotiation of contracts be concluded within a year after the close of the fiscal year, such renegotiation to be final.
4. Right of appeal to a designated body be granted.

None of these foregoing suggestions imply that the right to voluntary renegotiation, which was conducted on a substantial scale prior to the existing statute, should be curtailed in any way.

Until the renegotiation provision is abolished, companies deserve the protection of an amendment to the existing statute of limitations to allow for a redetermination of taxes for those years subject to renegotiation which otherwise might be closed.

This extension of the closing years should be contained in the pending bill.

INDIVIDUAL INCOME TAXES

No one has any doubt as to the willingness of the American people to sacrifice.

We believe, however, that the proposed new schedule of tax rates on individual incomes represents neither the easiest nor the fairest way of siphoning personal earnings into the Federal Treasury. In particular, we believe that the proposed new burdens are made unnecessarily difficult for the great mass of American people who are in the income brackets below $5,000 a year, when taken in conjunction with the remainder of our program.

We do realize, however, that higher rates on individual net incomes are necessary to meet the costs of war.

We submit to you a schedule of surtax rates graduating from 8 percent to 79 percent, parts of which may pass the point of diminishing returns.

CREDIT FOR INDIVIDUAL DEBTS

It is essential for the successful prosecution of the war and maintaining of morale that individuals as well as corporations be kept solvent.

We recommend individuals be granted a credit up to 10 percent of their taxable net income to be used either for the retirement of debts, such as the payment on mortgages and bank indebtedness or for life insurance premiums assumed prior to January 1, 1942, or for the purchase of Government bonds.

These bonds should be nonnegotiable and non-interest-bearing until the cessation of hostilities and thereafter to become negotiable, bear interest at 2 percent, and be repayable one-twentieth each year in the following 20 years.

FIVE PERCENT WITHHOLDING DEDUCTION

In these days of limited manpower and emphasis upon war production, the provision in the bill calling for a 5 percent withholding tax upon dividends, interest, wages, and salaries is a completely unnecessary hardship and expense to all companies.

WAR CONSUMPTION TAXES

After the greatest possible corporation and individual income taxes and so-called excise taxes, there will still remain additional billions to be raised.

To get these additional revenues, we recommended there be enacted now, to become effective January 1, 1943, an 8-percent war tax, on general consumption at the point of final sale. This, we estimate, will return $4,800,000,000.

The Treasury Department has gone on record as opposing sales taxes. We cannot see the consistency of this position when in the same statement it demands the imposition of excise-sales taxes in the sum of $4,500,000,000. These, in reality, are nothing more than selective sales taxes.

We think it is perfectly apparent that a broad consumption tax must be imposed to assist in raising these additional funds. Lack of political courage should not keep this tax from the present tax bill.

Seventy-five percent of the national income is in the hands of the so-called low-income group, having incomes of $5,000 and under. The increase in earnings of this group for 1942 is estimated at more than $15,000,000,000 and will be much greater next year.

That income can help pay the war costs with less hardship and more equality through a war-consumption tax than through any other means.

The sales tax affects an individual only when he has the money to spend.

He doesn't have to pay it until he actually spends the money, while his income-tax liability falls due well after the close of the year, when many people may have no money to pay their taxes.

The people in 22 States and 2 of the largest cities comprising over half the population of the United States have adopted retail-consumption taxes. They pay these taxes as a matter of course.

The CHAIRMAN. Could you give us the benefit of your recommendations without elaborating them, because we have gone over them with many witnesses?

Mr. COWDIN. All right, sir.

The CHAIRMAN. You have already consumed 25 minutes.

Mr. COWDIN. I think maybe if I had gone through right along I would have gotten through quicker. I will try not to elaborate further. I am sorry.

The CHAIRMAN. You will be privileged to file the remainder of your brief in the record after another 2 minutes, because we must give some opportunity for the others to be heard.

Mr. COWDIN. In our recent travels from one end of the United States to the other we found an overwhelming sentiment in favor of immediate enactment of a Federal consumption tax to help pay the cost of the war. This is substantiated by recent national polls of public opinion.

A consumption tax is additionally important in that it will tend to absorb a part of excess war income, not subject to other taxes, and will have a restraining effect on inflation.

It is the duty of Congress to control inflation effectively and immediately. The American people are deathly afraid of inflation. Farmers, workers, every man and woman is now seeing a rise in the cost of their living. Wages are being increased daily from one end of the country to the other. The general public gets no news about most of these increases. About all the ingredients of a runaway inflation are with us now and we can no longer afford to hide our heads in the sand. We must take drastic action.

We urge your committee to give immediate study to all the steps necessary to prevent inflation. A sales tax will be one step in that direction, and we urge consideration of compulsory saving as an additional step.

Throughout the country, there is grave fear that vital elements of the program we submit to you today will be postponed until after the coming elections.

If, for example, the sales tax is not enacted at this time and later adopted, such legislation must not be accompanied by proposals for additional corporation taxes added only for political window-dressing. Any additional corporate tax increases will bring catastrophe to business.

The business men of this country fully realize the desperate situation in which this war places all of us.

They see, perhaps, even clearer than the average citizen, that the war must be won, whatever the cost in money and inconvenience to themselves as individuals, and to the businesses they manage. No business and no man can gain from a lost war.

We know the cost will be staggering and that business must make major sacrifices. No one for whom we speak, if he were here today, would consider he were doing any less than his duty by paying taxes to the limit.

We have, therefore, attempted to interpret for you, today, the needs of business as business sees them in a time of national peril.

Upon the factory—large and small—we must depend for all the weapons we will need to win this war—the guns, the tanks, the ships, the planes. Without them we cannot win it.

Upon the factories we must also depend for the large share of the tax money which the Government must raise—not only this year, but next year and all the years this war lasts.

When peace comes, the factory must be the chief supplier of jobs.

These things being true, nothing is more constructive and essential at this time than to insure that American business be kept alive.

Throughout our travels, from one end of the country to the other, we found that businessmen have the greatest confidence in the integrity and wisdom of your committee. The sound financial statesmanship of our chairman is universally recognized. It is this confidence which gives American business the assurance that a bill eminently fair to industry, the country as a whole, and adequate to the times will result from your committee's work.

We sincerely trust that you will find our studies and recommendations to be of some value to you.

Gentlemen, it has been a great personal privilege and honor to be permitted to address you. Thank you.

(The chart and tabulations submitted by Mr. Cowdin are as follows:)

EXHIBIT A

Estimated Federal revenue from program of war financing recommended by National Association of Manufacturers

[In billions of dollars]

Covered by National Association of Manufacturers' recommendations	Calendar year 1942 [1]	Calendar year 1943 [2]
Corporation income taxes	11.9	13.5
Individual income taxes	8.0	9.0
War consumption taxes	4.8	5.2
Excises, employment, customs, miscellaneous and other taxes not covered by National Association of Manufacturers' recommendations	6.5	7.5
Total taxes	31.2	35.2
Savings on nonessential expenditures	2.0	2.0
Total Federal revenues	33.2	37.2
Aggregate State and local	10.0	10.0
Total revenues	43.2	47.2

[1] Estimated national income, $110,000,000,000.
[2] Estimated national income, $130,000,000,000 to $140,000,000,000.

National Association of Manufacturers recommendations for higher surtaxes

Surtax, net income (000 omitted)	Bracket rate: Present law	Bracket rate: N. A. M. proposal	Surtax, net income (000 omitted)	Bracket rate: Present law	Bracket rate: N. A. M. proposal
	Percent	*Percent*		*Percent*	*Percent*
$0 to $0.5	6	8	$38 to $44	53	59
$0.5 to $1	6	8	$44 to $50	55	61
$1 to $1.5	6	9	$50 to $60 [1]	57	63
$1.5 to $2	6	9	$60 to $70	59	64
$2 to $3	9	13	$70 to $80	61	66
$3 to $4	9	14	$80 to $90	63	68
$4 to $6	13	19	$90 to $100	64	68
$6 to $8	17	23	$100 to $150	65	69
$8 to $10	21	27	$150 to $200	66	70
$10 to $12	25	31	$200 to $250	67	70
$12 to $14	29	35	$250 to $300	69	72
$14 to $16	32	38	$300 to $400	71	74
$16 to $18	35	41	$400 to $500	72	74
$18 to $20	38	44	$500 to $750	73	75
$20 to $22	41	47	$750 to $1,000	74	76
$22 to $26	44	50	$1,000 to $2,000	75	77
$26 to $32	47	53	$2,000 to $5,000	76	78
$32 to $38	50	56	$5,000 and over	77	79

[1] There is substantial evidence indicating that even at present rates the law of diminishing returns operates to decrease Government revenues.

UNDER N.A.M. PROGRAM CORPORATIONS RETAIN LESS THAN 3%

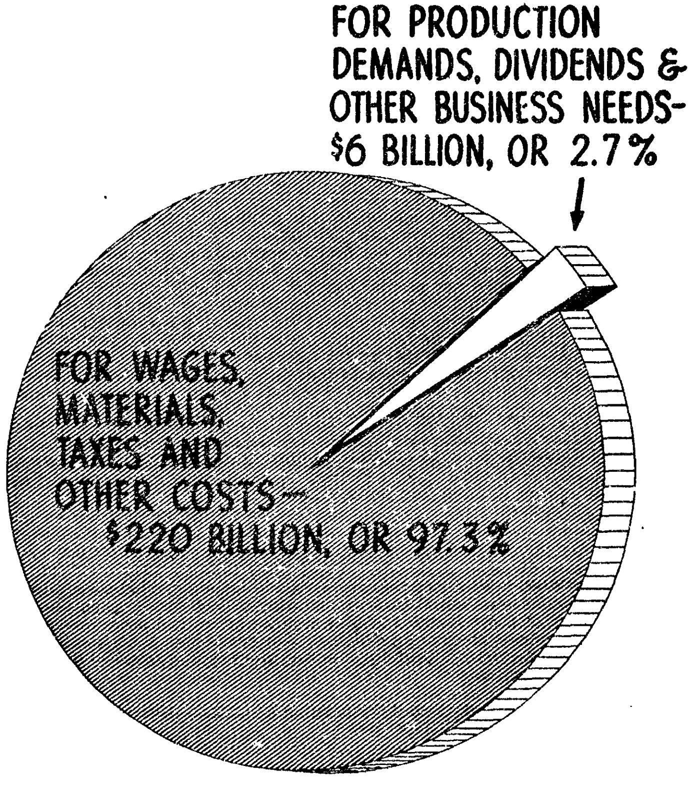


Exhibit B

The Record of Manufacturing Profits, Prepared by Statistical Department, National Association of Manufacturers, May 1942

MANUFACTURING PROFITS PRIOR TO DEFENSE, 1921–39

The highlights of part I of this study are:

I. The record of the net profits of manufacturing for 19 years prior to the defense period was one of wide variation between prosperity and depression with a much lower level of profit in the 1930's. From 1921 through 1930, the average annual profit as a percentage of gross income was 4.4 percent. For the period 1931–40 the average annual profit was only 1.5 percent.

II. The recovery in net profits from the 1931–33 period was not as extensive as the recovery from the 1921 depression. Gross income of all manufacturing corporations in 1923 was $17,584,000,000 greater than in 1921, a rise of 45.7 percent. Net profits of all manufacturing corporations in 1923 were $3,609,000,000 higher than in 1921. Yet between 1934 and 1937 net profits rose only $1,767,000,000, although there was a rise of $21,182,000,000 in gross receipts.

III. The proportion of manufacturing corporations reporting net income at the end of the 1934–37 business recovery was less than in earlier recovery periods. In 1923 approximately 63.1 percent of manufacturing corporations reported net income. In 1937 only 45.6 percent reported net income. Thus more than half of all manufacturing corporations failed to attain profitable operations in a relatively favorable year.

IV. The proportion of gross receipts of manufacturing absorbed by direct production costs, chiefly wages and raw material costs, varied little from 1921 through 1939, ranging from 73.1 percent of gross receipts in 1925 to 67.9 percent in 1933. Direct costs, prior to defense, did not contribute to the sharp decline in profits during the depression of 1931–33.

V. Indirect costs such as administrative expenses, rents, and interest responded slowly to the depression of 1931–33 and to the subsequent recovery. Indirect manufacturing costs did not decline appreciably until 1931 and did not reach their lowest point until 1934. They, therefore, accentuated the effects of the depression upon net profits. On the other hand, the rise in indirect costs from 1934 through 1939 was very gradual and the rigidity of these costs augmented the incidence on net profits of the rise in gross receipts after the depression. Indirect costs did not contribute to the reduced percentage of gross carried through to net income throughout the 1930's.

VI. In general, reserves for depreciation, taxes, and contingencies have been lower than they should have been over a period of years Actual payments for these purposes have exceeded provisions in reserves for them.

VII. The growth of taxes is clearly responsible for failure of net profits to respond after the depression of 1931–33 to an increase in gross receipts as they had in the 1920's. Net profits before taxes were 8.4 percent of gross receipts in 1936 as contrasted with 7.9 percent in 1929. Yet, after taxes, these figures were 5.5 percent and 6.3 percent respectively.

VIII. Aggregate dividend payments, encouraged by the Federal tax on undistributed profits, exceeded net income in the 1930's. From 1923 through 1929 aggregate net profit of manufacturing corporations was $7,392,000,000 greater than aggregate dividend payments.[1] From 1930 through 1940 dividends paid were $8,381,000,000 in excess of net earnings of all manufacturing corporations.

IX. The flow of new capital to manufacturing was checked during the 1930's, by the prospect of poorer earnings, lower security prices and heavy taxes on the income of individuals among other things. The result was a decline in capital invested in manufacturing. Scarcity of new venture capital retarded the development of new enterprises.

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[1] Aggregate net profit is the sum of profits for all profitable manufacturing corporations minus the losses of unprofitable corporations.

MANUFACTURING PROFITS DURING WARTIME

The relationships of receipts and costs in manufacturing industries since September of 1939 have been quite different from those observed earlier. The salient points from analysis of statistics covering the period from 1939 through 1941 are summarized below:

I. The demands made on manufacturing industries as a whole have been greatly increased by the war. The volume of production of war supplies has expanded steadily since June 1940 and at an accelerating rate.

II. Through 1940 production costs per unit of output declined with the gains in volume, resulting in larger net profits. This also meant that a large proportion of manufacturing corporations were profitable.

III. By 1941, raw material and labor costs were rising so much more rapidly than gross receipts that direct manufacturing costs were and are encroaching on profit margins.

IV. It appears probable that net profits of manufacturing reached their wartime peak during 1941 and are likely to recede in the future. Further expansion of output must be accomplished by adding less efficient manufacturing units which will involve higher costs.

V. The tax burden on corporations has risen steeply in the past 2 years, until in 1941 taxes absorbed more than half of earnings available for taxes (54 percent in 100 sample returns) From the same companies in 1940 taxes took about one-third (34 percent) of taxable net income. Taxes absorbed most of the gain in earnings before taxes. Even though net income before taxes for 100 large manufacturing corporations increased 55 percent from 1940 to 1941, the gain after allowing for Federal taxes was only 9 percent.

VI. According to Budget estimates and Treasury tax proposals over $9,000,000,000 is expected to be collected in taxes from corporations for the fiscal year 1943. The taxes collected from corporations in the 1941 fiscal year were about $2,000,000,000. Yet, the need for paying existing wages and taxes in cash has reduced the cash position of the manufacturing industries so that many corporations have been forced to borrow from the banks.

VIII. Financing the large volume of war business has necessitated a greatly increased investment in inventories and receivables. For 100 large manufacturing corporations the rise in inventories and receivables required use of funds of $514,000,000 in excess of net income. As a result, cash was decreased and borrowing expanded. Demands for further wage rises and for higher taxes ignore the weakening cash position of manufacturing corporations.

VIII. A blanket limitation on profits would be inequitable and impractical because of differences among industries. Further, profit limitations would deprive the Treasury of important sources of revenue. Not only would corporation yields be reduced, but taxes from individuals dependent for income on dividends would likewise be affected.

IX. Present reserves are inadequate to provide for the present abnormal depreciation of equipment Capital assets in the form of machinery and equipment are being used up with great rapidity. This, plus other drains on cash, may mean that after the war, manufacturing will be in a weakened financial position. This may make it difficult to finance a readjustment to peacetime operations.

PART I. THE PROFIT RECORD, 1921 THROUGH 1939

A sound appraisal of manufacturing profits during the past 2 years is impossible without some understanding of the long-term trend of profits to give a proper perspective. There are wide differences in the record among industries and companies, but in general terms the course of profits from 1921 through 1940 for all manufacturing companies (after taxes and with adjustments made for intercorporate dividends) is shown in table I. There are peaks and valleys for both gross and net income, but the outstanding characteristic of the table is the low level of net profit as a percent of gross income in the 1930's.

TABLE 1.—*Profits of all manufacturing corporations*

[In millions of dollars]

Year	Gross income	Net profits [1]	Net profit as percent of income	Year	Gross income	Net profits [1]	Net profit as percent of income
1921	38,480	[2] −435	−1.1	1931	43,716	[2] −913	−2.1
1922	44,566	2,330	5.2	1932	31,845	[2] −1,827	−5.7
1923	56,064	3,174	5.7	1933	35,070	77	....
1924	53,763	2,418	4.5	1934	40,768	778	1.9
1925	60,605	3,245	5.4	1935	47,334	1,508	3.2
1926	62,156	3,212	5.2	1936	56,431	2,570	4.6
1927	63,439	2,673	4.2	1937	61,950	2,545	4.1
1928	66,893	3,460	5.2	1938	50,864	931	1.8
1929	71,640	3,954	5.5	1939	[3] 55,000	[3] 1,900	3.5
1930	60,428	877	1.5	1940	[3] 62,000	[3] 2,500	4.0

Average, 1921–30=4.4 percent.
Average, 1931–40=1.5 percent.

[1] After taxes and adjustment for intercorporate dividends.
[2] Net loss.
[3] Estimated.

Source: U. S. Bureau of Internal Revenue.

Through the period from 1921 through 1930 the average annual profit on gross income was 4.4 percent. For the period for 1931 to 1940, the average annual return was only 1.5 percent. The 1920's are generally regarded as a decade peculiarly favorable to manufacturing profits, yet in the peak year, 1929, that profit return on gross income reached a maximum of 5.5 percent which was below the 5.7 percent earned in 1923 on a much smaller volume of business. In the depression years 1931 and 1932 losses of manufacturing corporations exceeded profits. The net deficit for 1932 amounted to $1,827,000,000. Even in the relatively good years 1936 and 1937 aggregate net profits amounted to 4.6 percent and 4.1 percent, respectively. There is no evidence here of a rising trend of profits—in fact quite the reverse. Nor is there any evidence that at any time manufacturing as a whole reaped an exorbitant return.[1]

TABLE 2.—*Number of manufacturing corporations reporting net income and no net income*

Year	Number reporting net income	Percent	Number reporting no net income	Percent	Total number [1]
1923	53,795	63.1	31,404	36.9	85,199
1924	51,342	59.1	35,461	40.9	86,803
1925	54,137	61.1	34,537	38.9	88,674
1926	55,094	59.1	38,150	40.9	93,244
1927	53,620	59.7	36,196	40.3	89,816
1928	55,007	60.1	36,566	39.9	91,573
1929	55,488	60.2	36,742	39.8	92,230
1930	40,641	44.4	50,863	55.6	91,504
1931	30,270	34.0	58,815	66.0	89,085
1932	14,985	17.0	72,931	83.0	87,916
1933	26,354	29.7	62,295	70.3	88,649
1934	34,023	37.3	57,269	62.7	91,292
1935	37,976	41.4	53,700	58.6	91,676
1936	45,926	49.9	46,104	50.1	92,030
1937	41,974	45.6	50,005	54.4	91,979
1938	34,034	38.6	54,033	61.4	88,067
1939	43,002	49.9	43,181	50.1	86,183

[1] Excludes inactive corporations.

Source: U. S. Bureau of Internal Revenue, "Statistics of Income."

[1] Profits are frequently measured as a percentage earned on capital investment in manufacturing. This is frequently a misleading measurement because of the wide variation in the investment required in different industries. Also accounting practices are so lacking in consistency in the valuation of assets that invested capital cannot be relied upon to give the true picture. Therefore in this study profits are related throughout to gross income.

Ours is a loss as well as a profit system in which a considerable proportion of manufacturing companies suffer a loss, even in boom years. This fact is clearly brought out in table 2 which gives the number of manufacturers reporting net income and the number of those reporting no net income for tax purposes. The figures also show that since 1930 an increasing proportion of manufacturing corporations have fallen in the no net income category. A few examples will illustrate this situation.

In 1923, 63.1 percent of manufacturing corporations reported net income, while 36.9 percent reported no net income. The percentage of companies reporting net income declined to 60.2 percent even in the prosperous year 1929. In other words, 39.8 percent reported no net income at the peak of the 1929 boom. In the depression years of the early 1930's there was an increase in the proportion of companies reporting no net income. For example, in 1932, 83 percent of all active manufacturing corporations reported no net income, while only 17 percent reported net income. In 1936, a fairly good year, about one-half (49.9 percent) of the companies reported net income, while 50.1 percent reported no net income. By 1939, the latest year for which these figures are available, the proportion was the same as in 1936—49.9 percent reporting net income and 50.1 percent reporting no net income.

When dealing with aggregate net profits for all manufacturing corporations the proportion reporting losses is important to the discussion. Aggregate net profits as shown in table I are the sum of net profits for all profitable manufacturing corporations minus the net losses of all unprofitable manufacturing corporations. If a temporary improvement in the profit relationships results in transfer of a substantial number of manufacturing corporations from the no net income to the net income category the result on aggregate net profits for all manufacturing corporations is exaggerated. (That is, an improvement that might add 10 percent to the net profits of companies which were already profitable, could mean a much larger gain in the aggregate figure if losses were likewise reduced.) This overstatement inherent in using aggregate profits was strikingly present during 1940–41.

In the 1930's there were a few years of fairly active business but the profit margin was much narrower than in the 1920's. In 1937, for example, with gross receipts of $61,950,000,000 the net profit of all manufacturing corporations was $2,545,000,000, as contrasted with $3,174,000,000 in 1923 when gross receipts were only $56,064,000,000.

The recovery of profits from the 1931–33 depression was not nearly so extensive as from the 1921 depression as shown in the increase in profits in the two periods. For instance, gross income of manufacturing corporations in 1923 was $17,584,000,000 greater than in 1921 and there was for the same period a gain in aggregate net profits of $3,609,000,000. (This reflected in part the transfer of companies from the no net income to the net income category and is not simply the rise in net income of companies previously profitable.) Between 1934 and 1937 a rise in gross receipts of $21,182,000,000 was accompanied by a rise in net profits of all manufacturing corporations of $1,767,000,000. In 1923, with gross receipts of $56,064,000,000, about 63.1 percent of manufacturing companies made money, but in 1937 only 45.6 percent of all manufacturing corporations reported a net profit.

Exhibit C

Summary Analysis of Confidential Tax Questionnaire, National Association of Manufacturers, August 1942

To date there have been 3,978 responses from corporations. These range from extremely small to very large enterprises and are from all sections of the United States. Not all replies gave complete information, but those which did made up approximately 20 percent of total taxable net income in 1941. The proportion of large companies answering the questionnaire to the United States total of such concerns is greater than the proportion of the very small companies to the United States total. This introduces a slight bias for which allowance has been made in applying conclusions drawn from averages of the sample to all corporations in the country. Moreover the data were classified by company size to obviate this difficulty in actual computations. While this qualification is necessary, the sample is otherwise representative. The survey has placed in the hands of the Association a valuable fund of information about sales, tax liabilities, and financial requirements of the country's industries under wartime conditions.

THE TREND OF SALES, 1940, 1941, AND 1942

The economy of the United States has experienced a substantial expansion since the start of 1940. In 1942, however, with industry fully mobilized for war production, important changes are apparent because of necessary restrictions on industries making peacetime goods. The National Association of Manufacturers survey throws light upon the extent and character of these changes.

A group of 2,895 corporations provided complete data on the dollar volume of their sales in 1940, 1941, together with estimates for 1942. These companies reported aggregate sales of $22,541,054,000 for 1941, as compared with $16,122,297,000 in 1940. The same corporations estimated that the dollar volume of their business in 1942 would be $26,588,556,000. In short, these companies experienced a rise of $6,418,757,000 or 39.8 percent in sales for 1941 above 1940 sales. With the Government spending huge sums for war purposes a further very substantial rise of $4,047,502,000 or 18 percent is anticipated in sales for 1942 above 1941. These are dollar figures and they could be distorted if an inflationary price rise should develop during the course of this year. They give a clear indication that the rate of increase in the expansion of business volume is beginning to slacken, although the absolute amount of gain will still be tremendous. When broken down and analyzed the sales data reveal some other interesting developments.

THE CHANGING CHARACTER OF 1942 BUSINESS

The anticipated gain in sales for 1942 will not be shared by as many companies as participated in the 1941 rise. Shortages of material and labor, restrictions on the output of consumer durable goods and other dislocations of a war economy are playing an increasing part to limit the operations of companies not manufacturing for war. The National Association of Manufacturers' survey gives a quantitative measure of this change.

During 1941, a total of 2,763, or 95.4 percent, of the 2,895 corporations reported a gain in sales over the preceding year. However, in 1942, only 1,878, or 64.9 percent of these companies, expected to show sales improvement. A shrinkage in sales this year was forecast by 844 companies. The balance, 173 companies, expected no significant change in sales for 1942 as compared with 1941.

THE RELATIONSHIP OF COMPANY SIZE TO SALES OUTLOOK

The fact that during a year of expanding business, nearly 30 percent of industry expects a decline in sales is of itself important because it implies, among other things, a redistribution of employment and earning power on a major scale. It becomes more significant when there is added the evidence that small businesses are the principal sufferers from these changes. For example, it may be noted that the aggregate sales of companies with a business volume of less than $1,000,000 is expected to be smaller for 1942 than in 1941. On the other hand, the aggregate sales of larger companies will show an increase.

The smaller concerns have a greater percentage of casualties from the dislocations of a war economy than do the larger concerns. It is equally evident that the situation is directly related to the greater adaptability of the larger companies to war work. If the smaller companies which are suffering a decrease in business volume are to survive in strong financial position to resume their places when the war is ended, they must be protected from unfair and confiscatory taxation in order that they may retain as much as possible of their reduced earning power.

THE RECORD OF WARTIME PROFITS

It has very frequently been charged that industry is reaping "unconscionable profits" from the war effort. Publicity has been given to exceptional cases of profiteering which has perhaps created in the minds of the public an entirely false idea. Certainly the average corporation has not been showing an increase in its profit margin because of war business. This is demonstrated by data from 2,225 companies. These are all corporations which were profitable in 1940, 1941, and expected to show a profit in 1942. If allowance were made for the losses of unprofitable corporations the showing would be much less favorable.

Net incomes as a percent of sales for 2,225 profitable companies in 1940, 1941, 1942

Size class 1942, sales	Number of companies	1940	1941	1942[1]
Under $200,000	50	7.1	6.3	4.1
$200,000 to $499,999	202	5.8	6.3	3.4
$500,000 to $999,999	314	5.7	6.3	3.5
$1,000,000 to $1,999,999	443	7.4	7.2	3.5
$2,000,000 to $4,999,999	491	6.1	6.6	3.4
$5,000,000 to $19,999,999	507	7.7	7.1	3.7
$20,000,000 and over	218	8.1	6.8	3.5
Average	2,225	7.8	6.8	3.5

[1] Under Ways and Means bill.

Obviously earnings after taxes do not indicate any widening of the profit margin but only that business is retaining for dividends and other corporate purposes a smaller and smaller proportion of sales. The reason for this is found primarily in tax payments.

FINANCIAL REQUIREMENTS OF INDUSTRY

Corporations engaged in war production and thus sharing in the expansion of business volume are experiencing increasing difficulty in maintaining adequate liquid reserves. The larger amount of business has meant the creation of large inventories. It has also necessitated an increase in accounts and notes receivable, tying up working capital that might otherwise be in more liquid form, either in cash or in marketable securities. Thus the problem of translating profits into cash resources has become more difficult. On the other hand, wages and taxes can be paid in cash only and both these items are rising. These factors are bringing about a drain on cash resources and an expansion in borrowing since earnings are not providing the necessary cash.

The burden of debt upon industry, even now by no means light, is likely to be enhanced. For example, it was found that out of the 2,895 corporations reporting sales information to the National Association of Manufacturers survey, a total of 2,866 had debt obligations to a total of $6,527,131,000.

Taxable net income, Federal taxes and net income after taxes for 2,225 corporations, 1940, 1941, 1942

[$000 omitted]

	Taxable net income	Total Federal taxes	Net income after taxes	Total taxes as a percent of taxable net income
1940				
Under $200,000	502	79	423	15.7
$200,000 to $499,999	4,064	794	3,270	19.5
$500,000 to $999,999	13,482	3,945	9,537	29.3
$1,000,000 to $1,999,999	41,066	10,347	30,719	25.2
$2,000,000 to $4,999,999	90,939	25,359	65,580	27.9
$5,000,000 to $19,999,999	329,939	94,082	235,857	28.5
$20,000,000 and over	1,157,208	372,218	784,990	32.2
Total	1,637,200	506,824	1,130,376	31.0
1941				
Under $200,000	603	144	459	23.9
$200,000 to $499,999	7,443	2,709	4,734	36.4
$500,000 to $999,999	24,448	10,199	14,249	41.7
$1,000,000 to $1,999,999	71,009	29,303	41,706	41.3
$2,000,000 to $4,999,999	164,431	75,446	88,985	45.9
$5,000,000 to $19,999,999	570,979	275,181	295,798	48.2
$20,000,000 and over	2,040,240	1,105,791	934,449	54.2
Total	2,879,153	1,498,773	1,380,380	52.1

Taxable net income, Federal taxes and net income after taxes for 2,225 corporations, 1940, 1941, 1942—Continued

[000 omitted]

	Taxable net income	Total Federal taxes	Net income after taxes	Total taxes as a percent of taxable net income
1942—Existing tax law				
Under $200,000	568	139	429	24.5
$200,000 to $499,999	6,661	2,472	4,189	37.1
$500,000 to $999,999	24,830	10,279	14,551	41.4
$1,000,000 to $1,999,999	68,275	31,099	37,176	45.5
$2,000,000 to $4,999,999	185,256	93,390	91,866	50.4
$5,000,000 to $19,999,999	680,009	357,575	322,434	52.6
$20,000,000 and over	2,534,824	1,418,213	1,116,611	55.9
Total	3,500,423	1,913,167	1,587,256	54.7
1942—National Association of Manufacturers tax proposal				
Under $200,000	568	239	329	42.1
$200,000 to $499,999	6,661	3,390	3,271	50.9
$500,000 to $999,999	24,830	13,766	11,064	55.4
$1,000,000 to $1,999,999	68,275	39,808	28,467	58.3
$2,000,000 to $4,999,999	185,256	115,018	70,238	62.1
$5,000,000 to $19,999,999	680,009	460,815	219,194	67.8
$20,000,000 and over	2,534,824	1,687,874	846,950	66.6
Total	3,500,423	2,320,910	1,179,513	66.3
1942—Ways and Means plan				
Under $200,000	568	290	278	51.1
$200,000 to $499,999	6,661	4,197	2,464	63.0
$500,000 to $999,999	24,830	16,435	8,395	66.2
$1,000,000 to $1,999,999	68,275	45,450	22,825	66.6
$2,000,000 to $4,999,999	185,256	131,924	53,332	71.2
$5,000,000 to $19,999,999	680,009	491,592	188,417	72.3
$20,000,000 and over	2,534,824	1,909,129	625,695	75.3
Total	3,500,423	2,599,017	901,406	74.2

Although manufacturing, for example, is in no way comparable to public utilities or to railroads in the matter of debt, it is obvious from this sample that obligations of industry are heavy and quite general. Moreover, of these 2,895 companies, 2,549 had debt repayable in 1 year to the aggregate amount of $1,998,498,000. In other words, 30.6 percent represents debt payable in 1 year.

The 2,225 profitable corporations which provided full information on sales and taxes, also estimated that in 1942 they would require $1,004,947,000 additional funds to finance the increase expected in inventories and receivables. These same companies had debt payable in 1942 to the amount of $1,728,962,000. To meet these requirements these companies expected that they would have net income after the taxes set up in the new bill of only about $1,000,000,000.

The net earnings of these companies are obviously much less than the amount required to finance larger receivables and inventories, and to meet taxes and repay debt, to say nothing of providing a modest amount for dividends. It should be pointed out that a substantial amount of debt payable in 1 year would probably be renewed in other than extremely unfavorable circumstances. In spite of this qualification it is clear that to meet the discrepancy, funds must be provide by drawing on existing cash resources or by borrowing more extensively.

The companies included in this tabulation provided about 20 percent of total taxable corporation income during 1940 and 1941 and may be expected to contribute a somewhat larger proportion in 1942. Therefore, there is reason to conclude that this problem is a very serious and very general one.

War creates an artificial activity for industry and brings about distortions of normal peacetime relationships. When the artificial stimulus is withdrawn, these distortions must be corrected. In the post-war adjustment period when industry returns to peacetime production, it is absolutely essential that it should be in a sound financial position. No one can question that the problems of a post-war economy will be severe; if they are placed before a debt-worn, depleted industry, they will be overpowering.

THE EFFECT OF TAXES ON 1942 DIVIDENDS

Because taxes have been increased to a point where they will bring a reduction in corporation net income after taxes for 1942 as compared with 1941 and where industry is having difficulty in maintaining its liquid resources, it is only natural that dividends for 1942 and 1943 should decline. The National Association of Manufacturers survey confirms this conclusion. Many companies apparently hesitated to commit themselves on future dividend policies, but 1,045 did hazard an estimate of what their dividend payments would be on the basis of 1942 earnings.

These companies giving dividend information did not all pay dividends in all 3 years. In 1940, a total of 748 of these companies paid dividends aggregating $325,724,000. In 1941 a year of general prosperity the number paying dividends was increased to 808 and the amount to $334,898,000. It was estimated that if the National Association of Manufacturers tax proposal were in effect the number of dividend payers in this group would drop to 776 and the aggregate amount to $295,698,000. Under the more drastic tax proposals in the pending bill the reduction of dividends would undoubtedly be much greater.

It should be pointed out that the data presented include an unknown amount of preferred dividends. The reduction in common dividends will unquestionably be more severe than indicated.

Reduction of dividend disbursements will, of course, cut individual incomes and reduce collections under individual income taxes.

STATEMENT OF A. B. CHAPMAN, NEW YORK, N. Y., ON BEHALF OF CONTROLLERS INSTITUTE OF AMERICA

The CHAIRMAN. Mr. Chapman.

Mr. CHAPMAN. My name is A. B. Chapman.

I am an attorney from New York City, and I am appearing on behalf of the Controllers Institute of America.

As some of the committee may know, the Controllers Institute is a national organization whose membership consists of the chief accounting officers of more than 1,800 of the active corporations throughout the United States.

Naturally, they are primarily interested in the provisions of the pending bill and of the present law that relate to corporations.

In the institute's prepared statement—which I ask leave to submit for the record—the institute takes a position with respect to the corporate rates, to the effect that the House rates of 90 percent excess-profits tax and 45 percent normal tax are dangerous to our efficient war production effort, and dangerous to the national economy, and expresses the view that the corporate structure will do well to bear an excess-profits tax of 80 percent and a normal tax of 40 percent.

The basis for the institute's views is set forth in the prepared statement, but primarily the statement is directed to the technical and administrative provisions of the bill and of the present law.

In the few minutes that I have I would like to devote my remarks to these technical and administrative provisions, for, after all, whether the Senate adheres to the corporate rates proposed by the House or whether the Senate committee concludes to take a more conservative view as to what the rate should be, we know that the rates are going to be so high that it becomes absolutely essential that every effort be made to perfect the technical and administrative provisions of the bill and of the law, so that normal profits will not be subjected to excess-profits tax, so that special hardship cases will unquestionably receive relief, and so the corporations will be left, at the end of the war period, in a position to face the difficult post-war transition period.

Now, with respect to the normal profits, we know that we have the two basic credits—the invested capital credit and the income credit.

Let's take the invested capital credit, to start with. In my opinion, the use of tax basis in lieu of cost in computing invested capital is one of the most serious and one of the most obvious technical defects that still remain in the law, particularly since this bill apparently is going to remedy supplement A, which probably took first prize up till now.

Now, the committee has heard frequently the plea for the use of cost in lieu of tax basis.

It is a difficult matter to demonstrate that the tax basis is the wrong basis, because it is a technical subject involving the reorganization and tax-free exchange provisions, but if, when I get through, the committee is not satisfied that it is the wrong basis for computing invested capital, I hope they will assume that I failed to prove my point, but I hope they don't assume that it is the right method to employ.

Now, in order to demonstrate what the tax basis will do, let me take a fairly simple case:

A $9,000,000 corporation acquires the assets of a $1,000,000 corporation, using current values. The consideration for the acquisition is voting stock. The assets of the transferor have a tax basis of $300,000, value of a million at the time of the transaction.

Although the transferor, or its stockholders, after the exchange, only have a one-tenth interest in the assets transferred, and although the corporation gave its stock worth a million dollars, nevertheless the invested capital of the transferee corporation is only increased by $300,000.

Now, to make it worse, let's assume that that transaction occurred prior to 1936, and instead of merely voting stock being given as a consideration, let's assume the consideration was stock and bonds.

Believe it or not, under section 760 of the new bill, it is possible, under those circumstances for the transferee corporation to come out with less invested capital than it had before it acquired the additional million dollars of assets; if the transaction occurred after 1936 instead of before, and both stock and bonds were given as the consideration, the transferee corporation could come out with an additional million dollars.

If after 1936 it gave partially common stock and partially preferred stock it would come out with a million dollars, but if it gave solely voting stock it would only have an additional $300,000.

In other words, you cannot find any rhyme or reason in the use of tax basis as a means for computing the amount of assets which are invested in the business and being used in the business.

It is a technical defect in the law that should be remedied, and tax basis should be continued, perhaps, if at all, to apply only in those cases where there is nothing more than the continuance of one corporation in a new corporate structure, as may happen, for example, where a corporation merely changes its domicile or merely reorganizes with the same stockholders controlling the transferee.

Now, on the income-credit side, we have some obvious flaws which cause hardship and should be removed.

There is no reason in the world why, after we have computed the average earnings, that we should be allowed only 95 percent of the result. That nick of 5 percent merely means that we are attempting to raise revenue by taxing normal profits to that extent.

Furthermore, the average earnings credit ought to be geared so that it will automatically take care of a very common situation, and that is, where one of the 4 years in the base period is so subnormal that to include it in the 4-year average distorts the real picture of normal earnings.

The institute has urged consistently the adoption of the 3-out-of-4-year rule that the committee has heard a good many times before. Recognition of the fact that something should be done is found in the automatic 75-percent provision that was tentatively adopted by the House committee. The institute believes that is a step in the right direction, but as long as we are trying to correct that situation, it ought to be done 100 percent instead of half way.

There is no reason in the world why the capital addition for income-credit corporations should not only be increased by additional property acquired for stock after the base period, but also by additional property acquired for bonds. In other words, 50 percent of borrowed capital should be recognized as a capital addition on the income credit side the same as it is on the invested capital side.

Now, so far as the income credit is concerned, there is one other technical point that I think I might have time to bring out, and that is that, where you have abnormal income under section 721 in the taxable year, which is attributable to the base period, there is no reason why that income should not be included in computing the average earnings for the base period. The Senate Finance Committee specifically said in its report, as you know in 1940, that this is what the committee intended, and yet the law has been construed under the regulations to the contrary. There is no reason why that intent should not be inserted specifically in the law.

So far as the general relief provisions are concerned—section 722—there is no doubt but that there has been a great improvement in this bill, but that doesn't mean that the general relief provisions are adequate yet. For example, they have a provision that where the change in the nature of the business occurs after December 31, 1939, it can be taken into consideration in granting relief if there are binding commitments before the beginning of 1940 to make those changes.

The binding commitment requirement is a technical requirement that, in the opinion of the institute, is absolutely unnecessary.

The word "binding" is very loosely construed in the report, the House committee report, but, nevertheless, it is an unnecessary limitation for this reason: If the change in character of business occurs any time after the beginning of 1940, there is no reason why that change should not be taken into consideration in computing average earnings during the base period because you only get a recomputation to the extent that you can show that that same change would have produced a different income during the base period.

For example, if a company goes into the business of manufacturing firearms now and makes large profits it wouldn't be able to show that if it had been carrying on that same business in the base period it would have made the same profits. It would be limited to a showing of what it would have made then.

The proof is in the pudding in that the section now provides for a constructive income for new corporations that don't come into existence until after January 1, 1940, and yet for those corporations, section 722 provides a constructive income during the same period. The same thing could be done for the corporations already in existence at the beginning of 1940.

As for the 5 percent penalty upon granting relief, I think there has been plenty of complaint about that already before the committee. It is too much. As a matter of fact, it can work so that granting of general relief will cost more than the relief is worth. It ought to be reduced to 5 percent or a fixed amount, whichever is lower, and it should apply only with respect to the first taxable year. Once you have gone through the machinery of granting general relief, there is no reason for imposing the penalty further.

Finally, there is the post-war problem, and we know that primarily the big problem there is to try to find some reasonable way of giving to corporations the opportunity to set up reserves to take them through the post-war transition period, and I am well aware of the careful consideration that the committee is giving to that problem.

I will merely add that two technical things ought to be done also: First, the committee ought to put in the inventory reserve proposal which was tentatively adopted by the House committee to put so-called first-in first-out taxpayers on the same basis as those on last-in first-out. So far as I can see, the proposal is perfectly sound. I think it was recommended by the Treasury, and perhaps the only reason it is not in the bill is because they didn't have time to perfect it from a drafting point of view, but it certainly should be included.

Second, the committee should also provide some relief for these corporations which are on the last-in first out basis, but by reason of priorities and inability to get materials, are being forced to deplete their normal inventories and they are showing these paper profits. The taxation of these profits should be postponed until it is determined how much it is going to cost the corporation to replace the normal inventory.

The institute's prepared statement includes a group of other propositions which I will merely refer to by reference without discussing them.

There is the plea for allowing a carry-back of the excess-profits yield as well as a carry forward.

There is a plea for the repeal or revision of section 734.

There is a plea for the continued allowance of corporate net capital losses against ordinary income as an ordinary deduction.

There is a plea for a discarding of the new fiscal-year provision which everyone seems to be opposed to, and there is a criticism of the provisions of the pending bill with respect to pension trusts. I understand that the subcommittee appointed by this committee is giving careful consideration to that problem and many of the defects are being taken care of.

The CHAIRMAN. Thank you very much.

(The recommendations referred to by Mr. Chapman are as follows:)

RECOMMENDATIONS OF CONTROLLERS INSTITUTE OF AMERICA, NEW YORK, N. Y., RELATIVE TO REVENUE BILL OF 1942 (H. R. 7378)

I. GENERAL PRINCIPLES

The Controllers Institute appreciates that the country's most crucial problem is the winning of the war and that all sacrifices necessary to reach that objective must be made. Also, that next in importance is the related problem of raising as much revenue as possible through taxation without greatly damaging or destroying the source thereof. No Congress in our history has ever been confronted with such a difficult task.

The recommendations contained herein are made in the belief that they will serve the best interests of the country in this serious emergency and will aid the Senate in its consideration of the revenue bill. With this thought in mind there are set forth below the general principles which the Institute believes must underly any sound wartime income- and excess profits tax law:

(1) Tax rates, on any class of taxpayers, should not be so high as to weaken the war effort or disrupt the economy of the country.

(2) The tax burden should be allocated in a realistic manner among the various classes of taxpayers so that each will bear its proper share thereof.

(3) Industry should be left with sufficient resources to carry on after the war in order to be in a position to convert its facilities to peacetime operation and to give employment to the millions of men and women who will be released from the armed forces and war industries.

(4) The income- and excess-profits taxes should be imposed only on true income and true excess profits, with offsets allowed for inevitable post-war losses.

(5) Inequities in the present act, resulting in many instances from purely technical defects should be removed especially since they become more severe with substantial increases in the tax rates.

(6) The tax liability should not be increased retroactively to past years.

II. RATES

The general policy of the Institute is to confine its comments on tax bills to the administrative and technical features. However, in view of the extraordinarily high corporate tax rates proposed in the House bill, it feels compelled to point out the dangers which it believes inherent in such rates, and to submit its recommendations with respect thereto.

The Institute recognizes that, however necessary borrowing may be, the Government must rely in the long run on taxation to pay for the cost of the war and that present taxes on all classes of taxpayers must be increased from present to maximum levels. Nevertheless, the Institute is of the opinion that the 45 percent combined normal and surtax rate and the 90 percent excess profits tax rate proposed by the House bill represent a drastically dangerous jump in the corporate rates that threatens to seriously impair the war effort, as well as our present and post-war economy.

The impact of the rates proposed in the House bill is illustrated in the following example:

A corporation which has an excess profits credit of $500,000 based on the income for the years 1936 to 1939, inclusive, paid an annual tax during the base period of about $90,000 which left available about $410,000 with which to provide increases in working capital, reduce indebtedness, and pay dividends. Let us see what the same corporation would retain after taxes under the House bill rates, even if its income is substantially increased over that it earned prior to 1940, as follows:

Net income for year	Normal tax, surtax, and excess-profits tax	Effective rate of these taxes	Net income remaining after taxes
		Percent	
$500,000	$225,000	45.00	$275,000
$600,000	310,500	51.75	289,500
$700,000	400,500	57.21	299,500
$800,000	490,500	61.31	309,500
$900,000	580,500	64.50	319,500
$1,000,000	670,500	67.05	329,500
$1,500,000	1,120,500	74.70	379,500

From the foregoing it will be noted that if the corporation has no excess profits and its income remains the same as during the pre-emergency period the tax proposed would be two and a half times the amount paid during the years before 1940, i. e., $225,000 as compared with $90,000. That even in the case where, due to production for war needs, "excess profits" of $1,000,000 have increased the earnings from $500,000 to $1,500,000, the net remaining after the taxes proposed of $1,120,500, would be only $379,500. As pointed out below, when the various cash requirements of the business have been met, especially in the case of the corporation whose operations have been expanded, it will be impossible in many instances for a corporation to pay dividends, even on its preferred stock. On the contrary, borrowing may become necessary in order to help meet the taxes and at the same time carry on the business.

In arriving at the conclusion that the corporate tax rates proposed in the House bill are dangerous, the institute has been influenced by a number of considerations, including the following:

(1) The corporate normal and surtax rate has already been increased since 1939 from 17 to 24 percent in 1940 and to 31 percent in 1941. The proposed 45 percent rate will represent a 50 percent increase over 1941 and a 150 percent increase over 1939. According to Treasury estimates, this rate when combined with the 90 percent excess-profits tax rate will result in Federal taxes of approximately $10,300,000,000 on 1942 corporate income estimated by the Treasury at approximately $16,000,000,000. Moreover, unless the recommendations for improvement in the technical features of the bill made hereinafter are adopted, the effective tax rate on the actual income of many corporations may closely approach 90 percent.

(2) The average corporation, and perhaps more especially the smaller one, will have extreme difficulty in finding the cash with which to pay the large taxes proposed. Even in normal times, profits are not necessarily represented by cash in the till. More so in times like these when maximum production for war needs is essential, a substantial portion of the profits must be used by the business to help pay for the necessary plant improvements and enlargements and for the additional inventories needed, and to supply additional working capital. In order to carry on, heavy borrowing will be necessary in many instances because of these needs and also because of the outlays for sinking funds and other similar obligations, liquidation of which does not result in any tax deduction under the present law or the House bill.

(3) Many corporations have not realized any substantial increase in profits since 1939. In fact, a large number have suffered reductions in profits, due to economic dislocations and Government regulations consequent upon the war effort. The normal tax and surtax will fall indiscriminately upon these corporations and upon those which have benefited from the war activity.

(4) The very high tax rates proposed will make it impossible for corporate business to provide in a reasonable and prudent way to meet the difficulties of post-war adjustments including those involved in changing over to manufacture of peacetime products. Industry should be left with sufficient resources after the war to give employment to the millions of men and women who will be released from the armed forces and war industries and to withstand the losses from curtailment of business that many corporations will doubtless sustain in the transition period.

(5) Drastic curtailment or stoppage of dividend payments will fall heavily on many stockholders whose personal tax rates have also been increased to maximum levels while living costs have risen. In this connection, it should be remembered that a large portion of annual dividend payments go to stockholders with incomes of less than $5,000 and who, in many instances, are entirely dependent on such dividend income for their support. Also, in addition to the huge taxes corporations will pay directly on their income the dividends paid by the corporation will be further subjected to taxes at very high rates in the hands of the stockholders.

(6) Corporate tax rates should not be placed at so high a level that extravagance and waste in the conduct of business will result from the lack of incentive to operate economically and efficiently. Chairman Donald M. Nelson, of the War Production Board, has recommended to the Ways and Means Committee that for this reason the excess-profits tax rate should not be over 80 percent.

The institute suggests as maximum corporate rates 40 percent for combined normal and surtax and 80 percent for excess-profits tax. It should not be overlooked that these maximum rates, even if imposed only temporarily, will leave many corporations with insufficient working capital and funds to meet their obligations. Should they be imposed for several years they would be ruinous to a substantial proportion of corporate enterprises. The maximum rates suggested above should not be imposed even temporarily unless the principal administrative and technical changes recommended herein are made so that the taxes will be imposed on true income and without discrimination.

If necessary from the standpoint of the Government's needs for funds to prosecute the war, the suggested reduction of the excess-profits tax rate can be accomplished through the allowance of a deduction for the purchase of a special series of Government bonds repayable after the war or a post-war credit to be allowed without any restrictions such as is being adopted in Canada.

III. ADMINISTRATIVE AND TECHNICAL AMENDMENTS

Much credit is due the Ways and Means Committee, the staff of the Joint Committee on Internal Revenue Taxation, and the Treasury Department officials for recommending and preparing certain administrative and technical amendments contained in the House bill which eliminate, in whole or in part, a number of the major inequities and defects of the present law and which, because of their nature, obviously required considerable study. Among these amendments are the simplification of the bad debt provision; elimination of the interim report requirements under the last in, first-out method in inventorying; extension of the normal-growth provision to supplement A; extension of the consolidated return privilege to normal income tax returns; and broadening of the relief provisions.

There still remain, however, a number of administrative and technical changes which should be adopted. In addition some of the administrative and technical amendments proposed in the House bill will create new, unwarranted hardships not now existing. For example, in one instance a new rule has been proposed which would increase the tax liability of a corporation retroactively to the original effective date of the excess-profits tax in 1940. In view of the fact that the tax rates must be increased substantially this year, it is all the more important that every effort be made to perfect the law in its administrative and technical aspects so that true normal and excess-profits income will be reflected and inequities and discriminations will be removed.

The recommendations of the institute with respect to the administrative and technical features of the House bill are as follows:

EXCESS-PROFITS TAX AMENDMENTS

A. Relief for corporations in existence prior to January 1, 1940, with abnormally low invested capital credits

Much progress has been made in the House bill to improve the relief provisions affecting taxpayers whose excess-profits credit is determined on the base period income method. However, no relief is provided in the House bill for corporations organized prior to January 1, 1940, whose invested capital, due to peculiar circumstances, is insufficient for determining a fair return on the assets used in the business.

Outstanding among this class of taxpayers is the corporation whose invested capital, computed under the present law, is abnormally low by reason of the fact that it must be determined with reference to the tax basis of its assets in the hands of a predecessor corporation.

Under section 718, equity invested capital consists primarily of the property originally paid in for stock plus accumulated earnings and profits. In determining the amount of property paid in, section 718 (a) (2) provides that it "shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange." In many instances, the aggregate of the property originally paid in for stock, included at its tax basis as provided in section 718 (a) (2), and the accumulated earnings and profits produce an equity invested capital in no way related to the cost to the taxpayer or the present value of the assets employed in the business. Accordingly, the institute again urges that in order to determine a fair and reasonable excess-profits-credit allowance, property paid in to a corporation for its own stock should be included in invested capital at the cost of the property to the corporation and not on the basis of the amount which the seller may have paid for the property many years previously. The latter may cause destructive tax inequalities between taxpayers whose businesses are identical except with respect to the history of their capital accounts.

If, however, the institute's recommendation is not accepted, then it would seem that the basis for property previously paid in for stock should at least be determined and fixed in accordance with the law in force for the year the property was paid in, and not under modifications made in the law for subsequent years.

The policy of the excess-profits tax law is that, regardless of the particular taxpayer's actual earnings during the base period, it should be entitled at least to a fair return on its invested capital before being subjected to excess-profits tax. Accordingly, if section 718 is not amended as urged herein, relief should be afforded to the taxpayer in the form of a constructive invested capital credit under section 722 which would represent a fair reflection of the capital actually employed in the taxpayer's business.

B. Invested capital of transferees upon tax-free exchanges

Section 760 of supplement C added in the House bill, which prescribes a new rule for determining invested capital of the transferee acquiring property in certain tax-free exchanges produces a severely inequitable result.

Section 761 of the present law provides that the amount of invested capital allowable to the transferee for capital stock issued in such an exchange shall, with certain adjustments not material here, be the basis of the property to the transferor and that any bonds issued to the transferor in such an exchange shall not be included in invested capital. Section 760 (b) of supplement C changes this rule so that the amount of bonds issued is deducted from the invested capital allowable under the present rule, presumably on the theory that the bonds belong in borrowed capital only half of which is includible in invested capital. However, as will be seen from the following example, section 760 (b) may result not only in denying any allowance in invested capital for the exchange transaction but also in reducing the amount of invested capital to which the transferee would be entitled without reference to the exchange transaction:

Assume:	
Invested capital allowable without reference to the tax-free exchange transaction	$600,000
Basis to transferor of property acquired under the exchange	300,000
Securities issued upon the exchange:	
Capital stock	1,000,000
Bonds	1,000,000
Invested capital allowable under sec. 760:	
Invested capital allowable without reference to the tax-free exchange transaction	600,000
Equity invested capital allowable on the exchange ($300,000 to $1,000,000)	None
One-half of borrowed capital	500,000
Total	1,100,000
Less: Excess of bonds issued over basis of property to transferor	700,000
Balance	400,000

It should not be assumed that the example shown above is at all exaggerated. Many corporations which had been operating for a long period of years had assets which when appraised for purposes of reorganization showed actual values far in excess of their book values. The House bill is entirely inequitable insofar as it compels the taxpayer to deduct bonds, the greatest portion of which were issued for asset values not on the transferor's books, from an amount which includes only the value shown on the transferor's books.

The institute believes such a result was not intended.

Before the transaction, the amount of the transferor's invested capital pertaining to the property transferred was $800,000 but this will be reduced through the inadmissibles adjustment by $150,000, the basis of the stock received on the exchange. The combined result of the transaction is that the transferor's invested capital is reduced by $150,000 and the transferee's by $200,000. If, as so frequently happens, the transferor is dissolved after the exchange, the combined reduction in invested capital would be $500,000.

If, as is recommended in point A above, cost in lieu of tax basis is adopted for determining invested capital, section 760 will no longer be necessary. Otherwise, if the present rule in section 751 is not deemed appropriate, it might be changed to require that the transferee's invested capital pertaining to the exchange shall be determined by allocating the transferor's basis of the property to the capital stock and bonds issued on the basis of the relative value of these securities.

Section 218 (b) of the House bill makes the unjustifiable changes effected by section 760 retroactive to all years beginning after 1939. This results in now imposing additional tax for the years 1940 and 1941. Even the adoption of substantially higher taxes late in the year retroactive to the beginning of the year results in severe hardships. The unforeseeable creation of new tax liabilities 2 years after the year has elapsed is certainly indefensible. The earnings for the particular year, after deducting taxes on the basis of the law then in effect, may have all been distributed by the corporation which may even now be without resources to pay the additional tax.

C. Retention of present rates for determining credit based on invested capital

The institute urges that the invested capital credit provided in section 714 of the code should not be reduced as proposed in section 211 of H. R. 7378.

The 1941 act reduced the credit from a flat rate of 8 percent on invested capital to 8 percent on the first $5,000,000 and 7 percent on the remainder. The House bill proposes to further reduce the percentages to 8 percent on the first $5,000,000 7 percent on the next $5,000,000, 6 percent on the next $190,000,000, and 5 percent on the excess over $200,000,000. It is submitted that there is no sound basis for reducing the measure of the normal profits as the size of the investment increases. Every corporation should be entitled to the same return per dollar of investment before being subjected to excess-profits tax. The effect of the proposed reduction is merely to produce additional revenue from the larger corporations using invested capital to determine their excess-profits credit, by subjecting a portion of their normal return to excess-profits tax.

The net return on a stockholder's investment in a corporation cannot be ascertained without reference to the tax paid by the corporation on its earnings. With an aggregate corporate normal tax and surtax rate of 40 percent (the maximum suggested by the institute) the rate of return on invested capital under present law before being subjected to excess-profits tax is only 4.8 percent on the first $5,000,000 and 4.2 percent on the remainder. The comparable rate under the House bill (at the 40 percent normal tax and surtax rate) would be as follows:

4.8 percent on first $5,000,000.
4.2 percent on next $5,000,000.
3.6 percent on next $190,000,000.
3 percent on remainder.

This proposed further reduction of allowable return on invested capital is obviously unsound.

D. Average base period net income

Under the present law, the average-earnings credit consists of the average earnings for the years 1936 to 1939, inclusive, except that if there was a deficit for one or more of these years zero can be substituted for the year of the largest deficit.

The only exceptions to this rule are found in section 713 (f) (the normal growth provision) which provides for some adjustment for companies with larger earnings in the second half of the base period than in the first half, and in the relief provisions of section 722.

The objection to the general rule in the statute is that it fails in most instances to provide a fair measure of normal earnings. In 1936, we were only emerging from a long depression, and for many industries earnings for the period 1936 to 1939 inclusive were on the average far below normal. The year 1938 was so typically below normal that the normal-growth provision is of very limited application. In addition, the relief provisions of section 722 are restricted to only certain situations and apply only where the excess-profits tax saving is at least 5 percent.

The provision of the present statute that the largest loss year may be included in the average at zero represents ineffectual recognition of the fact that, generally speaking, the base period does not reflect a period of normal earnings. The requirement that the aggregate earnings for the period, so adjusted, must be divided by four completely distorts the picture of a true average.

In order to offset in part inequities which will result in case of those companies which are now required to use the actual income for the full 1936-39 period for determining base period earnings, the Institute urges that corporations be permitted to use any 3 of these 4 years. The tentative approval by the Ways and Means Committee of an amendment which would have permitted a corporation to use for 1 of the 4 years in the base period 75 percent of the average excess profits income of the other 3 years indicates recognition that the use of the 4-year average does not produce an equitable result.

E. Income attributable to a base-period year but not realized until a later year

Section 721 of the Excess-Profits Tax Act wisely makes provision for transferring certain classes of income received in 1 year to either the prior or subsequent years to which the income is attributable. In this connection, the Senate Finance Committee Report No. 2114, page 16, contains the following:

"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."

This treatment is entirely proper because the income is attributed to an earlier year only because it is deemed properly includible for that year.

However, sections 721-723 of Regulations 109 issued by the Treasury Department provides 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."

There is no apparent justifiable reason for this regulation and it is directly contrary to the clearly expressed intent of Congress. It is recommended, therefore, that a clarifying amendment be made to the act in order to make certain this intent will be carried out in the administration of the law.

F. Defects in House bill revision of section 722 (the general relief provision)

The House bill revision of section 722 is a decided improvement over that section as it now stands in the law. However, with the necessary increase in rates, every effort must be made to remove from the general relief provisions any limitations which might prevent affording relief in true hardship cases. The following amendments to the House bill revision are suggested:

(1) As already suggested in A above, the section should provide for a constructive invested capital credit for all corporations with abnormally low invested capital.

(2) The granting of relief in the form of a constructive income credit on account of changes in capacity occurring in taxable years ending after December 31, 1939, should not be limited to those changes made as a result of commitments made prior to January 1, 1940. The maximum amount of constructive income possible in any event is automatically limited to the amount of income that the change would have produced if the results therefrom had been in effect during the base period.

(3) The 5 percent penalty on granting relief under the section is much too severe. The purpose of the penalty, i. e., to discourage applications for relief of

inconsequential value to the taxpayer, can be accomplished by making the penalty 5 percent or a fixed amount of $20,000, whichever is less. Once the relief has been granted the penalty should not be imposed for subsequent years.

(4) The revisions should be made retroactive to the taxable years 1940 and 1941, in order to prevent hardships in those years which cannot be corrected under the provisions of the present law.

G. Application of unused excess-profits credit against income of 2 previous years in excess-profits tax period

For accounting to stockholders, reports to various governmental agencies and for taxation, corporations must prepare income statements for each year. However, it is realized that except in the simplest form of enterprise, the determination of income on an annual basis must depend in a large measure on estimates and at best does not produce an accurate picture.

The imposition of excess-profits tax at very high rates solely on an annual basis is clearly unjustifiable. In one year, a corporation might have substantial earnings in excess of the excess profits tax exemption, whereas in another year its earnings might be far below the exemption. To subject the earnings of the very profitable year to an onerous excess-profits tax without reduction by reason of the meager earnings for the other year, is contrary to the ability-to-pay principle

The amendment adopted in 1941 permitting the unused excess-profits credit to be carried forward for a period of 2 years represents only partial recognition by Congress that for excess-profits tax purposes the emergency period should be considered as a whole. Thus, in order to give full effect to this principle, the Institute recommends that in addition the unused excess-profits credit should be carried back for at least 2 years.

H. Inconsistency provision

The Institute is opposed to the principle of section 734 which penalizes taxpayers who wish to compute their excess-profits credits correctly, because their tax liability for some prior years has been settled on an erroneous basis.

If, however, section 734 is retained in the law, the Institute recommends that it be amended in the following respects:

(1) The provision should be clarified to avoid uncertainty and litigation.

(2) It should not be retroactive for more than 10 years.

(3) No interest should be charged on the tax adjustments required by the section but if interest is charged it should be allowed as a deduction from taxable income instead of being considered a part of the excess profits tax.

GENERAL AMENDMENTS

I. Allowance for post-war losses

One of the most serious defects in the existing law is that it completely fails to make allowances for the losses that will inevitably be incurred in shifting back to normal peacetime activities and prices after the war. The more extensive the war effort, the more serious will such losses become The fact that such losses are inherent in the war effort itself should be taken into consideration in determining the amount of the present taxable profits. There follow examples of these losses:

(1) Losses on disposal after the war of inventories accumulated for production of war materials.

(2) Losses on disposal after the war of other inventories acquired at high prices during the war.

(3) Separation allowances to be paid employees who are discharged from their present positions after the war.

(4) Cost of rearrangment and alteration of existing facilities to revert to peacetime production basis.

(5) Repairs and maintenance deferred in order not to interrupt war production.

The Revenue Act of 1918 gave some recognition to the necessity for an adjustment for post-war losses by providing that losses for 1919 might be applied against either 1918 or 1920 income and that losses on December 31, 1918, inventories might be applied back against 1918 income in determining the tax liability for that year. These allowances alone would be inadequate under present conditions when we are confronted with much higher tax rates than in the last war and the emergency is likely to be of longer duration.

The Controllers Institute has previously urged before the committees of Congress that the present law should make some adjustment for post-war losses in computing current taxes. In the statements of August 14, 1940, and September 5, 1940, to the House Ways and Means Committee and Senate Finance Committee, respectively, and in the statement of May 12, 1941, to the House Ways and Means Committee, the Institute suggested as possible solutions—

(a) That losses for the first year or two after the emergency period should be applied against the earnings during the emergency period;

(b) That losses after the emergency period due to drop in value of inventory held at the end of such period should be offset against the income of the emergency period.

However, more effective adjustments to take care of these post-war losses should be devised. For example, the problem might well be solved by allowing a deduction in computing current net income for reasonable reserves set up to cover these losses. Administrative difficulties might be avoided by placing a percentage limitation on the amount of such reserves, and the revenues might be protected by requiring investment of such reserves in War bonds. Any portion of a reserve not required for post-war losses would become taxable income for the year in which such excess portion was set aside.

J. Capital losses

Under the House bill net capital losses are not allowed as a deduction against ordinary income but only against long- and short-term capital gains for the ensuing 5 years.

If there is any justification for such treatment of net capital losses in case of individuals, it is unwarranted in case of corporations because capital assets are, with rare exceptions, acquired by corporations in connection with their regular business operations and not for investment or speculative purposes.

Accordingly, the Institute recommends the contention of the present provision which allows net long-term losses as a deduction against ordinary income for normal tax and surtax purposes.

K. War losses in foreign countries

The losses incurred by American taxpayers in foreign countries through destruction or seizure by our enemies have been very substantial. In some cases, this property was owned direct; in other cases, it was held through other corporations.

Many problems are presented in respect to such losses, including those relating to the nature of the loss, the extent of the loss, the time when it was sustained and the treatment of subsequent salvage. The Institute understands that the Treasury is working with various groups particularly affected by the problem with a view to submitting to the committee a comprehensive amendment.

The Institute urges that any amendment adopted by the committee should at least provide that the losses be alowed in full regardless of the form in which the property is owned and that in no event shall the taxpayer be required to pay a tax on later recoveries in excess of the benefit previously derived from the deduction.

L. Inventory reserve

The Institute assumes that the inventory reserve allowance which the Ways and Means Committee tentatively approved retroactive to 1941 was not incorporated in the House bill because there was not sufficient time for drafting the provision. This allowance is essential in order to avoid taxing unrealized appreciation of inventories due to inflated prices, in case of those taxpayers who find it impracticable to use the elective method under section 22 (d) of the code.

In addition, a procedure should be set up whereby taxpayers may postpone the taxing of "gains" on sales from normal inventories made necessary by war conditions until the real profit can be determined upon the necessary replacement of the inventories. The present tax rates might well be applied to such profit when ultimately determined. Examples of these situations are reduction of inventories due to lack of shipping facilities, priorities, business discontinued because of diversion of raw material by Government order, and a change-over from civilian to war production.

M. Accelerated depreciation and obsolescence

To obtain the increased production of materials required for winning the war, it is essential not only that new facilities be constructed but also that the use of existing facilities be expanded to capacity. Mr. Donald Nelson, head of the War Production Board, has asked industry to operate its plants 168 hours a week.

The present tax law in section 124 allows 5 years amortization of emergency facilities acquired since June 10, 1940 (January 1, 1940, under the House bill), and completed prior to the end of the emergency period. However, in order to determine true income during the war period, industry should also be allowed deductions for accelerated depreciation and obsolescence sustained on other facilities by reason of the following factors:

(1) Prolonged and intensive use of equipment beyond the rates used in calculating normal depreciation rates.

(2) Unusual damage of equipment due to the high rate of activity and the operation by less experienced personnel.

(3) Increased deterioration due to deferment of repairs in order not to interrupt production.

(4) Accelerated obsolescence: Because of the present Government program of progressively building new and modern producing facilities to meet war conditions, machinery will become obsolete in much shorter time than formerly expected.

While under section 23 (d) as now written the Commissioner has the right generally to recognize these factors through accelerated depreciation and obsolescence allowances, the institute urges that in order to avoid uncertainty and litigation the section be amended to expressly direct and authorize the Commissioner:

(*a*) To give due consideration to conditions incident to the defense and war emergency in applying that provision; and

(*b*) To allow depreciation on part of the investment at one rate and on part at another, in recognition of the fact that, where plant is built for high capacity operation, only part of the capacity may be useful after the war.

N. Pension Trusts

The institute is of the opinion that the amendments in section 144 of the House bill to the present pension trust provisions go far beyond what is necessary to prevent the use of pension plans for tax avoidance and that the present provision is adequate for this purpose. The adoption of the amendment in its present form would disqualify many of the major industrial pension systems now in existence, which were established many years ago without any thought of tax avoidance either by the employer or employee.

If some amendments of the present pension trust provisions are deemed necessary, the institute urges that the changes made by section 144 of the House bill be revised in the following particulars:

(1) Under the amendment, a pension trust is recognized only if it benefits "such employees as 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." The intent of this classification as expressed on page 104 of the Ways and Means Committee report (No. 2333) on H. R. 7378 is far less restrictive than the language used in the amendment. In order to clarify the intent and effect of the statute and to avoid litigation in the future, it is urged that more appropriate language be used in the amendment to conform to the intent as expressed by the committee in its report.

(2) Section 165 of the present law prescribes as one of the tests "if under the trust instrument it is impossible, *at any time prior to the satisfaction of all liabilities with respect to employees under the trust* [italics ours], 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." This test is continued under the amendment except that the *italic* words are omitted There is no apparent justification for this omission because it is

impossible to determine prior to the death of the last employee covered by the pension plan what the actual cost of the pensions will be. It is inevitable, therefore, that upon the termination of the plan at some distant time in the future some amount may revert to the employer. The omitted phrase referred to should be reinstated.

(3) The amendment should be clarified in the following respects:

(a) It should be made clear that reduction of contributions to a pension trust or reduction of the cost of annuities purchased by reason of offsets for employees leaving the service of the employer or deaths do not constitute a diversion of the corpus or income of the pension plan to "purposes other than for the exclusive benefit of his employees."

(b) It should be made clear that the use of funds "for the exclusive use of his employees" is not limited to use for pension purposes.

(c) It should be made clear that or the purpose of the amended section 165 (a) (3) (A) and (B) eligibility of employees to share in the benefits of the pension plan rather than actual coverage controls. Otherwise, the section might be interpreted to be based on actual coverage which would mean that rejections of the pension benefits by eligible employees might result in noncompliance with the requirements of the section.

(d) Some companies, at the time of the adoption of the Social Security Act, revised their pension programs and in so doing they adopted new plans and suspended existing ones so that no further participation was authorized in the former plans. It is not clear that such former suspended trusts can qualify under section 165 in its present proposed form and it is therefore suggested that specific language be added to protect pension trusts in the process of liquidation by testing them for purposes of compliance with section 165 (a) as of the last day of active use of such trusts.

(4) The provisions regarding amendments to section 23 (p) of the code propose to limit the current deductibility of contributions to pension and profit-sharing plans to 5 percent of compensation paid to the beneficiaries of such plans, and any excess must be written off over a 60-month period following contribution.

Regardless of the real purpose of this limitation, which is obscure and is not given in the report of the Ways and Means Committee, this limit should not be imposed. Any contribution by a taxpayer to a plan qualifying under section 165 should be allowed immediately as a deduction for tax purposes.

If a limit on current deduction must be imposed, it is submitted that 5 percent is too low. The present cost of some of the large industrial plans in existence for many years is 10 percent or more. This is due in part to the substantial reduction of interest rates in recent years, which increases the requirements of the pension trust or the cost of annuities.

(5) The present amendment makes a pension plan acceptable for the year 1942 if it is perfected by the end of the year to conform with the requirements of the amendment. In many cases the necessary revision of the pension plan will require considerable study and stockholders' action, which could not be accomplished by the end of 1942. It is urged, therefore, that the pension trust amendments be made effective after 1942 and that the employer be allowed until the end of 1943 to revise the pension plan, or that the amendments be made applicable only to pension plans established after January 1, 1942.

Because the continuance of pension systems already in existence and adoption of such plans by other employers in the future is so important from the standpoint of the social welfare of the Nation, because of the diversity of the terms of the many pension plans now in effect and because the problem of preventing the use of pension trusts for tax avoidance purposes is so relatively inconsequential as compared with the preservation of the large corporation pension systems now in existence, The Institute urges that the Senate give the problem the comprehensive study it requires in considering the House bill amendments to the pension plan provisions, even if this means postponing these amendments until a later revenue act.

O. Renegotiation of Government contracts and subcontracts

Public Law 528 approved April 28, 1942, authorizes the War Department, Navy Department, and Maritime Commission to require in certain cases renegotiation of contracts whenever in the opinion of these Departments the contractors or subcontractors have realized or are likely to realize excessive profits from contracts with these departments or subcontracts thereunder.

It is the opinion of the institute that in order to obtain an equitable tax result the renegotiation settlement should be applied to the years in which there was included the net income under the original terms of the contract. The institute urges that in order to remove any doubt the law be amended to specifically cover this point.

The problem of renegotiation is so involved that the final contract price may not be finally settled with the Departments until after the expiration of the statutory period for claiming a refund of income and excess-profits taxes paid for the year in which the profits based on the original contract or subcontract were included. Accordingly, the institute urges that the statute of limitations for claiming tax refunds based on renegotiation of contracts with the Departments or between contractors and subcontractors under these contracts be extended to 7 years the same as is provided in the House bill for bad debts and worthless security losses.

P. Fiscal year companies

Companies which operate on a fiscal year basis do so not because of a desire to reduce their taxes but in order to reflect the results of their natural business year.

Section 120 restores, with certain modification, the old rule of section 105 of the Revenue Act of 1932. It requires that the tax liability of a corporation whose fiscal year begins in one calendar year and ends in the next shall be determined as follows:

(1) Tax computed under law applicable to first year allocated to number of months of fiscal year in first calendar year, plus

(2) Tax computed under law applicable to second calendar year allocated to number of months of fiscal year in second calendar year.

This method was tested for a long period and was discarded. It increases the already great amount of work involved in preparing tax returns and in auditing them. The fact that it is unduly complicated is evidenced by the exceptions made to this rule in the amendment.

Under the present rule the law applicable to the year in which the fiscal year begins governs.

The apparent advantage to the taxpayer from this rule during a period of rising tax rates is offset when tax rates decline because taxpayers on a calendar-year basis will benefit from declining tax rates as much as 11 months earlier than the fiscal year companies.

In any event, however, making the amendment retroactive to January 1, 1942, results in unjustifiable hardship. Fiscal-year corporations have fixed their dividend and working capital policies in reliance on the continuance of the present rule. Where the 1942 fiscal year has already ended, earnings statements on the basis of the present rule have already been furnished to stockholders.

Accordingly, the institute urges that section 120 be eliminated from the 1942 revenue bill. In the event this recommendation is not adopted, the institute recommends that the law be clarified to state specifically that a corporation with a fiscal year beginning in 1941 and ending in 1942 may use the consolidated return basis for determining its normal tax and surtax liability for the portion of such fiscal year which falls in 1942. The House bill is not altogether clear on this point.

Q. Foreign tax credit with respect to foreign income derived in one year but not realized until later year

By virtue of "blocked currency" situations arising from the war many items of income from foreign lands will undoubtedly not represent income in the year in which realization or accrual would ordinarily occur. This department might result in a loss of credit under section 131 of the Code for any foreign-income tax on such income where the foreign tax has to be paid when the foreign income is derived rather than at a later time when it is realized and becomes taxable income in the United States.

This possibility of loss of credit should be corrected by appropriate amendment of the Internal Revenue Code.

R. Prepayment of anticipated deficiencies

Under existing law and procedure, it is exceedingly difficult, if not impossible, to anticipate an actual deficiency assessment from the collector by payment in advance. It would often be the case, however, that a taxpayer, in order to stop the running of interest, would make an advance payment prior to actual formal assessment and notice and demand provided this were possible or feasible under existing machinery.

It is suggested that the law authorize collectors to accept advance income and excess profits tax payments from taxpayers without allocation by amounts or to specific years, leaving to the taxpayer at a future time the designation of the years to which the deposit would apply and the amounts thereof. Such procedure would serve to stop the running of interest and at the same time would give the Treasury its money in advance of the date it could otherwise expect payment.

S. Collection of tax at source

The requirements of H. R. 7378 as passed by the House include the withholding of taxes at the source as a prepayment against the individual's net income tax payable in the following year. These withholding provisions are of two classes, viz:

(*a*) A withholding from salaries based on the prescribed rate (5 percent in 1943 and 10 percent thereafter) applicable to the net amount, if any, after subtracting from the gross pay each pay period a withholding deduction based on the individual's marital status and dependents.

(*b*) A withholding from dividends and interest based on the prescribed rates applicable to the amounts of dividends and interest paid except where the payee produces an exemption certificate.

The withholding tax on wages is extremely complicated because of the necessity each pay period of subtracting the withholding deduction from the gross wage in order to arrive at the net wage to which the withholding rate is applicable. This withholding deduction will vary according to the individual's marital status and dependents and may change during the year. The gross wage for large numbers of employees will vary from pay period to pay period. This means a special determination each pay period to see whether an amount is to be withheld and, if so, how much.

The total number of employees in 1943 will probably reach 40 millions. In a recent hearing it was revealed that 2.5 million employers would collect income taxes from some 30,000,000 employees. Employers must go through certain clerical operations each pay period to determine that 10,000,000 employees have earnings less than their exemptions. For another sizable group, employers will perform the additional clerical operations to determine withholdings of small amounts. In the case of some individuals there will be pay periods when a withholding will be required and other pay periods where the gross pay will be less than the exemption. There will be a large group for whom some deductions will have been made during the year and the amounts remitted to the Government, after which the Bureau of Internal Revenue must refund the amounts previously withheld.

It is generally agreed that the provisions for withholding tax from wages, interest, and dividends and giving of receipts to the recipients will add greatly to the accounting work and expense of doing business as well as add to the work of the Bureau of Internal Revenue. These additional burdens on business come at a time when it is becoming more difficult to maintain adequate clerical help and at a time when the Government has placed priority restrictions on the production of office machines because these manufacturers are now engaged in war production. Many employers have already expanded their forces and have been required to buy additional equipment in order to establish, at the persuasion of the Treasury Department, pay-roll savings plans for the purchase of war bonds by employees.

While the Controllers Institute feels that it can visualize the effect on the accounting work of employers, it does not presume to evaluate the advantages to be derived from the prepayment of the individual's income tax. These advantages are stated to be a check on inflation and better tax collections.

The Controllers Institute is not asking that the withholding feature be withdrawn. It does ask that Congress give very serious consideration to whether the advantages clearly offset the disadvantages. In this connection it is suggested that Congress should not overlook the effect on the employees who will be required to pay the considerably higher income taxes in 1943 out of earnings reduced by the withholding tax and by pay-roll deductions for the purchase of war bonds. The Treasury is conducting a vigorous campaign to have individuals allot 10 percent of their gross pay for this purpose, and it is gratifying that so many individuals are complying with this request. There can be no doubt, it seems, that many bonds purchased under the pay-roll savings plans in 1942 will be used to pay the higher income taxes in 1943 and that these higher taxes will also result in reduced deductions during 1943 for the purchase of war bonds.

If the final decision of the Congress is that a withholding provision must be retained in the bill, the Controllers Institute suggests that all possible steps be taken to simplify the requirements. The Institute is aware that several proposals looking toward simplification have already been suggested to the Treasury Department and the Joint Legislative Committee, also that the Treasury Department has consulted many large corporations regarding the simplification. There is no need to duplicate these proposals here except to say that the Institute favors the type of proposal which fixes the amount of withholding on an average basis for prescribed ranges of gross pay arranged according to the individual's marital status and dependents. The Institute will be pleased to offer specific suggestions if requested and to cooperate fully with the Treasury Department in the preparation of regulations which will follow if the withholding provisions are retained in H. R. 7378.

Because dividend payments to many shareholders amount to only a few cents and because many bond interest payments are also small, it is suggested that the withholding provisions be made inapplicable to dividend and interest payments below, say, $100 a year. Under the present regulations, dividend payments need not be reported by a corporation unless they aggregate at least $100 for the year.

Respectfully submitted.

CONTROLLERS INSTITUTE OF AMERICA.

AUGUST 12, 1942.

The CHAIRMAN. Mr. Arthur H. Kent.

Mr. KENT. Yes, sir.

STATEMENT OF ARTHUR H. KENT, SAN FRANCISCO, CALIF., CHAIRMAN, CONFERENCE OF TAXPAYERS ON FOREIGN WAR LOSSES

The CHAIRMAN. It is a great pleasure to have you before us again.

Mr. KENT. It is a great pleasure to be before you again. I have not had the opportunity for several years.

May I hand you copies of a printed statement, the statement which I presented before the Ways and Means Committee of the House? It shows some background material which in the interests of economy of time I will not stop to put into my present statement, including an account of how this committee that I am representing happened to be formed, and I will leave that with you.

The CHAIRMAN. Very well.

Mr. KENT. I am an attorney at law of San Francisco, Calif. I think I am the only witness, Mr. Chairman, who is discussing at any length this group of problems.

One thing that our committee was able to do was to act as a clearing house on the subject. We were thereby able to focus the study of this problem and to designate some one individual to appear before the committee and present it to the committee rather than having a large number of individuals each presenting his own problem without very much regard to the problems of others.

I appreciate the opportunity afforded me to present to your committee a group of problems which are a direct result of the devastating war in which our country is engaged and a series of recommendations relating thereto.

These recommendations embody what our committee believes to be a minimum program. We have deliberately restricted our recommendations to such as are essential to a fair, reasonable, and immediately practical solution of the major problem. In so doing, the effort has been to disturb as little as possible the structure of the existing law.

An adequate solution of these problems is a matter of vital interest and importance to a large number of American taxpayers who were either carrying on business enterprises directly or had investments in enemy countries or occupied territories prior the declaration of war with the Axis powers. Such taxpayers were quick to realize that our entry into the war made it inevitable that they would have to incur heavy losses on account of these properties and investments.

CLASSIFICATION OF FOREIGN PROPERTIES AND INVESTMENTS

These interests of American enterprises in Germany, the Far East, and elsewhere vary greatly in detail but may be conveniently classified in certain well defined categories, in all of which losses may occur:

(1) Branches and other property abroad directly owned by an American company.

(2) Stock or securities of wholly owned subsidiaries.

(3) Stock or securities of majority-owned subsidiaries.

(4) Minority stock interests in foreign corporations.

(5) Interests in foreign partnerships or in other business units peculiar to foreign countries.

(6) Bonds, debentures, and long-term notes of foreign debtors.

(7) Accounts receivable and other open accounts and short-term indebtedness, and interests arising out of business contracts.

(8) Deposits in foreign banks.

(9) Royalty interests.

(10) Accrued interest and accrued dividends on foreign investments and profits on foreign operations which may or may not be convertible into dollar exchange, or otherwise removable from the foreign country.

Any and all of these interests, to the extent they have a basis, can become the subject of a tax loss.

NECESSITY FOR LEGISLATION

Many taxpayers, however, have very unpleasant and disturbing memories of somewhat similar problems which arose during the first World War. They recall the resulting confusion, when cases involving the proper tax treatment of such losses were pending in the Bureau of Internal Revenue or clogged the dockets of the courts and the Board of Tax Appeals for 15 years. They fear a repetition of that unfortunate history, unless prompt action is taken, and they believe that the public, as well as private interest will be served if such a repetition be prevented.

Careful study of these problems in all their aspects has led to the conclusion that they cannot be solved by administrative processes but that some form of remedial legislation is essential.

As will be shown more fully hereafter, the root of the difficulty lies in the fact that certain provisions of the Internal Revenue Code, which are framed to govern the generality of cases, are not well adapted for application to some of the extraordinary problems which have resulted from the war and from enemy action. Some special rules are necessary. These rules should, of course, be limited in the scope of their application to foreign war losses, as properly defined, leaving the general rules in the statute unaffected, as applied to cases in which such losses are not involved.

MAJOR DEFICIENCIES IN EXISTING LAW

I shall endeavor to point out briefly the major deficiencies in the existing law, as it would apply to these extraordinary losses.

The first of them is the virtual impossibility, under the conditions of the present war, of determining the taxable period to which the bulk of these losses is to be referred. The existing law is well settled that a loss can be deducted only in the taxable year in which it was sustained. In the case of bad debts, it has hitherto been the statutory rule that the deduction is allowable only in the year in which the debt is ascertained by the taxpayer to be worthless and is written off.

However, section 119 of the House bill has incorporated the constructive proposal of the Treasury (item 8 in Mr. Paul's statement of March 8) to eliminate the requirements of ascertainment of worthlessness and write-off in the case of bad debts (including corporate securities producing capital losses).

In lieu thereof the section applies the same objective rule as in the case of worthless stocks, viz, the year in which the debt in fact became worthless. Subsection (d) of the same section provides, however, a special 7-year statute of limitations on claims for refund based upon worthless stock and bad debt items. While both of these excellent amendments will be helpful in simplifying administration, they do not go to the heart of the foreign war loss problem.

THE PROBLEM OF PROOF OF LOSS

The ordinary rule limiting deduction of losses to the year in which they are in fact sustained necessarily assumes that a diligent taxpayer can obtain the necessary information to show what the facts are.

Such an assumption breaks down completely in the present situation. We know that we are engaged in a totalitarian war for which history supplies little precedent. The blockade of channels of communication and information with enemy countries and occupied territories has been virtually complete. For instance, it is only quite recently, despite the good offices of the State Department, that we have been able even to obtain authentic information as to decrees issued by the Nazi Government respecting American property interests in Germany.

There has been only a slight trickle of information—and that largely unofficial—as to the fate of specific properties and investments of American taxpayers. The Far East is virtually a blank, both with respect to information as to decrees of the Japanese Government and the treatment accorded to particular properties.

No one knows how long this state of affairs will continue. Quite likely it will be until after the end of the war, by which time essential books and records abroad may have been lost or destroyed and witnesses as to essential facts may have died or disappeared.

Under such conditions the impossibility of satisfying the requirements of proof under existing law as to the fact and time of loss is too obvious for comment. In the meantime taxpayers will be confronted, other than in worthless-stock and bad-debt cases, with a relatively short period of limitation, viz, 3 years, on claims for refund. Inability to determine the facts within such period may result in a complete loss of rights under the existing law.

NEED FOR FLEXIBILITY IN TIMING OF WAR LOSSES

But the difficulty under existing law plows even deeper than this practical impossibility of proof. It involves also the peculiar hardships and inequities which will result in many of these cases from one or both of two factors:

(1) The application to them of the ordinary provisions of the revenue laws based upon close adherence to the concept of determination of income upon an annual basis; and

(2) The very different tax treatment of losses, according to whether they happen to fall into the ordinary- or capital-loss categories established by the law. A few concrete examples will help to illuminate these points.

Illustrative of the first point, we have heard of several cases involving American taxpayers which owned properties and carried on operations in Malaya, Sumatra, Java, or elsewhere in the Far East. Some of these companies had large incomes in the calendar year 1941.

In the early part of 1942 their plants, equipment, and inventories or stock piles were completely destroyed as a result of bombing and other military operations or the execution of the scorched-earth policy, or their properties were overrun by the Japanese invading forces. Similarly, an American enterprise, carrying on operations in Manila or elsewhere in the Philippines, which may have escaped destruction during the December bombings, may have been seized by Japanese military forces shortly after December 31, 1941.

In such cases, it is certain that the very source of the taxpayer's income has either been destroyed or eliminated for an indefinite period. Yet the losses may well be held under existing law to have been technically sustained in 1942 rather than 1941.

The intolerable harshness and inequity of a strict adherence to the normal annual concept of income in cases of this type is self-evident. All the income is in 1941, where it is subject to tax at very high rates; all the losses fall into 1942 where there is no income against which to offset them. Even though these losses constitute ordinary losses which may be carried over from 1941 to 1942 and 1943 under section 122 of the code, the carry-over is of no benefit, since the source of income is gone.

It is apparent that the only adequate remedy for such cases is one which is based upon a realistic and common sense appreciation of the extraordinary circumstances under which this war began. These are in striking contrast to the situation in 1917.

Then the declaration of war came early in the calendar year; that is, in April, and was followed in the same month by the promulgation of a decree by the Imperial German Government authorizing the sequestration and administration of American-owned properties under its jurisdiction. Even so, it was not until 1927 that the decision of the Supreme Court in the leading case of *United States* v. *S. S. White Dental Manufacturing Co.*, 274 U. S. 398, began to introduce some order into the chaotic confusion as to the principles governing the realization of war losses with respect to American properties in Germany.

In the *White case*, it was stipulated that the taxpayer's properties in Germany were actually taken over by a sequestrator in 1918. The Government contended that no loss had been sustained, even in 1918, because of the possibility the taxpayer might recover the property or reimbursement therefor after the war. The Supreme Court held that, in order to support a loss deduction in a given year, there must be some definitive or identifiable event to fix the loss in that year, but that practical standards must be applied in determining the existence of such an event.

The Court thought that the sequestration of the property was such an event, and that the possibility of recoupment after the war was too speculative and remote to defer realization of the loss. In this connection, Justice Stone observed that the revenue laws do not require a taxpayer to be an "incorrigible optimist."

However, the General Counsel of the Bureau of Internal Revenue, in passing several years later on a claim for refund, ruled that losses in Germany were sustained in 1917, on the theory that the promulgation of an administrative decree authorizing sequestration operated as a constructive seizure in that year of all American properties in Germany. (See G. C. M. 10630, XI-2 C. B. 97.) Tax rates were much lower, of course, in 1917 than in 1918.

Unlike the situation in 1917, the present war was declared in December, very close to the end of the calendar year. It was not until 4 months later—that is, in April 1942—that the Nazi government formally authorized sequestration of American properties. Probably this dilatory procedure was due chiefly to the fact that the various exchange controls, such as blocked accounts, and restrictions on transfers of alien-owned assets and funds, which long antedated the formal declaration of war, had given the Governemnt of the Reich such complete control that haste in providing for formal sequestration was unnecessary.

Such facts, plus the whole character of totalitarian war, could be used to construct an argument that American properties within the jurisdiction of the Reich lost all value on December 10 when war was declared, and that a subsequent seizure, actual or constructive, was not necessary to fix the loss; yet it is by no means certain that such an argument would be sustained.

PRESENT UNCERTAINTIES

It follows that there is now complete uncertainty, under existing laws and conditions, as to whether the declaration of war, the promulgation of a sequestration decree, or actual seizure thereunder is the identifiable event which fixes the year of realization of foreign-war losses under existing law and present conditions. This uncertainty would continue until another test case wends it laborious way to the Supreme Court.

Such a delay would be productive of hardship to taxpayers and a vast amount of expensive litigation. It would also cause a serious delay in the prompt collection of needed revenues, since many taxpayers would be compelled to deduct the same losses in 1941, 1942, and even later years in order to protect their rights until one or more test cases had been decided by the highest court. Deficiencies asserted by the Commissioner and contested in the Board of Tax Appeals do not mean immediate cash in the Treasury.

We believe that the best interests of both the Government and its taxpayers would be well served by legislation which would minimize these uncertainties. Such legislation should be applicable only to foreign-war losses.

It should be based upon a realistic appreciation of the fact that American properties in territories within the jurisdiction and control of totalitarian Axis Powers have lost their value for practical purposes, and that properties subsequently coming within their jurisdiction, by reason of invasion and occupation of additional territory, have similarly lost their value.

It should also be recognized that properties in countries which the State Department determines to be allies of enemy countries have lost their value, even though a state of war has not been formally declared.

Moreover, it should be recognized that the concept of the annual period breaks down, when applied to this foreign war loss situation, at least so far as 1941 and 1942 are concerned. Many losses, particularly in the Far East, which may technically have been sustained early in 1942, were imminent and virtually certain at the end of 1941. This category includes losses due to military operations and scorched-earth tactics occurring in the early weeks of 1942 in the Pacific theater of operations.

Senator DANAHER. The fact of the matter is that they don't know anything really about it; isn't that so?

Mr. KENT. And there is the additional factor that nobody knows what has happened in these foreign countries.

Senator DANAHER. Would we not be justified in placing all of these foreign war-loss accounts in a suspense status? Isn't that the best way to do it?

Mr. KENT. I certainly think that in some aspects of the situation a longer status of limitations may be necessary. However, we have certain specific proposals as to other ways of dealing with the problem.

Senator DANAHER. Mr. Chairman, may I interrupt for a moment, please?

The CHAIRMAN. Yes.

Senator DANAHER. When we were considering the war losses insurance bill, we had quite a little difficulty with a subject which in some aspects might be considered somewhat analogous. If you have a problem of this kind where you cannot possibly know what the facts are, why should you be compelled to get at it even tentatively? Why not put it in a state of suspense and keep it there?

Mr. KENT. We have taken a somewhat different approach to this whole problem, which I have stated in the form of a recommendation as the fairest and simplest remedy from an administrative point of view, and that is that such foreign war losses—whether technically sustained in 1941 or 1942—be allowed to be deducted in either year at the taxpayer's election.

Let me point out that if by virtue of that provision any deductions are now allowed, and in subsequent years the property with respect to which those deductions referred is recovered or its value in whole or in part is recovered by a Mixed Claims Commission under a treaty of peace as an aftermath of this war similar as a treaty of peace to the Treaty of Versailles—and none of us is wise enough to know what that situation will be, but the amount recouped having been allowed as a tax deduction in an earlier year will have to be taken back into income so that the Government is protected to that extent against the allowance of premature deduction.

I will next discuss the classification of foreign war losses as ordinary losses.

The second major problem under existing law relates to the classification of losses into ordinary and capital loss categories. The classification of a loss produces extremely important differences in its tax consequences. Thus, ordinary losses are deductible for excess profits tax, as well as normal tax and surtax purposes. They also enter into the computation of the two-year net operating loss carry-over provided by section 122 of the Internal Revenue Code. Capital losses, on the other hand, are excluded for excess-profits-tax purposes of the normal tax and surtax, although a 5-year carry-over of capital net loss is provided. Also, capital losses do not enter into the net operating loss deduction. Three simple illustrations, based on common cases, will show how vital are these differences in connection with foreign-war losses.

In the first case, a domestic corporation owns a branch or other property in Germany directly, which is sequestered by the Nazi government. Under existing law the loss sustained is clearly an ordinarily loss.

In the second case, a domestic corporation has a wholly owned or a controlled subsidiary which owns the properties and operates the business in Germany. Here, by reason of the interposition of another corporate entity, the interest of the American corporation is represented by stock. If, as is likely in such a case, the Nazi government sequesters all the assets of the subsidiary, the effect thereof is to render its stock worthless. Under such circumstances the parent's loss would be a capital loss by virtue of section 23 (g) (2) of the code.

In the third case, a domestic corporation owns a minority interest in the stock, or some bonds of a German corporation which is controlled by German nationals. Since such a corporation is not subject to enemy control, the Nazi government is unlikely to seize its properties as such, but may very well sequester or expropriate the American stock or bond interest, just as our Government has done recently in the General Aniline Corporation case. The proper classification of the losses in such a case is not so clear. Prior to the 1938 amendments to section 23 (g) and section 23 (k), worthless-stock losses and corporate security bad-debt losses were deductible in full as ordinary losses. By such amendments they were reclassified as capital losses. I myself believe that these amendments do not govern the case I have put, but such a case is sui generis, and the loss should be treated as an ordinary loss.

Whatever justification there may be for such distinctions in ordinary cases, we believe that they have no proper application to the extraordinary losses with which we are here concerned. Losses such as these are truly war casualties, having nothing in common with losses which are due to the fluctuations of the economic cycle or the other ordinary risks incident to investment and the market place. They are more nearly analogous to losses by casualty, theft, or embezzlement, which are still treated as ordinary losses, than to a case in which stock becomes worthless because of the gradual decline and final insolvency of the corporation which issued it. They also resemble the losses sustained on involuntary conversion of property. These, under the provisions of section 137 of the House bill, are treated as ordinary losses if in excess of capital gains. Finally, there is no justification for making the tax treatment accorded to the loss of a foreign investment, due directly to the war, depend upon the technical form an investment happens to take, or upon the particular form of action taken with respect thereto by an enemy government.

Corporate taxpayers are about to be subjected to taxation on excess profits at rates which approach confiscation, on the ground that such profits are directly attributable to the war effort. Normal corporate incomes and individual incomes must be subjected to unprecedented burdens because of the fiscal necessities of war. We believe that simple fairness and sound policy equally require that taxpayers, which have sustained grievous losses as a direct result of the war which produces the excess profits, should be given a fair opportunity to offset such losses against income subject to tax. We think that this is necessary in order to strike a fair account between them and their Government for tax purposes.

We, therefore, recommend that all foreign war losses be treated for income-tax purposes as ordinary losses.

Senator DAVIS. What is the total of American investments abroad?

Mr. KENT. That is a very difficult problem, Senator. It would take me quite some time to go into the details.

Senator DAVIS. Then, just put it in the record if is is going to take any time.

Mr. KENT. The Department of Commerce has quite recently gotten out the 1940 figures on American direct investments in foreign countries, which throw some light on the question. According to the figures, the total of such investments was about $7,000,000,000.

Senator DAVIS. How much in enemy territory?

Mr. KENT. According to this table, the figures in the countries with which we are now in a state of war, and in the territories occupied up to the present time by the Axis powers—the best estimate that I could make on the basis of these figures was somewhere around $750,000,000.

Senator DAVIS. And you don't expect the enemy is going to continue to keep them in good repair and maintenance?

Mr. KENT. I do not. Many of these properties will be destroyed, or will have been worn out.

Senator DAVIS. Thank you.

Mr. KENT. As to the measure of foreign war losses, we recommend that the standard to be applied in measuring the amount of a foreign war loss deduction be the ordinary rule applied to other losses, viz, the adjusted basis for the foreign property or investment for the purpose of determining loss upon a sale or exchange, as determined under section 113 of the code. The use of this adjusted basis rule will avoid difficulties of valuation and will preclude the inclusion of unrealized appreciation in the deduction. It will also prevent a deduction on account of funds or other assets abroad, such as profits, dividends, or interest held in blocked accounts, which have never been returned for income-tax purposes and consequently have no basis. The deduction will thereby be limited to the American dollar investment, plus earnings or income which have been returned for tax purposes and reinvested or held abroad.

If the taxpayer wishes to take his foreign war losses on a net rather than a gross basis, he should be permitted to do so. This is especially desirable in cases where the foreign assets are offset by foreign liabilities, since in many instances the seized assets will be used to discharge such liability, thereby reducing the actual loss suffered by the taxpayer. And by the same token, reducing the amount of the deduction which he could claim on his American return.

PARTIAL WORTHLESSNESS OF SUBSIDIARY'S STOCK

Several other cases have come to light of which the following is typical. A domestic corporation has a subsidiary, all or the bulk of the operating assets and the business of which was in Germany. The German properties have been sequestered or have lost their value because of the war. The subsidiary, however, had some bank deposits in English banks or accounts receivable against customers in friendly countries which are still collectible. Consequently, although the heart of the subsidiary as a going concern has been torn out by the loss of its operating properties in Germany, so that its liquidation within a short time would be the normal consequence, its stock still retains more than a nominal value. Consequently, a deduction for total worthlessness would not be allowable.

We recommend that a deduction for partial stock worthlessness should be allowed in such a case, measured by the excess, if any, of the adjusted basis of the stock to the parent company over its remaining value. The right to such a deduction should be subject to strict limitations. It should be allowed only in cases where the domestic corporation owns at least 50 percent of the stock of a foreign corporation and where a high percentage of the assets of such foreign corporation, other than cash or bank deposits, accounts receivable, and possibly Government bonds, have become the subject of a foreign war loss.

RECOUPMENT OF LOSSES

The doctrine is now well established that, if a deduction on account of a loss has been beneficially allowed for a prior year and subsequently all or a portion of such loss is recouped, as by a monetary award of a Mixed Claim Commission set up under a treaty of peace, income is realized to the extent of the recoupment in the later year. Considerable concern exists among many taxpayers as to the extent of the application of this principle to the recoupment of foreign war losses. We recommend a clarification of the law on this point so as to make it certain that income is realized in the subsequent year only to the extent that the deduction resulted in a tax benefit in the prior year. This would accord in principle with the provisions of section 114 of the House bill, which in terms would now apply only to recovery of bad debts, prior taxes, and delinquency amounts. A fortiori, no income should be deemed to be realized in the later year if a taxpayer has taken no deduction on account of a foreign war loss in a prior year, even though such a deduction was allowable under the law applicable to such prior year.

THE FOREIGN TAX CREDIT

We recommend, as sound in principle and practically desirable, two amendments to section 131 of the Internal Revenue Code, relating to the foreign tax credit. One of these would preserve the credit for foreign taxes on blocked income until the year such income is released and is realized for income-tax purposes. This problem has already been explained in detail to your committee by Mr. Mitchell B. Carroll, appearing on behalf of the National Foreign Trade Council, in his statement to you on July 28, 1942 (hearings, unrevised, p. 206 et seq.). The other amendment would eliminate the requirement of an election between taking foreign taxes as a deduction or a credit, imposed by section 131 (a) of the code. There is no real justification for this requirement, either from the standpoint of equity or administrative convenience, and it may operate to deprive a taxpayer of the benefit of the credit, if the taxpayer makes a mistake and claims a deduction on account of a foreign war loss in the wrong year. Since most 1941 returns have already been filed, the elimination of the election ought to be retroactive to 1941.

LOSSES IN 1943 AND SUBSEQUENT YEARS

The recommendations which have been made are focused primarily upon the immediate problem of what to do about 1941 and 1942 foreign war losses. We fully appreciate that the year 1943, and perhaps later years, may produce their own grist of problems in this field. We suggest, however, that the inability to foresee accurately at the present time the extent of these problems makes it the part of wisdom to defer until a later time consideration of their treatment. We also recognize that there may be individual situations involving 1941 and 1942 losses, which may not be adequately provided for in this minimum program and which may require future consideration. Given a fair solution of the immediate problems, it should not be difficult later to extend its principles to subsequent war years.

Senator DANAHER. How is the next year different from 1942 with reference to American property in the Philippines, for instance?

Mr. KENT. I do not suggest it is any different, Senator. I do suggest that, if a fair solution of the immediate problems can be worked out, it will not be difficult to expand it, although we recognize that there may be individual situations which may need to be considered subsequently.

By the way of summary, our committee makes the following recommendations for consideration as to the form which necessary remedial legislation should take:

(1) A special category of losses, to be known as foreign war losses, should be defined in the statute. This should include:

(*a*) Property within the jurisdiction and control of an enemy nation on the date of declaration of war;

(*b*) Property coming within such jurisdiction and control, by occupation of territory and otherwise, subsequent to such date;

(*c*) Property within the jurisdiction and control of a nation proclaimed by the Department of State to be an ally of an enemy nation;

(*d*) Destruction or damage to property in the course of military and naval operations, including scorched-earth tactics, outside the limits of the United States.

(2) All foreign war losses, as defined, should be treated as ordinary losses, effective for taxable years beginning in 1941 and subsequently thereto.

(3) Foreign war losses sustained in 1941 or 1942 should be allowed as a deduction against income in either year, at the election of the taxpayer.

(4) The measure of the amount of a foreign war loss should be the adjusted basis for loss of the property or investment.

(5) A carefully limited deduction should be allowed where the stock of a foreign subsidiary of a domestic corporation becomes partially worthless by reason of a foreign war loss such subsidiary has sustained.

(6) A clarifying amendment should be made providing that the recoupment of a loss, in whole or in part, shall not constitute income unless a deduction on account thereof has been taken and beneficially allowed in a prior year.

(7) The foreign-tax credit should be allowed to be taken in the year in which the foreign income, with respect to which such taxes were paid, is realized for Federal-tax purposes.

(8) The requirement of election to take the foreign-tax credit should be eliminated.

The CHAIRMAN. You are sure that legislation is necessary?

Mr. KENT. Yes.

The CHAIRMAN. It cannot be reached by regulations?

Mr. KENT. We have had numerous conferences both with the administrative and legislative officials in the Treasury, but we are convinced that these problems will not yield to administrative processes, and we have made our suggestions to the Treasury. They are receiving careful consideration, and it is our understanding that the Treasury is actively engaged in considering the problem and may have some recommendations to make to your committee with respect to them.

There is one thing before closing: From the administrative point of view, the administration of this foreign-war loss problem will be immensely simplified if we realistically recognize that when the declaration of war came on December 10, American properties in Germany which were at that time in the jurisdiction and control of the German Government or the Italian Government, or on December 7 American properties which were within the jurisdiction and control of the Japanese Government, lost their value, and we suggest that the foreign-war loss be defined in such a way as to recognize that fact. Similarly when other properties, by virtue of invasion and occupation come within the jurisdiction of any enemy power, they lose its value as of that time.

However, we would not suggest a legislative definition which would mean that all property in enemy control on December 10, 1941, had to be treated as worthless on that date and the loss to be taken for 1941. However, if such a definition can be accompanied by a flexible provision which will allow that loss to be taken either in 1941 or 1942, then we think that it will do more than almost anything else that we can suggest to assure the quick and efficient administration of this whole problem and to get it out of the way.

CONCLUSION

The adoption of these recommendations, in order to meet this emergency situation, will not involve any general overhauling of the structure of the income-tax law. We respectfully submit that an extraordinary situation, in so many respects without precedent, calls for the application of appropriate special remedies, if intolerable injustices are to be avoided. We have endeavored to suggest certain special remedies, so limited as to be applicable only to this emergency situation.

Our recommendations are the product of many months of study of the problems by the members of our committee, and have been winnowed out of suggestions received from many different sources. During this period, numerous conferences have been held with members of the legislative staff of the Treasury and administrative officials of the Bureau of Internal Revenue, at which the foregoing problems and various suggestions for their solution have been presented. I may say that the Treasury staff has shown full appreciation of the reality and seriousness of the problem, and that it is actively considering a legislative solution. We urge that any plan which is recommended shall incorporate the foregoing minimum program. We believe that our proposals merit the careful consideration of your committee and hope that you will see fit to incorporate them in the pending revenue bill, before it is reported to the Senate.

I thank you for the opportunity of presenting this statement.

The CHAIRMAN. Thank you, Mr. Kent. You have undoubtedly made some contribution to our work, because this is a situation that ought to be dealt with and as early as we can.

Mr. KENT. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Sullivan.

STATEMENT OF BENJAMIN H. SULLIVAN, ATTORNEY AT LAW, WASHINGTON, D. C.

Mr. SULLIVAN. Mr. Chairman, I would state to begin with that I have reduced my statement to the very minimum.

My name is Benjamin H. Sullivan, an attorney here in Washington, and I appear at the request of Lester P. Barlow, an inventor who believes his situation is typical of a very small group of others who may be similarly situated.

I wish to call to your attention the situation with respect to tax liabilities which arise by reason of the receipt of payments from the United States in settlement of long-standing claims.

It is one which deserves the consideration of Congress because in some instances great injustices are being done by the law as it now stands.

Section 284 (a), title 28 of the United States Code provides:

> No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for payment of interest * * *.

Consequently, when the Government finally pays claims, after years of litigation, there is no allowance whatever for interest on the amount of a claim—as would be the case if judgment on a similar case were obtained against a private individual. On the other hand, the tax laws make no allowance in computing surtaxes for the fact that the claimant has lost interest over a long period of years due to the acts of the Government itself.

Section 106 of the Internal Revenue Code—which was enacted some years ago in an attempt to partly relieve this situation, reads as follows:

> In the case of amounts (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than 15 years, the portion of the tax imposed by section 12 attributable to such receipt shall not exceed 30 percent of the amount (other than interest) so received.

Because the Internal Revenue Bureau interprets it to mean that 30 percent in surtaxes shall be charged against the total amount of the money received—without deductions of any kind—such as the costs of litigation and prosecution of the claim—it does not do complete justice to cases of this character.

I am suggesting an amendment, which, in my opinion, would relieve the injustices of this situation on a logical and sound basis.

I propose that section 106 of the Internal Revenue Code read as follows:

> In the case of amounts received from the United States, after January 1, 1940, with respect to a claim against the United States and remaining unpaid for more than 15 years, if the payment does not include interest, the portion of the tax imposed by section 12 attributable to such receipt, shall be reduced by the amount of interest, at the rate of 3 percent, which would have accumulated on the principal of the claim during the period it remained unpaid.

To illustrate how this would work—let me state a theoretical example—in which a taxpayer has a claim against the United States in the amount of $500,000—which arose in 1921, but is not paid until 1942.

If the sum of $500,000 had been paid in 1921, the surtax upon this sum would have amounted to $263,510, leaving the taxpayer, after the payment of the surtax, the sum of $236,490. If the taxpayer had invested the $236,490 remaining in his possession at 5 percent, he would have received $240,000, in the 21-year period between 1921 and 1942, and this income would have been subject only to the normal tax.

Therefore, when the Government pays a claim, without interest, the taxpayer should be entitled to a claim against the surtax in an amount equal to the interest he has lost in the period the sum due him has been detained by the United States.

In the proposed amendment it is suggested that only 3 percent interest on the principal of the claim be allowed as an offset, which does not altogether place the taxpayer in the same position as if the claim had been paid when due and the tax had been paid at the same time, but it does relieve the taxpayer from some portion of the burden which he must bear if there is no relief whatever.

If no relief is granted in a case such as that in the example, the taxpayer will pay approximately $325,000 in surtaxes at the present rate, which is about $100,000 more than he would have paid if the amount due had been delivered to him in 1921, and in addition he has lost possible income of approximately $240,000 during the period the money has been detained by the United States.

If a claim of this character were asserted against any individual or corporation, interest would be included in the judgment and would serve as a partial or total offset against the surtaxes.

The injustices complained of arise, therefore, only in connection with claims against the United States upon which interest is prohibited by law.

The example relates, as does the proposed amendment, only to surtaxes. The normal tax is not affected and is not reflected in the example.

The CHAIRMAN. Thank you very much, Mr. Sullivan.

Mr. Wood.

STATEMENT OF GEORGE A. WOOD, BROOKLYN, N. Y., REPRESENTING BROOKLYN TRUST CO.

Mr. WOOD. Mr. Chairman and members of the committee, my name is George A. Wood, I am an associate of the law firm of Cullen & Dykman of Brooklyn, N. Y. I am appearing for the Brooklyn Trust Co. of Brooklyn to call attention to an apparent technical defect in section 151 of the revenue bill of 1942 which amends the definition of mutual investment companies, and changes their name to "regulated investment companies."

The purpose of the amendment, as shown by the report of the House committee, was to simplify the definition of mutual investment companies and to enlarge it to include some investment funds which have not heretofore been included.

The report of the House committee shows that there was no intention to narrow the definition or to exclude from it any mutual investment companies which have heretofore been included.

However, the way the definition is drawn, it would now exclude the mutual investment fund which is maintained by the Brooklyn Trust Co. for the collective investment of funds of trusts of which that company is the fiduciary and under which it is expressly authorized to make such collective investment. Such collective funds under the old definition have qualified as mutual investment companies. Their exclusion under the new definition results from the fact that the new definition includes only investment funds which are registered with the Securities and Exchange Commission under the Investment Company Act of 1940. These mutual investment funds are exempted from registration by the Investment Company Act because they are maintained by banks which are already under the supervision of Federal and State authorities, and therefore the Securities and Exchange Commission did not desire to have jurisdiction over them.

I should like to submit an amendment which would make certain that these mutual collective funds would be included in the new definition as they have been under the old. This amendment would add a phrase at the end of section 361 (a) of the Internal Revenue Code as amended by section 151 of the Revenue Act of 1942.

The CHAIRMAN. Have you discussed this matter with the Treasury?

Mr. WOOD. I have discussed the matter, sir, with the Treasury Department and with the Internal Revenue Bureau, and have had it discussed with the legislative counsel, who has considered this matter, of the Securities and Exchange Commission, and also with Mr. Stam; and it is my understanding—I may say that I was not authorized, of course, to speak for these departments or gentlemen—that they appreciate the fact that there was probably an omission that was not intended.

There is one other thing that I would like to mention, but I can dispose of it very quickly because at the hearing of your committee held on August 5, Mr. Morton's and Mr. Sholley's and Mr. Higgins' statements dealt with the problem of the mutual investment companies, or regulated investment companies as they would be called under the new definition. This problem relates to the bearing of unallowed capital losses on earnings and profits from which taxable dividends may be paid.

Without taking the time of the committee upon it, I would like to say that I concur in their statement of the problem, and I concur in the proposal they submitted to meet it.

The CHAIRMAN. Thank you very much, Mr. Wood.

Mr. WOOD. May I leave the amendment?

The CHAIRMAN. Yes; you may leave the amendment for the record.

(The amendment submitted by Mr. Wood is as follows:)

AMENDMENT OF SECTION 361 (A) OF THE INTERNAL REVENUE CODE, PROPOSED BY GEORGE A. WOOD, BROOKLYN, N. Y.

Proposed revision of section 361 (a) of the Internal Revenue Code, as amended by section 151 of the revenue bill of 1942. (New matter in italics; no old matter is eliminated.)

"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, *or which is a common trust fund or similar fund excluded by section 3 (c) (3) of that Act from the definition of 'investment company' and is not included in the definition of 'common trust fund' by section 169 of the Internal Revenue Code.*"

The CHAIRMAN. I think it is obvious that we cannot, without running too late, conclude the hearing this afternoon, as we expected to do.

If there are any witnesses who have very brief statements and who wish now to appear we will hear them.

STATEMENT OF GEORGE M. ARISMAN, COMPTROLLER, ARMSTRONG CORK CO., LANCASTER, PA.

Mr. ARISMAN. My name is George M. Arisman; I am comptroller of the Armstrong Cork Co., of Lancaster, Pa. It will take me but 5 or 6 minutes to present what I have to say. The clerk has copies of what I wish to present.

My subject falls under the "Last-in, first-out method of inventory valuation." I am here to point out a problem which that provision has brought about and a remedy for it.

Armstrong Cork Co. adopted the last-in, first-out method of inventory valuation for certain of its commodities as of January 1, 1940, among which the principal raw materials were cork, burlap, asphalt, and linseed oil. Cork and burlap are imported in their entirety, cork coming from Spain, Portugal, and North Africa, and burlap from Dundee, Scotland, Calcutta and Bombay, India. The jute making up the burlap coming from Dundee is first shipped from India to that point for manufacture in burlap and then reshipped to the United States of America. A large part of the purchases of linseed oil is purchased from Argentina, and asphalt from Trinidad.

One of the features under the last-in, first-out method of inventory valuation, along with the privilege of fixing the price of an inventory item as of a certain date, in our case December 31, 1939, is the fixation of quantities, which the taxpayer has the privilege under the plan to vary according to his policies; however, the present shipping situation under the war or emergency conditions prevents the Armstrong Cork Co. from being able to maintain the fixed quantities of cork, burlap, asphalt, and linseed oil.

Accordingly, because of the demand for war purposes and other uses, it was not possible to keep up the quantities of these inventories to normal, or last-in, first-out, despite the fact that cork has been rationed for more than a year, as to quantities to be used. These are circumstances entirely beyond our control.

The effect of Armstrong Cork Co. not being able to keep the quantities of the inventories to those established, on account of lack of bottoms for shipping under the emergency, the company has incurred paper profits in the first 6 months of 1942 in the amount of $600,000, on which we will pay taxes at the highest rate, and these will become greater as the year continues.

An estimate of this inventory adjustment at the end of the year is approximately $1,000,000, which paper profits in our case will be taxable in the 90 percent excess-profits tax bracket, or an amount of $900,000 will be paid out in the form of taxes. This represents 20 percent of the company's current cash which is working capital that will be paid out in this manner.

Under the present basis of taxation, if these paper profits are taxed, capital will be paid out in the form of taxes and these funds will not be available to replace these quantities when it will be possible to acquire and transport these materials to the United States of America.

Accordingly, it is felt some measure or provision of relief should be allowed taxpayers under these conditions, and the following method is suggested as a procedure to be followed to accomplish this end:

That the taxpayer be permitted to create an emergency last-in, first-out fund which shall be used to reestablish these quantities in total or in part when the emergency permits or is ended and such materials are available.

The basis of establishing the emergency last-in, first-out fund would be arrived at by establishing the purchase price paid for a quantity of inventory equal to the quantity reduction of that raw material as caused by the emergency. As an example, if the inventory for cork was reduced by 3,000 tons and the price of the last 3,000 tons purchased was $90 per ton, and the last-in, first-out value was $40 per ton, the emergency last-in, first-out fund would then be arrived at in the following manner:

Established purchase price – last-in, first-out inventory value × number of tons = emergency last-in, first-out fund, $90 – $40 = $50 × 3,000 T. = $150,000

In the event 3,000 tons were purchased at $80, when the emergency permits, the result would be as follows:

$90 – $80 = $10 × 3,000 = $30,000 taxable income

It was suggested that this amount be taxed at the rate which prevailed in the year in which the deficit was created, in this instance 1942, but that the tax be paid in the year when all or any part of the shortage in quantities under the last-in, first-out method of inventory valuation was replaced.

Senator DANAHER. Is the $40 a typical figure on your last-in, first-out basis?

Mr. ARISMAN. Yes, sir. I am not proposing that any tax be evaded here—simply the creation of a fund and a basis of determining the proper charges.

In the event the emergency ended and the quantities were available at a price at which the emergency last-in, first-out fund was established (in the above example $90 for cork) and the taxpayer did not avail himself of this opportunity within 2 years to build up all or any part of the deficiency in quantities, under the last-in, first-out method of inventory valuation the entire fund so set aside becomes taxable and at the rates which prevailed at the time the fund was created. An alternative here might be to make this a reasonable period after the emergency had ceased to exist.

Under this proposed relief provision through the emergency last-in, first-out fund, the items purchased as replacements should be priced at the original last-in, first-out value and the difference between the replacement purchase price and last-in, first-out value would be applied against the fund.

The Armstrong Cork Co. feels that there should be a relief measure as here suggested so that capital will not be depleted because of an emergency situation which will later be needed in the business and would remain there under the last-in, first-out method, if it were not for this unusual situation. Further, the principles of last-in, first-out will be continued by this method both as to price and fixation of quantities, without the adverse effect of taxes on paper profits caused through uncontrollable reduction in inventories. That is the particular point that Mr. Chapman referred to a short time ago in his testimony.

The Armstrong Cork Co. through its experience with last-in, first-out realizes this is a sound accounting principle under normal conditions and avoids the extreme inventory losses with the changes brought about through economic cycles and price fluctuations. We hope some relief can be given last-in, first-out principle of accounting under the emergency effected by shipping conditions, priority regulations, and similar uncontrollable situations.

Senator DAVIS. I would like to ask you a question.

When and why did you first adopt that last-in, first-out method of inventory?

Mr. ARISMAN. Senator Davis, the last-in, first-out method of inventory valuation was adopted by the Armstrong Cork Co. December 1, 1939, and the reason for it was that we felt that this new accounting provision and the regulations and the law permitted the company to level out its earnings over a period of time and not have the problem of losses at one time and large earnings in the more prosperous years. We are a company who have many products which flutuate a good deal. The price of cork, for example, was approximately $17 to $18 a ton, delivered, several years, and today we are paying anywhere from $90 to $100 a ton, and you can readily see that if we had to put that cork on inventory at these high prices and then we went into a bad part of the cycle again, there would be considerable loss there, and that is just exactly what the intention was in setting up this last-in, first-out method, and it has worked out very nicely in our company.

Senator DAVIS. In what manner has the emergency aggravated your problem?

Mr. ARISMAN. As I pointed out, many of our products come from abroad, and on account of the shipping conditions and the impossibility of getting bottoms, naturally we cannot get these items in. But there are other things which also affect this situation under a war emergency, such as priorities, where corporations are limited under the last-in, first-out to replenish their stocks.

Senator DAVIS. I would like to know what will be the practical effect of your inability to replace your inventory?

Mr. ARISMAN. There are two things. In the first place, we are going to pay out our capital in the form of taxes, and when we go to buy inventories, when we are in a position to buy them, we will not be able to replenish them—we will not have the capital. In the event we can replenish, we will need to replace these items at the higher prices, and then we will be no better off than if we had not adopted the last-in, first-out method of inventory valuation.

Senator DAVIS. What is your remedy for the situation that you are in?

Mr. ARISMAN. We would like to be permitted along with the others who are working under conditions brought about by this emergency, to establish an emergency fund which would not be taxable and could be used at the point where it becomes possible for us to replace these particular items.

There is one other thing that I would like to submit, Mr. Chairman. Mr. Alvord in his memorandum on page 1789 the other day, I think, made a statement which bears very closely to what we are thinking about here. He said:

The demands of the war may prevent the maintenance of inventories essential to normal operation and force postponement of replenishment until after the war. Certainly, paper profits resulting from the forced depletion of normal inventories should not be taxed. They are not real income and actually there is a decreased ability to pay.

We are not the only concern, Mr. Chairman, who is facing this problem. I should like you to take 1 minute more to ask that Mr. Herbert Adair, executive vice president of the Artloom Corporation, be permitted to make a statement in respect to their company.

The CHAIRMAN. I will be glad to hear him if it is not very long. He is not on the list, is he?

Mr. ARISMAN. No, sir; but he is present.

The CHAIRMAN. Very well.

STATEMENT OF HERBERT J. ADAIR, EXECUTIVE VICE PRESIDENT, ARTLOOM CORPORATION, PHILADELPHIA, PA.

Mr. ADAIR. Mr. Chairman and members of the committee, my name is Herbert J. Adair, of Philadelphia, the Artloom Corporation. We manufacture rugs and carpets. Our basic commodity is wool, and wool comes from abroad.

We adopted the last-in, first-out inventory, and as a result of present conditions we have been losing that inventory, which we will not be able to replace, and we will suffer as a result of taxation on paper profits, a loss in our working capital of about $300,000. In the meantime we have converted our plant to complete war production, and the capital involved in that situation is necessary to our business. It is true that when this last-in, first-out formula was adopted by the Treasury in 1939 that there was apparently no concept of what conditions might come about, but this is a situation which is abnormal and we ask, and concur as a matter of fact with the Armstrong Co., that consideration be given by the members of the Senate Finance Committee to this situation.

The CHAIRMAN. Thank you.

Mr. ARISMAN. In closing, Mr. Chairman, I just want to say that the Armstrong Co. thinks that this method of inventory valuation, last-in, first-out, is a very good thing and a very practical thing. We have now used it for over 3 years and have found it to be a very sound accounting practice.

Thank you very kindly.

The CHAIRMAN. Thank you, sir.

STATEMENT OF EDWARD C. McCOBB, REPRESENTING GRAND RAPIDS STORE EQUIPMENT CO., GRAND RAPIDS, MICH.

Mr. McCOBB. I have filed with the secretary of the committee, Mr. Chairman, a statement, and I wish to take just a moment or two to state what our problem is.

I represent the Grand Rapids Store Equipment Co., which was reorganized in the typical manner in 1933 and 1934. It was prior to the adoption of section 77 (b), so that the usual equity receivership procedure was adopted. In order to force the cooperation of a small number of creditors or stockholders, it had to be reorganized, and they bid the assets in at a price that was less than the asset value on the books of the corporation. In this particular situation, assets having a book value of about $2,250,000 were bid in for about $350,000 simply to force compliance with the reorganization terms of dissenters.

Since that time, may it please the committee, several things have happened to exclude reorganized corporations from the incidence of the tax laws. Under section 77 (b) corporations were granted relief to reorganize under that section, and it was made retroactive to June 7, 1934. February 3, of this year, the Supreme Court considered several reorganization cases, that is, reorganizations forced through judicial proceedings, and by an interpretation of the revenue act and the reorganization provisions thereof exempted all reorganizations that had taken place under the revenue acts prior to the 1934 Revenue Act. They interpreted the 1934 Revenue Act as inapplicable by reason of the fact that oftentimes there were considerations other than voting stock issued for the assets.

Another case came before the Supreme Court in June of this year, and the Supreme Court implied that section 112 (B) (5) of the Internal Revenue Code might possibly exempt other reorganizations, but in the concluding paragraph of the opinion said that other questions had been raised for the first time in the appellate court and could not be decided there, so they were not able conclusively to apply section 112 (B) (5) to such reorganizations; in other words, my particular client that went through most of this proceeding in 1933 and only lacked the actual delivery of instruments of conveyance by the master in chancery in the proceedings which took place in about January 1934, is now faced with litigation over the question of whether or not it is entitled to use its predecessor basis because it is contended that the reorganization was completed under the 1934 act instead of under the 1933 act.

You see, may it please the committee, there are a few corporate reorganizations in foreclosure cases where section 77 (b) has not been invoked where the consummation of the program did not take place until after January 1, 1934, where section 112 (B) (5) may not be strictly applicable, where they are claimed to be taxable and where the resulting corporation is said to have to use the price at the sale or perhaps the price at which securities were issued, or something of the kind.

I have pointed out in my written memorandum that there are numerous conflicting rules to these various classifications, and I have suggested if section 113 of the code be amended to permit judicially reorganized corporations to use the basis of their predecessor and to make that provision retroactive to January 1, 1934, to take care of those reorganizations that are not protected by the Supreme Court decision, that the whole matter can very easily and clearly be taken care of.

The resulting effect of the failure to permit these reorganized corporations to use the predecessor basis is that they have no reasonable credit either on an earning basis or on an asset basis or an invested capital basis to claim a reasonable credit for excess-profits tax calculations, and you know without my telling you that most of these concerns that have gone through reorganization usually are in struggling condition, and unless they are given a fair chance to meet competition and given a fair chance to take credits similar to those granted to their competitors, many of them will be forced out of business.

My statement goes into the matter in somewhat greater detail.

Thank you very much for giving me this time.

The CHAIRMAN. Thank you.

The matter will be taken under consideration. Your statement will be filed.

(The statement submitted by Mr. McCobb is as follows:)

STATEMENT BY EDWARD C. McCOBB, GRAND RAPIDS, MICH., REGARDING TAXATION OF CORPORATIONS REORGANIZED THROUGH JUDICIAL PROCEEDINGS

My name is Edward C. McCobb. I appear before your honorable committee on behalf of Grand Rapids Store Equipment Co., Grand Rapids, Mich., of which I am general counsel and a director.

The purpose of my appearance is to request amendment of the Internal Revenue Code so as to give relief to corporations reorganized since January 1, 1934, in legal proceedings other than bankruptcy, by permitting them to use the basis of their assets in the hands of their predecessors in computing reserves for depreciation, profit or loss on sales and exchanges, and equity invested capital for excess-profits taxes.

On March 16 I appeared before the Ways and Means Committee to urge action by the House of Representatives on the same matter, but perhaps due to the numerous highly controversial problems demanding their attention, I failed to strike a chord of sufficient responsiveness to gain my point in the House version of the 1942 revenue bill. I admit my client is a relatively small corporation; I admit that the taxes it pays are an almost negligible element in the national revenue as a whole; but I do say that businesses like the Grand Rapids Store Equipment Co. are the backbone of our national economic structure, and that their tax problems are of such importance that proper solutions are a matter of great national concern. It is with full confidence the members of your committee share the same view, that I venture again to take your time to urge solution of the vexing problem of taxation of judicial corporate reorganizations.

DIFFERING RULES UNDER PRESENT TAX LAWS

Prior to the enactment of section 77B of the Bankruptcy Act in June of 1934, nearly all reorganizations of distressed corporations were accomplished through court proceedings in which judicial sales were necessary. Frequently a small number of creditors or stockholders refused to participate, and to force their cooperation the majority of the creditors and stockholders found it necessary to organize committees, and through these committees to purchase the assets at judicial sales for such small bids that the obstructing creditors or stockholders were faced with the option of either participating in the reorganization or accepting a relatively small cash dividend.

While sales of this kind often had the desired result of forcing general cooperation, the assets were sold for prices far less than cost less depreciation.

Nearly all such court reorganizations resulted in scaling down or eliminating the equity of the stockholders and in issuing stock of the transferee corporation to the former creditors. In consequence in such proceedings it was by no means clear that a tax-free reorganization had occurred within the provisions of section 112 (g) (1), Internal Revenue Code, and the similar sections in prior revenue acts. As a result the Commissioner of Internal Revenue has often contended that under section 113 (a) (7) such reorganized corporations are not entitled to use the same basis for their assets that their predecessors had used.

(a) *The bankruptcy rule.*—The original section 77B of the Bankruptcy Act did not mention this problem with respect to bankruptcy reorganizations, but sections 268–270 of chapter X of the Chandler Act (52 Stat. at L. 904) specifically provided that for purposes of taxes on income, the basis of the property of the original corporation should be reduced only by the amount the indebtedness of the original corporation was canceled or reduced by the plan of reorganization. Section 276 (c) (3) made these sections retroactively applicable to all plans confirmed under section 77B.

Section 270 was amended as recently as July 1, 1940 (54 Stat. L. 709), to provide that the basis of the debtor's property should not be decreased below its fair market value on the date of the order confirming the plan.

(b) *The rule in other cases.*—In the absence of a statutory rule there has been a large amount of litigation over the question of the basis of assets in the hands of reorganized corporations which acquired them at judicial sales. Four of these reorganization cases were decided on February 3, 1942, by the Supreme Court. These decisions held that corporate readjustments of the type I have described met the statutory definition of reorganizations in the 1932 and prior revenue acts, but that by reason of the amendments to the reorganization section in the 1934 Revenue Act, such reorganizations were not thereafter tax-free because in nearly every instance something more than stock was issued in the acquisition of the assets.

In the *Cement Investors cases*, decided June 1, 1942, the Supreme Court took some of the sting out of this abrupt segregation of tax-free and taxable reorganizations by holding that reorganizations completed after January 1, 1934, might comply with section 112 (b) (5) as transfers of property, entitling the new corporation to use the transferor's basis with recognition of gain or loss involved in the transfer of any additional consideration. The closing paragraph of the opinion took much of the comfort out of the decision, for the Court refused to decide an issue then presented for the first time, of whether individual creditors were subject to a tax on the acquisition of the property in the preliminary steps of the reorganization. From the point of view of the new corporation such a contention, if accepted, might seriously affect its right to adopt the basis of the assets in the hands of the predecessor corporation, for its transferor might be held to be the creditors, not the defunct corporation.

It should be noted in passing that the Supreme Court in the *Marlborough House, Inc.*, decision approved an asset basis of fair market value at the date of sale in foreclosure cases where there had been no tax-free reorganization, referring to article 108, regulations 77, and to *Helvering* v. *New President Corporation* (122 F. 2d 92).

(c) *Excess-profits tax regulations.*—As respects calculation of equity invested capital under section 718 (a) (2), Internal Revenue Code, regulations 109, section 30.718-1, provides that where the basis is cost and stock was issued for the property, the basis is the fair market value of the stock at date of issue, but if the stock had no established market value, then the basis is the fair market value of the corporate assets at date of acquisition, less liabilities. There is no express statutory support for this regulation, and it is subject to change at any time.

Thus, in bankruptcy reorganizations the basis is that of the predecessor, scaled down by the amount the debtor's obligations are reduced under the plan, but in no event to an amount less than fair market value; in other types of reorganizations the rule is either predecessor's cost basis or cost at judicial sale, depending upon whether the reorganization was governed by the 1932 and earlier revenue acts, or by the 1934 and subsequent acts, or complies with section 112 (b) (5), with a variation of fair market value in foreclosure cases since January 1, 1934; and in excess-profits tax calculations the basis depends upon the market value of securities issued in exchange for the assets, or in the absence of such market value, upon fair market value of the assets.

The need for a uniform rule is obvious, and it is my belief that such a result can only be accomplished through amendment of the Internal Revenue Code.

THE CASE OF GRAND RAPIDS STORE EQUIPMENT CO.

To give point to the effect of these different rules, I should like to refer specifically to the problem confronting Grand Rapids Store Equipment Co. The predecessor corporation was placed in receivership by order of the District Court of the United States for the Western District of Michigan filed February 23, 1933. On the 23d of November 1933, the court entered an order to sell the assets. A formal plan and agreement of reorganization had been prepared dealing with the conflicting claims of various classes of creditors and security holders. The court approved the plan by an order entered December 14, 1933. A sale was held on December 23, 1933, the assets were bid in by the reorganization committee, and the sale was confirmed on December 28, 1933. At this sale assets having a depreciated cost value of approximately $2,275,000 were bid in for approximately $355,000. The assets were then transferred to a new corporation, but due to the amount of detail confronting the master in chancery, the conveyances were not delivered until January 19, 1934.

Under the plan the creditors received approximately 50 percent of the face of their claims in new debentures, of which more than $950,000 were issued, and the remainder of their claims in no-par-value common stock. Preferred stockholders received options to buy the new common stock and old common stockholders were eliminated altogether. The book value of the shares issued to creditors was based upon the book value of the assets of the old corporation, and not upon the price bid at the sale.

As a result of the plan, the reorganized corporation had the same assets as its predecessor. The general creditors had received one-half the amount of their claims in new debentures and the remaining half in no-par-value stock, relying upon the future profits of the enterprise for the recovery of their original claims.

This reorganization was consummated a little more than 5 months prior to the enactment of section 77B. While all the economic benefits and burdens of ownership were transferred in 1933, the Commissioner of Internal Revenue will probably assert that the reorganization was not consummated until 1934 when the conveyances were delivered.

The income-tax returns for the first years after reorganization deducted reserves for depreciation computed on the predecessor's basis. The Commissioner of Internal Revenue made deficiency assessments on the basis of the bid at receivership sale. These deficiencies for the first several taxable years of the reorganized corporation have been compromised on a more or less arbitrary basis. This compromise leaves open the question which, I am reliably informed, will be asserted when the first excess-profits tax returns are audited, of whether the reorganization was consummated under the 1932 act or under the 1934 act. Preliminary discussions have also revealed that the tax authorities refuse to recognize the applicability of section 112 (b) (5) under the *Cement Investors* decision. Still more litigation and expense will ensue unless the point is determined by legislation.

As respects depreciation deductions, it will readily be seen that if those reserves must be based only upon the bid price at judicial sale instead of the cost of the assets to the predecessor, normal income taxes will be substantially higher. This will mean that the corporation will be unable to accumulate more than a small fraction of the money necessary to replace its assets at the end of their useful life and ultimately will strangle for lack of invested capital. It will mean that creditors who accepted stock will be forever denied recoupment of their losses. Finally it will mean the reorganized corporation will be unable to maintain its competitive position in the industry against corporations which have weathered the depression or have been able to invoke some form of tax-free reorganization.

The most serious situation arises under the very large excess-profits taxes provided in H. R. 7378. When the Government takes such a great part of abnormal income, every effort should be made to be sure that the credits based on normal profits are fair and reasonable. The new company has not had substantial profits in the base period during its efforts to rally from its financial difficulties. If it is required to adopt an equity invested capital based upon the bid at judicial sale, or upon the price at which some discouraged creditors jettisoned their stock after reorganization, the credit based upon its invested capital will be almost negligible. With no adequate credit either on earnings or on invested capital, the excess-profits tax will become truly confiscatory. All the adverse results outlined above will be multiplied.

Both from the viewpoint of equality of treatment of such reorganized corporations compared with other businesses reorganized in bankruptcy, or compared with competitors, this problem is sufficiently serious to demand solution. These reorganized businesses should be kept alive as taxpaying, wage-paying organizations, and not penalized almost to extinction by reason of the necessity of court reorganization. They should be permitted to use the depreciated cost of their assets, just as their competitors are permitted to do, in making the tax returns. Congress recognized the need and granted relief to reorganized debtors under section 77B and chapter X of the Bankruptcy Act. It should not be less ready to act with respect to other types of reorganizations, especially since some are now favored by judicial decision if they were fortunate enough to have been reorganized prior to January 1, 1934, or can successfully invoke section 112 (b) (5).

NATURE OF RELIEF

Section 113 of the Internal Revenue Code should be amended, retroactive to January 1, 1934, so as to permit corporations which have completed judicial reorganizations since that date to use the basis of their assets in the hands of their predecessors. So far as a comprehensive amendment of the Internal Revenue Code is concerned, such relief might well be extended to cover future reorganizations of the same character.

(a) *Effective date.*—Because the Supreme Court decisions of February 3, 1942, hold judicial reorganizations consummated prior to the effective date of the 1934 Revenue Act to be tax free, but hold those consummated thereafter to be taxable, and because the Supreme Court in the *Cement Investors case* has not decided all questions relating to the right of a judicially reorganized corporation to use its predecessor's basis of assets, it is felt that the suggested amendment to the Internal Revenue Code should apply to all judicial reorganizations completed since January 1, 1934.

(b) *Good faith.*—It is conceded that the relief contemplated by the amendment should be given only in instances of good faith reorganizations, and not where a minority of creditors or stockholders acquires the property and freezes out the majority. For that reason the definition of control found in section 112 (h), Internal Revenue Code, might well be included to require 80 percent of the stock of the new corporation to remain in the interested parties, including stockholders, bondholders, and general creditors.

The proviso with respect to the good faith nature of the reorganization found in section 269, chapter X, of the Chandler Act might also be included.

(c) *Basis.*—By Supreme Court decision all judicial reorganizations consummated prior to January 1, 1934, enable the corporations so reorganized to use the basis of their assets in the hands of their predecessors. According to my information, the railroads and public utilities request similar relief. The privilege of using the predecessor's basis of assets is buttressed with strong arguments. Regardless of the cooperation of creditors in scaling down their obligations and accepting capital stock for the balance, the original investment is not thereby diminished, and the original investment should be fully available in the calculation of invested capital for excess-profits tax calculations. Furthermore, it will cost just as much to replace working assets at the end of their useful life as though no reorganization had occurred, and reserves for depreciation based upon their original cost are not only justified but are an economic necessity.

Because the right of many reorganized corporations to use the full cost basis of their predecessors has been judicially recognized by the Supreme Court, and because the arguments in support of the use of that cost basis by others in similar position are reasonable and fair, it is believed that the basis established in the Supreme Court decisions should be made universally available in all judicial reorganizations recognized by Congress as eligible for relief. The bankruptcy rule and the rule in foreclosure cases insofar as they differ from the rule of predecessor's cost basis should be made to conform by the provisions of the proposed amendment.

(d) *Retroactive effect.*—I have pointed out that the Chandler Act granted relief in bankruptcy cases retroactive to the effective date of section 77B, namely, to June 7, 1934. (See sec. 276 (c) (3) of ch. X.) I have also pointed out that the Supreme Court decisions make January 1, 1934, the date as of which reorganizations formerly tax-free became taxable, unless governed by section 112 (b) (5). If complete justice is to be done, it is felt that the tax relief should clearly be made retroactive to January 1, 1934.

The practical difficulties in the way of extended retroactive relief are recognized. Probably many corporations would be satisfied with relief, both for purposes of depreciation reserves, and for calculation of equity invested capital, for all taxable years beginning after December 31, 1939. If relief be limited to that extent, these reorganized corporations should be permitted to spread over the remaining useful life of their assets, whatever remains of the cost basis of their predecessors, after deducting the actual reserves for depreciation, taken on their tax returns, for the interval between reorganization and December 31, 1939.

RELIEF TO THE UTILITIES

Recently it has come to my attention that common carriers by rail and other public utilities have requested the privilege of using their predecessors' basis in event of reorganization. This relief is sought to be made retroactive to all taxable years beginning after December 31, 1938, but is limited in its scope to railroad and utility judicial reorganizations. Fully recognizing the propriety of such relief, on behalf of smaller industrial corporations I wish to express the firm conviction that the relief to be granted by Congress should apply generally to all classes of judicially reorganized corporations, and should not be restricted to any special class of reorganization such as public utilities. The problems of the utilities may be better known, the number of persons interested may be greater, and the public interest more obvious, but it is realized by practically everyone that to maintain our national strength in this emergency, the problems of the smaller business organization must be clearly recognized and as effectively solved.

It is believed that by broadening the amendment proposed by the utilities to cover all judicial reorganizations and by making it applicable to all reorganizations effected since January 1, 1934, retroactive to such date as Congress thinks proper, the entire problem can be handled in a general comprehensive amendment to the Internal Revenue Code.

CONCLUSION

It should be emphasized that these judicially reorganized corporations are not attempting to escape their full share of financing the war. They do seek equality of treatment with bankruptcy reorganizations, with reorganizations completed prior to January 1, 1934, with reorganizations able to invoke section 112 (b) (5), and with competitors. In this time of emergency when the Federal Government is calling upon private industry to assume drastically increased burdens of taxation, it is essential that all inequalities and unfairness be eliminated from the incidence of the tax laws.

These reorganized corporations are usually in weakened financial condition, or reorganization would not have been necessary. If they are penalized unduly, by reason of inadequate reserves for depreciation or by unusually large excess-profits taxes, they may soon be in a position where they cannot maintain their assets in competition and must face liquidation. Such a result will not only eliminate substantial taxpayers, but will create further loss of private employment, and will aggravate the problems of the inevitable readjustment which must follow the present war.

EDWARD C. MCCOBB.

AUGUST 13, 1942.

The CHAIRMAN. Mr. Javits.

STATEMENT OF BENJAMIN JAVITS, NEW YORK, N. Y., REPRESENTING INVESTORS FAIRPLAY LEAGUE

Mr. JAVITS. Mr. Chairman, I am appearing here in the interests of 15,000,000 security holders of American corporations, 64,000,000 policyholders, 20,000,000 home owners, and 40,000,000 bank depositors. These people, in their economic interests, are an unrepresented group as a group in the affairs of this country. There is no pressure group representing the investors as there is reputed to be representing management, labor, and the farmers.

A democracy functions by the balance of pressures. The Investors Fairplay League, of which B. C. Forbes is the head, has been organized to represent the men and women who have a financial stake in the well-being of this country. The tax bill is vital and important in their interests. What makes America different from Germany and Japan is the fact that we have a system of enterprise known as the free enterprise system, that is, that the industries of this country are not owned or even controlled in the broad sense by the Government. That is our free way of life, and that is the way of life that we wish to retain and foster.

We therefore respectfully suggest to you, first, that corporations, which are the common property of the American people, shall not be so taxed as to make it impossible for them to continue in the operations of their enterprises, or shall not be taxed so as to make it necessary for them to have the Government take them over. In other words, we do not wish a situation in this country where the Government owns the property of the people.

What we should like to see maintained is that the people own the Government and their own property. The expressions of the chairman of the committee which we have read in the newspapers have been very encouraging. The Investors Fairplay League is an organization newly formed and we hope that this organization, with intelligent and constructive leadership, will be able to give you gentlemen in Congress an organized group of security holders and property owners to whom you can look for either united action or aid and advice in helping to deal with the Nation's legislative problems. It is a grass roots organization. It has no ties with any financial interests, with any industrial interests, or with any political interests. It is seeking to provide the additional balance wheel needed in the organized groups of the Nation. We hope to work in full harmony with management, with labor, with agriculture, and with the men and women in government.

Notice of our opportunity to appear has been short, and we should very much like an opportunity to file a further brief in the interests of the forgotten men and women of property in this country.

We are interested in preserving our system so that our men who are fighting know what they are fighting for. We also believe that in this way civilian morale can be very much aided. We believe that the large borrowings of the Government will be so much better secured if the corporations, which in the final analysis are security for these debts, are and remain in good shape.

Secondly, we believe that in order to carry out the idea of encouraging the private financing of enterprise and industry, that the capital-gains tax should be handled in the way in which Mr. Emil Schram, president of the New York Stock Exchange, has suggested. There is no need of repeating that here, but I have Mr. Schram's statement in my hand and there is very little, if anything, I could add to that.

I am not a tax expert. I am only counsel to the Investors Fairplay League, and I am giving you the benefit of our views at this time. I say to you very frankly that as yet we actually do not represent a great many people, but we do speak for the interests of many millions of America's middle class, and we hope that the middle class, which is in danger of being destroyed in this country because of all that we have gone through in recent years, will be saved and helped by your efforts and the efforts of this organization which I represent.

Incidentally we feel that any reasonable amount of tax that you want to add to the individual is quite all right, but that the corporate structure of the country be preserved, and not destroyed or confiscated by any program in which you engage.

Thank you very much.

STATEMENT OF H. R. WEAVER, NEW YORK, N. Y., IN BEHALF OF INTERNATIONAL PAPER CO.

Mr. WEAVER. Mr. Chairman and members of the committee, my name is H. R. Weaver. I am appearing in behalf of International Paper Co., of which I am vice president and treasurer.

I want to preface the specific points I have to make with a few general statements as to the importance of the corporate structure in our economic life not only for the present but even more so for the future.

I have been in business for 33 years. I happen to have been associated for practically all of my business life with an industry which is fundamental in character but which for one reason or another has had its very marked ups and downs.

My company, International Paper Co., is certainly the largest and I think I can say, one of the soundest in this business. We cover practically the entire field of paper making. And yet there have been periods over the years when we have had a real struggle to maintain ourselves in a solvent position.

I know from my own personal experience what it means to have to raise large amounts of money continuously over a long period of years. I think this is exactly the problem which faces the Government of the United States today. Because of my own personal experience I speak therefore with some feeling and I think with some knowledge on this subject.

In the first place I think that a cardinal mistake to be avoided is any attempt to raise the maximum possible amount from corporations to day without consideration of the effects which such action will have on the future status of these corporations. While it is to be conceded that we must raise as much as possible of the cost of the war by taxes, thought must also be given to the future of our country after the war is over.

Any present tax policy, which, for the sake of a relatively small amount of additional taxes now, adversely affects the future of our business structure is penny-wise and pound-foolish. It is my mature judgment that the principles of taxation and the rates now proposed for corporations do just that.

I should like to impress on you as forcibly as I know how that the whole industrial and economic life of the United States is tied up today inextricably in the system of corporate organization. Whether we like it or not, or whether we think the system is antisocial or not makes no difference.

It is fundamental in our economic life and if a monkey wrench is thrown into its gears the result is bound to be chaos. The system of conducting business through corporations has developed and expanded hand in hand with the growth of the country. The resources of our country have been developed and expanded by corporations through their ability to produce profits and to distribute those profits to investors, thus encouraging further investment and further expansion.

I am thoroughly in sympathy at the present time with raising as much money from corporations as the corporate system can bear and still endure. Anything more than this will, in my judgment, be the gravest mistake not only from the standpoint of the corporations involved and the individuals who own them but from the standpoint of the United States Government itself which must now so largely depend upon the revenue to be raised from taxes imposed upon successful corporate activity.

Any system of taxation which does not permit corporations, with earnings, to retain a sufficient part of them to meet the constant need for plant improvement, debt retirement, and working capital and leave thereover something with which to pay a reasonable return to stockholders on their investment will inevitably cripple our corporate economic system and make worthless the billions invested in corporate stocks.

The corporation, of course, is nothing but the cooperative effort of a number of individuals who put their money into a common pool which offers greater possibilities for profit than if they did business purely as individuals. Common stock is the foundation of this system. Only after a substantial portion of the required capital has been raised from this source can additional capital be raised by the sale of preferred stock or bonds.

To tax the earnings of corporations at an excessively high rate will prevent the corporations from paying reasonable, and in many cases any, dividends on this stock. When individuals see that they get little or no return on their investment and that the value of their investment goes down, in many cases to the vanishing point, they will naturally refuse for many years to come to ever make similar investments again. If common stock cannot be sold in the future then the beginning of the end of the corporate system is in sight.

We need a strong corporate system for the future. We need it to provide high taxes which the Government will need for many years after the war. We need it to provide employment for those who have entered our armed forces. We need it to furnish opportunity for our children and our grandchildren.

It is my mature judgment that the high normal and surtax rates and the low excess-profits tax exemptions in the House bill seriously threaten the future of our corporate system.

First, let us consider the normal and surtax combined rate of 45 percent. If we assume a corporation earns exactly 6 percent on its invested capital and has no excess profits, it can retain only 55 percent of this 6 percent, or 3.3 percent of its earnings. The absolute needs of a prudently managed business will require a substantial portion of this amount, leaving an insignificant return or none available to stockholders in the form of dividends. If this same corporation had excess profits, its position would be slightly improved but contrariwise, if its earnings were less than 6 percent, its position would be worse than the example given.

In my opinion, the 45 percent proposed rate for normal and surtax is too high. I submit that this rate could be reduced to 35 percent with substantial improvement to the stability of our corporate system and with substantial benefits to investors, while the reduction in taxes now to be collected would not be great and eventually the Government would get more taxes. The personal income taxes on additional dividends, which could be paid by corporations under a lower normal and surtax rate, would partially offset the lowered corporate rates.

The figure of 3.3 percent which I just mentioned represented the return available to all stockholders. If one-half of the capital of the corporation were in the form of a 5-percent preferred stock and the balance represented by common stock, the results would be even more harmful. With only 3.3 percent return on its entire capital left to the corporation, a 5-percent dividend on 50 percent of the capital would represent 2.5 percent, leaving only eight-tenths of 1 percent available for the needs of the business and for distribution to the common stockholders.

Since it is obvious that the financial requirements of the business must be taken care of before any kind of dividend is paid, it necessarily follows that the preferred dividend would have to be seriously cut and there is no chance whatever for a common dividend.

With greatly increased tax rates now proposed, it seems to me that the status of preferred stock and preferred stock dividends must be changed unless we are prepared to see common stock wiped out as a medium for future corporate financing.

SUGGESTED CLASSIFICATION OF PREFERRED STOCK AS DEBT

I suggest that preferred stock could well be classified as debt and dividends paid on preferred stock treated as interest payments in the computation of taxable income.

The final burden of the present high tax rates falls upon the common stockholders. Insofar as their equity is concerned, the preferred stock is of a similar nature to debt. Full dividends on the preferred are payable before anything can be available to the common shareholders and the principal of the preferred stock represents a position prior to the equity of the common. Naturally, any corporation having excess profits and electing to treat its preferred stock as debt would have to adjust its "invested capital" basis or its "average earnings" basis correspondingly.

EXCESS-PROFITS TAX

The foregoing has dealt principally with the normal and surtax. Now, as to the excess-profits tax situation, I believe we should have excess-profits taxes and I am not concerned particularly with the rate of taxation. I am, however, very much concerned with the definition of what constitutes excess profits, in other words, the manner in which the excess-profits tax exemption is calculated, particularly by corporations who are forced to use the "invested capital" basis.

I have read the statement made by Thomas F. Patton, of Republic Steel Corporation, of Cleveland, Ohio, before this committee on this subject, and I wish to endorse his statement 100 percent.

His main points with reference to the excess-profits tax exemption on "invested capital" are:

(1) That the gradation in rates from 8 percent down to 5 percent based simply on the size of the corporation is unsound and discriminatory.

(2) That it is inequitable to reduce the "invested capital" credit while making no reduction and even allowing some additions to the "average earnings" credit.

GRADED CREDITS ON INVESTED CAPITAL ARE UNFAIR

As to his first point we should look through the corporation itself to its stockholders. Doing this we find that our large corporations today are not owned by a few wealthy individuals. Ownership is widely distributed among all classes.

People of lower incomes (with earnings of $10,000 per year or less) hold over 50 percent of the stock of our large corporations. The exact reverse is true of small corporations, which are generally closely held by families and individuals of better than moderate means. Thus the sliding rates are in reality a penalty against the small investor and should be eliminated.

As to his second point, I would like to show just how much taxes have been increased to the so-called "invested capital" companies over and above the increase to the so-called "average earnings" companies. Let us assume two corporations each have $100,000,000 of invested capital. Assume that one corporation averaged $10,000,000 of earnings in the base period 1936–39 and the other averaged only $5,000,000. For each of the tax years, 1940, 1941, and 1942, assume each company had the same earnings of $30,000,000 before taxes.

The following table will show the taxes for each company in 1940, 1941—and under the House bill proposals—for 1942:

	Taxes paid by invested-capital company	Percent	Taxes paid by average-earnings company	Percent	Difference in favor of average-earnings company
1940	$14,551,500	48.5	$13,801,500	46.0	$750,000
1941	18,767,240	62.5	17,003,797	56.6	1,763,443
1942	24,228,000	80.7	21,906,214	73.0	2,321,786

These figures show clearly that taxes to the "invested capital" group have been increased disproportionately to those of the "average earnings" group.

An 8-percent credit on "invested capital" would only permit the corporation to retain 4.4 percent plus 10 percent of its excess profits. Surely such a return can, by no stretch of the imagination, be called excessive. This 8-percent credit was allowed in the 1940 act. Subsequently the credit to the "average earnings" companies was increased, but the credit to the "invested capital" companies was reduced. This is neither fair nor reasonable nor sound tax policy and should be corrected by allowing the excess-profits tax credit to be based on a flat 8 percent of "invested capital."

I realize that the suggestions made herein will, if adopted, result in some diminution of tax revenue to the Government at a time when revenue is so sorely needed. However, needs of the moment should not lead us to take action which will have a serious effect upon the economic life of the country for many years in the future.

I believe that any loss in revenue arising from the suggestions above should be made up by a sales tax or by higher individual income taxes, or by both.

The CHAIRMAN. Thank you very much, Mr. Weaver.

The committee will now recess unless there is some other witness who can finish in a few minutes.

Mr. Easley.

STATEMENT OF GEORGE A. EASLEY, NEW YORK, N. Y.

Mr. EASLEY. Mr. Chairman and gentlemen, I am George A. Easley, formerly a resident of La Paz, Bolivia, during 12 years, but now a resident of New York. I have been engaged in business in and with that country for 30 years. I am speaking in behalf of my associates and other Americans who are and have been for years residents of Bolivia.

When I asked for the privilege of appearing before this committee with regard to the repeal of section 116 (a) of the Internal Revenue Code, I did not realize that on August 4 the chairman had already announced that you have no intention of repealing the exemption for the earned income of citizens who are bona fide residents of foreign countries, and I wish to express our gratification for this pronouncement.

I wish also to endorse the views expressed on August 4 by the representatives of the American Chamber of Commerce in Argentina, Brazil, Cuba, and Mexico, as well as of the National Foreign Trade Council.

From the standpoint of Bolivia I may say that only about 150 United States citizens, including women and children, are resident there and that they are greatly outnumbered by citizens of Great Britain, Germany, Japan, and other foreign countries. There is no doubt that the enactment of the exemption in 1926 has been a primary factor in inducing young Americans to go to Bolivia and stay there despite all the burdens and risks they have had to assume and that the continuation of this exemption is necessary to enable them and their companies to compete with the enterprises of the nationals of other countries.

The question of American employees and individuals in business in Bolivia has been so well covered by what has been said in regard to other countries that I need add nothing more.

However, if the committee will permit, I might add a word about the tax advantages which competing companies enjoy. Of course, purely Bolivian companies bear only the taxes of that country itself, and other governments have adopted measures which tend to put their companies on a basis of equality with Bolivian companies. Thus, France and Italy exempt their companies from profits taxes on profits allocable to establishments in Bolivia.

Great Britain refrains from taxing British companies whose business is carried on and managed in Bolivia until profits are brought home.

Essentially similar provisions in Canadian law exempt Canadian companies whose business is carried on entirely in Bolivia and tax the income only when it is brought home and distributed as dividends. Such provisions have been adopted to encourage the development of business abroad.

Consequently, there are more foreign companies operating in Bolivia than American comp^nies. This is due to the fact that an American company operating in Bolivia is liable not only to the capital-stock tax, even if its entire capital is utilized in the business in that country, but also to the income tax and surtax which are to total in the House bill 45 percent even if all the company's income is produced in Bolivia. The company will also have to pay the excess-profits tax unless it comes within the narrow limitations of section 727 (g) I. R. C.

Profits may be made in terms of bolivianos, but when converted into dollars disappear or are seriously reduced because of fluctuations in exchange or the costs of converting Bolivian currency into dollars.

The credit allowed for Bolivian income taxes is of vital importance, and especially if amended as proposed by the National Foreign Trade Council so as to allow the credit when the tax on income is computed on an empirical basis.

Nevertheless, it is not sufficient to allow for losses incurred in converting profits computed in terms of bolivianos into United States currency, or to place American companies in an equal competitive basis with the companies of other countries mentioned above. The question arises whether it would not be advisable to adopt, in addition to the proposed amendments to section 131, I. R. C., a provision in the pending revenue bill which would be essentially similar to the above-described provisions in the laws of Great Britain and Canada.

Thank you, Mr. Chairman.

The Chairman. Mr. Burnett.

STATEMENT OF GEORGE H. BURNETT, TREASURER, JOSEPH BURNETT CO., BOSTON, MASS.

Mr. Burnett. Mr. Chairman and members of the committee, my name is George H. Burnett, treasurer of the Joseph Burnett Co., of Boston, Mass. I appear before you as chairman of a special committee of the Flavoring Extract Manufacturers Association of the United States, and am authorized to speak for six additional national associations whose member companies manufacture medicinal preparations and food products requiring the use of alcohol.

In the bill before you it is proposed to tax alcohol or distilled spirits $6 per proof gallon. Spirits are measured on a proof basis when used for beverage purposes, but in the manufacture of medicine and food products 190-proof alcohol must be used, and thus the tax on a gallon of alcohol will be $11.40.

With the great increase in taxes on spirits the industry is confronted with a perplexing problem, and some relief is sought to permit food and medicine manufacturers to maintain their business and provide continued revenues to the Treasury Department.

Senator Tydings, of Maryland, who is familiar with our problem, a year ago introduced, and the Senate passed, an amendment to the then pending revenue bill, which provided for a refund of a portion of the tax paid on distilled spirits. This amendment was eliminated by the conference committee. Since that time we have been working on the problem, and the amendment I wish to discuss was introduced by Senator Tydings last Monday, ordered printed, and referred to your committee.

The purpose of this amendment is to establish a differential in the excise tax imposed upon distilled spirits which is used for nonbeverage purposes as opposed to that used for beverage purposes.

The scheme of the amendment is very simple. It provides first for the payment of all taxes upon the alcohol used in the manufacture or production of medicinal preparations and food products, and then the drawback of a differential in tax provided the person filing claim for such differential has paid a special occupational tax of $100 per annum, and can establish the fact that the spirits purchased by him and upon which he paid the full tax were used in the manufacture or production of medicinal preparations and food products not intended for beverage purposes.

The amount of differential which is provided by way of drawback brings the amount of tax back to that point where the yield to the Treasury reached its maximum.

The industry has been endeavoring for many years to obtain a differential in the tax levied upon distilled spirits used in the manufacture of food products and medicinal preparations. Since 1940 the quantity of distilled spirits used in the manufacture of these products has been on the decline. This is a matter of common knowledge within the industry. Accurate figures are not available due to military secrecy, but it is estimated that the use of distilled spirits in the manufacture of medicinal preparations, flavoring extracts, fruit and flavoring sirups, and domestic preservative preparations has declined between 50 and 60 percent in the last 2 years. There has obviously been a resultant loss in revenue.

This problem has been discussed with officials of the Treasury Department, who express themselves in sympathy with the general objectives of this amendment, and believe the relief asked to be equitable, meritorious, and not falling within that class of requests which might be classified as assisting a special privilege. They have indicated some opposition thereto, however, on two grounds.

The first of these is the belief the tax is being passed along to the consumer. While this may be true in a small percentage of cases, the experience of the industry is this:

In the case of medicinal preparations, it is not possible to increase the sales price of a product which has been sold at an established price for many years. The manufacturer has had to absorb increases in all other materials, labor costs, et cetera, because, due to consumer psychology and established price ceilings, he is not able to raise his price.

The manufacturer of flavoring extracts and fruit preservatives finds himself unable to pass the tax along on the 50 percent or more of his business which is usually done with the manufacturing wholesalers of ice cream, bakers, and confectioners. He has found that attempts to increase the price have resulted in the use of substitutes by these manufacturers and the consequent loss of business by him. The consumption of pure flavoring extracts and sirups using distilled spirits has decreased as the tax has been increased.

The second objection raised by the Treasury Department is that of the administration of a differential in tax. The proposed amendment eliminates these difficulties in the following manner:

(*a*) The tax is first of all to be paid at the same rate on all distilled spirits.

(*b*) The manufacturer must pay a special occupational tax of $100 per annum to become eligible for the privilege of draw-back.

(*c*) He must keep books and records to establish the fact that articles produced were not intended for beverage purposes, and must conform to rules and regulations in relation thereto as shall be prescribed by the Treasury Department.

(*d*) The claim for draw-back must be filed quarterly.

The Treasury is amply protected under the above arrangement, in that all taxes have first been paid. A special tax of $100 per annum is required, which will be more than sufficient to pay the cost of checking drawback claims. The manufacturer must establish to the satisfaction of the Treasury that no part of the spirits used was consumed in products intended for beverage purposes.

The amendment eliminates unnecessary and burdensome work which would be attendant upon the passing on claims for draw-back which would not involve an amount sufficient to pay for their preparation, examination, and disbursement, this being accomplished by requiring payment of the occupational tax.

From information gathered by the industry, the majority of users of small amounts of spirits use them in the performance of a personal service, for example, the compounding of prescriptions. Such a service is not subject to price control and price ceilings and these users are at liberty to pass on, if they choose to do so, to the consumer the tax which they pay upon the small quantity of spirits which they may use, and which they customarily purchase at retail. There is no competition between the personalized service of these small users and the wholesale manufacturers of packaged products. In the event that those who perform this personalized service use sufficient quantities of alcohol to justify payment of the occupational tax, and the keeping of the necssary records and the filing of claims for draw-back, the provisions of the amendment are available to them.

That a differential in tax is fair, equitable, and capable of administration is conclusively evidenced by the following:

Every country in the world imposing a tax on distilled spirits—except the United States—provides for such a differential.

The United States during the last war recognized and administered a differential in tax, the tax during that period on alcohol used for beverage purposes being $6.40 and that used for nonbeverage purposes $2.20.

Canada under present war conditions recognizes a differential, and tax imposed on alcohol used for industrial manufacturing purposes is 21.47 percent of that imposed on alcohol used for beverage purposes.

In conclusion, I should like to submit for the record a more detailed statement covering this problem with the hope the information therein contained will prove helpful to the committee.

The CHAIRMAN. That may be done.

(The statement submitted by Mr. Burnett is as follows:)

SUPPLEMENTAL STATEMENT OF GEORGE H. BURNETT, TREASURER OF JOSEPH BURNETT CO., BOSTON, MASS.

It is proposed in the tax bill before you to increase the tax on alcohol from $4 per proof gallon ($7.60 per volume gallon, 190 proof) to $6 per proof gallon ($11.40 per volume gallon, 190 proof). This increase in tax will affect not only the users of alcohol in the manufacture of beverages but also the users of alcohol for solvent and preservative purposes in the manufacture of flavoring extracts, fruit, and flavoring sirups, soda-water flavors, medicinal preparations, proprietary medicines, and household remedies.

The manufacturers of these last-named preparations are represented by the following national organizations or associations, namely:

The Flavoring Extract Manufacturers of the United States.
The National Association of Manufacturers of Fruit and Flavoring Syrups.
The National Association of Manufacturers of Soda Water Flavors.
The Proprietary Association of America.
The Interstate Manufacturers Association.
Grocery Manufacturers of America, Inc.
American Pharmaceutical Manufacturers' Association.

Practically all member companies of the foregoing associations are vitally interested in the present and proposed tax on distilled spirits due to the fact that they use ethyl alcohol in the manufacture of food products, drug, and medicinal preparations.

Every member company is aware of the difficulties attendant upon taxation generally and keenly alive to the need for increased Federal revenue. In the case of most of the member companies they would prefer to continue to use alcohol as a solvent or preservative instead of resorting to a substitute, thereby producing a better product and at the same time continuing the internal revenue.

It is common knowledge that one great source of revenue is the tax on distilled spirits. This has been true ever since 1794. Presumably this is a painless tax paid for by those who can afford the luxury of drinking liquor. Unfortunately, however, for the industries mentioned, distilled spirits embraces the following classifications:

1. Distilled spirits for beverage purposes, that is, whisky, gin, brandy, etc.;
2. Distilled spirits (or ethyl alcohol, for instance) used in the manufacture of food and medicinal products;
3. Distilled spirits (denatured and unfit for beverage use) used industrially; and
4. Distilled spirits (or ethyl alcohol used by the Federal and State Governments, hosiptals, institutions, etc.

The last two classes are tax-free users and no revenue accrues to the Government. The first two classes are required to pay all the revenue derived from the tax on distilled spirits. In part I of subchapter C of the Revenue Code it is quite clear that the tax should be collected on the products enumerated in class 1. There is some doubt, however, whether there ever was any congressional authority for the tax collected on the products enumerated in class 2. There is justification for the conviction that without legislative authority the Bureau of Internal Revenue by regulation—and in opposition to the clear meaning of the statute—imposes the same tax upon the products incorporated in classification No. 2 as that imposed upon the products incorporated in classification No. 1.

As long as this tax was not prohibitive or confiscatory the industry has paid it. However, as the tax has become more and more prohibitive, those manufacturing products covered in classification No. 2 have found it necessary to protest more and more vigorously. The increase in tax has been tremendous in the last 8 years. Before February 1934 the rate was $1.10 per proof gallon or $2.09 per volume gallon, 190 proof. In February of that year it was raised to $2 per proof gallon or $3.80 per volume gallon, 190 proof. In 1938 it was again upped to $2.25 per proof gallon or $4.27½ per volume gallon, 190 proof. The present tax is $4 per proof gallon or $7.60 per volume gallon, 190 proof, and the proposed bill would call for a tax of $6 per proof gallon or $11.40 per volume gallon, 190 proof.

In every other country which imposes a tax on alcohol—and that is practically every country—a differential in tax is recognized. Canada, for example, taxes beverage alcohol on the equivalent of $9.625 per United States wine gallon, 190 proof. It taxes nonbeverage alcohol for manufacturing use on the equivalent of $2.0625 per United States wine gallon, 190 poof. Putting it simply, Canada taxes alcohol employed in nonbeverage uses at 21.47 percent of the rate applied to that put to beverage uses. The proposed United States rate of $6 per proof gallon would tax nonbeverage users $11.40 per proof gallon as against the present Canadian tax per equivalent United States wine gallon, 190 proof, $2.0625. Canada operates under a system of bonded warehouses with inspection costs to cover the inspection service rendered.

During the last World War the tax on distilled spirits used for beverage purposes was at the rate of $6.40 per proof gallon. Ethyl alcohol (distilled spirits) used for nonbeverage purposes was taxed at the rate of $2.20 per proof gallon.

When ethyl alcohol (distilled spirits) is used for nonbeverage purposes in the production of food and medicinal preparations, it should not bear a tax equal to the tax on beverage spirits for the following reasons:

1. Essential food products such as food flavors must be made available at the lowest possible cost consistent with compliance with the Federal and State food, drug, and cosmetic acts;

2. Medicines and medicinal preparations for the preservation of the public health must likewise be made available at the lowest possible cost complying with Federal and State food, drug, and cosmetic acts;

3. Both food products and medicinal preparations fall into the category of "essentials" and are clearly to be differentiated from luxury items such as whisky, gin, and brandy.

As the tax on alcohol has been increased and the pinch upon the users of alcohol for nonbeverage purposes has become more and more severe, the members of the industry have discussed from time to time with representatives of the Treasury Department the problem which faces their industry and the Treasury.

The principal difficulty of the Treasury Department as stated to the representatives of the industry, however, has been this: How can a differential in tax be administered so that the relatively small revenue received from the tax on alcohol used for nonbeverage purposes shall not jeopardize the larger revenue which is yielded by the tax on alcohol used for beverage purposes?

After several meetings with representatives of the Treasury Department, including the Administrator of the Alcohol Tax Unit, his counsel and assistants, it was felt that the scheme proposed in the amendment offered presented distinct possibilities for the solution of the problem. That scheme is as follows:

(*a*) The tax is first of all to be paid at the same rate on all distilled spirits.

(*b*) In order to be entitled to obtain the differential in tax, the manufacturer of all medicinal preparations and food products not intended for beverage purposes must have—

(1) Registered with the Commissioner;

(2) Kept the records prescribed by the Commissioner;

(3) Paid an occupational tax of $100 per annum; and

(4) Established the fact that the distilled spirits purchased by him and upon which he paid the full tax at the time of purchase were actually used by him in the manufacture or production of medicinal preparations and food products not intended for beverage purposes.

It is believed that the method proposed by the amendment would (1) increase the Federal revenue; (2) not create any insurmountable administrative problems; (3) eliminate the possibility of diversion of alcohol for bootlegging purposes (because the tax would have to be paid in the first instance, War Production Board now exercises control over this strategic chemical and, since alcohol is now available at retail at licensed stores in 45 of the 48 States, conditions are far different from what they were during the prohibition era); (4) result in savings to consumers. (The effect of the recognition of a differential in Canada, for example, has been to increase the amount of flavoring extract which can be purchased for the same money 25 percent. Similar savings to consumers in this country can be expected either through increased quantity or decreased price.)

Enactment of legislation embracing the above suggestions, close cooperation between the Treasury and War Production Board, and the assured cooperation of the industry would, I think, result in the public interest being served and the revenue of the Treasury Department increased.

The CHAIRMAN. Mr. Foreman.

Mr. FOREMAN. My name is H. E. Foreman, managing director of the Associated General Contractors, with offices in the Munsey Building, Washington, D. C.

STATEMENT OF H. E. FOREMAN, WASHINGTON, D. C., MANAGING DIRECTOR, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC.

Mr. FOREMAN. This presentation is being made in behalf of the Associated General Contractors of America, Inc., representative of nearly 3,000 general contractors throughout the United States who have been and are now engaged in constructing the majority of the

Nation's construction war needs. Testimony will be primarily with respect to supplement U, "Collection of tax at source on dividends, bonds, interest, and wages," commencing on page 159 of the House bill.

The purpose of this testimony is to demonstrate how this will operate on construction projects, pointing out the problems of both employer and employee and to make suggestions as to an alternate method which will not reduce the contemplated revenue but will avoid many of these problems.

A study of the provisions of this supplement indicates quite clearly that it was drafted contemplating employment at a fixed location, with such employment being reasonably steady with the same employer throughout the year. Operations in the construction industry are the very opposite of these conditions. The site of employment in construction is different for each project. Each employer within the construction industry who keeps reasonably busy throughout the year will carry on operations at from 2 or 3 locations, to 25 or more, depending upon the size of the given construction organization and the size of the individual projects on which he is engaged. These are not operated simultaneously, but are at different locations at different times during the year. The locations for a given firm may be separated one from another, from a few blocks to hundreds and even thousands of miles. Each project differs from the other, requiring different men with different skills for its execution. The duration of a given project varies from a few days, many endure from 6 to 8 months, and in exceptional cases may require 2 or 3 years for execution.

However, on each project, as the work progresses, different classes of skilled men are needed at different times during the work and only relatively few of the workmen are on a given project from start to finish, and with a given construction organization only the executive and supervisory personnel are permanent employees.

There are some 26 classifications of construction workmen, each with special skills and duties. Workmen from such of these classes as are required to execute a given project are brought onto the work when the project reaches the point where their particular skill is required, and they remain on the project only for such period as is necessary to perform that branch of the work requiring their particular skill. Then these workmen leave and other classes come onto the work.

In all cases where organized labor is used, each of these skills or crafts have their separate unions with the jurisdiction of each as to the work that each may perform carefully defined by each union and observances closely watched by representatives of each particular union.

These facts demonstrate that continuity of employment of construction labor by a given employer is an impossiblity and the records of employment of construction employers show a huge turn-over by reason of constant change of location of the contractor's scene of operations, the infinite number of types of projects that are executed, and the variation of skills required for their execution. As a consequence, the construction employee ordinarily works for many different employers during the course of a calendar year.

Should the variable withholding-tax provision contained in H. R. 7378 become law, then after January 1 every construction employer would have to secure from each employee as of that time such evidence as the Treasury Department might require as to the marital status and dependents of each employee. It would be incumbent upon him to undertake an explanation to each of these employees as to what was required and to describe to the employees what constitutes dependency. Without a doubt, many complicated questions would be propounded almost daily and the employee would look to the employer for advice.

Except that he had readily available the services of competent counsel, he would be extremely hesitant to pass upon these questions, as opinions issued through him might subject him to responsibility and liabilty, possibly both to the Treasury and to the employee in case his advice was wrong. This would be a daily problem as employees are taken onto the work and the employee would be faced with furnishing such information as is required to each new employer as he moved from job to job.

After having obtained this information to the best of his ability, the employer would find that each man on a pay-roll sheet would differ from the next as to dependents and, in making up the pay roll, a different amount would have to be subtracted from the gross amount due each employee and an entry made on the pay-roll as to the amount subject to the withholding tax. Then a calculation would have to be made of 5 percent of the amount subject to taxation, and the result entered again on the pay roll as a deduction.

This would have to be combined with the deduction required for old-age benefits, entered in an additional column, and this total deducted from the gross amount due, and the net amount to be paid entered in a final column.

In order to obtain first-hand information as to the work involved, the association obtained the loan of two men now acting as paymasters on construction jobs. These men are experts in their line, having had many years of experience in this field, and it was found that for each man on the pay roll, 10 distinct operations had to be carried through to obtain the proper result and make the proper entries so that all calculations could be checked. Each of these operations injects the possibility of error.

In addition to the calculations and entries upon the pay-roll sheets, card entries would also have to be made for each man so that when he finished his work on a project he could be given an accumulative statement of the taxes withheld from him, as is required by the bill, which information also would have to be retained by the employer for take-off in making quarterly reports to the Treasury Department.

In addition, the employer would be required to furnish to each employee at each pay period a receipt for the amount withheld as tax. He is already required to give such a receipt in connection with deductions for old-age benefit and, in those States where a deduction is also made for unemployment insurance, a receipt for this deduction is required as well.

The pay period in the construction industry is almost universally on a weekly basis. This is a specific requirement on Federal work, being so required by the Bacon-Davis or prevailing wage law. The usual procedure is to pay off once a week and that this pay-off take place at closing time on the third day following the end of the pay period.

The time put in by a given workman is variable with each day, depending upon many factors, one being the weather. If it is outside work, a workman may not be able to work at all on a given day, or only for a portion of the day. Also, if some portion of the work falls behind or materials are not immediately available, work may have to be suspended on a certain class of work until other classes of work are far enough advanced to permit resumption.

There is the other situation where, on rush jobs and in order to make up time, overtime is worked which calls for time and one-half for time worked in excess of 8 hours in any one day. As each class of workman usually calls for a distinct rate of pay per hour, calculations are difficult at best.

By way of example, the rate for a union painter in the District of Columbia is $1.71¾ per hour. If this man worked 35 hours at straight time during a week, and 5 hours overtime, he would be entitled to 42½ hours, calculated at $1.71¾ per hour, or $72.86. Assuming that this man is a married person with two dependents, in addition to his wife, according to the table on page 162, he would be entitled to an exemption of $26 as a married person and $8.50 for each dependent in addition, or $17, making a total of $43, plus 10 percent of such credits, or $4.30 in addition, making his total exemption for the week $47.30. This deducted from $72.86 leaves $25.56 subject to the 5-percent withholding tax. His tax would thus be $1.28. The deduction for old-age benefits of 1 percent on the gross—that is, 1 percent of $72.86—would amount to 73 cents, making a total deduction of $2.01.

Thus the payment to be made in this particular example would be $70.85. If bond purchases are authorized by the employee, additional calculations and deductions would, of course, have to be made and receipts covering all of these deductions, at least separately noted, would have to be presented to the workman when he drew his pay.

These conditions mean that the pay roll cannot be prepared in advance of the end of the pay period. Payment is now made 3 days later. If the procedure of the House bill is required, we are told, the pay day will have to be delayed at least one more day.

As before stated, all of this data would have to be compiled on a card record so that accumulative statement could be given, in addition, to this workman when his employment was being terminated.

A record would have to be compiled for all men working during a given quarter and reported to the Treasury Department under such regulations as it would prescribe, together with a remittance of the amount withheld. With this large turnover of men that is the rule in the construction industry, mistakes would be bound to develop. Either too much might be deducted on a given workman's pay or not enough. Doubtless a procedure for straightening this out would become complicated.

In order to get first-hand information as to what may be expected, I have made inquiry of one of the larger construction firms to ascertain how many individual record cards it was now preserving by reason of requirements under the Social Security law. I am informed that this firm now has 85,000 such cards in its files, and that 23,000 of these are in the 1942 files, although not more than 5,000 men are employed at any one time, and this firm anticipates that before the year is out this number will at least double.

Under the Social Security law, calculations are relatively simple, when compared with the withholding-tax procedure, as the former are based upon a flat percentage of the gross amount, and being 1 percent thereof the chance for error is greatly reduced over what may be expected under the procedure set forth in the House bill. Also, the record keeping is very much more simple than would be the case in the House bill where substantiating information would have to be retained as to dependency.

From the proceeding outlined, it can be judged that the cost to the employer will represent an amount which is a substantial percentage of the amount of tax collected. The cost to the Government in checking and auditing of accounts will likewise represent a considerable percentage when related to the amount collected.

In the example cited, one employee earns approximately $73 in a week, and is a married man with two dependent children, and is entitled to a weekly tax exemption of $47.30. The resultant tax as related to the gross earning will be less than 2 percent, yet $73 weekly is certainly higher than the normal for the average employee. If the worker's earnings amounted to but $50, subtracting the $47.30 nontaxable amount, we have $2.70 taxable at 5 percent, making the tax deduction amount to 13½ cents, or less than $\frac{3}{10}$ of 1 percent. Getting into the higher brackets, a married man with two dependent children earning $100 a week, the taxable amount would be $52.70, of $2.62 tax. Certainly the percentage of workers who may be expected to earn $100 or more throughout the year will be relatively small.

The expense to the employer of applying the present provisions of the bill will be substantial and is certain to result in increased cost which will either be passed on to the consumer or, if prevented by price ceilings, will have the effect of reducing the taxable profits of the employer, thereby reducing the income from that source. The increased expense to the Government will be substantial and must be considered as a charge-off when reckoning the net yield of this particular tax-raising provision.

It is apparent that the real percentage of earnings that will be withheld under the present provisions would vary with each employee and would vary for a single employee from week to week, would fall within a bracket of from zero to about 2½ percent with the average far below the top figure mentioned.

It is offered that a flat percentage based on gross income be substituted for its stead. Very probably a flat rate as low as 1½ percent would yield equivalent gross revenue and certainly a greater net revenue by reason of the elimination of the many complications that have been recited. Certainly a flat withholding tax of 2 percent would yield far more revenue. Doubtless the Treasury Department has tables to show what percentage of earnings fall within various brackets, and it may be that even 1 percent on the gross earnings would yield as much or more gross revenue than would be produced by the present proposal. There is much to be said for having a flat percentage withholding tax at an even percentage rather than at some fractional figure.

We are aware of the arguments that have been advanced in behalf of the variable plan contained in the House bill; that of working a hardship upon the man with many dependents as compared with a man with fewer dependents. However, it is worthy of consideration that wage rates are not established on that basis, as a single man will ordinarily receive the same rate per hour as does the married man with many dependents for the same skill in the same location.

The fact remains that the deduction of 1 percent on the gross earnings for old-age benefit now being assessed has not worked any particular hardship. It is not believed that the addition of 1 percent or even 2 percent more to this deduction, calculated in the same way, will cause hardship or distress.

An employee earning $30 a week at the present time has 30 cents deducted for old-age benefits. If an additional 1 percent is added, the deduction would be 60 cents. If 2 percent additional is to be withheld, the total would be 90 cents. The employee with $50 earnings per week has 50 cents now deducted. If 1 percent additional is withheld, then he would receive $49. If 2 percent more than the old-age benefit deduction is taken away, he would receive in cash $48.50.

It is our hope that this recommendation will commend itself to the committee and to the Congress. It will avoid the necessity for an employee to produce records of dependents and deliver the same to each employer, and it would present a proposition which was easily understandable. It would greatly simplify record keeping but the employee could still be furnished with a statement of his earnings of the amount withheld for taxes which he could present with his income-tax return.

It is recommended that every wage earner intended to be reached should be required to file an income-tax return, whether or not a tax is due. An incentive for so doing might well be an enactment by the Congress that the employee's old-age benefit account would be impounded until an income-tax report had been filed for each and every year.

Another procedure to simplify the operation of the withholding tax would be the installation of a stamp plan whereby the employee would be given stamps in the amount of that withheld to the nearest 5 cents, at each time of payment; these stamps to be of a special tax anticipation type. It is recognized that this might present a problem to the employee of preserving these stamps for submission as part payment on tax due, or for submission for a refund in case he had overpaid.

However, it is believed that this could be overcome by setting up some arrangement, possibly connected with the Postal Savings System whereby these stamps could be deposited with the Post Office and the employee given a special tax credit account.

Thank you, Mr. Chairman.

STATEMENT OF EDWIN R. ERICKSON, PENSION UNDERWRITER, BUFFALO, N. Y.

Mr. ERICKSON. I have a statement here, Mr. Chairman, which I am especially anxious that you refer to the pension trust subcommittee which you have appointed.

The CHAIRMAN. I understand that the committee has already made some progress.

Mr. ERICKSON. I have one thought in my brief which did not arise in the pension trust hearings, and that is why I am especially anxious that they see this statement.

The CHAIRMAN. You may file it, and we will be very glad to consider it.

Mr. ERICKSON. Thank you very much.

(The statement submitted by Mr. Erickson is as follows:)

MEMORANDUM TO SENATE FINANCE COMMITTEE, PENSION TRUST SUBCOMMITTEE, SUBMITTED BY EDWIN R. ERICKSON, BUFFALO, N. Y.

PENSIONS—PENSION TRUSTS

Gentlemen, I am familiar and impressed with much of the testimony already given in connection with the subject of pension trusts. However, I feel that there are still matters of importance regarding the House bill which should receive your attention and, as well, I would like to place emphasis on some of the testimony already given.

1. It would seem advisable and less confusing if the subjects of self-administered pension plans, group pensions, pension trusts, profit-sharing, and bonus were dealt with in separate sections—or at least subsections—of the law.

It is true that all incentive plans come under the heading of profit-sharing; the same may be said of wages, but obviously a retirement income or pension plan has far more reaching benefits for the employee, employer, and by no means least, the United States Government itself as an old-age security measure than the mere plan of distributing possibly uncertain extra profits or bonuses. Although when dealt with separately, they have a very effective and important place in an incentive plan, but certainly not on a par with pensions.

The primary purpose of a retirement plan is to afford a solution of the employer's old-age problem by providing reasonably adequate retirement incomes which will be available for employees when they reach retirement age. A retirement plan which attempts to achieve this objective, but makes no guaranty that employees will actually receive their anticipated income, causes employees to feel a lack of security. This is a detrimental factor which not only affects the employees' appreciation of the employer's efforts on their behalf but also does not enable them to work with the same freedom of mind as would be the case were they certain that the future was provided for. Further, when there is no such guaranty, there is no certainty that the old-age problem will be solved. It may be increased if employees rely upon retirement incomes which, for one reason or another, are not forthcoming.

The retirement plans which are meeting with the greatest favor today are those which give the employees participating in them definite guaranties as to what their status will be under these plans, and give the employer definite assurance that his old-age problem will be solved.

Therefore, for reasons which seem to be quite apparent, the self-administered pension plan should not be confused with the more formal type of pension plan, group pension, and pension trust; consequently, should be dealt with separately.

To one who is familiar with facts pertinent to group pensions and pension trusts, it is obvious that the same factors of cost liability cannot apply comparably.

Group pension plans make provision for the purchase of a past-service pension as well as a future-service pension. The cost of the former will create an immediate liability or one which may be spread over a reasonable number of years, such as the five referred to in the House bill. The future liability establishes an annual recurring cost.

In the case of a pension trust, the only practical way of distributing the cost is by payment of a future-service premium bearing an annual recurring liability. There is no practical advantage of creating other than a total annual liability. The excess over 5 percent employer contribution, referred to in the House bill, cannot adequately apply to pension trusts, and if permitted to pass, will definitely terminate every existing pension trust plan in force in the country today and will go a long way toward greatly modifying most group pension plans. It seems to me that the drafters of the House bill had in mind principally cost factors as they applied to a group pension plan rather than a pension trust.

The subjects of profit sharing and bonus combined in the same discussion with group pensions and pension trusts have always tended to make the laws relative thereto more confusing than seemed necessary; therefore, I think a break-down would be advisable.

2. It would be well if the word "discriminatory" were ruled out of the bill because it is such a grossly misunderstood word, and even though the application of it may be wholly fair and acceptable to suit a particular circumstance, in the minds of most people it has an inference of unfairness or cheating. If the rules were definitely defined, then I can see no occasion to apply discrimination, acceptable or otherwise. The term "reasonable" is also a dangerous word, because it involves the element of human equation, which may vary from one time to another and change to suit particular circumstances and create rules without precedent. More definite rules than the present House bill contains would tend to reduce the latitude of the broad term "reasonable."

3. The lower-bracket incomes have a substantially satisfactory percentage-wise social-security income, and it is my opinion that the same relative consideration should be given to retirement incomes for those earning higher than minimum wages where mutually agreed upon by the employer and employee, permitting a tax exemption for the total current liability—the theory being that the maintenance of a desirable standard of living is equally as essential for one wage group as another. Whereas social security fulfills the one objective, private pension plans should receive equal consideration in the fulfillment of all other comparable objectives. The necessity of such a plan during the current high-tax era is apparent because of the inability of the individual to create an estate adequate in size to assure his own independent retirement.

4. Whereas to date a great deal of attention has been paid to pension limitations in the House bill, no single reference has given any consideration to the continuation of an employee pension program during lean years.

From an employer's point of view, and more especially from the employee's point of view, he will come to be dependent upon a promised pension for his old-age security. However, unless some provision is made for maintaining its expense during the lean years, the ups and downs of business will inevitably take their toll upon pension plans intended to materialize but failing to do so because of the lack of finances to meet their costs.

Only one of three things can take place if a corporation fails to earn a sufficient profit to maintain its pension program: First, the plan may be terminated, which will completely defeat its objective. Second, the plan, under some circumstances, may be suspended temporarily (some plans do not permit suspension), and continued at some later date. This would modify the objective in proportion to the length of time it was suspended. Third, it may be said that the employee could carry on the expense of his own pension. However, this expectation would hardly be reasonable because if his imployer could not maintain the plan, what assurance would there be that his earning ability—let alone the possibility of being laid off from work, would be sufficent to maintain the expense of his own part of the pension plan?

In the foregoing reference I hope to indicate to you that a pension program is only as sound as its ability to continue; therefore, there should be some allowance made for a corporation to create a nontaxable pension reserve (with some limitation) which would guarantee the existence of the plan through lean years.

Unless the final law makes provision for a future cost liability to be met out of current profits, then it is my opinion that the law fails in its original purpose.

Pensions are designed to meet the needs and requirements of employers seeking a means of providing for the retirement of their superannuated employees. There are but three ways to deal with the superannuation problem:

(1) *Fire old employees.*—Nothing good can be said for such a plan.

(2) *Retain old employees on the pay roll.*—If pensions are paid from pay roll, then costs may be expected to increase steadily and substantially due to there being more and more people alive at age 65 and over. It is quite conceivable

that these costs can increase to the point where they may be a serious burden and a continuation of the payments may be far from a certainty. Because of the lack of guaranties and actuarial soundness, it may be said that ordinarily pensions paid from pay roll have little to merit their serious consideration.

(3) *A sound pension plan.*—The reasons for having a supplementary pension plan are:

(*a*) The desire on the part of management to provide a reasonable retirement income for employees when they reach the age at which they should be superannuated. This desire is partly humanitarian, but it is also a desire to give recognition to long and faithful service. In any event, it is scarcely practical and it is certainly not pleasant to discharge an employee without a pension or an adequate pension when he reaches the age at which he should be retired.

(*b*) The adoption of a pension plan is beneficial from the point of view of company morale and public relations. Assurance that employees are not going to be dependent in old age results in a much more contented, efficient, and loyal working force. The systematic retirement of older employees will result in several times as many promotions among younger and energetic employees. This in turn results in a stimulation of the whole working force.

Insofar as public relations are concerned, it would seem that the favorable reaction in the community, which results from adequate provision for older employees, should be especially desirable to the United States Government.

(*c*) The adoption of a formal pension plan is good business practice. It results in consistent and impartial treatment of employees. It thus eliminates discrimination and paternalism. By providing adequate retirement incomes, when combined with social security benefits, it enables the retirement of employees when they reach an age at which they slow down and may be a drag on the efficiency of the organization.

(*d*) Since the benefits payable under the Social Security Act will not be sufficient in most cases to bring about the retirement of superannuated employees, these benefits must be supplemented by an additional amount of pension, if full advantage is to be severed from the social security pay-roll taxes being paid.

The incentive advantages of a sound pension plan are definitely established and cannot be denied.

I am convinced that this Senate Finance Committee is wholeheartedly sympathetic toward reasonable pension plans. I trust, therefore, the recommendations which I have outlined may be of some little value in your consideration of these items of importance.

Very truly yours,

EDWIN R. ERICKSON,
Pension Underwriter.

AUGUST 28, 1942.

STATEMENT OF F. B. BYERLY, NEW YORK, N. Y., ACTING CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. BYERLY. I desire to file a statement. It is just a very brief request for tax-return extensions by corporations, filed in behalf of the New York State Society of Certified Public Accountants. It is a thing which has been presented before, but we want to add our statement to the record.

The CHAIRMAN. You may offer it, and the committee will be very happy to take it under consideration.

(The statement submitted by Mr. Byerly is as follows:)

STATEMENT OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, SUBMITTED BY F. P. BYERLY, ACTING CHAIRMAN, COMMITTEE ON FEDERAL TAXATION

REGARDING AN AMENDMENT GRANTING THE RIGHT TO EXTENSIONS OF TIME FOR FILING CORPORATE INCOME AND EXCESS-PROFITS TAX RETURNS

The New York State Society of Certified Public Accountants seeks relief in behalf of the accounting profession from a condition with which they were confronted this year, and which it is believed may become even more onerous next year. The relief sought will not deprive the Treasury of one penny of revenue.

We ask the inclusion of a provision in the Internal Revenue Code that corporate taxpayers shall as a matter of right be granted an extension of 3 months for the filing of their income and excess-profits tax returns, provided that:

(1) A request for the desired extension be filed prior to the due date of the return;

(2) A tentative return (showing the estimated amount of tax due) be filed on or before the due date of the return;

(3) One quarter or more of the tax due (as shown by such return) be paid at the time of filing the tentative return; and

(4) Interest (at 6 percent per annum) be paid to the date of filing the definitive return upon any deficiency in the amount of the first quarterly installment paid with the tentative return.

The Commissioner of Internal Revenue should of course have discretionary power to grant longer extensions in exceptional cases.

The foregoing procedure with respect to extensions has long been in force, with one important exception—such extensions of time for filing returns have been granted only in the discretion of the Commissioner of Internal Revenue or of the local collectors. Some collectors could be counted upon to cooperate with taxpayers and accountants in this regard—some proved less willing to do so.

Under war conditions both corporate taxpayers and public accountants are increasingly handicapped by the shortage of personnel and the growing demands upon their time.

Even before conditions were aggravated by the present war situation, there was obvious need for more than 75 days in which to perform all the work necessary to close the books of all corporations filing calendar year returns, audit their accounts, and prepare their income and excess-profits tax returns. Evidence of this need was the large number of requests for such extensions.

Public accountants have cooperated in the efficient administration of the income-tax laws since their inception and do not hesitate to ask for this relief to enable their services to be more effective in these critical times.

AUGUST 13, 1942.

The CHAIRMAN. If there are any other statements to be filed by any who have not been reached, the committee will receive them.

STATEMENT OF THEODORE C. NEMZEK, NEW YORK, N. Y., REPRESENTING ASPINOOK CORPORATION

Mr. NEMZEK. I have two statements which I should like to file.

The CHAIRMAN. That may be done.

(The two statements submitted by Mr. Nemzek are as follows:)

NEW YORK, N. Y., *August 7, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR: In connection with the discussions presently being conducted by your committee regarding the proposed Revenue Act of 1942, we would call to your attention the situation resulting to four textile mills located in Connecticut and Massachusetts, i. e., The Aspinook Corporation, Jewett City, Conn., The Lawrence Print Works, Inc., Lawrence, Mass., The Permatex Fabrics Corporation, Jewett City, Conn., and Arnold Print Works, Inc., Adams, Mass. All four of these companies are closely affiliated through stock ownership and are under the same management.

All of these plants were purchased at a time when they were being offered for sale for liquidation purposes. It is a fair statement to say that the four plants would have been dismantled and torn down had it not been for the confidence of the present management in the future of these business enterprises at a time when the economic security of the New England States was being seriously challenged and plants similar to these were actually being liquidated. It is believed that the management has rendered a real service to New England and the Nation by saving these plants from destruction and preserving them for the important part which they are now playing in the war effort and in supplying necessary civilian requirements.

Due to conditions existing in the textile industry, equity financing was not available for the above enterprises and the ends achieved could be accomplished only with borrowed capital, which, of course, must be repaid out of earnings. It was found that borrowings through banks or governmental agencies could not be effected. Accordingly, these enterprises could be financed only through the medium of private loans which, under the circumstances, were made with considerable risk. We submit, therefore, as one point, that the management of these companies would seem justified in expecting some leniency to be shown by the Federal Government in its tax program to companies so situated and that some provision would be made whereby such companies could retain sufficient of their earnings to meet their fixed obligations, particularly since the incurring of these obligations required more than ordinary courage on the part of both the management and the investors and resulted in the salvaging of an industry.

We note from newspaper accounts that you are aware of the problems of debt payment above indicated and feel that some relief should be afforded, particularly with regard to indebtedness incurred before some date such as January 1, 1941, or January 1, 1942, providing certain factors exist which would assure the debt being bona fide and incurred for a reasonable business purpose. In general we approve of this proposed relief but we wish to suggest that the provision for a definite set date is not adequate. We believe the taxpayer should establish that the debt was incurred in a bona fide transaction conducted "at arm's length," so to speak, but the date thereof should not be controlling.

The situation of Arnold Print Works, Inc., above mentioned, is particularly in point. This corporation was organized 1 month ago. It purchased a large industrial property, which was about to be liquidated by its owners, and has continued the operation of that property and continued the employment of the workers therein.

In connection with the purchase, the new company raised $250,000 in new capital, represented by capital stock, and gave debt obligations to the former owners of the property in the total amount of $625,000, with an agreement that these debt obligations would be repaid over a period of 5 years, or an average of $125,000 per year. The new company and the former owners are totally unrelated companies, and the deal was in all respects an "arm's length" transaction.

The debt obligation bears interest at 6 percent, and under the present Federal tax proposals, half of it will be regarded as invested capital, but half of the interest thereon will have to be added back for excess-profits tax purposes.

Therefore, this company's credit for excess-profits tax purposes will, in effect, consist of 8 percent of its paid-in capital, or $20,000; plus 2 percent of half of the borrowed capital, or $6,250 plus the $10,000 specific exemption; or a total of $3[illegible]250.

Operating conditions look favorable, and it is expected that this company will have a substantial income during its fiscal year ended June 30, 1943. If we assume that this income will be $336,000, the company would, under present proposals, be taxed approximately as follows:

$300,000 at 90 percent	$270,000
Combined normal tax and surtax approximately	15,000
Total normal, surtax, and excess-profits tax	285,000

The company would, therefore, have left for corporate purposes, after payment of normal and excess profits taxes, a total of about $51,000 determined as follows:

Net income before taxes	$336,000
Less taxes as above	285,000
Net income after taxes	51,000

Since it is committed to a debt-payment program of $125,000 per year, the money remaining after payment of taxes is, of course, grossly inadequate for that purpose. In fact any additional income the company might make, beyond $336,000 would be subject to 90 percent excess-profits tax, and therefore only 10 percent would be available for corporate purposes. In order to earn enough money before taxes to have $125,000 left after taxes, the net income before taxes would have to be increased to about $1,050,000 which, of course, is totally impossible.

It, therefore, seems to us that if any provision is made, as we think it should be, for a special credit on account of debt payments, the privilege should be extended to a company like this.

We would suggest, as a measure of equity and to protect the Government's revenue that a taxpayer should have to establish that the debt was incurred in a bona fide business transaction at arm's length, and that the amount recognized as available for debt credit should be limited to an amount not more than 50 percent of the total purchase price of the property. In addition, it perhaps would be well to provide that the credit for debt retirement should in no case be more than 25 percent of the income subject to excess-profits taxes.

In this case that would mean that approximately $425,000 of the $625,000 of debt obligations would be eligible for special credit for excess-profits tax purposes, or approximately 70 percent of the total net obligation in the suggested case. Therefore, if the company retired $125,000 in debt during the year ending June 30, 1943, it would be entitled to a maximum credit of about 70 percent of $125,000 or $87,000, subject to the limitation that its income for that year subject to excess profits tax would have to be at least $350,000 in order to entitle it to the maximum credit.

We have tried to be specific in this suggestion because we recognize the need for safeguarding the Government's revenues, but at the same time feel that some adequate measure of relief should be afforded to companies like this one, as well as to those whose debts were incurred prior to January 1, 1941, or January 1, 1942.

Our proposal applies only to the excess-profits tax and not to the normal and surtax.

In the foregoing comments on Arnold Print Works, Inc., it will be noted that the possible tax of $285,000, represents approximately 85 percent of the company's assumed earnings (before taxes) of $336,000. A like situation prevails with respect to The Lawrence Print Works, Inc., previously mentioned. The Lawrence Print Works, Inc., was organized in August 1941. It purchased a large industrial property which also was about to be liquidated by its owners and continued its operations. This company has only a nominal amount of equity capital and gave debt obligations to the former owners in the amount of $275,000, which amount is to be paid in full by December 1942. In addition, to complete the purchase and carry on operations the company has incurred demand obligations in the amount of $250,000, all of which must be paid out of earnings. The new company and the former owners are totally unrelated companies and the deal was in all respects an arm's length transaction.

The debt obligations bear interest at an average rate of approximately 5 percent; under the present Federal tax proposals, half of these obligations will be regarded as invested capital but half of the interest thereon must be added back for excess-profits tax purposes. This results in a total excess-profits tax credit of $17,500, including the $10,000 specific exemption. On the basis of an assumed income (before taxes) of $200,000 the total excess-profits tax, normal tax, and surtax will amount to approximately $169,000 or approximately 85 percent of the (assumed) income. Therefore, the company would have left for corporate purposes a total of approximately $31,000, which, in view of its commitments, is entirely inadequate. This situation emphasizes again the necessity for a special credit on account of debt payments.

With regard to The Aspinook Corporation, the dominant corporation in this group, a slightly different situation prevails. This corporation was organized in February 1938, for the purpose of acquiring the plant and equipment of the old Aspinook Co. from the liquidating committee of that company Immediately after the acquisition of these properties the plant was reopened and has been in operation to date. Due to the conditions existing at that time, The Aspinook Corporation could only be financed by a small equity investment and a bond indebtedness of $600,000 maturing in 1948, of which $500,000 are still outstanding. The indenture under which these bonds were issued provides for retirement of the bonds before maturity out of earnings through the operations of a sinking fund.

As in the case of each of the other companies heretofore mentioned, the invested capital base for excess-profits tax purposes is very low. The Aspinook

Corporation, therefore, uses the income method in computing its credit under the excess-profits tax provisions. The resulting credit is low because during the rehabilitation and development incident to starting and building up the business the present productive capacity could not be attained.

On the basis of its present volume of business it is anticipated that The Aspinook Corporation will have annual earnings (before taxes) of approximately $250,000. After deducting the specific exemption of $10,000 contemplated under the proposed revenue act and the excess-profits credit of approximately $85,000, a balance of $155,000 remains which will be subject to the excess-profits tax at the rate of 90 percent. The excess-profits tax, the normal tax, and the sur tax will amount to approximately $182,000 or 73 percent of the earnings before taxes and leaving a balance of approximately $68,000 for corporate purposes. It is obvious that this net balance will not permit the retirement of the bonds prior to maturity as originally intended unless some relief is afforded through a special credit on account of debt payments.

In conclusion we wish to point out that in all the above situations the business and properties of companies which were practically defunct were taken over at a liquidating price and made into going concerns employing over 1,800 workers and contributing effectively to our Nation's war efforts as well as to civilian needs.

The plant comprising the present Arnold Print Works, Inc., is located at Adams, Mass., and had been acquired by a liquidating company and the dismantling thereof was contemplated. This would have resulted in unemployment for 820 persons and an obvious detriment to the community. Due to the timely and efficient efforts of Arnold Print Works, Inc., and its management, this property was taken over with practically no interruption in operations.

The plant now owned and operated by The Lawrence Print Works, Inc., consisting of six manufacturing units and a tract of 22 acres of land at Lawrence, Mass., was formerly the print works division of Pacific Mills. In 1941 the stockholders of Pacific Mills voted to liquidate the print works division and, thereafter it was offered for sale. Various concerns engaged in the liquidation of manufacturing and textile establishments submitted offers for the machinery and equipment having in mind the complete dismantlement of the buildings and the termination of the division as a going concern. Since this plant was one of the principal employers of labor in Lawrence, strenuous efforts were put forth by local and State officials to save the enterprise. Again a new corporation was formed, i. e., The Lawrence Print Works, Inc., which took over the property with no interruption in operations and saved an industry which is again an integral part of its community and an important factor in the national economy.

With regard to the Aspinook Corporation, its plant is located at Jewett City, Conn. The old company had been in business there for 40 years and with its 500 employees constituted the major industry in that community. After various difficulties the old company ceased operations in 1937 and went into liquidation. This was a staggering blow to Jewett City, which soon took on the appearance of becoming a ghost town. In 1938 the present Aspinook Corporation was organized to acquire the properties, business, and good will of the old company. With courage, determination, and borrowed funds which were raised in part from bonds purchased by over 400 former employees, the management reopened the plant, which has been in continuous operation ever since. Not only was another industry saved but another community has been restored to its normal, thriving condition.

The proposed revenue act will, in effect, penalize these constructive efforts because of the methods used in financing same, which methods were the only ones then available.

Respectfully submitted.

SWIGER, CHAMBERS & KELLEY,
By THEODORE C. NEMZEK,
Counsel for The Aspinook Corporation and Affiliated Companies.

SCOVELL, WELLINGTON & CO.,
By THEODORE F. WOODWARD,
Accountants for The Aspinook Corporation and Affiliated Companies.

NEW YORK, N. Y.,
August 7, 1942.

Hon. WALTER F. GEORGE,
Chairman, Finance Committee of the Senate,
Washington, D. C.

DEAR SIR: Section 129 of the revenue bill as passed by the House of Representatives changes the plan of taxation of taxpayers reporting on the basis of a fiscal year other than the calendar year. This means a change back to the confusing situation which existed prior to the Revenue Act of 1934.

Each taxpayer which files tax returns for a year ending other than December 31 will, under section 129 of the Revenue bill of 1942, be required for the year ending in 1942, to file what amounts to two returns, one under the Revenue Act of 1941 and one under the Revenue Act of 1942 (but with many confusing exceptions). The total tax will be a fraction of the 1941 tax corresponding to the period from the beginning of the year to December 31, 1941, plus a fraction of the 1942 tax relative to the period from January 1, 1942, to the end of the fiscal year.

Assuming that section 129 is adopted, and that the same policy is followed in subsequent revenue acts, every time a new revenue act is passed, each fiscal-year taxpayer will have the same problem—and there have been one or more new revenue acts every year from 1932 to date.

The second Revenue Act of 1940, which imposed the excess-profits tax, was enacted October 8, 1940, and the Revenue Act of 1941 was enacted September 20, 1941. The revenue bill of 1942 will probably not be enacted until September or October 1942. Consequently, if section 129 is adopted, a corporation with a fiscal year ending early in the calendar year, will be obliged to close its books and prepare its statements for creditors and stockholders, without any opportunity to determine at all accurately the amount of its Federal income and excess-profits taxes.

Beginning with the Revenue Act of 1934, it has been provided, in general, that new revenue acts should apply only to years beginning after December 31. This is a practical and wise provision, which we believe should be continued.

Over a period of time, the continuance of the present practice should not result in any loss of revenue to the Treasury Department.

Respectfully submitted.

SWIGER, CHAMBERS & KELLEY,
By THEODORE C. NEMZEK.
SCOVELL, WELLINGTON & CO.,
By WILLIAM W. JOHNSTON.

The CHAIRMAN. Mr. Octave Blake.

STATMENT OF J. D. GARRISON, OF LORD, DAY & LORD, NEW YORK, N. Y., IN BEHALF OF CORNELL-DUBILIER ELECTRIC CORPORATION

Mr. GARRISON. Mr. Blake was called to Canada suddenly due to the death of his father. He asked me to read this statement which I have here. I am representing him as attorney here. If I cannot read it, I would like to file it.

The CHAIRMAN. Can you come in the morning?

Mr. GARRISON. I have an appointment in New York.

The CHAIRMAN. You may file the statement. On what subject is it?

Mr. GARRISON. This statement is in behalf of the Cornell-Dubilier Electric Corporation, a company engaged in war production. It is a growth company. The suggestion made here is that where companies in the position of working primarily on war production and having a very much increased business for that reason and therefore in need of working capital, if they can show the Commissioner that the immediate payment of tax will be embarrassing due to their needs for working capital, they should be allowed an extension until after the cessation of hostilities.

The CHAIRMAN. You are not asking for an abatement of the tax?

Mr. GARRISON. We are not asking for a reduction of the tax, but simply a postponement of collection.

The CHAIRMAN. You may file the brief, and we will be very glad to take it under consideration.

Mr. GARRISON. That would be a fixed obligation on the part of the company.

(The statement of Octave Blake submitted by Mr. Garrison is as follows:)

STATEMENT OF OCTAVE BLAKE, NEW YORK, N. Y., PRESIDENT OF CORNELL-DUBILIER ELECTRIC CORPORATION

Proposal that Commissioner of Internal Revenue be authorized and directed to postpone, until after the war, payment of part of corporate taxes in cases where companies show that working capital must be conserved for war production.

GENTLEMEN: On behalf of many medium sized companies now almost wholly engaged in vital war production, whose volume of business has since 1939 been greatly increased, and will continue to increase, with a resulting strain on working capital, I respectfully present the following proposal for the consideration of the committee:

There shall be included in the revenue bill (H. R. 7378) now before the committee, a provision authorizing and directing the Commissioner of Internal Revenue to postpone, until 6 months after the cessation of hostilities, payment without interest of such part of the income and excess-profits taxes as shall be found necessary to conserve working capital of any company which shows that payment in full of such taxes will impair working capital required for war production.

The predicament in which Cornell-Dubilier Electric Corporation, of which I am president, will find itself if the relief here suggested is not provided, will be, I believe, typical of many companies engaged in vital war production. Cornell-Dubilier Electric Corporation and its wholly owned subsidiary manufacture various types of capacitor, known also as fixed electrical condensers. It is unnecessary for me to explain the extremely vital role in the present war of radio and electronic devices, such as submarine and airplane detection devices, other sound and direction devices, and devices for sound recording, communication, control and measuring. All such apparatus employ several capacitors. New electronic devices are continually being perfected, which are manufactured in volume. This requires a steady increase in the volume of production by my company and other companies in the capacitor industry. In the words of a high-ranking officer of the armed forces, the continued large volume of production of electronic devices is one of the two most critical supply problems now confronting the armed services.

Such repeated demands for ever-increasing volume of production are, I am sure, the experience of many war industries of modest size, many of whom such as Cornell-Dubilier Electric Corporation, were originally small companies that have grown gradually over a period of years. In ordinary times, many of such companies are loathe to expand if such expansion requires public financing. Many of us have in fact been undercapitalized, even during normal times, financing ourselves out of profits instead of paying regular dividends. With the advent of the war, we have been called upon to multiply our production many times.

Our pay rolls have been increased enormously, not only by reason of the increase in the number of employees, but also because of increases in wages ordered by the War Labor Board. We use much more material for which we must pay higher prices. We carry much larger inventories of raw materials and work in process. Such profits as we have made in the past 2 years are not represented by idle cash in the bank, which could be paid out in dividends if it were not for the increased taxes, but is reflected in increased inventories, accounts receivable, and increased cash working capital required to carry on the much larger volume of War business.

We estimate that the sales of the company for its fiscal year ending September 30, 1942, will be from 4 to 5 times what they were before the war, and that the ratio of sales to assets will be at least 3 to 1 if not more. A company with this rapid turn-over requires much more cash working capital if pay rolls are to be met and materials paid for. Even before the high taxes proposed in the 1942 revenue bill were known, Cornell-Dubilier Electric Corporation found itself pressed for working capital and was obliged, reluctantly, to sell publicly in January 1942, $1,500,000 principal amount of sinking-fund debentures. Under the revenue bill now before the committee, substantially all the profits so badly needed for working capital would be paid to the government in the form of income and excess-profits taxes.

The proposal is, therefore, that during the war, the Commissioner of Internal Revenue be authorized and directed to postpone until after the war, when working capital for war production is no longer required, the payment of such part of the income and excess-profits taxes as shall be found necessary in order that war industries will not be deprived of much needed working capital. At the cessation of hostilities, when the volume of war business will be substantially curtailed, resulting temporarily at least in a reduction in pay roll and in bills payable for raw materials, war industries such as Cornell-Dubilier Electric Corporation will, as their accounts receivable are liquidated, have ample funds with which to pay the deferred taxes. There will be no danger that funds which the company is permitted to retain for working capital for war production will be used for working capital for civilian production for the obligation to pay the postponed taxes will be a fixed obligation, payable at a definite time—shortly following the cessation of hostilities—and in most cases before a company can get any substantial civilian production under way.

To summarize, medium-sized companies doing a large volume of business with a comparatively small investment are required to have a substantially larger amount of cash working capital to provide them with the necessary financial flexibility. Such companies are particularly hard hit by the high excess profits taxes as they receive very little credit either on an average earnings basis or on an invested capital basis. To avoid the danger of sudden financial embarrassment, with attendant legal complications, which might well hamper production (particularly in cases where companies have been obliged to sell obligations under indentures rather than equity securities in order to secure funds), it is extremely important to the war effort that the proposal hereby suggested be accepted.

Respectfully submitted.

OCTAVE BLAKE,
President of Cornell-Dubilier Electric Corporation.

The CHAIRMAN. In lieu of the personal appearance of Mr. L. A. Freiberg, on behalf of the National Association of Hairdressers and Cosmetologists of St. Louis, Mo., we will enter this brief.

(The brief of L. A. Freiberg is as follows:)

BRIEF SUBMITTED BY L. A. FREIBERG, ST. LOUIS, MO., ON BEHALF OF NATIONAL HAIRDRESSERS AND COSMETOLOGISTS ASSOCIATION, INC.

IN THE MATTER OF PROPOSED AMENDMENTS TO SECTION 2402 (B) OF THE INTERNAL REVENUE CODE

To the Honorable Chairman and Gentlemen of the Committee on Finance of the United States Senate:

This brief is filed by L. A. Freiberg, on behalf of the National Hairdressers and Cosmetologists Association, Inc., executive office, St. Louis, Mo., the membership of the association consisting of beauty shops in all sections of the United States, and is concurred in by the Beauty and Barber Manufacturers.

1. *Purpose of brief.*—This brief is submitted for your consideration in order to bring before the Committee on Finance of the United States Senate a proposal

for amendments to the present section 2402 (b) of the Federal Revenue Act relating to toilet preparations.

2. *Present law.*—Section 2402 (a) of the Internal Revenue Code imposes a 10-percent retailers' excise tax upon the sale of toilet preparations. This organization proposes no change in this subdivision.

Section 2402 (b), the second subsection of 2402, was enacted because Congress realized that the major portion of the beauty shops' toilet preparations purchases are not for resale but for professional consumption.

However, section 2402 (b) fails to differentiate between bulk merchandise purchased for consumption in performing professional services and retail packaged merchandise to be sold at retail to the beauty shop's customers.

The present section 2402 (b) requires the prepayment of tax by beauty shops on retail merchandise, thus placing the beauty shop in an inequitable position in relation to all other retail outlets selling toilet preparations such as drug stores, department stores, etc.

3. *Proposed amendments.*—Our proposed amendments make the acquisition by beauty shops of those toilet preparations in retail packages intended for retail sales subject to the payment of the Federal excise tax only after the sale is made rather than a prepayment of the tax based upon the wholesale cost—in other words, to put the beauty shop on a par with other competing retailers.

4. *Amendments.*—It is suggested that amendments be made to section 2402 (b) by inserting the words "to be used or consumed within such establishment" after the word "establishment" and by changing the semicolon to a period after the word "retail," striking out the balance of the section.

Further amend by eliminating the words "persons operating a."

As herewith shown:

(SEC. 2402. TAX ON TOILET PREPARATIONS.)

(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 (to be consumed within such establishment) shall be considered a sale at retail, (.) ~~resale by such person shall be subject to tax as a sale at retail, but there shall be credited against the tax payable by such person with respect to such resale the amount of tax paid on the sale to such person.~~

Such amendments would then make the section read as follows:

"SEC. 2402 (b). BEAUTY PARLORS, ETC.—For the purposes of subsection (a) the sale of any article described in subsection (a) to any barber shop, beauty parlor, or similar establishment to be used or consumed within such establishment shall be considered a sale at retail."

The elimination of the words "persons operating a" is sought so that there will be no doubt that beauty shops operated by department stores are within the scope of this subsection.

5. *Further arguments.*—Under the present Internal Revenue Code establishing an excise tax on toilet preparations, retailers other than beauty shops are not required to pay the tax until the sale has been made to the consumer. The beauty shop, however, is required to pay in advance, 10 percent on the wholesale price, to the jobber or manufacturer from whom the merchandise is purchased. Then, upon sale to the consumer, the beauty shop is required to pay the difference between the tax already paid by the supplier to the internal-revenue department and the amount collected on the retail price. This forms a complicated method of collection for both the beauty shop and the internal-revenue department. The excise-tax department construes the present law to mean that regardless of the fact that the beauty shop may have paid this tax to the jobber or manufacturer, the beauty shop is nevertheless liable for such tax if the jobber or manufacturer fails to pay it to the Federal Government. Surely Congress did not intend such injustice, making it possible that the beauty shop could be twice liable.

The amendments suggested would easily correct this discrimination and place the beauty shops, so far as retail merchandise is concerned, in the same category as other retailers, that is, drug stores, department stores, etc.

The wholesaler supplying bulk merchandise to the beauty shops for professional consumption performs the functions of a retailer and in such respect cannot be considered analogous to the functions of a drug jobber selling only retail packaged merchandise for "across the counter" or retail sales to consumers.

As Congress has indicated a recognition of such function in section 2402 (b) of the present excise-tax law, we believe that the retention of such section, with the adoption of the amendments our organization has proposed, will simplify the work of the internal-revenue department as the bulk of the tax on such class of toilet preparations sales would be reported by a relatively small number of jobbers as compared with the 88,071 beauty shops as shown by the Census of Business for 1939. Furthermore, it will simplify the keeping of proper bookkeeping and statistical records by the beauty shops and no professional assistance will have to be employed by the small beauty-shop owner. Inasmuch as bulk sales of toilet preparations for professional consumption constitute the major portion of sales to beauty shops by wholesalers, we urge the retention of section 2402 (b) with the above proposed amendments.

We believe that the Committee on Finance of the United States Senate will see the justice in the amendments which we seek since the present method of requiring the beauty shops to pay a tax on retail packaged merchandise for sale at retail, before it has been sold, is an inequality. We believe that your committee will wish to correct this unintentional discrimination.

Respectfully submitted.

NATIONAL HAIRDRESSERS AND COSMETOLOGISTS ASSOCIATION, INC.

The CHAIRMAN. In lieu of the personal appearance of Mr. G. Kibby Munson, of Washington, D. C., on behalf of Virginia Blue Ridge Railway, we will file his statement.

(The statement of G. Kibby Munson is as follows:)

STATEMENT OF G. KIBBY MUNSON, ATTORNEY, WASHINGTON, D. C., ON BEHALF OF VIRGINIA BLUE RIDGE RAILWAY

Section 114 of the new tax bill provides that where deductions for bad debts and taxes in prior years did not result in a reduction in taxes there will be no taxable income from the subsequent collection of such debt or the subsequent refund of such taxes previously deducted.

We believe that this same relief should be extended to cover instances where for a period of years a corporation on the accrual basis has accrued interest which it has been unable to pay and such interest accruals resulted in no tax benefit. If the interest is actually paid in a subsequent year that corporation should be permitted to deduct such interest payment in that year.

Back in 1914 a group of men financed the acquisition of 28,000 acres of timberland in Nelson and Amherst Counties, Va. Two large sawmills were built to manufacture lumber from that timber, and this group built the 20-mile Virginia Blue Ridge Railway to get that lumber out to market. They were just coming into production when the first World War brought about a drastic shortage in railway cars, and under the system of car control invoked at that time cars were no longer available for the shipment of their lumber. This condition continued and by the time that the car shortage began to ease in 1921 the chestnut tree blight hit the timber, destroying 70 percent of it, and leaving very little traffic for the railroad.

The group which had financed the timber operations and the railroad knew that the railroad was located in a highly mineralized section of Virginia, and had faith that the minerals could be developed so as to provide traffic for the railroad.

With this in view they continued to finance the railroad over a long, hard period, digging down into their own pockets for money to pay operating expenses and using their personal credit to borrow several hundred thousand dollars from the bank, on which they had to pay interest currently, sometimes as high as 7 percent, and to repay the principal.

During all of this time the railroad company was unable to pay interest on its bonds, notes, and open-account indebtedness. It now has outstanding $266,000 of bonds which were issued in 1916 and on which no interest has been paid. Some of these bonds were originally issued as collateral security for notes and were subsequently reduced to possession. In addition, the railroad has outstanding over $800,000, principal amount, of notes and open-account indebtedness. Unpaid interest has accrued to the extent of over $450,000, and until 1941 no back interest was ever paid. Conditions got so bad on the railroad that for the year 1935 it took in only $8,579.90 gross from its entire operations over 20 miles of road.

Since 1935 the men behind this enterprise have interested capital, and upwards of $7,000,000 has been invested in four separate enterprises adjacent to the railroad, engaged in the mining of three different minerals. At the time of their development it was not suspected that they had any particular defense use, but it is now known that all three are of defense importance and all three are now being used for defense purposes.

The railroad has now begun to pay for some of its ancient obligations, but is confronted with this situation—it has in past years taken deductions for accrued but unpaid interest of over $450,000 for which it has received no tax benefit. It is beginning to pay off its accrued interest and such payments are being made to the men who used their own bank credit to finance the railroad.

Under present law it is doubtful whether any deduction can now be taken for the actual payment of past accrued interest, and, in that event, none of these payments can be made except out of taxable net income which is first subjected to taxation at very high rates.

Under the bill as it passed the House the railroad's income would first be subjected to a normal and surtax of 45 percent, and so much of its income as will be subject to excess-profits tax will be subjected to a tax of 90 percent. Thus little is left out of which to pay up accrued but unpaid interest; only 55 cents out of a dollar of some net income and only 10 cents out of each dollar on the balance. Not much back interest can be paid out of income which is taxed to the extent of 90 cents on each dollar, and yet if the railroad were allowed a deduction for the back interest it would be taxable in the hands of the recipients at a fairly high rate.

The situation is so serious under the provisions of the new tax bill that if a corporation is unable to pay its interest for 1 year it may become practically impossible to ever pay it, if it has to come from income that is taxable at excess-profits rates; if a corporation passes 2 years' interest it is still more serious.

Nearly everything that this railroad hauls comes under the class of natural resources. The minerals which are shipped out over the road are limited in quantity and once they are all shipped there is no repeat shipment. If the road had factories on its line we might expect them to continue in business indefinitely, but that is not true in the case of minerals. The real effect of defense activity upon the road is to use up the source of its traffic more rapidly. While an increase in earnings results, it is at the expense of future traffic.

Testimony has been given urging that some concession be made to debt-ridden corporations, but it may be that unless it is specifically provided for no relief will be granted for the payment of that part of an indebtedness which is represented by accrued but unpaid interest. Some relief should be given where the previous deduction for the accrued interest resulted in no tax benefit. In other words, the Government never lost any taxes through the deduction.

One more point: The corporation that borrows money to build a defense plant is protected through the 5-year amortization provision. That corporation may recover back the entire cost of the defense plant out of earnings over a 5-year period before the payment of taxes, and properly so. That protection, however, does not help the Virginia Blue Ridge Railway. It has not borrowed any money to build defense facilities, but it did borrow money long ago to build facilities which are now being availed of for defense; and under the new tax bill it is going to be practically impossible to pay up a large part of the back interest that in common honesty is owed to those who advanced their funds, because it will mostly go for taxes, and yet if some of that money were used to pay up the back interest the Government would still get a very considerable part of it in taxes paid by the individuals to whom the interest would be paid.

G. Kirby Munson.

The Chairman. In lieu of the personal appearance of John Wiseman, in behalf of a number of companies named in the statement, the committee will enter the brief submitted.

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

AUGUST 10, 1942.

In re section 129 of H. R. 7378 relating to fiscal-year taxpayers.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

GENTLEMEN: This brief is filed on behalf of the American Window Glass Co. of Pittsburgh, Pa.; the Rolland Glass Co., of Clarksburg, W. Va.; the Fourco Glass Co., of Clarksburg, W. Va.; the Fostoria Glass Co., of Moundsville, W. Va.; the Warwood Tool Co., of Wheeling, W. Va.; the Indiana County Theatres Co., Inc., of Greensburg, Pa.; and the Monessen Amusement Co., Inc., of Greensburg, Pa. While the brief is filed specifically on behalf of the aforementioned taxpayers, it is believed that there are thousands of taxpayers in the United States who would be similarly affected by the fiscal year provisions of the proposed act.

The American Window Glass Co. and the Rolland Glass Co. are manufacturers of sheet glass used for various purposes. The Fostoria Glass Co. is a manufacturer of high-grade table glassware. The Fourco Glass Co. is a sales agent for various manufacturers of sheet glass. The Warwood Tool Co. manufactures picks, mattocks, mine tools, etc. The Indiana County Theatres Co., Inc., and the Monessen Amusement Co., Inc., are operators of motion-picture theaters in a number of communities in the State of Pennsylvania. The products of the sheet glass manufacturers and the Warwood Tool Co. are largely devoted to the war effort.

This brief does not concern itself with the rates of taxation under the 1942 act because we believe that Congress has other testimony and evidence before it from which some fair rate of taxation will eventually be determined under the 1942 act, but it concerns itself with the levying of a tax based upon these rates, on taxpayers whose books, in many cases, have been closed, or are about to be closed, and who expected to pay whatever the final rates will be decided upon under the 1942 act, on the income for their fiscal year beginning in 1942. In that way they would not be avoiding their share of the increased tax burden but would be merely paying for it during a 12-month period beginning a little later than the calendar period.

The proposal to tax fiscal year taxpayers at the 1942 rates on the proportion of their earnings for the fiscal year beginning in 1941 equal to the proportion of their fiscal year which falls in 1942 is a radical change in the established policy which our Congress has followed for the past 9 years in making changes in tax laws applicable to taxable years beginning on or after January 1 of the year of enactment. Such a change is particularly unfair to the taxpayers in whose behalf this brief is filed, as well as to all other taxpayers who have fiscal years, because of the following results:

(1) Three of these taxpayers had already closed their books on June 30, 1942, which was prior to the time when the House seems to have considered this particular provision of the proposed 1942 act. Two of the taxpayers are about to close their books at the end of August, and the other two will close their books at the end of September. No doubt thousands of taxpayers throughout the entire United States have already closed their books for fiscal years ending prior to August 1942. In most instances these books were closed prior to the time the House of Representatives made this important change in the established policy of making taxing acts applicable only to years beginning on January 1, or thereafter, of the year during which the act was enacted. These taxpayers were led to believe by the 1941 act, and by previous revenue acts, that their fiscal year which began in 1941 would be subjected to a full 12 months' tax under the 1941 Revenue Act.

These taxpayers have completed all of their plans involving the application of funds to new construction, to the payment of dividends to shareholders, and to the setting aside of a reserve for Federal income and excess-profits tax. Having done all of this in most instances, and having closed the books upon their fiscal year which contains some months in 1942, and having set aside what they knew at that time to be a correct amount for their Federal income and excess-profits taxes, under the law then existing, and which they had a right to believe would continue to exist since that method of taxing fiscal year taxpayers had been used for more than 9 years, before any intimation was made public that there would be included in the new revenue act a provision radically changing the basis for taxing fiscal year taxpayers, to now levy an increased tax against these taxpayers, based upon the rates in the 1942 act, really constitutes a capital levy against those taxpayers.

A somewhat simple illustration of the unfairness of this would be a case where your youngster asked you for 5 cents with which to go to the store and buy an ice cream cone. Both the youngster and yourself had definite knowledge of the fact that the store in which he was going to buy the ice cream cone was selling these cones for 5 cents each. As a matter of fact, when he went into the store to buy the cone they were still selling for 5 cents and the storekeeper gave him the cone for 5 cents and the youngster consumed it while he was in the store. However, as soon as he had finished consuming his cone and started to leave the store the storekeeper took a hold of his arm and told him he was then advising him that he was changing the price of his cones to 10 cents each as of the moment before the youngster purchased and consumed the cone. He then threatened the youngster with dire punishment if he didn't get the other nickel with which to pay the new price for the cone which he had already consumed at the old price. How would you feel about such a storekeeper? What is the difference between this simple illustration and the result if the Congress would permit taxpayers to complete their fiscal year operations without even considering a change in the act to make those taxpayers pay more taxes than they were advised by law that they would have to pay for such fiscal year; then after such taxpayers had finished their year and spent their money, with the exception of the funds set aside to pay income taxes, they would be notified that they owed 20 to 40 percent more in income taxes than had been set aside in accordance with the provisions of the law that existed at the time its year was closed and which by a long-established policy the taxpayers were led to believe would apply against the fiscal year just closed or about to close?

(2) It denies to these taxpayers the right to be taxed for a full 12 months at the rates of tax and under the provisions of the 1941 act, whereas all other taxpayers on a calendar-year basis have been afforded the benefits of being taxed under the 1941 act for a full 12 months. Compared with a calendar-year taxpayer, this will have the effect of transferring the tax on the income for the number of the 1942 calendar months that remains in their fiscal year, from the rates under the 1941 act to the rates under the 1942 act. This would be equivalent to asking a calendar-year taxpayer to pay an additional levy for the calendar year 1941.

Attached hereto is a schedule showing a summary of the income of the fiscal-year taxpayers in whose behalf this brief is filed. That summary indicates that the increase in the tax for these taxpayers, as computed under the fiscal-year provisions of the 1942 act as compared with what they had been led to believe they would pay under the 1941 act, is as follows:

	Percent
American Window Glass Co	30.2
Rolland Glass Co	29.3
Fourco Glass Co	23.0
Fostoria Glass Co	21.2
Warwood Tool Co	18.8
Indiana County Theatres Co., Inc	35.2
Monessen Amusement Co., Inc	23.5
Average of above companies	24.7

The above-named taxpayers do not have any objection to paying increased taxes under the revenue act, inasmuch as they realize these are difficult times, and all taxpayers must pay increased taxes. What they object to is the fact that they are being subjected to an increased tax for a 12-month period over and above what other taxpayers have paid for their own 1941 12-month period under the 1941 act, which they had been led to believe they would be taxed under, and to having such a change in the method of taxing their fiscal-year incomes made at a time when their fiscal years are closed or about to be closed.

(3) It will be unfair to fiscal-year taxpayers in the future if this provision is enacted into law because of the fact that if a mathematical average of fiscal-year closings is assumed to be June 30, such taxpayers, if the revenue acts are enacted yearly, as seems to be the trend at the present time, will not know their income and excess-profits tax liability when their books must be closed because of the fact that it now appears that the consideration of these acts usually runs into the second half of each calendar year. No doubt, it is impossible to complete the consideration of a complicated revenue act much before June 30. In such a case these taxpayers will have no definite knowledge of what their Federal

income-tax liability (the largest single item of expense in many cases) will be when their books are closed. They would have to keep their books open for several months to determine this important liability. They could not take any definite steps toward the investment of their funds in plant improvements, payment on long-term debts, or distribution of any profits to shareholders, etc., during their fiscal year for fear that if they overestimated the balance of income that would be left after paying income taxes they would be placed in an embarrassing financial position.

(4) It would have a tendency to quickly force thousands of fiscal year taxpayers to believe they should adopt the calendar-year basis. For many years it has been urged that taxpayers change to their natural business year in order that the taxpayer's statement may be one that includes the 12 months of its natural business year. As a general rule it has been customary for thousands of taxpayers to close their books at the time of the year when their activities are lowest, such as the operation of the plant, the sales, inventories, accounts receivable, etc. In other words, these taxpayers have determined when their activities are at their lowest ebb and have decided that that would be the natural time for them to close their books. It likewise spreads the work of accountants and the tax department of the Government more evenly over the year rather than concentrate all of it in a short period during the early part of each calendar year. In March 1940 the Chief Accountant of the Securities and Exchange Commission stated as follows:

"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."

From the subcommittee on independent audits and audit procedure of the committee on stock list of the New York Stock Exchange, adopted by its Board of Governors, August 1931, the following is quoted:

"The natural business year of an industry in which a company is engaged is recommended, unless impracticable for special reasons, as the fiscal year of the company instead of the calendar year."

The committee on auditing procedure of the American Institute of Accountants and the committee on practice procedure of the New York State Society of Certified Public Accountants reported in the August 1942 issue of the Journal of Accountancy that 21,861 taxpayers adopted a fiscal year basis between July 1, 1935, and January 1, 1942. This was accomplished through the efforts of many organizations over a long period of years. The established policy of Congress during the past 9 years in making the changes in tax laws generally applicable to the full 12 months of a taxable year, whether calendar or fiscal, beginning after January 1 of the year of enactment of the new act, has, no doubt, helped many thousands of taxpayers to decide to use the natural business year when that year happened to end during a month other than December. They did it with the assurance, by law, that each fiscal year would be taxed on the basis of a single taxing act whose provisions they would have definite knowledge of before the end of their fiscal years.

It can readily be seen that it is much better to try to have taxpayers spread their accounting years over different periods, accomplishing, among other important results, the spreading of the filing of tax returns and the preparation of various reports, most of which are now crowded into a few months during the early part of the year. One of the results of this is the same as that accomplished by staggering the work hours of the Government employees in Washington. When they were all on the same work hours it created a terrific rush at certain periods during the day, whereas on a staggered basis it permitted a better spread of the flow of traffic throughout the city. If this fiscal year provision is adopted we are sure that it would do a great deal toward canceling the efforts of many organizations made over a period of years to induce businesses to use the fiscal year-end closing date which coincides with the lowest point in their annual operations.

(5) Accountants have already certified to thousands of financial reports of fiscal year taxpayers whose books were closed before the House of Representatives made public the fact that it was considering a new fiscal year provision in the law that would tax these taxpayers for a much larger tax than they would have been taxed under the 1941 act. Loans have been arranged, commitments of different kinds have been entered into, and no doubt many securities have been underwritten, bought and sold, permitted to be sold by the Securities and Exchange Commission, or valued for other purposes, on the basis of financial posi-

tions and the operating results that were reflected in such audit reports or on the books of those businesses whose fiscal year had been closed before they could possibly take into account the now contemplated changes in the Internal Revenue Code.

In many instances the income and excess-profits tax is the largest single item of expense of the business. For many of the businesses, whose year has already been closed, to be suddenly confronted with the fact that their tax bill for that year is to be 20 to over 35 percent higher than they provided for would be a serious, unexpected, financial headache.

Therefore we respectfully urge your committee to eliminate section 129 of H. R. 7378 or at least eliminate the retroactive subsection which makes it applicable to fiscal years beinning in 1941 and ending in 1942.

Respectfully submitted.

American Window Glass Co.,
Rolland Glass Co.,
Fourco Glass Co.,
Fostoria Glass Co.,
Warwood Tool Co.,
Indiana County Theaters Co., Inc.,
Monessen Amusement Co., Inc.,
By John Wiseman, *C. P. A.*

Effect of the new fiscal year provision of the proposed 1942 Revenue Act as passed by the House on the tax liability of certain taxpayers

	American Window Glass Co.	Rolland Glass Co.	Fourco Glass Co.	Fostoria Glass Co.	Warwood Tool Co.	Indiana County Theatres Co., Inc.	Monessen Amusement Co., Inc.
Current fiscal year ends	Aug. 31, 1942	Aug. 31, 1942	June 30, 1942	June 30, 1942	June 30, 1942	Sept. 30, 1942	Sept. 30, 1942
Fiscal year for which income was used for this illustration	Aug. 31, 1941	Aug. 31, 1941	June 30, 1942	June 30, 1942	June 30, 1942	Sept. 30, 1942	Sept. 30, 1942
How estimate was made of income for fiscal year beginning in 1941.	1941 fiscal year income used because 1942 figures not yet available		Audited results for the full year	Results for the full year per the books after adjustments	Results for the full year per the books, before audit and adjustments	Results per books for 9 months placed on an annual basis	Results per books for 9 months placed on an annual basis
Net taxable income for fiscal year used in this illustration (figures are rounded out for simplicity)	$804,000.00	$378,000.00	$146,000.00	$546,000.00	$65,000.00	$75,000.00	$50,000.00
Excess-profits credit plus specific exemption under 1941 act (figures rounded out)	[1] 804,000.00	[2] 209,000.00	[1] 146,000.00	[2] 286,000.00	[2] 24,000.00	[2] 46,000.00	[2] 28,000.00
Tax under 1941 act:							
Excess-profits tax	None	78,000.00	None	122,000.00	15,400.00	10,600.00	7,800.00
Income tax	192,960.00	72,480.00	35,040.00	101,760.00	11,904.00	15,456.00	10,128.00
Surtax	56,030.00	20,890.00	9,970.00	29,43[illegible].00	3,222.00	4,258.00	2,704.00
Total tax under 1941 act	248,990.00	169,370.00	45,010.00	253,190.00	30,526.00	30,314.00	20,632.00
Tax under 1942 act:							
Excess-profits tax	None	147,600.00	None	229,500.00	32,400.00	21,600.00	15,300.00
Income tax	192,960.00	51,360.00	35,040.00	69,840.00	5,490.00	12,240.00	6,730.00
Surtax	168,840.00	44,940.00	30,660.00	61,110.00	3,780.00	10,710.00	5,060.00
Total tax under 1942 act	361,800.00	243,900.00	65,700.00	360,450.00	41,670.00	44,550.00	27,090.00
If fiscal year provisions are enacted the tax would be made up as follows:							
Portion of tax under 1941 act	82,996.67	56,456.67	22,505.00	126,595.00	15,263.00	7,578.50	5,158.00
Portion of tax under 1942 act	241,200.00	162,600.00	32,850.00	180,225.00	20,835.00	33,412.50	20,317.50
Total tax under fiscal year provision	324,196.67	219,056.67	55,355.00	306,820.00	36,098.00	40,991.00	25,475.50
Increase over tax under 1941 act	75,206.67	49,686.67	10,345.00	53,630.00	5,572.00	10,677.00	4,843.50
Percentage of increase	30.2	29.3	23.0	21.2	18.3	35.2	23.5

Grand total above taxes under 1941 act, $808,032.
Grand total above taxes under fiscal year provision, $1,007,992.84.
Increase, $199,960.84 (24.7 percent).

[1] Over.
[2] Increased $5,000 under 1942 act.

The CHAIRMAN. The questions presented in Mr. Wiseman's brief have already been presented to the committee by others, and the subjuct will be considered in connection therewith.

I have a letter from Hiram W. Johnson, senior Senator from California, enclosing a telegram from C. G. Willis, geologist and engineer for certain oil companies in California. These will be entered in the record. The information contained therein will be considered by the committee.

(The letter and telegram referred to are as follows:)

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
August 12, 1942.

Senator WALTER F. GEORGE,
Chairman, Finance Committee,

DEAR SENATOR: I send you herein telegram I have received this morning from C. G. Willis, geologist and engineer, president, Hilldon Oil Co., Basin Oil Co., general partner, Valley Co., 417 South Hill Street, Los Angeles, Calif., on the question of depletion.

Sincerely yours,

HIRAM W. JOHNSON.

[Telegram]

LOS ANGELES, CALIF., *August 12, 1942.*

Senator HIRAM JOHNSON,
Senate Office Building, Washington, D. C.:

In view of the extreme importance, not only to all independent oil operators in California and elsewhere, but also to the maintenance of an adequate oil reserve for this country in time of war, it would be much appreciated if you could see your way clear to convey the following to the Senate Finance Committee now holding hearings on the question of 27½ percent depletion allowance and the option of expensing intangible drilling costs.

It is generally accepted that approximately three-fourths of the present United States oil supply, or close to one half of the total world supply of oil has been found, and to a large extent developed, by American independent oil operators numbering many thousands, who have risked their meager capital drilling prospect wells, and where successful have then taken their income from production and drilled more wells with it. In view of present high tax brackets, if these independent operators are deprived of 27½ percent depletion allowance and the option of expensing intangible drilling costs, they will almost as a body no longer have the means to continue to search for and develop new reserves, and new exploration will only be possible by a few large integrated corporations with sufficient capital to wait a long time for their return, and who cannot take the place of the concerted effort of thousands of independent operators above mentioned.

The writer has been an independent operator for the last 15 years, and together with associates has discovered and partially developed three substantial new areas of production in California since 1936 and has drilled three deep and costly prospect wells in two other California areas during the same period. Further development in the area already discovered and further exploration is now planned by him. If deprived of percentage depletion allowance and of the option of expensing intangible drilling costs, further development or exploration on the part of he and his associates would become a financial impossibility. It is believed that this situation is typical of the great majority of small independent operators throughout the country.

Respectfully yours,

C. G. WILLIS,
Geologist and Engineer; President, Hilldon Oil Co.;
President, Basin Oil Co.; General Partner, Valley Co.

The CHAIRMAN. There will be entered in the record a brief submitted by Martin H. Miller, national legislative representative, Brotherhood of Railroad Trainmen. This is being submitted in lieu of personal appearance.

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

STATEMENT SUBMITTED BY THE BROTHERHOOD OF RAILROAD TRAINMEN, BY MARTIN H. MILLER, WASHINGTON, D. C., NATIONAL LEGISLATIVE REPRESENTATIVE

THE 1942 REVENUE ACT SHOULD BE BASED UPON THE ABILITY OF THE TAXPAYER TO MEET THE OBLIGATIONS IMPOSED

The Brotherhood of Railroad Trainmen, a labor organization whose membership consists of railroad conductors, brakemen, switchmen, train baggagemen, switch tenders, car retarder operators, yardmasters, and highway bus drivers, is deeply interested in the 1942 tax bill, H. R. 7378. We are interested in tax legislation that will be formulated upon the principle of the ability of the taxpayer to meet the obligations imposed. Such principle of taxation should be adhered to at all times; it is essential in time of war, if our Nation hopes to maintain a steady economic balance and avoid disastrous inflation.

President Roosevelt recognized the dangers of an unbalanced economy when he issued the seven-point anti-inflation program. Your honorable committee has a most difficult task in sifting from the mass of testimony, the House bill, and your vast accumulation of material the Nation's 1942 tax program. The national stability in our war crisis will depend much upon the good judgment you use in making the 1942 tax bill an effective agent in preventing inflationary conditions.

The members of the brotherhood, as well as members of other labor organizations, recognize that the Nation's expenses, however great, must be met and that taxation affords the media to meet the expenses of government The workers of the Nation, through their labor unions, were among the first of the Nation's group to pledge their all-out efforts to support the Government in winning the war. The willingness to withhold the use of the strike in settlement of disputes, the acceptance of wage stabilization program and the purchase of Defense and War stamps and bonds, are only examples of the many sacrifices of labor. Labor will continue to serve and sacrifice for the present and future welfare of our Nation at war, or in peace. We ask that others do likewise.

The tax bill now being considered appears to have been drafted by those not in accord with the principle of the ability to pay, for instead of being an instrumentality of spreading the tax burden with fairness and equality to all, it imposes larger portions upon the lowest income groups, at the same time maintaining the loopholes and tax exemptions for the major portion of the highest income groups. It is really the reverse of that which it should be.

The Brotherhood of Railroad Trainmen, by action of several conventions, has unanimously adopted resolutions opposing the idea of sales taxes. The proponents of sales taxes are usually the representatives of the high income groups who support such methods of taxation in the hope that the great bulk of the tax burden will be shifted from them to many millions in the low-income groups.

The representatives of the high-income groups are constantly on the alert for new and better ideas of how to quickly and surely readjust the tax burden that those in the low-income groups will pay more and more. The individual exemptions were lowered, and the present bill makes still lower exemptions. The payroll withholding idea has seemingly been changed to another idea of a so-called head tax of 3 percent on wages and dividends. Of course, the 3-percent head or wage tax will hit hardest upon the lowest income groups; that is the design. An individual receiving dividends is in much better position to pay 3 percent of such dividends into additional taxes than those in the low-income group. Three percent on families of low incomes is such a burden that it will jeopardize the stability of the family's welfare. Such a toll, without or in addition to the lowered exemption, will fall heaviest upon the children of such families; less food, fewer clothes, denial of opportunities for higher education, and resultant effects upon health, with general demoralization of hopes and future aspirations. The only and paramount matter of importance seems to be the shifting of the burden of taxation from those with ability to pay to those who do not have, under the pretense that it will be a long, drawn-out war, calling for sacrifices from all. Nature has been most generous in bestowing largest numbers in the families of the low-income groups, which makes the shifting of the tax burden to them more cruel and inhumane.

Statesmanship calls, and common sense dictates, that the Nation's taxing methods should be resolved to the basic principle of the ability to pay the obligations imposed. The President's seven-point anti-inflation program should be carefully considered in building the tax structure for the war and post-war era; the individual base exemptions should be maintained, since being lowered in last year's tax bill; the special consideration for oil wells and mines, in form of percentage depletion, should be eliminated as wholly unnecessary and unjustified tax exemptions; and the loopholes and exemptions which permit corporations and those of extremely high incomes to escape paying just proportion of taxes, in accordance with the ability to do so, should be closed.

It is unfortunate for the people and for your committee that the millions of citizens in the lowest income groups do not have and cannot have expert representatives to study, to plan, to devise, and to continually offer ideas of taxing methods favorable to them in order that you and the other Members of the Congress could have the value of the differences by comparison of equal submissions. The inability of those groups to be equally represented makes your task that much harder and oftentimes leads to the acceptance of the ideas of the groups best represented rather than a fair and equitable distribution of the tax burden based upon the ability of the taxpayer to meet the imposed obligations.

The representatives of business corporations and persons in the highest income groups are supporting a sales tax as high as 10 percent on retail sales and a withholding tax of 5 percent, with claims that over $10,000,000,000 will be added in revenue, of which the major portion must come from the low income groups. According to a newspaper article, a representative of the chamber of commerce, in attempting to justify such unreasonable and un-American ideas of shifting tax burdens, is reported to have said, "If $30 000,000 families each had $1,000 more income than last year, this would mean $30,000,000,000 of new purchasing power, competing for a diminishing supply of civilian articles. Taxes must cut down this purchasing power." Of course, the person making such statement knows that 30,0 0,000 workers will not have $1,000 increase in income over last year; very few, if any, will have such an increase. To build a tax structure on such information would be building on a false foundation and would heap unreasonable and unjust burdens upon those least able to pay tax increases. It is indeed a strange situation when the representatives of the high income groups have so much fear that a few dollars in possession of the workers, the low income group, will endanger the Nation to the disaster of inflation, while at the same time the ever-increasing amounts of high income groups must be protected from just taxation. They overlook the fact that already increased costs of living on almost every item and the purchase of War stamps and bonds have more than offset any increase in the available purchasing power of the 30,000,000 or more workers.

The same representative is reported to have said, "A courageous offensive is required to fight inflation. Victory on the home front is vital. There is no place for appeasers." We agree with him on those words. The nation needs a courageous offensive to fight inflation, victory on the home front is vital, and there is no place for appeasers in building the tax structure on the commonsense principle based upon the ability of the taxpayer to meet the obligations imposed.

MARTIN H. MILLER.

The CHAIRMAN. In connection with the statement of Mr. John B. Haggerty, appearing on page 716 of these hearings, there will be entered also a letter from Mr. W. C. Hushing, chairman, national legislative committee, American Federation of Labor, relating to the same matter and stating specifically the position of the American Federation of Labor on the recommendation of Mr. Haggerty.

(The letter referred to is as follows:)

AMERICAN FEDERATION OF LABOR,
Washington, D. C., August 12, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MR. CHAIRMAN: I transmit herewith a brief setting forth the opposition of the American Federation of Labor to the tax on radio as proposed before your committee by Mr. John Haggerty in behalf of the allied printing trades.

Will you kindly have this letter and the accompanying brief printed in the official hearings on the revenue bill?

Sincerely,

W. C. HUSHING,
Chairman, National Legislative Committee, American Federation of Labor.

Enclosure.

BRIEF SUBMITTED BY W. C. HUSHING, CHAIRMAN, AMERICAN FEDERATION OF LABOR, NATIONAL LEGISLATIVE COMMITTEE, OPPOSING TAX ON RADIO

When the 1941 Revenue Act was before the House Ways and Means Committee, Mr. John B. Haggerty, president of the International Allied Printing Trades Association, appeared before the committee and advocated a tax to be levied on the gross incomes of radio-broadcasting stations; and the committee recommended, and the House approved, such a tax.

When the bill H. R. 5417, Public, No. 250, was before your committee, I appeared in August 1941 and made a statement in opposition to the radio tax. This statement is found on page 1476 of the hearings. Your committee then eliminated the tax on radio, and the House agreed with the Senate action.

This year Mr. Haggerty made similar proposals to the House Ways and Means Committee on the revenue bill for 1942 (H. R. 7378), but the committee and the House declined to include in the bill the proposals made by him. Mr. Haggerty then, on August 3, 1942, appeared before your committee on the bill and continued to advocate the tax on radio. His statement is found in part 8, page 656, of the revised hearings on the 1942 bill.

The situation this year in regard to this tax on radio is unchanged and the attitude of the American Federation of Labor is on all fours with its 1941 stand, which is as follows:

"While labor believes that the United States Government should levy extra taxes on the people to pay for defense work we do not believe in punitive or discriminatory taxation as a special levy on radio advertising broadcasts."

Four of the organizations who are advocating this tax on radio through their president, Mr. Haggerty, are affiliates of the American Federation of Labor. They have joined in this matter with one organization not affiliated to the American Federation of Labor. None of the organizations advocating the tax have members employed by the radio stations, while on the other hand, four organizations affiliated to the American Federation of Labor have many members directly employed by the stations.

This tax is designed to cause the transfer of work now done by radio stations to newspapers. It is contended by the advocates of the tax that unless this is done their members will be unemployed. This last contention is untrue because since radio stations have come into existence during the last 10 years, these organizations who advocate the tax have increased their membership on an average approximately 10 percent to approximately 46 percent.

This proposal is not a new question by any means, as it is a well-recognized fact that whenever a new industry comes into existence the employees of an old industry are fearful, as a rule, that they will lose their employment because the products of the new industry may supersede those manufactured by the old one.

Far back in history illumination was produced by wicks floating in vessels containing oil. Then candles came along, then the oil lamp—finally gas and electricity. The punitive tax advocated by Mr. Haggerty in this instance could just as well and just as logically have been proposed by the workers engaged in candlestick making, the manufacture of lamps, etc., as each new improvement came along.

I regret to note that in his testimony Mr. Haggerty states in effect that the executive council of the American Federation of Labor, when it opposed the radio tax advocated by him, were misled. As a matter of fact, when the executive council took action one of the members of the allied printing trades—who is a member of the executive council—was present, so the council did know all the facts when it took action. And it is further pointed out that thereafter a convention of the American Federation of Labor was held and the affiliated organizations of the International Allied Printing Trades Association did not bring the matter to the attention of the convention.

I previously stated that this was not a new question, and I have tried to point out the fear existing in the minds of employees in old industries when a new one comes into being which they anticipate will cause them to join the army of unemployed, and I have also tried to point out the fallacy of this idea.

I want to cite one further instance, as follows: In the middle of the nineties there was another new industry coming into existence and one of the largest central labor unions in the country, at the request of one of its affiliated locals, adopted a resolution that no member of organized labor would ride in an automobile, even to a funeral, because members of the local who proposed the resolution would lose their positions. Events have proven that the fears of this particular local in the middle nineties were groundless, because the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America has become one of the largest and most powerful organizations in the world.

The tax proposed by Mr. Haggerty and his associates is on all fours with the proposal which was adopted by the central labor union as just stated, and we do hope that the Finance Committee of the Senate and the Senate itself will register itself in opposition to the tax on radio.

If, as Mr. Haggerty contends, the income of radio stations is outrageous and excessive, it seems to us that the proper method of approaching the subject would be through the excess-profits tax.

The CHAIRMAN. There will also be entered a request from one of the members of the committee to have included the following letter from L. M. Walker, president, National Rural Letter Carriers' Association, on the question of the gasoline tax.

(The letter referred to is as follows:)

NATIONAL RURAL LETTER CARRIERS' ASSOCIATION,
Washington, D. C., August 13, 1942.

Hon. Walter F. George and Members of the Senate Finance Committee.

MY DEAR SENATOR: I shall not take the time of your good committee in making a personal appearance before you, and shall not go into details as to the many reasons I might recite in support of our opposition to an increase in the Federal gasoline and lubricating oil tax.

I represent more than 32,000 rural letters carriers, who drive in line of duty each day 1,400,000 miles, and who serve approximately 29,000,000 rural Americans. Almost 100 percent of the motor fuel and lubricating oil now consumed by this group is consumed in the actual performance of duty; that is, the delivery of mail to and the collection of mail from the immediate proximity of the homes of these 29,000,000 rural Americans.

We believe it would be obviously unfair to this group to impose a heavier tax upon them, which in the final analysis would constitute a tax upon this very essential Federal service to a very large segment of American society.

Thanking your committee for this opportunity of filing a brief statement, and earnestly soliciting your careful consideration of this matter, I am

Sincerely yours,

NATIONAL RURAL LETTER CARRIERS' ASSOCIATION,
L. M. WALKER, *President.*

The CHAIRMAN. The committee will now take a recess until 10 o'clock tomorrow morning.

(Whereupon, at 6 p. m., a recess was taken until 10 a. m. Friday, August 14, 1942.)

REVENUE ACT OF 1942

FRIDAY, AUGUST 14, 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. Denson.

Mr. DENSON. Yes, sir, Mr. Chairman.

The CHAIRMAN. You are from Birmingham, Ala.?

Mr. DENSON. Yes, sir.

The CHAIRMAN. Proceed, sir.

STATEMENT OF W. A. DENSON, BIRMINGHAM, ALA.

Mr. DENSON. Mr. Chairman and gentlemen of the committee, at the outset, may it be said that this witness feels very deeply and very intensely the great privilege which has been accorded him, in being permitted to address this branch, the most important of the ablest, most renowned, parliamentary body in the history of man on a question vital in a world crisis—and with the humblest humility this witness prays Almighty God that this witness be given the physical, the mental, and the spiritual strength with which to meet this responsibility to the utmost.

Our country is at war on two fronts, the combat front, which is the global, and the economic front, which is felt more keenly at home than elsewhere. In addition to the interest, the product of patriotic fervor, this witness has a more personal interest in the combat front, where he has two sons, one a major and the other a captain, in the armed forces of the United States; and in the economic front, the witness also has an additional personal interest, perhaps beyond that of the average citizen, in that the district from which he comes, namely, Birmingham, Ala., is regarded as a taxpayer of no mean proportion.

Impelled by such interests in each of the fronts of this war, believing he had information of value to the Government on both fronts, this witness came to Washington 4 weeks ago last Tuesday to deliver that information to the Government. After many trials, troubles, and tribulations this witness, last Tuesday, succeeded in delivering to the Truman Special Committee to Investigate the National Defense Program the information he had of vital importance to the Government on the combat front, and immediately thereafter, turning attention to the economic front, this witness now finds himself before this distinguished and efficient body with the opportunity to deliver to the Government the information in respect to the economic front.

Believing these two species of information to be correlated and so concatenated as to logically constitute a composite whole, each illuminating the other, this witness asks that the information as to each front be allowed to be filed with he clerk of this committee.

The CHAIRMAN. Do you wish to file your brief?

Mr. DENSON. This one here [indicating]. That was what was given before the Truman committee last Friday.

The CHAIRMAN. You can file it. I don't know that we can print it. If it is already in the record, there is no need to print it, but we will be glad to see it.

Mr. DENSON. Yes.

(A copy of the statement of W. A. Denson referred to will be found in the original (reporter's) transcript of the proceedings of the Special Committee of the Senate to Investigate the National Defense.)

Mr. DENSON. Now, Mr. Chairman and gentlemen of the committee, we are informed that you are now engaged in an effort to create ways and means of financing the Government in its present economic stringency; in aid of your efforts to accomplish this end, the following communication is respectfully submitted for your consideration:

FINANCING THE WAR AND OPERATIONS OF GOVERNMENT

This war cannot be financed by the issuance of Government bonds.

It is not necessary for the Government to issue bonds in order to finance this war.

If every producer of wealth invested every dollar he produced, reserving nothing for food, clothing, and shelter for himself and family, it would not be one-tenth of the amount necessary for the financing of this war.

Senator BAILEY. You have a lot of generalities here. What is your proposal?

Senator GUFFEY. We are pressed for time.

Senator BAILEY. We have many people waiting.

Mr. DENSON. I think I would get through quicker, if you will allow me to proceed with my statement.

Senator BAILEY. What is your proposition?

Senator GUFFEY. Yes; what is your proposition?

Mr. DENSON. I will come to that.

Senator GUFFEY. Give us what you have without a lot of verbiage.

Mr. DENSON. It has to do with the financing of the war and the operations of Government. That is my proposition that I am dwelling upon.

An attempt to finance this war by the issuance of bonds can only result in the impoverishment of this generation and the enslavement of posterity.

It is respectfully submitted that the record of the investigation by this committee clearly demonstrates beyond peradventure of any doubt whatsoever that the present-day banking system and method of financing the operations of Government, municipal, county, State, and National, have been outmoded by the exigencies of the times, are incompatible with the progress of civilization, and like the implements of the stone age and other worn-out and cast-off things, outmoded by the progress of civilization should be thrown into oblivion, and relegated to the confines of innocuous desuetude; and that any effort at their maintenance, or any other treatment than that stated, is mere nonsensical nonsense, and can only result in failure and chaos.

The CHAIRMAN. Wait just a minute, Mr. Denson. You are talking about money and matters of banking. This committee has no jurisdictoin over those matters.

Mr. DENSON. I am getting to the point. That was merely preliminary.

Senator GUFFEY. Well, jump to the point about how to raise the money.

Mr. DENSON. If you knew all about what I was going to say, there would be no necessity for me to be here and speaking to you. If you will listen to me, I think that I can get through quicker than by interruptions.

The CHAIRMAN. I want to remind you that we have no jurisdiction over banking.

Mr. DENSON. I understand that; this is merely preliminary.

The CHAIRMAN. Get down to what this committee has to do with, and talk to us about that.

Mr. DENSON. I am going to come right to that.

The CHAIRMAN. But this committee's jurisdiction is not on coining money.

Mr. DENSON. I think you will find it all connected—how this war can be financed and the expenses of Government which have to be met.

This war can be financed only in the manner in which the Constitution of the United States of America declares it should be financed; namely:

The Constitution imposed upon the Congress the duty to regulate the value of money. The value of money can only be regulated by those having the possession of money. The banks have the possession of the money; therefore, in order to carry out the mandate of the Constitution, the Congress must operate the banks; it may be—interrogation mark—through the same employees that now operate them.

If the Constitution were thus conformed to, all of the money would be at the disposal of the Government at all times, and there would be no necessity for the issuance of bonds. The idea of the ability of the Government to finance this war, being dependent upon the capacity and inclination of its citizens, including the banks, is too fantastic, too bizarre, too ridiculously absurd to entertain the inquiring mind.

Money is not the property of the citizen. Money is the medium of exchange, created by the Government for the convenience of itself and its citizens. It is at all times the property of the Government. No citizen, or organized group of citizens, has the right to deface, disfigure, or destroy money, or, in anywise, even to change the appearance of money; and to do so, is made a felony, punishable by imprisonment in the Federal penitentiary for a long period of years. Likewise, also, is punished any effort to photograph or create any likeness of money.

Money is the only thing known to present-day civilization which responds solely and directly to the law of supply and demand. Everything else is dependent, not only upon the law of supply and demand, but also upon the money available in the marts of trade and industry. Given the power to determine the money available in the marts of trade and industry, and with it goes, as an inescapable concomitant the power to determine the price of every element of wealth, every product of labor and, of course, as an inescapable corollary the price of labor itself.

Therefore, no one should be allowed to hoard money, but should be required at all times to keep money deposited in the banks operated by the Government subject to the order of the person depositing it there.

There is no despotism more despotic than that which determines what the individual shall eat and wear; what shelter he shall have over his head; what conveniences, amusements, and advantages he shall give his family, and what time he shall have for the improvement of his body, mind, and soul, as well as that of every member of his family, thereby, in fact, determining the destiny of the life of the individual, as well as that of every member of his family.

There is no individual, or organized group of individuals, possessed of so high a degree of perfect altruism as would fit them to be the repositary of such power. Hence, our forefathers, by specific mandate of the Constitution, reposed this power in the duly-elected representatives of the people; and, by the same sacred, solemn contract between the Government and its citizens, gave to the latter the right to change these represenatives every 2 years.

The failure of our representatives in Congress to enforce this mandate of the Constitution has been the sole cause of every economic ill—as many as terrific and as destructive as they have been—which the citizens of this Government have been, are now, and will continue to be, forced to endure unless this cause be removed; the farmer's loss of his farm, the industrialist's loss of his enterprise, the laborer's loss of his job, the white-collar class' loss of their insurance policies, homes, and jobs——

The CHAIRMAN (interposing). Mr. Denson, you are not speaking to a single point over which this committee has any jurisdiction as a committee

Mr. DENSON. I am approaching that point now.

The CHAIRMAN. I have let you proceed, thinking——

Mr. DENSON (interposing). Is this of interest to the committee?

The CHAIRMAN. No, sir; because we have no jurisdiction over it.

Mr. DENSON. I understand exactly. I am driving up to the proposition that you don't have to tax, you don't have to issue any bonds, and yet have plenty of money to finance this war.

The CHAIRMAN. We are not that committee. We are charged with taxation.

Mr. DENSON. I understand that.

The CHAIRMAN. What you are speaking of is not within our jurisdiction. That is for the whole Congress and not just this committee, which has limited jurisdiction over subject matters.

You may put your brief in the record, but we have not the time to listen to a brief, however enlightening it may be and however interesting it may be, that is wholly apart from the question. We are sometimes imposed upon and have been indulgent.

Mr. DENSON. Let me see if I understand the position of the committee: It is that you are not interested in acquiring the financial support for this war and the operation of Government in any manner other than taxes? Of course, if I am precluded from showing how it can be done, without that, there is nothing more to be said, because the whole proposition is directed to that alone.

The CHAIRMAN. I do not say that we are not interested in it, if you can show the Congress what it is; but that is not our responsibility, so far as this committee is concerned.

Mr. DENSON. The only thing this committee is concerned with is: How to levy taxes?

The CHAIRMAN. Yes.

Mr. DENSON. In other words, you assume you must have taxes and you must have——

The CHAIRMAN (interrupting). We are not assuming anything, but we are charged with the responsibility of considering a bill that has passed one of the Houses of Congress and is before us.

You may file the rest of your brief if you desire.

We want to be courteous to you, but there is no need of continuing any discussion along those lines.

Mr. DENSON. Very well, sir. I will file the statement.

(The extension of brief filed by Mr. Denson is as follows:)

EXTENSION OF BRIEF OF W. A. DENSON, BIRMINGTON, ALA.

You assume you must have taxes and you must have their suicides, premature deaths, undernourished bodies, inadequately educated children, and all the rest, so well known to all of us; and so recent, the wounds are still with us; 70 percent of the flower of our youth found to be undernourished when examined by the Government for admission into its armed forces—organized to defend the American way of life.

THE AMERICAN WAY OF LIFE

It is no excuse for the Representatives in Congress to say they created the Federal Reserve System and then permitted that System to be operated by a board composed of bankers, any more than it would be an excuse for the exploitation of the public by high freight rates, to say that they created the Interstate Commerce Commission and then permitted it to be operated by the railroad presidents.

In the year 1939 the banks and insurance companies, the latter being but another illy concealed form of bank, having identically the same ownership as the former, appropriated to their own control more than 50 billions of the 73 billions of wealth created that same year by the wealth producers of this country.

On less than one-third of this amount the four forms of government—municipal, county, State, and National—are annually operated, in normal times, at their greatest efficiency. In other words, with this money in the municipal, county, State, and National treasuries, where the express mandate of the Federal Constitution requires it to be, there would be no necessity, whatever, for any taxes, in any form, to be levied against the citizens and their property, and after having met the expense of government, in its most efficient operation, there would still remain in said treasuries more than $35,000,000,000; or, placing the sum of newly created wealth at $110,000,000,000, the figure reported by the Government for the last fiscal year, there would remain in said treasuries, after the payment of all costs of government—municipal, county, State, and National—more than $63,000,000,000 to be applied on the expense of the conduct of this war, and that too without the levy of $1 of taxation, and without the issuance of a single, so-called, Defense bond, or even stamp.

The continuation of this stupendous economic waste—namely, five-sevenths of the entire annually created wealth of this Nation, diverted, in direct violation of the express mandate of the Federal Constitution, into the possession of organized groups of individuals, who never have, do not now, and never will create $1 of wealth—is utterly incompatible with that degree of efficiency demanded by the exigencies essential to the winning of the conflict in which the Nation now finds itself engaged. Such communism—and we use the phrase advisedly, for the ordinary nonproducing Communist demands that his share only equal that of the wealth producer, while these banker nonproducing Communists demand their share be two and one-half times the producer's—such communism, we repeat, cannot be allowed to continue to exhaust the resources of this Nation, and at the same time the Nation be expected to win this war.

Is it not plainly apparent that the dark and gruesome economic picture of the bankers' propaganda, now being dished out to the citizens of this country over their exclusive, venal, radio, and through their subsidized press, has for its foundation not the expense of the carrying on of this war, but the continuance of the maintenance of the bankers' communism, set forth above? And that every economic deprivation, now being enforced upon the citizenship of this country, is for, and will continue in the future to be for, the avaricious cupidity of bankers' communism—with no connection whatever with the successful waging of this war, except as an obstruction thereto, impoverishing this generation, and enslaving its posterity.

If this war is to be won, and this Nation, in the future, to enjoy any one, or all, of the four freedoms, for the establishment of which, as so often declared by the proclamation of the President of the United States of America, this war is being waged, then these men must be driven from the Halls of the Nation's Congress, and their influence, if any, in the Nation's White House, terminated.

It was the governmental theory of these men which sapped the fighting spirit of France, brought England almost to her knees, created the conditions which brought forth Hitler in Germany, Mussolini in Italy, and will as surely create the same sort of creature in America; or, losing the war, place the "Iron Heel of Hitler" on our necks.

We respectfully submit that it is the determination of these men, and their efforts to carry into effect such determination—to maintain their control over money in direct violation of the express mandate of the Constitution, and secure to themselves the infinitely stupendous loot resulting therefrom—that is responsible for every form of corruption in the life of this Nation; no one is allowed in the public life of the Nation, who has the intelligence, the integrity, and the courage to challenge the legality of their constitutionally outlawed scheme; they crush him with a brutality, having no parallel in history; they own, control, and dominate the press, the radio, the cinema, and every means of propaganda, and therewith crystallize public opinion, electing our representatives, selecting our executives, and appointing our judiciary; enacting our laws, construing our laws, and executing them; thereby dominating every branch of the government, corrupting every election, and, if allowed to continue in their course, will reduce the great, grand, and glorious Government created by the Constitution, designed by our forefathers, to the most despotic, reprehensible oligarchy that the history of civilization gives any account of.

It is respectfully submitted, that if the profits of the banks, including also the insurance companies, went into the treasuries of the municipalities, counties, States, and Nation for the benefit of all the people, instead of becoming loot in the pockets of these private individuals, then there would be removed from our national life the soil in which burgeons all of the corrupt, despotic, tyrannical, oppression threatening the loss of this war, and the life and liberties of this Nation, now and hereafter; and it is further respectfully submitted, that the solemn, sacred oath of each and every Member of both Houses of the National Congress, to preserve, protect, and defend the Constitution, demands such immediate action on his or her part.

A RÉSUMÉ

In conclusion we respectfully submit the following recapitulation:

Neither the war of combat, now engaging the Nation, nor the economic war, which is to follow, can be won, unless the Government operates the banks, including in said term, insurance companies; that the profits of said business be the property of government—municipal, county, State, and national—and the vast sums of money invested therein be deposited with and subject to the control of said government. One of these concerns, alone, has over 23 billions of assets, more than all of the Government's gold, and twice the amount of money now circulating in the marts of trade and industry; thereby enabling the board of directors of this concern to withdraw from circulation every dollar of money now in circulation; and, were it not for the wholesome law which you enacted at the very beginning of the Seventy-third Congress, would enable them to take unto themselves every particle of gold now in possession of the Government, as the property of the people of the United States of America; and would, thereby, enable said board of directors of said concern to determine, as to every citizen of the United States, whether he, she, or it (if the citizen be a corporation) shall sink or swim, survive or perish, live or die, financialy, professionally, politically, and socially. Then where is the seat of our Government? Is it in Washington, where are gathered and assembled the duly elected representatives of the people, or is it in the council chamber where are gathered the board of directors of this concern? Remember, government is power; and, without power, there can be no government, whatever may be the form thereof; and where the power is, there also is the government, whether you will, or no.

It is respectfully submitted that, if our Government is to continue a government of laws and not of men; if government of the people, by the people, and for the people is not to perish from the earth; then the President and Congress of the United States of America must keep their oaths, and enforce the Constitution in the respect herein delineated.

Respectfully submitted.

W. A. DENSON.

The CHAIRMAN. Dr. Fisher.

STATEMENT OF IRVING FISHER, PROFESSOR EMERITUS OF ECONOMICS, YALE UNIVERSITY, NEW HAVEN, CONN.

Mr. FISHER. My name is Irving Fisher, professor emeritus of economics of Yale University. I think it will save the time of the committee if I read what I have to say.

My chief suggestion is that you should—

(1) Put a special tax on that part of personal incomes which is spent;

(2) Reduce, or still better, abolish, all taxes on that part of incomes, whether personal or corporate, which is saved.

In making this suggestion I am representing no business, industry, organization, or other special interest. I speak merely as a student of the subject, having written about it, especially a book on what I call "constructive" income taxation. Advance copies of this book, I hope, will be available for this committee in a week or two.

Although I have no ax to grind, I doubt if anyone who has appeared before this committee can have a keener wish than I do to see that you find the best tax measure you can. I have this wish so keenly because of the critical situation in which our country now finds itself. The war is going too well from Hitler's viewpoint. Clearly a long fight lies ahead, a fight which we must finance wisely. I most seriously believe that, so far, we have not been very wise. I even fear that, unless we correct our biggest mistake, as I see it, worse disasters may come in the long years ahead.

I mean that we are, in taxing savings and undivided profits, killing the goose that lays the golden egg. We may thereby get a little more tax revenue this year but we are killing revenues in future years, revenues which will be even more needed then than now.

I have no patent on this idea that to tax savings is unwise. John Stuart Mill, the great English economist, philosopher, and parliamentarian, stated the principle clearly and crisply in the following words:

> If, indeed, reliance could be placed on the conscience of the contributors, or sufficient security taken for the correctness of their statements by collateral precautions, the proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested (and all savings, speaking generally, are invested) it

thenceforth pays income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income tax, the contributors are twice taxed on what they save, and only once on what they spend. To tax the sum invested, and afterward tax also the proceeds of the investment, is to tax the same portion of the contributor's means twice over.

Mill also appeared before a parliamentary committee to champion the exemption of savings, saying:

But what I should lay down as a perfectly unexceptionable and just principle of income tax, if it were capable of being practically realized, would be to exempt all savings.

Other authorities have written similarly, including Alfred Marshall, the world's leading economist of the last generation and many others in many countries.

Here in Congress, our own Ogden L. Mills, the leading American authority on taxation in his day, introduced a bill for a spendings tax.

I learned day before yesterday that Mr. C. W. Hazelett had advocated the same idea before this committee. I may add that he reached the idea independently, finding in it a good case of what he so well calls "incentive taxation"; for to tax spendings would be an incentive to spend less, and to take off taxes on savings would be an incentive to save more.

The only claim to originality which I can make is this: I have found a way to make the calculation of spendings a precise calculation. You will remember that John Stuart Mill begged Parliament to find a way to calculate spendings precisely. It did not succeed. The lack of such a calculation procedure has hitherto prevented the adoption of a spendings tax, though it has often been proposed, and bills have been introduced in Parliament as well as our Congress.

Secretary Morgenthau has well said that what we need is to reduce our spendings and increase our savings. That is the soundest of sound wartime economics. And the best way to reduce spendings and increase savings is to tax spendings and untax savings.

The New York Times of June 28, 1942, stated that:

The Treasury, seeking a way to impose higher income taxes than these in the pending bill without penalizing too heavily persons who have fixed debt charges to meet, is studying a special income levy from which at least part of "saved" income would be exempt.

A "spendings tax," imposed on top of the income tax, would increase the tax on income ordinarily spent for commodities but not on income used, for example, to meet mortgage payments.

The idea, it was learned today, was broached by Randolph Paul, tax adviser to Secretary Morgenthau, in a memorandum prepared for the Ways and Means Committee. Mr. Paul indicated that the exemptions would cover such things as payments on a home, purchase of war bonds and possibly life insurance premiums.

His memorandum said:

"Even under this separate tax, a complete exemption of all savings might be unnecessary; one-half or three-quarters, or some other fraction of the saved income could be exempt.

"The spendings tax would differ from a sales tax in at least three respects:

"(1) It would be collected directly from the consumer, not from business firms;

"(2) It would grant personal exemptions and a credit for dependents; and

"(3) It would have a progressive rate scale, graduated by spending brackets."

It will be seen that Mr. Paul, according to this dispatch, would not or as he says "might" not be willing to go the whole way in exempting savings.

Others besides Mr. Paul have expressed a partial acceptance of the idea of exempting savings, including Prof. Roswell Magill, formerly Under Secretary of the Treasury.

Personally, I would like to go the whole way and at once. This is war and we must not, as Simon Lake, the inventor of the submarine, recently said, hesitate to take up new ideas. He who hesitates is lost. A nation may be lost that way. We need all the help we can get.

Nevertheless, if you think you cannot go the whole way, half a loaf is better than no bread, and I deem it one of the greatest merits of my proposal that it lends itself to any degree of adoption, or to eventual complete adoption by degrees. All I now ask is that you give the matter the attention it deserves and, to my mind, it deserves your main attention.

In other words, if not now then later, when you are not so pressed for time, I would recommend a thoroughgoing reform of our present income taxes, by repealing all taxes whatsoever on savings.

By "savings" is meant any sort of capital-accumulation and whether of individuals, partnerships, or corporations.

The immediate proposal is to place special new taxes on all personal spendings above a specified minimum exemption, such, for instance, as exemptions of $500 for single individuals and $1,000 for married couples.

To illustrate, and this is only illustration, for a single individual the new tax might be 5 percent on his spendings up to $5,000—that is, on whatever thereof exceeds the minimum exemption, the said $500—

On the next $5,000, or any part thereof, that is, up to spendings of $10,000, the tax would be, say, 10 percent.

For the next bracket up to $15,000, 15 percent.

Up to $20,000, 20 percent.

To $25,000, 25 percent.

And so on, up to a maximum rate of 50 percent for the last $5,000 bracket (namely, $45,000 to $50,000), and beyond. Thereafter the same 50 percent without further progression, in view of the high rates already applying to the upper brackets in our existing income-tax laws.

For married couples making joint returns, the bracket ranges should be doubled, that is, not $5,000 but $10,000, which is $5,000 for each of the two people.

To reckon the spendings the special way to which I referred is an indirect way, not by adding up the separate spendings for food, clothing, rent, amusements, and so forth, which can never be precise, but by adding up the gross receipts from all sources and then deducting certain specific items to be specified in the law. The most essential deductibles are:

All business expenses and reinvestments;

All taxes paid within the taxable year; and

Reasonable deductions for dependents.

What is left after the deductions must necessarily be personal spendings.

A detailed schedule for thus ascertaining personal spendings is given in my forthcoming book.

It will be seen that this proposed new tax is not merely a spendings tax but a luxury tax.

The minimum exemptions and the deductions for dependents mean that there is no tax on necessities, as is involved in a sales tax. The spendings of the very poor would not be taxed at all. Only the middle class and the rich would bear the tax. Moreover, the greater the spendings—which means the more luxurious—the higher the rate.

Such a luxury tax is more truly a luxury tax than any tax which can be devised on specific luxuries such as costly automobiles or oriental rugs.

It is absolutely impossible to define satisfactorily a luxury as a specific object. But it is easy to specify, and with absolute definiteness, what constitutes luxurious spending and in all its gradations.

There are many arguments to support a policy of reducing or removing the taxation of savings. The two chief arguments are:

(1) That such a tax constitutes a subtle form of double taxation, one unjust to the saving taxpayer, while its converse, the double exemption of dissavings is unjust to the Government;

(2) That such a tax is destructive of capital and therefore of its income—especially in the case of young growing industries; for it is a tax on, and so a deterrent to, that growth or expansion.

First as to the double taxation argument:

To take an analogy—and this is only an analogy—if we lay a tax of 1 percent on an orange grove of 100 trees, we may (theoretically) do it simply by handing over, once for all, 1 tree to the Government. This is equivalent to handing over annually the oranges which 1 tree bears. But to do both, to hand over 1 tree at first and then to hand over annually 1 percent of the oranges borne by the 99 trees remaining, is virtually to hand over two series of oranges and reduce the fruit of the orchard twice; for the only value of an orange tree lies in its yield of oranges. That is, 1 tree is handed over outright and, in effect, a second tree is set aside or earmarked for the Government, since its fruit or 99 percent of it must go to the Government.

So also the value of $100 of savings lies in its fruit—its interest. To pay a tax of $1 on the $100 and then, in addition, to pay a 1-percent tax on the fruit of the remaining $99 is virtually to hand over two sets of fruit.

Any tax on savings is merely a pretax on their yield. If we are to tax the yield after it comes we should not also tax it before it comes—unless, of course, we really want for some special reason to tax the same thing twice.

And, just as it is inequitable for the taxpayer to have to pay twice on his gains, so it is inequitable for the Government to have to grant double exemption for his losses.

We all remember how shocked the whole country was to learn that J. Pierpont Morgan and his partners were paying no income taxes during the depression. But they were not to blame. The law is to blame when it deprives the Government of revenue by allowing capital losses to be deducted besides the later deprivation which follows from the lessened income due to those losses.

The second argument is even stronger. A tax on savings or any form of capital accumulation is a penalty on and a deterrent to, expansion.

An airplane factory—and this was written before the testimony you had from the Boeing Aircraft Co.—should have every incentive to enlarge. But if all its earnings are taxed, including its undivided profits, those plowed back in the business, this reinvestment is thereby penalized when it should be encouraged.

The destructive effect of taxing savings and business expansion is far more important than is realized.

Savings or capital increases are a very peculiar and sensitive sort of income, if we choose to call them income at all. To tax them kills them. The consequences are, paradoxically, that the higher the tax the less the tax yields, that more can be collected out of an estate left at death than out of the installments out of which it was accumulated, and even that more can be gotten by taxing the estate alone than by taxing both the estate and the installments which built it up.

All of these contentions can be substantiated mathematically. Every reduction you make in taxes on savings means:

(1) An increase in the Nation's capital equipment; and so,

(2) An increase in future taxes as well as in immediate power to buy Government bonds.

As to increased future taxes, the chief increase will be in death duties.

The death of the accumulator usually marks the end of any rapid accumulation. From a fiscal point of view, therefore, there is usually little, if any, advantage in delaying beyond that point the taxation of savings, if savings are ever to be taxed at all; while, from a social point of view, the argument is strong to appropriate much of the accumulation on the ground that the heirs do not deserve much of what they did not themselves save. From every point of view, therefore, the death of the accumulator marks an appropriate, in fact the only appropriate, time to tax accumulations of capital, that is, savings. That is the only proper savings tax.

And this brings us to the second way to help the Government finance.

Taxation is being overdone. The rates are too high. There are other ways more important. One is increased Government economy. Another is what I especially stress here, increased investment of savings in Government loans.

The plan here proposed would mean increased savings and, therefore, more opportunity to invest in Government bonds which in fact could be made compulsory more easily than at present. In other words, the plan (to tax spendings and untax savings) would immediately help Government financing either through more taxes or through more loans from savings or both. This would appeal to the administration and all responsible for raising funds for the war.

In wartime we are shooting away our savings and cannot afford to tax them away besides. In particular, I stress not so much war taxes as war loans out of savings as a means of financing the war.

It is true that after the Government has crippled industry by taxing profits which ought to be for expansion, the Government can and does turn around and lends the industry the money it has just taken away.

This policy will land us in State socialism after this war if we do not look out. Our Government expenditures in financing the expansion will swallow up all our receipts from the taxes on the expansion. There is, I submit, no fiscal advantage in such taxation. On the contrary, there is, later, a serious disadvantage. For, if we do not let business retain out of its earnings, the wherewithal for financing its own expansion, we cannot get so much in taxes later.

I do not object to a 90-percent or 94-percent tax so far as it applies to income spent, in the highest bracket. But great harm will come so far as the tax applies to income saved and invested in the war effort.

There should be no limitation on what is saved, only on what is spent.

The papers report that a distinguished Senator, appearing before your committee, advocated the preservation of the standard of living in our lower income brackets. I hope he was misquoted; for it seems to me that except for an incompressible minimum we should all sacrifice on our standards of living, which is merely another name for spendings. And I believe that almost every man and every woman among us is willing or even eager to do this, if the sacrifices are fair.

In many ways the proposed measure would help combat inflation whereas the present system, by killing savings, compels the Government to make fictitious loans, that is, to borrow of banks out of newly created credit; in other words, out of inflationary issues of "check book money."

My main point is that the two parts of income, spendings and savings, are very different and should be treated differently in our tax program. Our taxes should come largely from taxing spendings, and our subscriptions to Government bonds should come largely from untaxing savings.

The CHAIRMAN. Thank you very much, Professor.

Are there any questions?

Mr. FISHER. I have a little bit more; but I think I will just file that.

Senator TAFT. A corollary of your theory would be the complete repeal of the capital gain and loss taxes?

Mr. FISHER. Yes, sir.

Senator TAFT. Both ways?

Mr. FISHER. Yes, sir.

Senator TAFT. Wipe them out now?

Mr. FISHER. Capital gains and losses are a particularly bad way of taxing savings. There is a straddle there. A capital gain is not always a gain within the taxable year, but a gain that may have been going on for 10 years, and if taxed at all should have been taxed before.

Senator DAVIS. How much revenue would you raise under this plan that you have set forth here on page 5?

Mr. FISHER. I got one of the Government tax experts to try to estimate that. Of course, it is based on the existence of the present income tax. If the present income tax were abolished and this were substituted it would raise many times as much, but if it were merely superimposed on what we already have he estimated, I believe, it would raise between a half a billion and a billion—perhaps three quarters of a billion dollars. But that was given merely for illustration. I will say this, with the utmost confidence: That—while I have not tried to make, and I do not think I would be capable of making any exact computation as to what you could raise by thoroughly revising our system to conform to these principles—I am satisfied that you would raise much more than now, probably several times as much in the end—though not in the first year.

The CHAIRMAN. Thank you very much, Professor.

Are there other portions of your statement that you desire to have entered in the record?

Mr. FISHER. Yes.

The CHAIRMAN. Just hand them to the reporter.

(The supplemental statement submitted by Mr. Fisher is as follows:)

SUPPLEMENTAL STATEMENT OF PROF. IRVING FISHER, YALE UNIVERSITY, NEW HAVEN, CONN.

The following quotations from the book Constructive Income Taxation will give a rough idea of how a spendings tax can be set up:

"An entirely new approach to income-tax legislation has long been needed. This is evidenced by the amendments to the laws which have been piling into our statute books year after year through a quarter of a century. The volume of them has become stupendous and still grows. Moreover, as this book goes to press, the need of reform has become more urgent than ever, by reason of the new tangles which our defense and war problems have introduced and the frantic efforts of Congress again to rewrite the tax laws.

"In our opinion, the present income taxes are objectionable in many ways. For instance:

"(1) They are unfair, both to the taxpayer and to the Government, not only because they impose double taxation (by taxing savings and their fruits) and allow double exemption, but also because they thus tax the producers of the Nation's wealth more heavily than those who merely spend, especially the 'idle rich.'

"(2) By taxing the increase of capital, they kill the most important geese which lay, for us all, the most important golden eggs.

"(3) They are unwise, largely because they actually kill much of the revenue which they should produce.

"(4) Their administration is unduly costly and vexatious to the taxpayer; and their uncertainty and complexity require the continuous employment of expensive tax specialists in government, in business, and in private life.

"(5) They keep a sword of Damocles hanging over the head of the taxpayer. Several years after his original return has been filed with great care and in good faith, he is still exposed to the chance of receiving from the Treasury a deficiency notice, which it is often difficult and costly to contest.

"THE TAX BASE

"The essential feature of our proposal is that the proposed tax base is income spent; that is, income used for consumption purposes, excluding all income saved, such as undivided profits and investments, presumably used for production purposes.

"How do we figure what we spend in a day? We need only two data:

"1. The amount we had to spend; that is, what we had or received during the day.

"2. The amount we did not spend; that is, the amount left over as determined by counting at the end of the day.

"The application of this simple procedure to the tax problem is the only novelty in the present proposal.

"Moreover, the data needed for this calculation are considerably more trustworthy than those used in our present income taxes, which often depend on debatable estimates.

"We propose, then, to reckon the taxable spendings, not by adding together the separate items spent for food, clothing, rent, amusements, etc., but by adding together the gross receipts from all sources and then deducting all items of outgo other than 'spending.' The chief deductions under this proposal are investments, taxes paid during the taxable year, the proper exemptions for the taxpayer and his dependents.

"THE TAX WOULD BE A LUXURY TAX

"It will be seen that our proposed new income tax is not merely a spending tax; it is practically a luxury-spending tax—'luxury' being defined as any excess above reasonable necessities. These necessities would mostly escape the tax through the 'minimum exemption.' Thus, unlike a sales tax, this luxury tax would allow little or no taxing of necessities; and would spare completely the spendings of the very poor. The middle class and, still more, the rich would bear the burden; for, the greater the spendings—which means the more luxurious—the higher the rate.

"WOULD ALSO BE A NET CASH AND YIELD TAX

"To this proposed tax, either of two names may be applied—one, as just indicated, in terms of disbursements and the other in terms of receipts:

"(1) It is a tax on spendings.

"(2) It is a tax on what is here called net cash yield.

"Net cash yield may be defined as the gross payments received by the taxpayer in the taxable year from all income sources, less any payments he may make into income sources during that same year, and less certain other deductions to be specified by law.

"Following is an outline of what the proposal would include in an individual's tax return in order to arrive at his 'net cash yield' (or its equal, his 'spendings').

THE TAX RETURN

[To be filled out by taxpayer for a given taxable year (under a net cash yield system)]

Report all cash yields from (*a*) work, (*b*) investments, etc., and (*c*) cash balances

(A) WORK

1. Net cash receipts from salaries, wages, fees, commissions.

(B) INVESTMENTS, ETC.

2. Net cash receipts from private business, partnerships, syndicates, pools.
3. Dividends.
4. Rents and royalties.
5. Interest received, less interest paid (the difference may be either plus or minus).
6. (As to principal of loans to others:) Repayments received on such loans less any lendings made in the taxable year (may be either plus or minus).
7. (As to principal of loans from others:) Any borrowing less repayments [1] (either plus or minus).
8. All cash received from sales of investments, less all cash paid out in purchase of investments and less all brokerage and other expenses incidental to said transactions (plus or minus).
9. Cash from windfalls, gifts, bonuses, insurance, bequests, etc.
10. Net cash from any other sources (specify).
11. Total net cash yield from "investments etc." (sum of lines 2–10).

(C) CASH BALANCE

12. Cash on hand at beginning of year.
13. Cash on hand at end of year.
14. Net cash yield from cash balance (line 12 less line 13) (plus or minus).

SUMMARY

15. (*a*) From work (line 1 repeated).
16. (*b*) From "investments etc." (line 11 repeated).
17. (*c*) Drawn (net) from cash balance (line 14 repeated).

[1] But when these repayments to others consist of paying off a mortgage on a dwelling or other consumer goods, the repayment may, for simplicity, be treated as spendings. See appendix to part 1.

18. Total net cash yield from all sources (sum of lines 15, 16, 17, but subject to deductions below).

DEDUCTIONS (OF OUTGO[5]) TO BE SPECIFICALLY AUTHORIZED BY LAW

19. Payments, made within the taxable year, of all taxes.
20. Payments of insurance premiums for business purposes and of all life-insurance premiums.
21. Costs of medical, nursing, surgical, and dental care, subject to specific legal limitations.
22. Funeral expenses, birth expenses, both subject to specific legal limitations.
23. Fines, forfeitures, penalties, and payments for damages.
24. Gifts and contributions made by the taxpayer, subject to specific legal limitations.
25. Minimum exemptions of taxpayer and dependents.
26. Any other deductions authorized by law.
27. Total deductions (sum of lines 19-26).

FINAL RESULT

28. Taxable spendings (line 18 less line 27).

"The foregoing form of tax return is sufficient for purposes of our exposition. In practice, of course, other details would be supplied, as to the progression brackets, special rates on (or 'credits' for) personally 'earned income' (line 1), taxes paid at source, allocation of tax between periods and between American and foreign sources, so as to provide for the deduction of foreign taxes, if any, or perhaps the deduction merely of the foreign proportion of an inclusive American tax. We need not discuss these complications here.[6]

"Also, of course, the form of return would be accompanied by routine explanations and directions.

"WHEREWITHAL FOR TAXES ALWAYS AVAILABLE

"One merit of the proposed system is that it imposes a tax where and when there is cash out of which to pay the tax. That is, if we go back to the gross receipts before any disbursements are taken out (whether for reinvestments, for spendings, or for any other purposes), there is always wherewithal for paying the tax.

"This is not always true of other taxes. A tax on property may be imposed when the property yields no cash. In such a case the tax has to be financed from some other source than the property itself. A tax on cash yield need never be financed unless the wherewithal is recklessly dissipated.

"COULD BE ADOPTED GRADUALLY

"The ultimate objective of this proposal for income-tax reform is to substitute the net cash yield tax (or luxury-spendings tax) for all existing income taxes, but this substitution could, if desired, be approached by successive stages especially if the start were made in wartime. Without necessarily repealing or even altering the existing income taxes of either individuals or corporations, we could add to existing taxes the luxury-spendings tax here proposed, and call it a new war tax. If this recommendation were adopted, it would be easy after the war to continue the new tax while repealing the preexisting income taxes or gradually reducing them until only the new spendings tax remained.

"Another approach would be to transform gradually our existing personal-income tax into a net cash yield tax. For instance, we could begin by abolishing the troublesome capital-gains tax (see ch. 15) and substituting the English system (see ch. 10) or, still better, the tax indicated by line 8 of the above tax return. Next, we could introduce the analogous taxes (plus or minus) indicated by lines 6 and 7, which are seldom important.

"These simple changes would accomplish 99 percent of the desired transformation. For the rest of our tax return is substantially identical with existing laws.

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[5] No deductions of income are recommended, such as from tax-exempt securities. For discussion of the deductible items, see appendix to part 1.
[6] The problem of allocation is discussed in appendix to part 1.

All that would be needed to complete the transformation would be the adoption of lines 9 and 10 (rarely applicable) and 14 (of infinitesimal importance).

"The above changes refer to personal-income taxes. As to corporation-income taxes, the important step, if their abolition must also be gradual, would be to reduce and then abolish all taxes on corporate profits, especially profits not distributed as dividends.

"We make these suggestions for a gradual transition simply because new ideas must usually win their way slowly. We would greatly prefer to have the plan adopted immediately and in full. If this were done, we believe (for reasons which will appear in due course) that immediate benefits would result, and that these benefits would, as argued in chapters 9 and 10, speedily grow to colossal proportions, far beyond what, at first blush, would seem possible."

The CHAIRMAN. Mr. Connolly.

STATEMENT OF JOHN L. CONNOLLY, ST. PAUL, MINN., SECRETARY AND GENERAL COUNSEL, MINNESOTA MINING & MANUFACTURING CO.

Mr. CONNOLLY. Mr. Chairman and members of the committee, my name is John L. Connolly. I am secretary and general counsel of the Minnesota Mining & Manufacturing Co., St. Paul, Minn., which is and has been for the past 30 years engaged exclusively in the manufacture of coated abrasives, which is sandpaper, "Scotch" adhesive tape, rubber cement, roofing granules, and other related products.

NORMAL AND EXCESS-PROFITS TAX RATES PROVIDED BY HOUSE BILL

Our primary purpose in appearing before your committee is to urge upon you the necessity for giving further consideration to growth companies in the matter of establishing an excess-profits tax. The Revenue Act of 1942 as passed by the House imposes an excess-profits tax of 90 percent on corporate earnings in excess of the excess-profits tax credit, which credit may be computed at the election of the taxpayer either under the invested capital or average earnings method; and a rate of 45 percent on the normal tax net income.

With an excess-profits tax rate of 90 percent, it becomes important to corporations which were growing steadily prior to 1940 that only true excess profits be taxed.

PRESENT METHOD FOR DETERMINING AVERAGE EARNINGS CREDIT

On March 8, 1941, the act was amended to permit use of the average net income for the base period or to use the average net income for the base period produced by the so-called growth formula. The base period is divided into two parts—the years 1936 and 1937 representing the first half and the years 1938 and 1939 representing the second half.

If the income for the first half is exceeded by the income for the second half, one-half the excess is added to the total for the second half, and this result is divided by 2, with the limitation that the average earnings credit by this formula cannot exceed the highest income of any year in the base period.

On June 26, 1942, the House Ways and Means Committee tentatively adopted an amendment which would permit corporations a further election in computing their average earnings credit by substituting for any year in the base period 75 percent of the average of the 3 better years.

Before the act was reported to the House, this election was eliminated.

SUGGESTED AMENDMENTS TO THE EXCESS-PROFITS TAX ACT

In line with the foregoing record, which indicates clearly that Congress recognizes the need for special consideration for growth companies, I submit for the consideration of your committee a recommendation that section 713 be amended in the following particulars:

(1) The full average earnings for the base period be allowed as a credit.

(2) Permit corporations a third election. In all cases where the average earnings for the second half of the base period exceeds by 25 percent or more the average earnings for the first half of the base period, the right to substitute the average earnings for the years 1937 and 1939 for the year 1938.

(3) Eliminate the provision to the effect that the excess-profits tax credit cannot exceed the amount of the net income for the highest year in the base period.

EFFECT OF SUGGESTED AMENDMENTS

To my knowledge no estimate has been made as to the effect on the revenues of raising the credit from 95 percent to 100 percent.

Great Britain and Canada permit earnings at 100 percent. Your committee and the House committee recognized the soundness of the policy of allowing the computation of the credit on the basis of average earnings; and it is recognized that a method for computing excess profits based upon invested capital alone will penalize many corporations and favor their competitors.

Many examples of this may be cited, one of which is a corporation organized in a period of low values would be discriminated against in favor of a corporation organized in a period of high values.

Therefore, it seems to me that if average earnings is a proper yardstick to measure the credit of certain corporations, no reduction should be made after the credit has been properly determined. If the credit is reduced by 5 percent, why can it not be reduced by 50 percent?

In order to determine what effect the second and third proposals might have upon revenue, an analysis of the publicly owned companies listed in Moody's Investors' Service for 1941 was made. It was found, because this formula provides such a rigid test for growth, that out of the several thousand companies listed, only 204 would be able to meet this test.

The total increase in the earnings credit for these growth companies would be $17,500,000. With an excess-profits tax rate of 90 percent and a normal tax rate of 45 percent, there would be a reduction in revenue of $7,875,000.

It is possible that your committee would prefer that this average be applied for any 2 years and be substituted for the income or deficit for any year in the base period; also, you might desire to reduce the figure from 25 percent to some lower percentage.

This amendment would give separate consideration to growth companies whose average earnings for the second half of the base period—1938 and 1939—exceeded by 25 percent or more their average earnings for 1936 and 1937.

By giving this additional consideration to truly growth companies, Congress would be making recognition of the fact that these companies which showed steady and increased earnings during the trying years of the base period were carrying a large share of the tax load during that period prior to the national defense period.

We submit further that these companies which were making money and paying taxes during the base period prior to the war-preparation period are the companies most likely to be making profits after the war is over and are the companies upon which the Nation will depend largely for payment of taxes on profits in the post-war period.

We urge that a distinction be made between these companies with such earning records during the base period and those companies which showed little, if any, profits and in many cases, losses, until the war-preparation work was undertaken.

RENEGOTIATION OF ARMY, NAVY, AND MARITIME COMMISSION CONTRACTS

Section 403 (a), Public Law 528, Seventy-seventh Congress, approved April 28, 1942, which is the act authorizing the renegotiation of contracts with the Army, Navy, and Maritime Commission, should be repealed for the following reasons:

(1) If this act remains on the statute books, all new plants for the manufacture of war activities will have to be financed by Federal Government, as no contractor will (and he cannot be expected to) finance new plants for the manufacture of war materials and wait several years before he will be able to determine at what price it is to be sold.

(2) Taxpayers who have had Government contracts and paid State income, Federal income, and excess-profits taxes upon the basis of the original contract are now asked to renegotiate.

The Treasury Department will have authority to make the necessary adjustments in the Federal income and excess-profits taxes if the contract is renegotiated, but I know of no State with a State income tax which has such authority.

(3) Corporatio .s using the invested capital method for determining excess-profits credit will be unable to determine their earned surplus.

(4) No such legislation is necessary. Any doubtful question can be met by contract arrangement.

Senator BARKLEY. The renegotiation of contracts was enacted by Congress as a substitute for rigid profit limitation, and it was done, at least in part, at the request of business. What is your suggestion about a substitute?

Mr. CONNOLLY. If you are asking me for a substitute, I would say that any renegotiation should come after all taxes have been paid and taken into consideration. There should be then certain definite limits as to how far back you might go in renegotiating.

Senator BARKLEY. It is not a fundamental objection you have then to the renegotiation, but the limitations that are placed upon it, is that true?

Mr. CONNOLLY. I do have a fundamental objection to renegotiation, Senator Barkley, but I say if we have to have renegotiations, they should come only after all taxes have been paid. I don't think they are necessary.

And my last point I make here is this, that no such legislation is necessary, because any doubtful question can be met by contract arrangements. And to amplify that statement, Senator, I have in mind a situation where the Government and the contractor, neither is able to determine what the article to be manufactured is to cost—it is a new article. They can make provision in their contract in the first instance to provide that if and when the cost is determined, the profit shall be so much.

Senator BARKLEY. Of course, where they have a contract permitting renegotiation, the law is not necessary at all—you don't have to have a law to enforce that kind of a contract if it is entered into between the contractor and the Government at the time. But they had developed some rather incongruous situations prior to the enactment of this law—which did not come out of this committee, by the way.

Mr. CONNOLLY. I realize that, Senator. Maybe the Senator is referring to the famous or the infamous case of Jacks—I guess is the name of it.

Senator BARKLEY. Jacks or hijacks?

Mr. CONNOLLY. When you come right down to it, I think that the Treasury Department has been meeting those situations for many years, to my knowledge, where they have been paying out profits under the guise of bonuses or salaries. I think with the 90-percent excess-profits tax and a 40- or 45-percent normal tax, in the general line of articles that are being sold to the Government, you have nothing to worry about.

Senator BARKLEY. I think that one of the reasons why Congress repealed the profit limitations on Government contracts was because they thought they could reach it better in the tax bill than you could by rigid limitation of profits on a percentage basis, but a good many companies came in voluntarily and said that they thought that they were making too much money out of contracts that had already been entered into and wanted to give part of it back to the Government—not simply this "hijack" case—or whatever the name was. That one was the most famous or infamous of them all, but there were a good many situations where the contractors realized that where contracts were entered into in a hurry—and had to be, you cannot sit down over a table for weeks and haggle over prices on a war contract that may supply vital material. And it turns out that some of them had made more than they really thought they ought to make in good conscience, and they wanted to return it to the Government. They could have done it anyhow, I suppose; but they did not. And growing out of all of these situations, this power to renegotiate was passed. I wonder, if we repeal that, whether you are going back to the situation that existed prior to its enactment?

Mr. CONNOLLY. I think, Senator, those are exceptions rather than the general rule, and to get at those exceptions you pass a general rule and you run into more difficulty than if you took care of those particular exceptions or let them alone.

Senator TAFT. Doesn't the 90 percent excess-profits tax get 90 percent in of those profits back anyway? That is the thing it seems to me which makes the difference, the fact that we are now imposing a 90 percent tax where formerly we had 60 percent.

Senator BARKLEY. I don't think the Congress or the law should squint at unconscionable profits just to get some of it back by way of an excess-profits tax.

Senator TAFT. The Army Renegotiation Board, I understand, has said: "Why should we pay you the money and you pay it right back to the Treasury? If you let us keep it, we will have more to spend on war materials." If that philosophy prevails in the Renegotiation Board, we are not going to get very much money from excess profits.

Senator BARKLEY. That may have been some individual Army officer talking to some individual contractor rather than a policy in general.

The CHAIRMAN. I suggested at the time of the passage of the Senate amendment which was finally taken in conference with the first provision that was inserted in the House appropriation bill, the proposition of an over-all flat limitation after taxes—after all taxes, of say blank percent, say 6 percent, not upon specific contracts but upon all war contracts, prime and subcontracts, and to use the same method of ascertaining profits and losses as you already apply in your income tax act, so that there would not be any necessity for recomputations. Would business have any objection to that?

Mr. CONNOLLY. I would think so, Senator George, for the reason that it is pretty hard to put them all under a flat 6 percent or 8 percent or 10 percent. That is one of the difficulties, as I see it, in the attempt to renegotiate today. You cannot classify all types of contracts and put them in a certain slot and say they should make a profit of 10 percent or 6 percent. I don't think that can be done.

The CHAIRMAN. It can be made.

Mr. CONNOLLY. Yes, sir; it can be done, but not to satisfying the rank and file of contractors.

The CHAIRMAN. Let me state it again. I did not suggest that each contract be limited, but that all the war contracts over the entire period be subjected to a flat profit limitation, confining it to primary contracts and those subcontracts which—well, not chasing it down to somebody who made some paint part of which may have gone on a battleship and some on a dwelling house—using your same method of computing profits and losses on those war contracts that you now use, and with a flat over-all limitation of say 6 percent or some other percentage.

Senator BARKLEY. Any over-all limitation has to be an over-all limitation as to all contractors. You cannot have one limitation as to one contract and a different limitation as to another.

The CHAIRMAN. My suggestion was to confine it to war business—an average flat limitation on all war contracts after taxes, because if you undertake to impose it before taxes, you will destroy your revenue, and the fiscal policies of the Government insofar as it depends upon the taxation of those profits.

Senator TAFT. You suggest a net limitation and not a gross one?

The CHAIRMAN. A net limitation.

Mr. CONNOLLY. I don't understand, Mr. Chairman, as to the yardstick. Would the percentage be applied to invested capital or would it be applied to costs?

The CHAIRMAN. Profits on all contracts, using your same method of computing your profits as is used in computing your profits for taxation purposes. You would not have to duplicate your work.

Mr. CONNOLLY. Well, take an organization that is using an invested-capital method for computing excess profits——

The CHAIRMAN (interposing). It would not make any difference about that. You have to find out what profits you make on a contract before you can return it. You use that, and simply lump all of your contracts together at the end of the war, however long it is, say over a 5-year period, and then simply say that there shall be a flat limitation of 6 percent net after the payment of all taxes on all war contracts.

Mr. CONNOLLY. Six percent of what figure is what I am trying to find out.

The CHAIRMAN. On the profits on your contracts.

Mr. CONNOLLY. Six percent of the invested capital or 6 percent of the cost?

The CHAIRMAN. Whatever basis you are on; however you figure your costs.

Mr. CONNOLLY. Well, the only objection to that, generally, as I would see it would be that some organizations might not feel that they should be limited or that they should have as much as others in whatever that percentage might be.

The CHAIRMAN. That is true, but I am thinking of an over-all limitation, because I do not think that you can get away from this renegotiation without some substitution that will protect the Government and the people against unconscionable profits.

Senator TAFT. Practically everybody here has been complaining that they are only going to have 2 percent or 3 percent or 4 percent or 5 percent left, so they would not be prejudiced at all.

Mr. CONNOLLY. The whole point, as I see it, is that you are going to get at one group of taxpayers where there is a lot of others that are making unconscionable profits from this war effort.

The CHAIRMAN. That might be, but your excess-profits tax will fairly well take care of them. I grant you that is true, but I assume that the excess-profits tax and the normal and surtaxes will fairly well take care of the people who have no war business, who have no Government contracts, prime contracts or subcontracts, and I would separate that from the balance and say—that is a suggestion, I am simply throwing it out—the suggestion was to separate them and say that with respect to those contracts, the profit on the total of those contracts performed by a contractor during a 5-year war period or whatever length the war ran, should not exceed, after all taxes, the net profits shall not exceed more than a certain fixed percentage. I suggested 6 percent. That, it seems to me, does not make it necessary to renegotiate every individual contract.

Mr. CONNOLLY. You would have the same method for determining costs for each particular taxpayer as he now determines his costs for tax purposes?

The CHAIRMAN. Exactly.

Mr. CONNOLLY. That would get away from this haggling with the Navy on the one side and the Army on the other, as to just what constitutes cost, under the present bill.

The CHAIRMAN. Exactly. Then, whatever you get by with with the Treasury on costs, you would get by with on this computation of a limitation on your net profits on contracts, not on your capital but net profits on all your contracts.

Mr. CONNOLLY. One of the objections I find for many groups is that they try to negotiate with the Army and then they turn over to the Navy, and they don't use the same pattern at the present time.

The CHAIRMAN. I am sure of that.

Senator TAFT. And the Maritime Commission is different from the other two.

The CHAIRMAN. It seems to me that something along that line must be necessary if we are to get rid of the renegotiation provision now in the law.

Mr. CONNOLLY. I would say that is far superior to what we have at the present.

The CHAIRMAN. I suggest it to you so that it might be thought over. Are there any other questions of Mr. Connolly?

(No response.)

The CHAIRMAN. Thank you very much.

Mr. Straus.

STATEMENT OF HARRY H. STRAUS, PRESIDENT, ECUSTA PAPER CORPORATION, PISGAH FOREST, N. C.

Mr. STRAUS. Mr. Chairman and members of the Finance Committee, my name is Harry H. Straus, president of the Ecusta Paper Corporation, Pisgah Forest, N. C.

I appear before you as a manufacturer of cigarette paper, not as an expert on taxes, to show you the insurmountable difficulties which the proposed excess-profits-tax rate of 90 percent will impose upon this company as a debtor corporation and, undoubtedly, upon many other corporations similarly situated. Such corporations cannot, under the proposed rates, meet both their debts and their taxes.

In the case of this corporation, I might mention that the rates adopted by the House result, on the basis of our estimates, in a total tax of actually 87 percent of our entire earnings.

The CHAIRMAN. That is the normal, surtax, and the excess-profits tax?

Mr. STRAUS. The normal, surtax, and excess-profits taxes will consume 87 percent of our entire earnings, not taking into consideration the State taxes which we have to pay.

Senator BARKLEY. Do you mean net earnings?

Mr. STRAUS. Net earnings.

Having observed the large number of witnesses scheduled to appear before your committee today, I know that I must be brief. I therefore wish in this oral presentation merely to summarize our problem, which is set forth in some detail in the statement you have before you, and to offer certain suggestions which, should any one of them meet with your approval, would be helpful.

The CHAIRMAN. Yes; we will be glad to have you put your brief in, Mr. Straus.

Mr. STRAUS. As you will note from pages 1 and 2 of the statement, we are a new corporation. The company was organized in 1938, but did not start manufacture until the last 4 months of 1939 and did not reach its full productive capacity until this year, 1942.

I have been engaged in the cigarette-paper business in the United States since the year 1914, chiefly in the importation of cigarette paper.

In the past, cigarette paper was mostly imported from France where it was made from dirty, unattractive linen rags collected by rag pickers all over Russia, Poland, and the Balkan States. The development of the Ecusta processes for utilizing American raw materials, and the erection of the Ecusta plant, resulted in the final emancipation of the American cigarette industry from dependence for its paper upon this foreign source of supply.

There was never any doubt that there were available, in this country, paper machines, pulp equipment, and everything that was needed in the mechanical line to produce paper superior to that procured from and used in France. We also had at our disposal the highest type mechanical and engineering talent. However, what we did not have was the raw material to be used for the making of cigarette paper. Therefore, our first problem—which had to be solved before we could construct a plant in this country—was that of finding or developing a suitable domestic raw material to replace the old rags then used. Cigarette paper is difficult to manufacture. It is a specialty paper. It must be thin, strong, not stick to the lips, burn at the same rate as tobacco, be pure white and tasteless.

Accordingly, as early as 1933 chemists, engineers, and agronomists were employed by me to develop a suitable American raw material, and experiments were carried on with various types of fiber. Finally, by 1938, this research resulted in finding in American seed-flax straw a material suitable for the manufacture of a high quality cigarette paper. Seed flax is grown in many parts of the United States, particularly Minnesota, California, Kansas, Wisconsin, Texas, and Oregon.

Please note these dates: We started this development in 1933; we organized the company in March 1938, 5 years later. To prepare a new agricultural product for industry is a long program which requires patience, perseverance, and courage. As I shall emphasize later, we are in no sense a "war baby."

The CHAIRMAN. May I ask you, Mr. Straus—perhaps it will help the committee to understand your problem—how many acres of flax now are you utilizing?

Mr. STRAUS. I calculate that out of the 1942 crop of Minnesota and California flax, we will utilize the product of 500,000 acres.

The CHAIRMAN. Five hundred thousand acres?

Mr. STRAUS. Yes, Mr. Chairman.

The CHAIRMAN. For your factory?

Mr. STRAUS. For our factory and similar purposes, but particularly measured for our own purposes.

As I say, we are in no sense a so-called "war baby."

In June 1938 the erection of the plant was begun at Pisgah Forest, N. C. I visualized a mill which would eventually have eight paper machines and a building site was selected accordingly. The first four units were completed and manufacture begun in the last part of 1939. The paper produced was highly succcessful and in all respects met the rigid requirements of the cigarette manufacturers in this country. In 1940 the corporation authorized and commenced construction of the four additional units, which were completed the latter part of 1941. Thus the year 1942 will be our first year of full production, with eight units.

Perhaps it will not be deemed out of place to note in passing that, but for the establishment of this plant in the United States at this time, the cigarette industry would be without an adequate supply of paper and we should face a situation somewhat comparable to that now existing with respect to rubber. Presumably smoking would be rationed and the Government would be losing hundreds of millions of dollars in revenues.

Now about our capital structure. As you gentlemen can well appreciate, the development of this new American industry required a large amount of capital. We could not finance the entire plant construction with our own resources and accordingly obtained loans which, as of January 1, 1942, aggregated $9,200,000. Equity capital paid in in cash amounted to $1,900,000, so that the total capital which went into this undertaking is $11,400,000—represented by $1,900,000 capital stock and $9,500,000 capital loans.

This indebtedness—as you will note from page 4 of the statement you have—is repayable over 8 years at an average annual rate of $1,235,000 per year. The payments this year and next are $1,175,000 per annum—after which it goes to $1.275,000, and so on. These loans were contracted in good faith and after a careful study of our ability to pay.

As you will also note—from the same page—our estimated net profit, after taxes—and assuming the excess profit rate to be 90 percent—is $729,711.43, or approximately $446,000 less than enough to meet our debt installments this year.

The House bill had added certain general relief provisions to section 722 of the Internal Revenue Code. They are, undoubtedly, intended to grant relief to taxpayers such as this one. Clearly, its claim for relief would be consistent with the spirit and principles underlying the specified tests.

However, whether or not a specific taxpayer will receive the benefit of this section may depend upon its ability to establish commitments, legally binding prior to January 1, 1940, for any projected expansion. Moreover, the relief sections contain no yardstick as to the extent of the relief that may be granted or withheld.

Also, determination of tax liability under the relief sections is not made until after the close of the taxable year and a period of years may elapse before the taxpayer knows his actual tax liability for a specified year.

In the meantime, this taxpayer would be confronted with the impossible task of setting aside almost 87 percent of its profits for Federal taxes and still meet its debt obligations and State income taxes.

I have said it is a fact that this corporation is in no sense a "war baby." It is running at its normal rate. We got into production in the fall of 1939. If we had been in production 4 years sooner—in 1936—or even 2 years later--in 1941—I am confident that just as soon as the usual adjustments of a new business had been worked out, it would have been running at about the level of today. Its production is measured by the use of cigarettes. This use is not dependent to any measurable extent upon war or peace.

If this company had been in operation 4 or 5 years earlier it would have been able to have an earnings base that would put it today substantially into the group of the average excess-profits taxpayers. What I mean is that our volume and earnings in the base period would have been only moderately less than our volume and earnings are today. Our earnings would constitute our excess-profits tax credit.

Therefore, I say, if we had been able to work out the many complex problems which we finally did work out, but had been able to do it 4 years earlier, I would not now be standing here. We would be treated as any other average earnings corporation and very frankly would be a relatively modest excess-profits taxpayer.

I am not saying that this company would not be a large taxpayer. It certainly would be, should be, and wants to be. The point is that it would be paying 45 percent normal and surtax on the larger part of its earnings, instead of 90 percent excess-profits tax on practically all of its earnings—as provided for in the House bill.

In this view I think it not altogether selfish to suggest to you that this corporation and certain others in like categories—those started after the base period whose business is in no way dependent upon war expenditures for their normal profits—might properly receive in the law specialized treatment.

In other words, this corporation and others like it are, in their very nature, not really excess-profits earners.

Senator CLARK. Do you have any information as to the number of corporations that would be in a situation similar to yours?

Mr. STRAUS. Not until I appeared here and heard quite a few cases stated. Prior to those, I knew that others must be in the same situation as we are, but it seems there are quite a number.

I have made three suggestions at the end of the statement you have. They are:

1. That the excess-profits tax rate be reduced to 80 percent; or

2. That a limitation be imposed under which the aggregate of excess-profits taxes, normal and surtaxes which any corporation shall be required to pay, shall not exceed 70 percent of its net income before such taxes; or

3. If the committee should decide to adopt the Treasury's recommendation of a 90-percent excess-profits tax rate coupled with a 10-percent credit to be refunded after the war, that provision be made whereby debtor corporations may, at their option, forego such credit and refund and retain and apply to their debts the amount over 80 percent, less reasonable interest charges, which otherwise would be payable under the Treasury proposal.

In addition to these suggestions, I ask, if it seems reasonable and fair to you, that you consider providing for a fourth alternative. Establish in the bill that new corporations whose income is not derived from the war effort shall have a base period earnings credit substantially equal to what their actual earnings at this time would entitle them to, if their present actual earnings were reflected back into the base period as excess-profits tax credit.

I thank you.

Senator BARKLEY. In your table here in page 4, you calculate on your tax estimates for 1942 that after paying all of these taxes you have left net profits of $729,000?

Mr. STRAUS. That is correct, Senator.

Senator BARKLEY. I have made a rough calculation here based upon the same figures at 80 percent excess-profits tax and 40 percent and surtax which has been advocated here by a great many people and that calculation leaves you instead of $729,711 approximately $1,269,000.

Mr. Straus. That is very nearly correct according to my own figures, Senator Barkley. You must realize that the normal and surtax practically do not affect us at all. They amount to only $171,000, whereas our excess-profits tax amounts to nearly $5,000,000.

Senator Barkley. I don't know what could be done about it, but if your suggestion and the other suggestions of reduction to 80 percent and 40 percent were adopted, you would then have enough profit left to pay your debt obligations for the year and have something like $100,000 a year left.

Mr. Straus. That's about right.

Senator Bailey. What would be the situation under your last suggestion?

Mr. Straus. If we could operate under a base period which would take into account——

Senator Bailey (interposing). On the basis of your actual operations, when did you start business?

Mr. Straus. In the latter part of 1939. During the first period, we operated at a loss, because they were new machines, and new experience and no background. We operated in 1939 with a substantial loss.

Senator Bailey. How about 1940 and 1941?

Mr. Straus. We started to double the capacity of our mill, which we finished in 1941, and only during 1942 will we have the full benefit of the capacity in our complete installations. This corporation would be in excellent position to meet its debt obligations and provide additional working capital, which is necessary, and also pay a modest dividend to its stockholders if the excess-profits tax rate be reduced to 80 percent, or a limitation be imposed whereby the aggregate of excess-profits taxes, normal, and surtaxes shall not exceed 70 percent of the net income before such taxes.

Senator Bailey. Your case is one in which you do not get the benefit of the base which we provided. If we could move up the base for new corporations, would that meet your situation?

Mr. Straus. That would meet our situation perfectly.

Senator Bailey. I am very much interested in this matter. Where would the whole cigarette industry be—the whole cigarette taxes be—if you had not anticipated the collapse of France and transferred your manufacture of cigarette paper from France to America?

Mr. Straus. There is no doubt about it, Senator Bailey, that there would not be any cigarette paper available today in such quantities as needed to enable the cigarette manufacturers to take care of their business and also to take care of the steadily increasing demand for cigarettes. It would be a calamity, not only as far as the comfort of the smoker is concerned, but it would affect the income of the Treasury, which, as you know, collects substantial income from the cigarette industry.

Senator Bailey. You use farm products instead of the rags used by the manufacturers in France; do you not?

Mr. Straus. That is correct.

Senator Bailey. The French manufacturers got their rags from Russia and Poland and other countries over there?

Mr. Straus. Wherever they could get them.

From all countries classified as nondependable countries.

Senator BAILEY. And you make a clean product from an agricultural raw material, in contrast to the product previously made in France from these rags collected in these various countries such as Russia and Poland?

Mr. STRAUS. We make our cigarette paper from a virgin American agricultural product which we developed ourselves, and it is just as pure and attractive as the tobacco itself.

Senator BAILEY. That comes from California and Minnesota?

Mr. STRAUS. Chiefly.

Senator BAILEY. And Wisconsin?

Mr. STRAUS. And Wisconsin—and especially in Kansas we do considerable work at the present time. We have developed Kansas to a very large extent.

Senator BAILEY. What is it made of, Senator Clark would like to know? It is flax straw, is it not?

Mr. STRAUS. Yes, sir; flaxseed is crushed to produce linseed oil, and the straw which in the past had been burned and could not be used has been converted by us into new processes and into a very attractive raw material for cigarette paper.

Senator BAILEY. Did they ever make it out of rice straw?

Mr. STRAUS. Never. They called it rice paper, but the only relation that I could find to it being called rice paper is that like rice it was white, but it was never made of rice.

Senator BAILEY. It was really made of old rags?

Mr. STRAUS. Yes, sir. As a matter of fact I would welcome that all of you gentlemen would visit our plant and our warehouses and see for yourself what the process is.

Senator BAILEY. I want to emphasize that the French paper was not made from an American agricultural product but from these rags as Mr. Straus has testified.

They cleaned the rags before they put them into the cigarette paper, didn't they?

Mr. STRAUS. Oh, certainly, they were thoroughly sterilized. Although you gentlemen have smoked many, many cigarettes made with paper which was made from these rags no one has ever suffered anything because of that use.

Senator CONNALLY. What is the little brown paper made from?

Mr. STRAUS. That is also a straw, but only a very small percentage of that type of paper is used. The entire percentage of those brown cigarette papers does not constitute more than one-quarter of 1 percent of the entire quantity used.

Senator BAILEY. Have you been able to get the North Carolina farmers to begin the production of this flax straw for cigarette paper?

Mr. STRAUS. Yes, sir; we have started out in North Carolina, where we are trying not only to develop flax but also other crops which can be grown, and not only in North Carolina but in other southern States. We have made very remarkable progress in that direction.

Senator BYRD. As I calculated it here, you will pay 87 percent of your net income in Federal taxes?

Mr. STRAUS. Correct.

Senator BYRD. You are domiciled in North Carolina?

Mr. STRAUS. Yes, sir.

Senator BYRD. You would have a State income tax, too, to pay?

Mr. STRAUS. That amounts to 6 percent, or about $356,624.
Senator BYRD. And you have local taxes?
Mr. STRAUS. Yes, sir.
Senator BAILEY. The North Carolina tax can rise to 10 percent.
Mr. STRAUS. Yes, sir.
Senator BAILEY. But you are in the 6-percent bracket.
Mr. STRAUS. At the present moment.
Senator GUFFEY. How many people do you employ?
Mr. STRAUS. About 1,800 people.
Senator BYRD. What will happen to you if you are not able to meet your debt obligations?
Mr. STRAUS. The same thing that will happen to anybody who does not live up to his obligations—we just cannot pay.
Senator BAILEY. You would have to come to Washington and borrow some money and probably turn your plant over to the Government.
Mr. STRAUS. It would be a terrific humiliation to me to be compelled to do so, because I am mighty proud of having accomplished this industry and established it in this country, but it is a very sad picture to contemplate any such possibility.
Senator BYRD. Are these bank loans?
Mr. STRAUS. Partly bank loans and partly advances from my customers.
Senator BYRD. I see that your debt here is five or six times the amount of your capital stock.
Mr. STRAUS. Right. We have a very substantial loan—I think about $3,000,000—from the banks.
The balance we have borrowed from our customers.
The CHAIRMAN. In the way of advances?
Mr. STRAUS. Yes, sir; in the way of advances.
Senator BARKLEY. You pay those debts back in annual installments, or do you pay them back in merchandise, in cigarette paper?
Mr. STRAUS. No; we pay them in annual installments, just the same as any loan, and not in shipments in cigarette paper. We gave them notes, and when the notes come due they must be paid.
The CHAIRMAN. And you figure your total Federal tax now runs to approximately 87 percent?
Mr. STRAUS. Eighty-seven percent of our earnings.
The CHAIRMAN. Are there any other questions for Mr. Straus?
(No response.)
The CHAIRMAN. Thank you, sir. You may file your complete brief.
(The briefs submitted by Mr. Straus are as follows:)

STATEMENT OF HARRY H. STRAUS, PRESIDENT, ECUSTA PAPER CORPORATION, PISGAH FOREST, N. C., ON THE PROBLEMS OF A DEBTOR CORPORATION UNDER THE PROPOSED EXCESS-PROFITS TAX RATES

Ecusta Paper Corporation presents this memorandum to show the insurmountable financial difficulties which the proposed excess-profits tax rate of 90 percent will impose upon it as a debtor corporation, and undoubtedly upon many other corporations similarly situated. Such taxpayers will be unable to meet both their debt maturities and pay taxes at this high rate. They are confronted with bankruptcy.

The history of Ecusta Paper Corporation is built around Mr. Harry H. Straus, its organizer and president. Its history goes back to 1938 and involves the development of the manufacture of cigarette paper in the United States from an American farm product.

The cigarette industry in this country had been dependent for its requirements upon paper imported from France, manufactured there from old linen rags collected by rag pickers in Poland, Russia, and the Balkans.

Mr. Straus was originally and for many years in the business of importing cigarette paper and was interested in a French mill. In order to develop the manufacture of cigarette paper in the United States he had, since 1933, employed in the United States chemists, engineers, and agronomists to develop a suitable domestic raw material to replace the unattractive, dirty rags then used.

Experiments were carried on with various types of fiber. Cigarette paper is difficult to manufacture. It is a specialty paper. It must be thin, elastic, strong, and not stick to the lips, burn at the same rate as tobacco, be pure white and tasteless. Pure water is important in the manufacturing process.

Early in 1938 this research and development resulted in finding in seed-flax straw a material suitable for the manufacture of high-quality cigarette paper, and the processes and formulae for separating the necessary fiber from the flax straw in large quantities and for its manufacture into cigarette paper were perfected. Seed flax is grown in many parts of the United States, particularly Minnesota, California, Kansas, Wisconsin, Texas, and Oregon. Development work for the growing of this flax fiber in other sections of the country is now being carried on.

On March 23, 1938, this corporation was organized. A mill which would eventually have eight paper machines was contemplated. In June 1938 the erection of the plant was begun at Pisgah Forest, N. C. The plant originally consisted of four paper machines and the necessary auxiliary equipment. Manufacturing began the latter part of 1939. The paper produced by these new formulae and processes was highly successful and in all respects met the rigid requirements of the cigarette manufacturers in this country. In 1940 the corporation authorized and commenced construction of the four additional paper machines and equipment. These were completed in the latter part of 1941. The year 1942 will be the first full year of operation of the plant thus expanded.

In December 1938 the corporation contracted with some of its prospective customers to supply cigarette paper at a price, after all costs, including taxes, which would leave a profit of 30 cents per standard bobbin (enough paper to make 57,000 cigarettes). During 1940 similar contracts were entered into with some other customers. This 30-cent margin was agreed upon and fixed in that amount so as to provide the corporation with funds with which to pay its debt maturities.

At various times during 1939–41 loan contracts were entered into with some customers and with banks. The total long-term loans remaining unpaid, 1942–50, amount to $9,200,000, to be curtailed at an average annual rate for the next 5 years of $1,235,000. At present about half of the production is sold to customers who have no sales agreements and are not lenders. Irrespective of sales agreements and loan contracts, the corporation sells at the same price basis to all of its customers.

Under the provisions of the existing sales agreements, the sales price must be based upon costs, including taxes, actually experienced. The present sales price of $2.31 per bobbin was based upon such costs, including taxes under the 1941 tax law, experienced during the third quarter of 1941. In order to meet the conditions of these sales agreements and loan contracts and provide for its taxes and necessary debt requirements for 1942 under the proposed rates (excess profits 90 percent, normal and surtax income 45 percent)—and assuming these rates become effective by October 1—it would be necessary to increase the price for the fourth quarter of 1942 to approximately $9.95 per bobbin. (Based upon 12 months of operations under the House tax rates, the increase would be from $2.31 to $4.20.) Even if such an increase were economically possible, it is doubtful whether Office of Price Administration would permit it. Such an increase would amount to enforced inflation, which the Administration properly condemns.

The total capital invested in the corporation is $11,400,000, represented by $1,900,000 of fully paid-in capital stock and $9,500,000 in capital loans. No capital stock was issued or other consideration paid for the value of the developed processes and formulas for the manufacture of cigarette paper from flax fiber, although these are admittedly of tremendous value.

The corporation estimates its 1942 corporate tax liability, if it had to use the invested capital method for excess-profits tax purposes, computed on the basis provided for in the bill as adopted by the House, would be as follows:

	Total amount
Sales (6,000,000 bobbins, at $2.31)[1]	$13,800,000.00
Cost (not including taxes)	7,916,262.00
Profit before taxes	5,943,738.00

		Total amount
State income taxes, 6 percent		$356,624.28
Net income for Federal tax		5,587,113.72
Excess-profits credit	$541,246.93	
Less unallowable interest	171,246.80	
Net credit	370,000.13	
Exemption	10,000.00	
		380,000.13
Taxable at 90 percent		5,207,113.59
Excess-profits tax at 90 percent		4,686,402.23
Normal and surtax (45 percent on $380,000.13)		171,000.06
Total estimated Federal taxes		4,857,402.29
Net profit after taxes		729,711.43

[1] It is not to be expected that this capacity can be maintained year in and year out.

This shows a net profit, after taxes, of $729,711.43, whereas its debt-curtailment obligations are as follows:

1942	$1,175,000
1943	1,175,000
1944	1,275,000
1945	1,275,000
1946	1,275,000
1947	775,000
1948	1,025,000
1949	975,000
1950	250,000
Total	9,200,000

In order to meet only its debt maturities under the proposed law, the corporation would have to increase its earnings, before taxes, from $5,943,738, estimated in 1942, to $11,478,722.79, an increase of 93 percent—or $10.64 additional for each $1 finally available for debt service. This will require an increase in annual sales volume from $13,860,000, estimated in 1942, to $19,394,984.79, an increase of 40 percent.

In order to comply with its contract provisions, including its debt obligations, the corporation, under the proposed law, would have to increase its earnings, before taxes, from $5,943,738, estimated in 1942, to $17,329,786.62, an increase of 190 percent—or $10.63 additional for each $1 finally available after taxes. This would require an increase in annual sales volume from $13,860,000 to $25,246 048.62, an increase of 82 percent.

The foregoing may be further illustrated by the following comparison, using the maximum plant capacity of 6,000,000 bobbins.

	Sales price $2.31 per bobbin	Sales price $3.23 per bobbin	Sales price $4.21 per bobbin
Sales (6,000,000 bobbins)	$13,860,000.00	$19,394,984.79	$25,246,048.62
Cost (not including taxes)	7,916,262.00	7,916,262.00	7,916,262.00
Profit before taxes	5,943,738.00	11,478,722.79	17,329,786.62
State income taxes	356,624.28	698,723.86	1,039,787.19
Federal normal and surtaxes 45 percent	171,000.06	171,000.06	171,000.06
Federal excess-profits taxes 90 percent	4,686,402.23	9,358,999.37	14,318,999.37
Total taxes	5,214,026.57	10,228,722.79	15,529,786.62
Net profit after taxes	729,711.43	1,250,000.00	1,800,000.00
Percentage of total taxes to net profit before taxes	87.72	89.11	89.61
Net profit per bobbin ... cents	12.16	20.83	30

Obviously, any such increases are out of the question, and the corporation cannot possibly meet its obligations and pay the proposed taxes. Any concern which is unable to meet its obligations inevitably faces bankruptcy.

On the basis of the House tax rate, this corporation, with a selling price of $2.31 per bobbin and an annual production of 6,000,000 bobbins, will earn a profit of $5,943,738, from which must be deducted State income taxes amounting to $356,624.28, leaving a profit of $5,587,113.72, out of which it would be required to pay a Federal excess-profits tax of $4,686,402.33 and normal and surtaxes of $171,000.06, aggregating $4,857,402.29, or the equivalent of a composite rate of almost 87 percent for all Federal taxes. This leaves the corporation with a net profit, after taxes, of $729,711.43, and, as indicated previously, for debt maturities alone in 1942, $1,175,000 is needed, and its net earnings are $446,311.43 short of its debt requirements alone.

Increases in working capital may be necessary. This, as well as other contingencies may arise making the retention of a reasonable portion of earnings necessary in addition to debt requirements in the prudent conduct of the business, which, of course, is out of the question under the proposed Federal tax rates.

It is worthy of emphasis in passing that the chief impact of the proposed excess-profits tax rates will be upon new corporations, such as this one, which have no prior record of earnings. Thus, under the proposed 45 percent normal and surtax rates, these taxes, in the case of this company, amount to only $171,000, as against nearly $5,000,000 in excess-profits taxes. In other words, the effective tax rate applicable to this and other companies similarly situated is, for all practical purposes, 87 percent of its net income. Any such discrimination in tax policy against essential new industries is not believed to be in the public interest.

The House bill has added certain general relief provisions to section 722 of the Internal Revenue Code. They are, undoubtedly, intended to grant relief to taxpayers such as this one. Clearly, its claim for relief would be consistent with the spirit and principles underlying the specified tests. However, whether or not a specific taxpayer will receive the benefit of this section may depend upon its ability to establish commitments, legally binding prior to January 1, 1940, for any projected expansion. Moreover, the relief sections contain no yardstick as to the extent of the relief that may be granted or withheld. Also, determination of tax liability under the relief sections is not made until after the close of the taxable year and a period of years may elapse before the taxpayer knows his actual tax liability for a specified year. In the meantime, this taxpayer would be confronted with the impossible task of setting aside almost 87 percent of its profits for Federal taxes and still meet its debt obligations and State income taxes.

It is not believed that any such destructive result—as would assuredly flow from the 90 percent excess-profits rate—is intended by the Congress.

As practical alternatives believed to be wholly consistent with the public interest, it is respectfully suggested:

1. That the excess-profits tax rate be reduced to 80 percent; or

2. That a limitation be imposed under which the aggregate of excess-profits taxes, normal and surtaxes which any corporation shall be required to pay, shall not exceed 70 percent of its net income before such taxes; or

3. If the committee should decide to adopt the Treasury's recommendation of a 90 percent excess-profits tax rate coupled with a 10 percent credit to be refunded after the war, that provision be made whereby debtor corporations may, at their option, forego such credit and refund and retain and apply to their debts the amount over 80 percent, less reasonable interest charges, which otherwise would be payable under the Treasury proposal.

Respectfully submitted.

ECUSTA PAPER CORPORATION,
By HARRY H. STRAUS, *President.*

STATEMENT OF CHAMPAGNE PAPER CORPORATION, PISGAH FOREST, N. C., BY HARRY H. STRAUS, PRESIDENT, IN OPPOSITION TO ANY INCREASE IN THE EXCISE TAX ON CIGARETTE BOOKLETS

Champagne Paper Corporation is engaged in the making of cigarette-paper books—formerly with imported paper—now with cigarette paper it buys from Ecusta Paper Corporation. The following is a brief explanation and summary of its objections to any increase in the excise tax on these books at the present time.

The Commissioner of Internal Revenue classifies cigarette-paper books under two headings:

1. Tax-paid books.
2. Tax-free books.

Champagne Paper Corporation manufactures both types.

All cigarette paper put up in books is used for "roll-your-own."

Tax-paid books.—These retail for 5 cents, and most of them contain 150 leaves. They are sold by the tobacco manufacturers as an independent item, at a very nominal profit. Until about 1932, practically all such books were imported from France, where they were made by old men, women, and children in a so-called "home" industry.

By developing automatic equipment, by which we managed to overcome the labor advantage of the imported product, Champagne Paper Corporation brought a new industry to this country and—even prior to the war—the importation of books ceased.

Champagne Paper Corporation employs about 400 people.

On tax-paid books there is imposed the following tax:

Cigarette papers made up into packages, books, or sets, containing more than 25 but not more than 50 papers, per package, book, or set, one-half cent.

Cigarette papers made up into packages, books, or sets, containing more than 50 but not more than 100 papers, per package, book, or set, 1 cent.

Cigarette papers made up into packages, books, or sets, containing more than 100, per 50 or fractional part, one-half cent.

In other words under the present law—

For each 50 leaves, one-half cent.

For each 100 leaves, 1 cent.

In the new tax bill as passed by the House—and in accordance with the recommendation of the Treasury—all papers are taxed one-half cent per 25 papers, which in practice results in the following rates on cigarette-paper books:

Up to 25 leaves, one-half cent; 50 leaves, 1 cent; 100 leaves, 2 cents; 150 leaves, 3 cents; 200 leaves, 4 cents.

Double the present tax—a 100-percent increase.

The House bill further provides—under the heading of Cigarette Papers—that there shall be no exemption; that all papers shall be taxed one-half cent per 25 papers.

Tax-free books.—These are books which contain less than 25 leaves and—under a practice long established in the industry—have been distributed free by tobacco manufacturers. A search of the record reveals that the policy of exempting these booklets from any tax originated with this committee in 1917 and specific exemption is provided for in the Revenue Act of 1926 and in all succeeding acts.

Smoking tobacco and free books are closely interdependent, the latter being regularly distributed with their products by the following companies: R. J. Reynolds Tobacco Co., Winston-Salem, N. C.; the American Tobacco Co., Inc., New York City; Liggett & Myers Tobacco Co., Inc., New York City; P. Lorillard Co., Inc., New York City; Brown & Williamson Tobacco Corporation, Louisville, Ky.; the Axton-Fisher Tobacco Co., Inc., Louisville, Ky.; Larus & Bro. Co., Inc., Richmond, Va.; Scotten-Dillon Co., Detroit, Mich.; Penn Tobacco Co., Wilkes-Barre, Pa.; and many others.

VOLUME OF CIGARETTE PAPER BOOK BUSINESS

According to published figures, pages 130 and 131, tables 26 and 27 of Annual Report of the Commissioner of Internal Revenue for the fiscal year ending June 30, 1941, the following amounts of cigarette papers were withdrawn:

Tax-free (less than 25 leaves): 1,632,318,944 with an estimated actual leaf content of 16	26, 128, 000, 000
Tax-paid: 101,349,419 with an average leaf content of about 150 leaves	15, 202, 000, 000
Or a total of individual cigarette papers	41, 330, 000, 000
From which ought to be deducted what I calculate at the present to be wastage of, say, 10 percent	4, 133, 000, 000
Net	37, 197, 000, 000
Or, say	37, 000, 000, 000

It has been estimated by various sources that as many as 600 cigarettes can be rolled out of a pound of tobacco. This, however, I find, is exaggerated. I figure that about 480 cigarettes is closer to the actual condition.

During the calendar year 1941—and again I quote from published statistics—197,622,000 pounds of smoking tobacco were produced. Of this total, we estimate some 59,000,000 pounds, or 30 percent, is used for cut plug and other non-roll-your-own mixtures. If I use the basis of cigarette papers consumed to find out how much smoking tobacco has been used for "roll your own," and if I take 480 cigarettes to the pound, I find, as a very fair yardstick to establish how many "roll-your-own" have been actually used, that by dividing 480 into the amount of papers used—37,000,000,000—the great amount of about 77,000,000 pounds of tobacco, out of a total of 138,000,000 pounds, appears to be a close approximation of the amount of tobacco used by "roll-your-own" smokers.

"Roll-your-own" smoking tobacco plays a fundamental part in every branch of the tobacco industry.

The farmer needs an unrestricted outlet for all portions of his crop, including certainly that which is usable only for smoking tobacco.

The tobacco manufacturer must find an outlet for certain types and certain parts of the leaf, which he finds unsuitable for cigarettes, such as tobacco which is too fine to be cut long enough for cigarette tobacco, and the vast amount of leaves broken during the innumerable processes through which tobacco leaf must pass in its preparation for cigarettes which makes it too short for such purpose. All this is, of course, also of direct and material benefit to the farmer.

Under the provisions of the House bill, the tax on smoking tobacco has been substantially increased from 18 to 24 cents per pound.

To this would have to be added under the House bill, an additional one-half cent per bag for a book of cigarette papers which in the past has been exempt from taxes.

In other words, an ounce bag of tobacco retailing at 5 cents would be burdened at the rate of 24 cents per pound with an excise tax of 1½ cents per ounce, with an additional ½ cent for cigarette paper booklet (which always has been free of taxes). An ounce of tobacco which retails for 5 cents and wholesales for approximately 4 cents would carry an excise tax of 2 cents; in other words, when the retailer pays 4 cents for an ounce bag of tobacco, half is for the cost of tobacco and the other half for the ost of the tax.

The "roll your own" smoker is accustomed to buy a nickel bag of tobacco. Bear in mind that the "roll your own" smoker is seldom a city dweller. You do not find him in Washington, New York, Philadelphia, or Chicago, but in farming communities and in large industrial centers. When the whistle blows at noon hour, you see armies of men leave their job, pull out their little bag of tobacco, and begin to roll—watch them and you will realize how necessary smoking tobacco is to them, and huw destructive it would be to deprive these people of their form of enjoying tobacco.

Also, very often, smoking tobacco in "roll your own" form is used during short recesses, when a cigarette will not do because it is too expensive for the few minutes that can be devoted to smoking.

"Roll your own" is almost as old as the tobacco industry itself, and to tax it out of existence is certainly not the intent of the revenue bill under discussion.

Smoking tobacco has shown lately a decline in consumption.

There are many causes to which this condition can be attributed, one of which being the fact that, in factories, smoking is prohibited, whereas employees are permitted to chew, which accounts chiefly for the increase in the consumption of chewing tobacco, twist, and snuff.

It is agreed among authorities that tobacco is not a luxury, but a necessity. It is a needed stimulus to the human system. The prominent part it plays during war time is graphically reflected in the observations of A. H. Maxwell, British Tobacco Comptroller, who during a recent visit to this country told us that the first thing an Englishman asked for when an "all clear" was given after an air raid in London, was "a cup of tea and a cigarette."

The strain of living under the abnormal conditions of war historically stimulates the use of tobacco in some form, and the importance it plays in the lives of both the civilian population and armed forces of all countries is readily recognized.

It has been stated that there is a waste in the use of cigarette papers, especially of the tax-free type.

This was true at one time, when many new brands of "roll your own" smoking tobacco were put on the market and the "roll your own" smoker was unaccustomed to the art of rolling his cigarettes, so that many papers were naturally wasted, also a small percentage of the tobacco.

This condition, however, does not apply today. Today, the smoker is more economical in the use of paper because he knows how to make a cigarette, and the tobacco manufacturer does not pack with his tobacco more paper than is absolutely necessary, since from his own observation and experience he knows just about the amount of paper needed to roll the quantity of tobacco in the particular bag or can that is being used. There is no intention to be extravagant.

CONCLUSION

In conclusion I would like to say that the proposed tax increase on tax-paid books, plus the impost of a tax on the present tax-free-books, plus the proposed increase of the tax on smoking tobacco—from 18 cents to 24 cents per pound—would without question do four things:

First, this additional burden would fall on precisely that group—the lowest-income consumers—who are least able to bear it. Its direct and primary impact would be upon farmers and laborers in the very lowest brackets of income. In practice it would operate as a selective sales tax, but at an unheard of excessive rate.

Second, it would restrict the use of certain types of tobacco, thereby prejudicing the interest of the farmers who need an outlet for this type of leaf. The admission is implicit in the Treasury estimates that this proposed tax would contribute to an anticipated decrease in volume.

Third, the effect of these proposed taxes on the cigarette paper and book manufacturers would be devastating. His equipment cannot be used for any other purpose and hundreds of working people would lose employment.

Fourth—and finally—the revenue which would result from this proposed increase would be negligible. This is especially true if you consider your total revenue from smoking tobacco and papers as one sum. Remember that the House bill provision for the new tax on the present tax-free booklets, plus the doubling of the present tax on "tax paid booklets," will certainly result in still further reducing the sales volume on smoking tobacco, so that even with the proposed increased tax on smoking tobacco the net income for revenue might, very likely, be substantially unchanged from the present revenue.

For these reasons it is respectfuly and most earnestly urged that the present excise tax on cigarette paper be not increased and that the exemption from any tax of books containing not more than 25 leaves be permitted to stand.

Senator LA FOLLETTE. I was requested by a representative of a Wisconsin corporation to have printed in the record a statement made up by their certified public accountant showing the effect of this tax on their company.

The CHAIRMAN. That may be done.

(The statement submitted by Senator La Follette is as follows:)

EFFECT OF PROPOSED TAXES ON A SHIPBUILDING COMPANY

The company expects to complete approximately $10,000,000 of Government contracts during 1942, on which its profits before income tax are estimated at $500,000. Federal income taxes under the revenue bill of 1942 and Wisconsin income taxes will take $144,545, leaving the company net income of $55,455, or only 0.55 percent of its sales. To complete these contracts the company will be required to make capital additions at a cost of approximately $200,000 and thus its working capital will actually be reduced $144,545 as a result of its year's operations.

The company had invested capital at the beginning of the year of approximately $100,000, but no base period earnings. Its excess-profits credit is thus $8,000. While the company might be entitled to a constructive base period net income of approximately $30,000 based on earnings during the 1926-29 period under section 722, the reduction in tax due to use of this section would be negligible considering the 5-percent addition it provides if this section of the act is availed of.

Obviously the national defense program cannot function efficiently when taxes are levied which imperil the financial position of the numerous contractors in this same situation.

As a remedy the following alternative proposals are made:

The total of the normal tax and surtax shall in no case exceed the larger of the following:

(a) Normal tax net income less 2 percent of gross income, or

(b) Seventy-five percent of normal tax net income.

Under this proposal the company retains 2 percent of gross income or 25 percent of net income, whichever is less. The rate of 75 percent is arrived at by taxing one-third of the income at normal tax rates and two-thirds at excess-profits tax rates.

The alternative proposal which we suggest would be to defer the tax payable with respect to profits required to be invested in emergency plant facilities in order to carry out the contracts. Expenditures of this nature are customarily reimbursed by the Government to large contractors, but smaller contractors are frequently required to finance their own capital expenditures. The provision in the tax statutes to accomplish this purpose might read somewhat as follows:

The tax payable on the "due dates" may, at the taxpayer's option, be reduced by 90 percent of the cost of emergency facilities purchased during the year, less the sum of depreciation, depletion, and amortization claimed for the year.

Should the latter exceed the former in a subsequent year, the tax will be increased by 90 percent of such excess, but in no case more than the previous net reductions. Should there remain a net reduction due to this provision at the close of the present war, it shall be payable over a period of not more than 3 years.

SCHEDULE 1.—*Estimate of profit after taxes of a shipbuilding company, based upon the revenue bill of 1942 as passed by the House of Representatives*

		Income	Tax
Estimated sales		$10,000,000	
Estimated costs and expenses (other than income taxes)		9,500,000	
Profit subject to income taxes		500,000	
Federal income tax deductible in computing Wisconsin income (10 percent of income)		50,000	
Subject to Wisconsin income tax		450,000	
Wisconsin income tax at 7 percent			$31,500
Profit subject to income taxes		500,000	
Less Wisconsin income tax		31,500	
Subject to Federal taxes		468,500	
Interest on borrowed capital		4,500	
Total		473,000	
Excess-profits credit	$8,000		
Specific exemption	10,000		
		18,000	
Profit subject to excess-profits tax		455,000	
Excess-profits tax at 90 percent			409,500
Subject to Federal taxes		468,500	
Subject to excess-profits tax		455,000	
Balance subject to normal tax and surtax		13,500	
Normal tax at 15 percent on first $5,000 and 17 percent on balance			2,195
Surtax at 10 percent			1,350
Total taxes			414,545
Profit remaining after taxes			55,455
Additions to fixed property			200,000
Resulting decrease in working capital			144,545

NOTE.—The excess-profits credit is computed at 8 percent of the invested capital ($100,000). The company might be entitled to a constructive base-period net income of approximately $30,000 based on earnings during the 1926-29 period under sec. 722, but the reduction in tax due to use of this section would be negligible after considering the 5-percent addition it provides if this section of the law is availed of.

SCHEDULE 2.—*Estimate of profit after taxes of a shipbuilding company*

	Based upon Treasury proposals for 1942			Based upon 1941 rates		
	Percent	Income	Tax	Percent	Income	Tax
Estimated sales		$10,000,000			$10,000,000	
Estimated costs and expenses (other than income taxes)		9,500,000			9,500,000	
Profit subject to income taxes		500,000			500,000	
Federal income tax deductible in computing Wisconsin income (10 percent of income)		50,000			50,000	
Subject to Wisconsin income tax		450,000			450,000	
Wisconsin income tax at 7 percent			$31,500			$31,500
Profit subject to income taxes		500,000			500,000	
Less Wisconsin income tax		31,500			31,500	
Subject to Federal taxes		468,500			468,500	
Interest on borrowed capital		4,500			4,500	
		473,000			473,000	

SCHEDULE 2.—*Estimate of profit after taxes of a shipbuilding company*—Continued

	Based upon Treasury proposals for 1942			Based upon 1941 rates		
	Percent	Income	Tax	Percent	Income	Tax
Excess-profits credit		$8,000			$8,000	
Specific exemption		5,000			5,000	
Total		13,000			13,000	
Subject to excess-profits tax:		460,000			460,000	
Excess profits tax:						
1st bracket	50	20,000	$10,000	35	20,000	$7,000
2d bracket	55	30,000	16,500	40	30,000	12,000
3d bracket	60	50,000	30,000	45	50,000	22,500
4th bracket	65	150,000	97,500	50	150,000	75,000
5th bracket	70	210,000	147,000	55	210,000	115,500
Total		460,000	301,000		460,000	232,000
Subject to Federal taxes		468,500			468,500	
Excess-profits tax		301,000			232,000	
Subject to normal tax and surtax		167,500			236,500	
Normal tax	24	167,500	40,200	24	236,500	56,760
Surtax	31	167,500	51,925	7	236,500	16,555
Total taxes			424,625			336,815
Profit remaining after taxes			75,375			163,185
Additions to fixed property			200,000			200,000
Resulting decrease in working capital			124,625			36,815

Senator DANAHER. Mr. Chairman, I have received a request from an attorney, Walter N. Maguire, a member of the firm of Cummings & Lockwood, of Stamford, Conn., to appear before the committee to recommend the repeal of section 403 of Public, 528, relative to the renegotiation of contracts. I explained to Mr. Maguire the predicament of the committee with reference to witnesses, and suggested that he submit a memorandum for the record in lieu of his appearance.

I have that memorandum and would respectfully request permission that it be printed in full.

The CHAIRMAN. Yes; it will be printed, Senator Danaher.

(The brief submitted by Senator Danaher, as per request of Walter N. Maguire, is as follows:)

STAMFORD, CONN., *August 12, 1942.*

To the Members of the Finance Committee of the United States Senate:

GENTLEMEN: The purpose of this memorandum is to support the writer's request that section 403 of Public Law 528, Seventy-seventh Congress, also known as H. R. 6868, dealing with renegotiation of war contracts and war subcontracts, be amended so as to clarify its provisions, or if it is not possible to clarify it, that it should be repealed.

The important part of the section is subdivision (c), under which the Secretary of each department is authorized and directed "whenever in his opinion excessive profits have been realized, or are likely to be realized, from any contract with such department or from any subcontract thereunder"—

(1) to require the contractor or subcontractor to renegotiate the contract price;

(2) to withhold any amount found as a result of renegotiation to represent excessive profits; and

(3) where payment has been made to the contractor, to recover excessive profits from the contractor.

The act is stated to be applicable "to all contracts and subcontracts hereafter made and to all contracts and subcontracts heretofore made, whether or not such contracts or subcontracts contain a renegotiation or recapture clause: *Provided*, That final payment pursuant to such contract or subcontract has not been made prior to the date of enactment of this Act."

Under subdivision (h) provision is made that renegotiation may take place at any time up to 3 years after the termination of the war.

The renegotiation statute is fatally defective, in my opinion, in that it does not contain a statement of the standard to be applied in determining what are "excessive profits," and if the Supreme Court of the United States shou'd honor its earlier decision in the *Schechter case*, which held the National Recovery Act to be unconstitutional, it is my opinion that this law also would be held to be unconstitutional.

However, even if it be assumed that the law is constitutional and would be so found by the Supreme Court of the United States, the difficulty still remains of ascertaining the standards to be applied by the governmental agencies charged with administering the law.

Congress has recognized the necessity of establishing standards for purposes of the excess-profits tax. In the excess-profits-tax law there is a provision for determining what constitute reasonable profits which should not be subject to the high taxes on excess profits. Three approaches to the problem are outlined by Congress: first, the taxpayer may take an average of his net income during certain pre-war years and use that as an earnings base. Or, secondly, if that is subnormal, he is permitted to take a certain percentage of his invested capital. Or, third, if neither the first nor the second approach is equitable, in order to avoid undue hardship, provision is made whereby the Commissioner of Internal Revenue can set up a constructed base.

A reading of section 403 of H. R. 6868 shows that no such standard is devised for the determination of excessive profits for the purposes of this renegotiation statute.

Moreover, the administrative agencies which are charged with the administration of this law have not set up any standards which are susceptible of clear understanding or application and the law will be administered by different agencies on different bases, producing a complete lack of uniformity, and there is no doubt that such an administration will produce inequities.

It is also submitted that the task of examining all contracts and subcontracts will present a herculean task and will necessitate the setting up of a gigantic auditing organization.

The act provides for the renegotiation of each contract or subcontract. There must be at least several hundred thousand contracts and subcontracts which could come within the scope of the act; and it is obvious that, if the cost of performance of each such contract and subcontract must be determined by an audit, the task is practically an impossible task.

This may well account for the reports which have emanated from Washington in magazines and bulletins that the Price Adjustment Boards have been contemplating over-all adjustments based upon total profits during a particular year as compared with profits during pre-war years. This departure from the specific language of the act indicates possibly a recognition by the Boards that the task outlined by the act cannot be accomplished on a piecemeal basis.

Moreover, the act contains no definition of cost and there is likely to be a great deal of dispute as to the proper elements of cost entering into the performance of contracts.

This is particularly true in the case of the production of peacetime products, such as bolts, nuts, and screws, and other standard commercial products which are made in large runs wherever possible, and not only in the amounts called for by particular orders received from the trade. With respect to many such items companies do not keep precise cost figures. The selling prices of such articles have been determined prior to the war period by competition and the Office of Price Administration has imposed maximum price ceilings over such goods. The inference is inescapable that a price not exceeding the maximum price ceiling established by the Office of Price Administration is a far price, permitting of a fair margin of profit in the particular industry.

It is submitted that if the purpose of the law is one that Congress wishes to carry through, it should be amended to provide an exemption with respect to contracts, subcontracts, and orders, following somewhat the pattern of the exemption under the Vinson Act, which at first permitted an exemption of $10,000 and subsequently an exemption of $25,000. Such an exemption would permit the Price Adjustment Boards to concentrate on the large contracts and subcontracts, which we assume was the purpose of Congress in using the figure of $100,000 in section 403. While this amount of $100,000 is not referred to as an exemption, it is quite obvious that Congress, in requiring that contracts and subcontracts amounting to over $100,000 should contain a provision for renegotiation, impliedly intended that small contracts or subcontracts or orders under $100,000 should not be the subject of renegotiation.

This purpose can be made clearer with benefit to the Government as well as to manufacturing concerns receiving contracts, subcontracts, or orders for smaller amounts.

The writer has no suggestion as to what the exemption should be, but urges that there should be an exemption, the amount being determined by Congress.

It is also submitted that a difference should be recognized between companies manufacturing peacetime products which are adaptable to war purposes and companies manufacturing war products which are uniquely war products not manufactured in peacetime and not usable for peacetime purposes.

In the first instance, the costs are known and the selling prices have been established by competition, as well as now being controlled by the maximum price ceilings established by the Office of Price Administration.

It is in the latter situation, however, that no prior experience in costs exists, and for that reason governmental procurement divisions are unable to know in advance what a fair price should be. It must be recognized that in such cases the work should be done and when a sufficient volume of production has been reached the costs should be analyzed to determine what a proper cost is and predicated thereon what a proper price is to be paid by the Government.

In the first instance, if the volume of production of peacetime products increases by virtue of either greater demands or greater production due to increased shifts or expanded plants, or a combination of the foregoing, 90 percent of any profits over the peacetime average would be recoverable under the excess-profits tax law as presently proposed in the tax bill passed by the House of Representatives and now under consideration by the Senate Finance Committee.

If a 90-percent or even an 80-percent tax rate is ultimately applied to excess profits, as defined by the tax law, it is submitted that such a recapture of excessive profits is all that should be attempted.

If the renegotiation statute is designed to recapture the difference between the excess-profit-tax rate of 80 or 90 percent and the 100 percent of excessive profits, it attempts too much. It would deprive industry of the small pittance remaining after provision for the excess-profits tax, which small margin of profit is necessary to pay off indebtedness, much of which has been incurred to expand plant facilities and purchase additional working materials and inventories for war purposes. It might also destroy the incentive of manufacturers who would be forced to conclude not only that the extra production requested of them would have a trivial return, but that they might even have no return or incur substantial losses.

Manufacturers who voluntarily at the request of governmental agencies have expanded their facilities, and have made investments in abnormal inventories, have assumed great risks against which they have very limited protection.

In determining what profits are excessive for purposes of renegotiation, should not recognition be given to the necessity of permitting manufacturers to establish reserves, such as those for the following purposes: (1) Shrinkage in value of inventory at the end of the war period; (2) nonliquidity of abnormal inventory as well as of normal inventory at end of the war period; (3) existence of surplus machinery and equipment which would not be needed in the post-war period; (4) the necessity for maintaining a sound working-capital position in order to be certain to produce at a maximum rate?

Possibly other reserves should be recognized to the extent that they are necessary to keep American industry producing at a maximum rate. If management is worried as to where money is coming from to meet pay rolls and material invoices, such a condition interferes with its ability to concentrate on production.

Another fault in connection with the renegotiation statute is that it makes the ultimate determination of price a unilateral matter in the control of the secretary of the particular department. There is no provision whereby Court review can be had of the propriety of any such determination. It is submitted that some provision should be made for a judicial determination of what constitute excessive profits if the determination of the secretary is deemed to be unreasonable or to impose an undue hardship.

Another problem arises out of the use of the word "subcontract." The Army Service of Supply, on July 14, 1942, issued circular 23, and in that circular refers to a subcontract as being one that calls for "the same article or articles which the contractor is required to deliver to the Government under the contract." A further definition issued by one of the Army agencies purported to include within the scope of the word "subcontract" any component part of the ultimate product called for by the prime contract. On this basis nothing would be exempt and a subcontract would follow on down through to the very original material, such as ore, incorporated into the end product.

The Second War Powers Act of March 27, 1942, refers to three categories of purchases: (1) Contracts, (2) subcontracts, and (3) orders; H. R. 6868 refers only to contracts and subcontracts.

It is submitted that the word "orders" has a significance different from the word "contracts" or the word "subcontracts," and it is believed that this word "orders" means orders other than those issued by the Government for standard peacetime-commercial products.

Recognition has heretofore been given by governmental agencies to the difference between subcontractors and materialmen.

It is believed that a clarification with respect to the definition of subcontracts would be helpful.

Another defect in the statute is that under subdivision (h) renegotiation can take place any time up to 3 years after the termination of the war.

It is submitted that once renegotiation takes place, the conclusion arrived at should become the final conclusion, not subject to being opened up in the absence of fraud.

Another objection to the renegotiation statute is that it purports to apply to all contracts and subcontracts made prior to April 28, 1942, "provided that final payment pursuant to such contract or subcontract has not been made prior to the date of enactment of this act." I submit that there is question as to the legality of the act with respect to contracts where performance by the contractor had been completed prior to April 28, 1942, but with respect to which payment had not been made by the Government or by the prime contractor prior to that time. It does not seem to me that the line of demarcation should be made with respect to the date of payment, but rather with respect to the time when the contractor or subcontractor, as the case may be, completed performance of his obligations under the contract.

In one instance, to which my attention has been called, performance had been completed in 1941, but the contractor had not received payment of 10 percent of the contract price because that had been withheld as a guaranty against defects of materials or workmanship for 1 year after final delivery had been made. It is submitted that such a contract should not be subject to renegotiation where it had been fully completed before April 28, 1942, on the part of the manufacturer.

It is submitted that a limitation of profits by use of a fixed percentage based upon cost of performance is unworkable and entails undue and improper hardships, and that any amendment involving one fixed percentage limitation is unsound.

The Vinson Act at first provided a limitation of 10 percent on the cost of construction of naval vessels and 12 percent on the cost of construction of Army or Navy aircraft. Later this was modified to 8 percent.

These percentages may very well have been appropriate to the two products referred to, but such percentages might very well be out of line with proper margins of profit in other industries where the recognized margins under normal competitive conditions are either greater or less.

It may well be that the proper action to take is to repeal section 403 of H. R. 6868.

The apparent purpose of the act is to cut down the prices of goods purchased by the Army and Navy and Maritime Commission. To the extent that payments by these departments are cut down, the necessity of raising money by taxes is relieved. However, in the process of cutting down prices, the excess-profits revenues will be directly diminished.

I am unable to state whether renegotiation would be ultimately advantageous to the Government after balancing the savings on renegotiation of contracts against the tax revenue lost by reduction of profits, or whether the net result would be to produce less for the Government than would be produced by the excess-profits-tax law alone. However, the net result might well be prejudicial to the Government.

It is presumed that the purpose of the renegotiation statute is to benefit the Government by getting more back on a price-saving basis than it would get in the normal course of events by application of the income- and excess-profits tax law.

If by renegotiation the net revenues of the Government will be diminished, then obviously the renegotiation statute is not beneficial to the Government.

If, however, the result will be to take away from the manufacturer more than the 90 percent which the excess-profits-tax law takes away from him by reason of excessive profits, then the renegotiation statute acts as an additional tax law and deprives business of the very small amount of benefit left from the war work with which to meet its wartime obligations, incurred in connection with the war effort, and to provide the reserves which will in all likelihood be necessary to permit them to carry over through the inevitable transition period at the end of the war into a peacetime economy.

Unless the renegotiation statute can be amended, so as to clarify its purposes and its application, it should be repealed.

If the result of the application of such an amended statute would be to strip American industry of any benefit from the war work and impair its ability to meet obligations incurred for the war effort and to build up reasonable reserves to insure the safety of the enterprise through the post-war transitional period, including its ability to continue to operate and give employment to workmen, it should be repealed.

Respectfully submitted.

WALTER N. MAGUIRE.

Senator McNARY. Mr. Chairman, I would like to present for the record two letters. The first is from L. B. Sandblast of Portland, Oreg., on the subject of a Federal "head tax"; and the other is from the Oregon Fairs Association regarding the proposed Federal tax on pari-mutuel betting.

The CHAIRMAN. They may be entered in the record.

Senator McNARY. Thank you, sir.

(The letters referred to are as follows:)

PORTLAND, OREG., *August 10, 1942.*

Hon. CHAS. L. McNARY,
United States Senator, Washington, D. C.
Re: Head tax—$1 a week.

DEAR SENATOR: I am prompted to address you on a matter of vital importance in the revenue program of the Government.

This emergency justifies an individual tax which will be referred to as head tax. Making allowance for exemption of minors, indigents, and mothers who are unemployed wives of workers, there would be derived approximately $5,000,000,000 a year if the rest were required to pay $1 a week. This can be paid by the purchase of a $1 stamp a week. In my estimation there would be 100,000,000 who would pay weekly which would total about $5,000,000,000 a year.

To simplify collection each individual would be given a button, pin, or emblem having displayed on it "Head Tax, Paid," or "H. T. P'd." Those not wearing such a pin would be announcing that the head tax has not been paid. Those who are unable to pay would be exempt by making a showing by way of affidavit, but there would be a liability for such an amount if such a person was later restored to an income producer.

My thought is that this will avoid the increase in the tax rates on income which is at the top in the high brackets and so high in the lower brackets as to nearly take business out of business.

The Senate Finance Committee and the Ways and Means Committee are seeking about three billion more at this time. If the head tax was started out at $2.50 per month it would produce the amount needed at this time to balance the Budget to the required extent.

Millions who have never paid direct taxes would be affected. It would avoid the necessity of abolishing exemptions now allowed by income taxpayers, $750 for individuals and $1,500 for married people. There is considerable opposition to lowering this exemption, throughout the country as far as the rank and file of low income taxpayers are concerned. A head tax would provide the additional tax and is just, equal, and fair. If it works a hardship on some too much, provisions can be made to relax the tax as to those who are unable to pay, of course.

I have discussed this with several here and they think that it should be submitted and I am doing so and would appreciate it should you turn this over to the chairman of the Finance Committee of the United States Senate for its consideration.

The agitated sales tax is unpopular, regardless of its merits. Most of the orthodox tax laws are unpopular because of "red tape," and the troublesome and technical tax returns. May it not be obvious that many will welcome some method that removes some of the bookkeeping trouble and task and be current with their taxes when they pay as they go, each week, without being worried about a lump sum payable throughout the following year, and after the income has been expended for living and other expenses?

I shall be grateful if you care to give me some information as to any reaction to this proposal.

With kindest personal regards, I am,

Sincerely yours,

L. B. SANDBLAST.

OREGON FAIRS ASSOCIATION,
Molalla, Oreg., July 29, 1942.

Hon. CHARLES L. MCNARY,
Senate Office Building, Washington, D. C.

DEAR SENATOR MCNARY: I am greatly disturbed over the apparent probability that the new revenue measure will include a special Federal tax on pari-mutuel betting. That you may understand the situation as it will affect Oregon, I ask your indulgence in the following necessarily rather extended statement of facts.

Oregon State Fair was organized in 1861, and has held an annual exposition each year since then. We have 40 organized county fairs, and district county fairs, in addition to which we have the Eastern Oregon Livestock Show, at Union, the Northwest Turkey Show at Oakland, Pacific Livestock Exposition at Portland, and the Pendleton Round-up.

All of the foregoing are beneficiaries and are largely sustained by the funds received from the Oregon Racing Commission.

In 1933, when Oregon authorized legalized racing, with pari-mutuel betting, we were in the depth of the depression, and Governor Meier was under the necessity of raising substantial sums of money for relief at a time when our property owners were permitting their property to revert to the counties, by reason of nonpayment of property taxes. To meet this situation, Governor Meier felt it necessary to eliminate all unnecessary State expenses.

Early in the 1933 session he notified the legislature that he would veto any appropriation for any of the fairs. At that time this would have meant that the State fairs, the Pacific International, and nearly all of the county fairs would have had to close unless some other source of revenue could be found.

Instead of placing the Oregon share of the racing fund in the general fund, the racing law provided that all of the net returns to the State should be appropriated for the various fairs and exhibitions.

For 9 years the State fair, the Pacific International, and the county fairs have participated in the proceeds derived from racing. In 1935 the legislature added as beneficiaries the Eastern Oregon Livestock Show, at Union, the Northwest Turkey Show at Oakland, and the Pendleton Round-up.

In 1939 the legislature increased the State's participation by one-half of 1 percent and placed this money in the general fund.

As a result of the foregoing, and excluding the money received in 1942, there has been paid to the State and its beneficiaries, over and above all expense of the racing commission, the following sums of money derived directly from racing, and by racing I mean, pari-mutuel betting:

General fund, in 3 years	$52,045.34
Oregon State Fair, in 9 years	279,573.52
Pacific International Livestock Exposition, in 9 years	279,573.52
Pendleton Round-Up, in 7 years	33,260.00
Eastern Oregon Livestock Show, in 7 years	33,260.00
Northwest Turkey Show, in 7 years	8,268.00
County fairs, in 9 years	230,079.70
Total	916,690.08

While the above amounts are not large, considering the length of time elapsed, nevertheless they have been sufficient to permit the continuation of all of our fairs, with a regular annual growth and with a proportionate increase in the benefits to agriculture, horticulture, and other rural activities.

These funds have been of special benefit in that it has made possible a continuation and enlargement of the social and economic benefits derived from 4-H Clubs and Future Farmer activities of the rural citizen. This has made it possible to make farm life more attractive and in a substantial way has increased the possibility of keeping the young people interested in an desirous of remaining at home on the farms.

This 4-H Club and Future Farmer activity is recognized as two of the very outstanding economic and social activities which are yielding annual benefits of great value to our communities.

In 1928 we organized the Oregon Fairs Association. I have been president of this organization from its beginning. All of the county fairs, the State fair, the Pacific International, the Pendleton Round-up, the Eastern Oregon Livestock Show, and the Northwest Turkey Show are constituent members of our fair association.

We hold an annual meeting in January of each year, which is attended by representatives of the various fair boards; usually the attendance numbers from 100 to 150.

I enclose you the following of our publications: Roster of Fairs and Other Information January 1941, which furnishes considerable detailed information; also our publication, Oregon Fairs.

In 1941 I sent out a questionnaire to all of the fair boards including the Pacific International, State fair, etc., in order to gather the deliberate judgment of these fair officers and organizations, as to the benefits which have accrued from the funds derived from racing.

The information contained in this booklet Oregon Fairs is authentic as given to me by the signed statements of these fair boards and their officers, all of which are preserved in my files.

The purpose of this letter is to call to your attention the importance of our fairs to our people, with all of which, in a general way at least, you are thoroughly familiar.

I also wish to call to your attention the further fact that without the support of the funds derived from pari-mutuel wagering few of these fairs would now be in operation.

The proposal to take a new tax of 5 percent from the money wagered on pari-mutuel racing would, in my opinion, absolutely eliminate all legalized racing in Oregon.

As it is now, 12½ percent of all money wagered is deducted every day. This deduction pays the expenses of the operator, furnishes the funds for purses to the contestants, and pays to the State the 3 percent it receives, plus the $800 per day license fee it charges, and it is from this source that the State receives the money it has distributed as above set forth.

It would be an uninformed and misguided person who would conclude that the wagering public is unconscious of the deductions now made under the law, and it would be the height of folly to assume that persons would wager the same amount of money if they realized that an additional 5 percent was to be deducted. As a matter of fact, there is no doubt in my mind that this new tax would close all legalized racing in Oregon within 2 years after it was imposed.

The result of the foregoing would be that our fairs would lose the support they have received and we would revert to the old play of the "bookies" and the like form of illegal gambling on races which was in full force in Oregon when our racing law was passed and which has now largely been eliminated. This illegal gambling on races was one of the reasons our legislature passed the law legalizing pari-mutuel wagering and prohibiting any wagering on racing contrary to the provisions of the pari-mutuel law.

Our racing commission has always been made up of men of the highest type. I call your attention to the fact that the following four of the five members have been members of the racing commission since it was first created, to wit: Henry W. Collins, grain merchant; William F. Turner, retired railroad president; T. B. Wilcox, a capitalist, and owner of the Wilcox and Stevens Buildings, two of our important downtown office buildings; Fay LeGrow, banker at Athena. The fifth member, J. N. McFadden, of Corvallis, retired at the end of his 6-year term and was succeeded by C. A. Huntington, merchant and businessman at Eugene, who is now serving his fourth year on the commission.

Racing with pari-mutuel wagering has been of other benefit to Oregon. You are, no doubt, aware of the George A. White Service Men's Center, which is officered by Mrs. Maria Jackson, owner of the Oregon Journal, as chairman of the board, and four other worthy citizens. They maintain the one servicemen's center in Portland and have already catered to the well-being and comfort of more than 200,000 servicemen during their stay in Portland, and the service is particularly beneficial to the new inductees who have come in from their respective draft board.

This organization is without financial support, but it has been sustained by women's organizations who give their time, food, and other services to the comfort and entertainment of the service men.

The Multnomah Kennel Club has conducted greyhound racing at the Multnomah Civic Stadium since the racing law was passed and is now in its tenth season. It has contributed 95 percent of all of the money to the racing fund. At the request of Mrs. C. S. Jackson and her associates, and as agent for the George A. White Service Men's Club, they conducted 6 days of racing this season, paying over all of the net proceeds to the Service Men's Club. The net proceeds were very materially increased by the contribution of 1 day's pay by each of the employees, 1 day's purses by each of the contestants, and $3,500 rental by the Multnomah Kennel Club and other similar contributions and donations. The net result of the racing gave $27,000 to the Service Men's Club of which they retained $19,000, and paid $4,000 to the American Red Cross, $2,000 to United Service Organizations, and $2,000 to the local community chest.

The Oregon Journal carried an announcement of the races during this 6-day period across the bottom of the front page of each edition of this paper, which, of course, I take to mean that the Oregon Journal felt this movement of sufficient general interest to warrant this very effective publicity.

If it is within your conception of your public duty, I do most respectfully urge that you find some effective means of eliminating this proposed special Federal tax.

My interests, of course, are confined to Oregon, and that is as far as my information goes, but from what I have stated, you will observe that this tax, while it will produce a comparatively small amount of money for the Federal Government, will undoubtedly seriously impair our activities to an extent far greater than any benefit that can be derived by the Federal Government.

It seems to me that this tax money should be left alone for the benefit of the State and its dependencies rather than to have this field invaded by the Federal Government.

Respectfully yours,

H. H. CHINDGREN,
President, Oregon Fair Association.

The CHAIRMAN. I submit for the record a statement from Paul J. Kern, of New York City, representing the committee on national taxation, National Lawyers Guild, which will be inserted in the record at this point.

(The statement of Mr. Kern is as follows:)

STATEMENT SUBMITTED BY PAUL J. KERN, NEW YORK, N. Y., FOR COMMITTEE ON NATIONAL TAXATION, NATIONAL LAWYERS' GUILD

TAXATION FOR VICTORY

The revenue bill before your committee to raise the funds required for the speedy prosecution of this war of survival is of desperate importance. We are faced with revenue needs and a tax program of a magnitude unthought of in modern times. We all realize it is imperative to raise every possible dollar of additional revenue. Sacrifice never known before will be required of every American and of every element in our national economy to assure the success of our war effort—and of speedy victory.

We have been solemnly assured by President Roosevelt that a sound tax program is vital to the successful prosecution of the war. We have been vigilantly warned by Secretary Morgenthau that "it is a million times cheaper to win than to lose." And yet the tragic fact is that day after day—dating back to early in March when the Treasury submitted its tax program to the Ways and Means Committee—we witness with but very few exceptions the never-ending pleas for special privileges, the demands of selfish groups urging that the Treasury's proposals, insofar as they affect the particular interests of the pleader, be abandoned or whittled down, predicting dire calamity to the Nation if they are adopted. The proposals of the Treasury, molded and cast into "an instrument of victory," have been ruthlessly dissected.

We come here to plead for no special groups, to ask no favors for anyone. We come here to plead the case for our country, to plead its solemn wish that the original program of the Treasury, which is in fact a program for victory, should not be scuttled or abandoned to meet the partisan desires of the many selfish and greedy interests.

The revenue bill as it stands does not make the tax program "an instrument of victory." It does not meet the basic requirements of a revenue act for America at war. It does not fulfill the standards of taxation enunciated by the President in his seven-point antiinflation program. It violates the cardinal principle of equality of sacrifice urged by the President—it perpetuates tax shelters for the privileged few while placing disproportionately oppressive burdens on those with meager income. The revenue bill thus hinders the war effort by tending to undermine the morale and health of our people and of our soldiers of production creating the arsenal of democracy.

The tax bill passed by the House fails to raise the revenue urgently needed for the war effort. It is expected to yield $6,271,000,000 in new taxes—$1,339,000,000 short of the Treasury's original request for $7,610,000,000 in additional revenue and $2,468,000,000 short of the Treasury's revised request for $8,739,000,000.

These, in our judgment, should be the cornerstones of a victory tax program:

1. Taxes must be fair, nondiscriminatory, and levied in accordance with ability to pay.
2. Every special privilege and every tax loophole should be abolished.
3. Taxes should be designed to check inflation.
4. Excess profits and undue profits should be effectively recaptured by the Treasury.
5. The health and morale of the people must not be undermined by new burdens on low income groups already heavily taxed.

Because the Treasury's tax program as originally submitted to the Ways and Means Committee is, in the main, in keeping with these principles, it deserves the support of the American people. It is a sound tax program for America at war.

There are important modifications in the Treasury's program which we believe should be made in order to fashion out of the tax bill, in the words of Secretary Morgenthau, an "instrument for victory." We shall deal with those modifications later. For the moment we turn our attention to the revenue bill drafted by the Ways and Means Committee and passed by the House under a gag rule which allowed it little alternative.

Turning first to the individual income tax, the House's action in reducing personal exemptions, coupled with the changes made in the Treasury's surtax rate schedule, results in heavier increases on the lowest bracket taxpayers (as compared with the Treasury's original proposals) while the burden on the middle and higher bracket taxpayer is lightened. Thus persons with comfortable and large incomes are favored at the expense of the low income taxpayers.

We have prepared tables which show that under the House bill, as contrasted with the proposals originally made by the Treasury (retaining existing exemptions), all married persons with incomes up to approximately $4,000 a year will pay higher taxes, while taxes payable by such persons with incomes above $4,000 will be decreased. Thus, the Treasury proposed that a married man with no dependents who earns $2,000 a year pay an increased tax of $38. The Ways and Means Committee added an additional $60 beyond the Treasury's figures, while at the same time cutting $59 off the Treasury's proposed tax on a $5,000 income, $283 off the Treasury's levy on a $10,000 income, and $740 off the Treasury's tax on a $25,000 income.

As a matter of fact, according to statistics issued by the Treasury Department (we refer to exhibit A, on page 57 of the transcript of the current hearings before this committee), the striking fact is revealed that of the entire additional revenue of $2,872,000,000 from individual income taxes, the net income classes under $2,000 will pay $885,000,000 compared to the $851,000,000 which will be paid by the net-income classes above $5,000, so that persons with the most meager incomes will therefore be contributing more than those with the most comfortable incomes. Another striking fact is that the increased tax on net incomes under $3,000 is $1,500,000,000, which is more than 50 percent of the total additional revenue which will be produced under the individual income tax. It is therefore the lower brackets which will bear the brunt of the new taxes levied on individual incomes. Moreover, the net-income class under $1,000 will have its tax increased 554 percent, the net-income class of $1,000 to $2,000 will have its tax increased 262 percent, the net-income class of $2,000 to $3,000 will have its tax increased 141 percent, while the net income class of $5,000 to $10,000 will have its tax increased only 76 percent, and—most striking—the net-income class above $10 000 will have its tax increased only 13 percent. This is inequality with a vengeance. Favoritism toward persons with large incomes at the expense of persons with small incomes is hardly commendable at any time—it is intolerable at a time like this.

The House's action in lowering personal exemptions appears to ignore the facts that the low-income groups are already living under economic conditions which make unjust and undesirable the imposition of additional taxes. Studies prepared by the Office of Price Administration have shown that the 9,800,000 families with incomes under $1,250 a year cannot at present, even without war bond and stamp purchases, make ends meet; they are constantly in the red. The 13,000,000 families with incomes of from $1,250 to $2,500 just manage to keep a step ahead of the butcher, the grocer, and the landlord. And the single person with an income of $500 to $700 ends the year in the red.

The low-income groups are already contributing far more than their just share of the American tax bill. Secretary Morgenthau stated on March 16, 1942, that Treasury studies have shown that a single person earning $750 a year, not subject to Federal income tax, paid direct and hidden Federal, State, and local taxes of $130. This constitutes 17.3 percent of his income and represents 8 weeks' pay. A married man, with no dependents, earning $1,500, pays $250 in taxes—16.7 percent of his income, or an equivalent of 8 weeks' work. These statistics prove that individuals and families below the exemption level are already contributing their utmost, and, more, decency and fair play demand that these low income groups be left free of additional taxation.

Nor can the House committee's imposition of a disproportionately large share of the burden of new taxes on low income groups be justified as essential to the campaign to stave off inflation. Many of the veteran advocates of lowered personal exemptions, a Federal sales tax, and other levies designed to place the tax burden on those least able to bear it now shout for these proposals under the guise of stemming the tide of inflation. This is, indeed, a remarkable coincidence.

Taxation is but one of the weapons available in the fight against inflation. We have already begun to use two other basic weapons—price control and rationing, in addition to credit and other controls. This is the democratic method of dealing with the inflationary gap, a method whereby the supply of goods is made available to all the people who can pay the prices fixed by Government ceilings.

There are other measures which can and should be taken to deal with inflation. We must make the most effective use of available plant equipment, raw materials, imports, and manpower. The waste and misuse of plants and materials, exposed by the Truman committee, are a sorry chapter in American production which we cannot afford to repeat. The failure to utilize small plants, the existence of millions of unemployed in some sections of the country while others suffer labor shortages, the discriminations against workers because of race or creed—these all serve to reduce the supply of goods and services available, and hence are openings in the dam being built against inflation. They must be closed.

Taxation, too, has an important role to play in dealing with inflation. The tax collector siphons off the income before it gets into the stream of purchasing power. But it must be emphasized that taxation is only one of the instrumentalities available in fighting inflation. Unlike rationing and price control, income taxation as an anti-inflationary weapon is a crude and unrefined mechanism, for through income taxation, the income taxed is reduced in toto. The taxpayer may, for example, be prevented from buying milk for his children (or from going to the beauty parlor) or may have to cut down on the movies as a result of his tax bill. Yet we may have more than enough milk (and beauty parlors) and too many movie houses.

Because the funds of 19,500 000 families with incomes under $2,000 are expended largely for goods and services as to which, in general, we are not experiencing our prime shortages, and because further reductions in these incomes through increased taxes would deal a severe blow to the health and well-being of the soldiers fighting the battle of production, it is not sound anti-inflationary policy to increase taxes on such groups through a sales tax, lowered income-tax exemptions, or otherwise. Because funds of the 13,000,000 families with incomes in excess of $2,000 constitute the main source of the buying pressure on the goods and services as to which, in general, we are suffering the severest shortages, and because taxation of income groups can be carried out without substantially affecting the health or well-being of the people, anti-inflationary policy to adopt Treasury's original income-tax proposals.

This conclusion is made doubly compelling by the termination of the production of most consumers' durable goods. For it means that the middle and higher income groups which spend billions of dollars for automobiles, refrigerators, washing machines, etc., in previous years have idle purchasing power which is seeking new channels for expenditure. It has been estimated that nondefense durable goods, including equipment for their production, absorbed $15,000,000,000 of the national income in 1941. A substantial part of this $15,000,000,000, or 1942 equivalent in consumers' pockets, is a most serious inflationary danger. To cut off these billions from the market place requires heavily increased taxes of the higher than $2,000 income groups.

It is therefore sound anti-inflationary policy to siphon off as much as possible, of the incomes of the middle and higher income brackets, through income and corporation taxes, and to resist all attempts to increase the tax burdens of low-income groups, through sales taxes, lowered exemptions, or otherwise. Thereby the incomes which primarily threaten inflation will be diverted to the war effort without impairing the health or stamina of the average family fighting the war of production in the shops, the fields, and the factories.

THE $25,000 CEILING IN INCOMES

The President in his seven-point anti-inflation program urged that personal incomes be limited to $25,000 after the payment of taxes. The Treasury presented a concrete plan to the Ways and Means Committee, but the $25,000 ceiling has been rejected. It has been reported that the $25,000 limit would bring in $660,-000,000 in revenue. Under the bill many Americans will be permitted to retain 10 or 20 times $25,000, while the rest of the Nation is tightening its belt for the war.

What meaning can equality of sacrifice have if we fail to adopt the $25,000 ceiling? Nothing could be more calculated to stir the indignation 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 a few thousand favored persons are allowed to retain hundreds of millions a year after taxes and beyond their exemptions of $25,000. How can we ask John Q. Citizen to put 10 percent of his income in war bonds or stamps, or to agree to stabilize his wages, while these few thousand at the top of the American economic scale retain their hundreds of millions a year?

The failure to adopt the President's $25,000 limitation would hinder the war effort by undermining morale, would breach an important sector in the battle against inflation, and would violate every principle of equality of sacrifice.

SPECIAL PRIVILEGES AND LOOPHOLES

The Treasury recommended the elimination of three special privileges and loopholes:

1. The abolition of the privilege of filing separate returns, which would produce estimated revenue of $420,000,000 (without allowance for the working wife tax credit).

2. The taxation of the interest on all outstanding and future issues of State and local securities, which would yield $275,000,000.

3. The termination of the special privilege of percentage depletion beyond cost for owners of oil wells and mines, which would bring an additional $206,000,000 into the Treasury.

These tax shelters, these loopholes, these special privileges are, as pointedly stated by Secretary Morgenthau, "bad enough in time of peace" they are "intolerable in time of war." Despite the barrage of propaganda from special and vested interests which these proposals have evoked, they are reforms on the "must" list, if we are to have a tax law which makes any pretense of eliminating tax shelters and havens of exemptions for privileged taxpayers. The Treasury has completely demolished the case sought to be made by the advocates of these special privileged; our position is more fully developed in a memorandum in which I shall request leave to file with the committee. Indeed, we see no reason, moral, legal, or economic, why all outstanding Federal securities, as well as State and local securities, should not be made subject to tax. But the point I wish to emphasize now is the utter unacceptability to the American people of a tax bill which imposes oppressive burdens on the man with a $20 or $30 a week income and yet allows nearly $1,000,000,000 in revenues to remain untaxed to the higher income groups through its refusal to end unwarranted tax exemptions and to terminate special privileges. Such a tax bill does not fit the pattern of a democratic tax program to finance this peoples' war.

ESTATE AND GIFT TAXES

The House approved the Treasury's recommendation of a $60,000 estate-tax exemption and a $30,000 gift-tax exemption (which incidentally means that $90,000 can still be transferred without paying a single penny in gift or estate taxes), but it rejected the proposal for a $5,000 maximum exclusion for annual gifts for each donor, deciding instead that hereafter no more than $3,000 a year could be given to any individual tax free. But the donor could still give that much to as many different people as he wanted every year. The House turned down the recommended increases in estate and gift-tax rates.

The fact is that the increased rates recommended by the Treasury are comparatively mild in the light of war-tax standards. The net result of the rejection of the Treasury's recommended increases in estate and gift-tax rates and the changes made in the estate-tax exemptions is that instead of increasing estate and gift taxes in the amount of $309,000,000 as the Treasury recommended, there will be a loss of $7,100,000 under the revenue bill as it stands.

At a time when persons in the lowest income brackets are making heavy sacrifices for war, it is intolerable for Congress to pass an act which rejects these proposed increases in estate and gift-tax rates. As President Roosevelt stated in his Budget message of 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."

The 1942 revenue bill should go far beyond the Treasury's mild estate and gift-tax proposals. The urgency of the times requires the adoption of an integrated estate and gift-tax system, with a single exemption of $20,000, including the life-insurance exclusion, and a single set of drastically increased rates. Hundreds of millions beyond the $309,000,000 proposed by the Treasury could thus be added to the financial arsenal.

MEDICAL EXPENSES, DEBT PAYMENTS, AND MISCELLANEOUS PROVISIONS

We support the Treasury's recommendation that a deduction be allowed heads of families for extraordinary medical expenses, and that employed wives should be given an allowance for expense incurred in the home by reason of such employment. We favor also the Treasury's recommendation that the $400 credit for children be expanded to those from 18 to 21 years, where the dependent is in college.

We are opposed to granting special allowances for payments by individuals and corporations to meet debt payments and other fixed charges. There is no sound justification for the substantial loss of revenue which would result therefrom.

In addition to the foregoing recommendations which, in the main, follow the Treasury's original proposals to the Ways and Means Committee, there are two particular features of the current tax situation which are of pressing importance—the excess-profits tax and the drive for a general sales tax.

EXCESS-PROFITS TAXATION

The 90 percent excess-profits tax rate adopted by the House deserves the support of the American people and should be accepted by the Senate in line with the objective of recapturing the unparalleled profits being made by industry in this war period. But high excess-profits tax rates alone will have comparatively little effect on the corporations which virtually escape the tax because of the large credits allowed under the excess-profits tax. The existing law, which subjects to excess-profits taxation only the annual profits above (1) 95 percent of the average 1936-39 earnings, or (2) an 8 percent return on the first $5,000,000 invested capital and 7 percent on the remainder, whichever credit is higher, is a "heads the corporation wins tails the Government loses" proposition.

Apart from a large number of relief provisions designed to benefit taxpayers, the only basic change in existing credits proposed by the House bill is the reduction of the invested-capital credit to 6 percent on capital above $10,000,000 and 5 percent on capital above $200,000,000 (formerly the applicable rate was 7 percent). The average-earnings credit remains unchanged so that corporations with large pre-war earnings continue to avoid their fair share of the excess-profits tax. Borrowed capital is still treated as invested capital to the extent of 50 percent. In short, the revenue bill as it stands retains the fundamentally unsound provisions which induced Assistant Secretary of the Treasury John L. Sullivan, in his testimony before the Ways and Means Committee on the 1941 revenue bill, to conclude 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".

Because of the heavy capitalization of some corporations, and the prosperous pre-war earnings of others, the unprecedented profits of some of the largest and most profitable corporations in America will not be substantially recaptured under the existing profits tax law.

The President, in his anti-inflation message, said:

"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."

In line with the tax plank of the President's seven-point program, we propose that the credit for equity invested capital be reduced to 5 percent for the first $10,000,000 and 4 percent for the balance; this is a "reasonable" post-Pearl Harbor rate in the spirit inasmuch as interest deductions provide a proper allowance for the cost of such capital. We would impose a rate of 90 percent on all profits in excess of such allowances on invested capital, and where a corporation's current profits exceed its average 1936-39 profits; we would tax the increase up to the invested-capital credit at the rate of 72½ percent. The latter is a rate halfway between the top normal and surtax corporate rate of 55 percent (proposed by Treasury) and the 90 percent rate here proposed. By this plan, corporations increasing their earnings in wartime would pay an excess-profits tax on the increased war profits. The profits subject to the 90 percent and 72½ percent excess-profits tax rates would not be subject to the corporate normal tax or surtax. Corporations with net incomes under $10,000 would be entirely exempt from the excess-profits taxes.

Such an excess-profits tax would reflect the serious beginning of a rejection of the current philosophy of "regressive sacrifice" for national survival—which asks of men in military service the utmost of sacrifice and allows industry an 8 percent and 7 percent return on capital, or its 1936-39 profits, whichever is higher, before taxing the balance as excess.

FEDERAL SALES TAX

The adoption by the House of a bill which falls nearly $2,500,000,000 short of the Treasury's revenue requests has given new impetus to the drive for a Federal sales tax—a drive which was effectively stopped in the House. The rejection by the House of the Treasury's progressive tax proposals, designed to tap genuine ability-to-pay sources lays the basis for the oppressive sales tax, which would burden unfairly and disproportionately the factory workers and farmers with small incomes.

The oppressive nature of a Federal sales tax is indicated by the fact that such a tax would hit the poorest people four times as hard as the wealthy. The sales tax is the exact opposite of the ability-to-pay income tax. The income tax graduates upward from no tax on the lowest incomes to a top of 88 percent (under the House bill) on the highest incomes. But a sales tax would graduate downward. For example, a sales tax absorbing 10 percent of the income of persons earning less than $500 a year would graduate downward so as to absorb 2.7 percent of the income of persons making more than $10 000 a year.

The Secretary of the Treasury in his testimony before the Ways and Means Committee 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 at necessities 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."

Treasury estimates of yields disclose that a sales tax that does not hit food would not raise much revenue. Even a stiff 10 percent retail tax, which excluded food, Government purchases, and those articles already subject to severe excise taxes, would raise only $1,691,000,000. If medicines, clothing, and fuel were also exempt, a 10 percent sales tax would considerably complicate our fiscal problems, for it would tend to increase substantially the cost of producing the sinews of war.

Nor can we, too, strongly warn of the grave effect on national morale if Congress were to adopt so unfair, inequitable, and regressive a measure as a general sales tax. A general sales tax would foster national disunity and seriously hamper the war effort—a worker without calories cannot efficiently produce war materials.

CONCLUSION

This committee can make a genuine contribution to the war effort and to the battle against inflation by reframing the revenue bill along the following lines:

1. Enact an effective excess-profits tax of 90 percent on profits above 4 and 5 percent of invested capital and 72½ percent on earnings in excess of 1936-39 earnings up to 4 and 5 percent of invested capital.

2. Adopt the Treasury's individual income surtax schedule, retaining the existing $750 and $1,500 exemptions with a $25,000 ceiling on incomes.

3. Abolish the special privileges and tax shelters of tax-exempt securities, percentage depletion above cost, and separate returns.

4. Reject the sales tax.

Such a program as the Lawyers Guild's tax program would fit the pattern of a democracy paying the tax costs of this people's war of survival. It would fit into the struggle against inflation and the effort to keep the Nation's morale at its high peak. It would create a powerful instrument for victory.

Respectfully submitted.

PAUL J. KERN.

The CHAIRMAN. Mr. Lewis.

STATEMENT OF CHARLES W. LEWIS, OF TOWNSEND & LEWIS, NEW YORK, N. Y., COUNSEL FOR HUYLER'S

Mr. LEWIS. Mr. Chairman and gentlemen of the committee, I am Charles W. Lewis, counsel for Huyler's, a New York corporation.

I appear before you on behalf of Huyler's to request that supplement C of the Revenue Act and section 270 of the Bankruptcy Act be amended as hereinafter requested.

Huyler's was incorporated in 1882 with a paid-in capital of about $15,000. The records of this company between 1882 and 1917 are lost, so it is impossible to determine how much additional money was paid into the corporation in the interim. We know that in 1922 additional stock to the extent of $1,200,000 was issued, but that appeared to have been a capitalization of surplus, which surplus was partially lost, so what the invested capital of Huyler's is at the present time I am unable to state.

Huyler's of Delaware was incorporated in 1926, and had an invested capital of $6,000,000. Huyler's of Delaware, the parent, paid $3,000,000 of that money for all of the stock of Huyler's. That money was paid to the stockholders who were members of the Huyler family. Huyler's of Delaware, the parent, subsequently advanced to Huyler's most of the remaining $3,000,000 of the money that was paid in to the parent company.

In 1940, pursuant to a reorganization, the parent Huyler's transferred its assets, consisting of all of the stock of the subsidiary Huyler's and notes for $3,000,000 of subsidiary Huyler's to the subsidiary Huyler's. Subsidiary Huyler's simultaneously exchange its reclassified stock for the stock of the parent Huyler's and the parent Huyler's was liquidated.

Parent Huyler's was liquidated solely to simplify the corporate structure under which the Huyler's business is transacted, as has been done in the case of many other similar corporations.

In view of supplement C, as approved by the House, this liquidation, however, might have been a great mistake, because if parent and subsidiary had been permitted to remain, or if parent had liquidated subsidiary, or if parent and subsidiary had been merged, leaving either parent or subsidiary the surviving corporation, or if parent and subsidiary had been consolidated, resulting in the creation of a new corporation, the busines of Huyler's would still have the benefit of an invested capital of $6,000,000, but since parent was liquidated, leaving subsidiary surviving, the Huyler's business might be held to have an invested capital of only $15,000—the amount that we know was paid in—plus any additional amount which we find was paid in—plus a sum which I will hereinafter refer to.

The $3,000,000 that was invested by the parent in the subsidiary will be lost unless supplement C is amended.

It is submitted that there is no apparent reason to distinguish adversely between the liquidation of a parent by a subsidiary and the liquidation of a subsidiary by a parent, or between the merger and consolidation of parent and subsidiary, and the liquidation of a parent by a subsidiary.

Referring to the $3,000,000 advance by parent to subsidiary, if there had not been a bankruptcy proceeding, clearly this $3,000,000 would have been treated as invested capital of the subsidiary when the obligations of the subsidiary to the parent were canceled. The situation, however, is muddied by section 270 of the Bankruptcy Act which says that the base of property of a bankrupt must be reduced to the extent that the debts are forgiven but not less than the fair market value of such property.

It can be seen that if this rule were applied to Huyler's and other corporations similarly situated, Huyler's would be compelled to reduce its invested capital to less than what it otherwise would have been; in other words, instead of subsidiary benefiting from the liquidation of parent, subsidiary would probably be hurt.

It is respectfully submitted that section 270 of the Bankruptcy Act should be amended to make certain, first, that the base of the property in the hands of the debtor for purposes of determining profit and loss is not necessarily determinative of the invested capital of the corporation; and secondly, that the forgiveness of a debt by a parent corporation in a bankruptcy proceedings constitutes a contribution to the capital of a subsidiary.

Mr. Chairman, I submit a memorandum which deals more fully with this subject, and which I respectfully request be included in the record.

The CHAIRMAN. You may include it.

Have you talked this problem over with the Treasury?

Mr. LEWIS. Yes, sir; I have.

The CHAIRMAN. Have you made any progress with them?

Mr. LEWIS. I think so.

The CHAIRMAN. You have such a highly technical question here. You may insert the brief. Thank you very much.

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

MEMORANDUM SUBMITTED BY CHARLES W. LEWIS, IN BEHALF OF HUYLER'S A NEW YORK CORPORATION

EXCESS-PROFITS TAX PROBLEM OF REORGANIZED FORMER SUBSIDIARY INDUSTRIAL CORPORATION WHICH ACQUIRED ASSETS OF PARENT

A. The pertinent law

Supplement C to the excess-profits tax law, being section 218 of the revenue bill of 1942 as approved by the House of Representatives, defines invested capital in connection with certain exchanges and liquidations. The provisions of section 761 of supplement C insofar as they relate to mergers and consolidations and to liquidations of subsidiary corporations by parent corporations are submitted to be fair and equitable. Section 761 appears to be defective, however, in that it does not embrace situations in which a parent corporation is liquidated, with the subsidiary surviving, and in which there is not a merger of the parent into the subsidiary. It is submitted that the provisions of section 760 relative to exchanges would, under certain circumstances, be inequitable, and would work a hardship on corporations and stockholders thereof who have been parties to such exchanges.

To avoid such hardship cases and remedy such defects, it is respectfully submitted that supplement C be amended and section 270 of the Bankruptcy Act, as heretofore amended, be further amended as hereinafter suggested.

B. Example of hardship case

For instance, assume that parent corporation was organized in 1926 with an invested capital of $6,000,000; that subsidiary corporation was organized in 1882; and in 1926, before acquisition of its stock by parent from stockholders of subsidiary, had a paid in capital of $15 000; that parent in 1926 purchased all of the stock of subsidiary for $3,000,000; that parent subsequently advanced subsidiary $3,000,000 to be used and which was used for improving its fixed assets and for the expansion of its business; and that parent and subsidiary were reorganized and parent transferred to subsidiary its assets, consisting principally of stock of subsidiary for which parent paid $3,000,000, and notes of subsidiary aggregating $3,000,000 and the subsidiary assumed certain of the liabilities of parent and issued new classes of its stock in exchange for the stock of the parent.

Now, if parent and subsidiary had merged, leaving either parent or subsidiary the surviving corporation, the surviving corporation, pursuant to section 761 of supplement C, would have had an invested capital of $6,000,000. The consolidated or resulting corporation would also have had an invested capital of $6,000,000 if there had been a consolidation of parent and subsidiary. Likewise, if parent had liquidated subsidiary, parent or surviving corporation would have had an invested capital of $6,000,000.

But since parent delivered to subsidiary all of its assets, consisting of stock of subsidiary, for which it paid $3,000,000, and notes of subsidiary aggregating $3,000,000, pursuant to a reorganization as defined by section 112 (g) (1) (c) of the Internal Revenue Code, and subsidiary delivered new classes of its voting stock to the stockholders of parent and assumed certain of parent's liabilities pursuant to a plan of reorganization and in accordance with section 112 (b) (3) of the Internal Revenue Code, the subsidiary or surviving corporation, pursuant to section 760, might be held to have an invested capital equal only to the invested capital of subsidiary before the reorganization increased by the aggregate amount of subsidiary's notes returned to subsidiary, to the extent that the return of such notes was deemed to be a contribution to capital. In other words, because the reorganization was effected by the liquidation of the parent and exchange of stock as above described, rather than a merger, consolidation or liquidation of subsidiary by parent, the surviving corporation might be deprived of a substantial part of the invested capital of the parent.

It is respectfully requested that supplement C be amended as indicated in the addendum hereto so as to prevent the possibility of hardship cases similar to the one above described.

C. Analysis of pertinent law

The opinion herein expressed is based on the following analysis of supplement C and section 270 of the Bankruptcy Act, as amended.

1. *Section 760. Exchanges.*—This section provides in substance that, in connection with an exchange as defined in paragraph (a) thereof, the amount paid in for stock of the transferee or as paid in surplus, or as a contribution to the capital of the transferee shall be deemed to be an amount equal to the excess of the basis (for determining loss) in the hands of the transferee of the property of the transferor received upon the exchange over the sum of (i) the amount of liabilities of the transferor assumed by the transferee, (ii) the amount of any other liability of the transferee constituting consideration for the property so received, and (iii) the aggregate of the amount of any money and the fair market value of any other property transferred to the transferor.

Applying the above formula to the parent corporation above described, the base of the obligations of $3,000,000 owed by subsidiary to parent, in the hands of subsidiary, would probably be zero (except to the extent that the return to subsidiary of its notes representing such obligations was deemed to involve a contribution to capital), and the base of the stock of the subsidiary, for which parent had paid $3,000,000, in the hands of the subsidiary would probably also be zero. Consequently, the subsidiary or the surviving corporation may be held to have derived relatively little benefit, from the point of view of added invested capital, from the acquisition of all of the assets of the parent which had an invested capital of $6,000,000.

2. *Section 761. Transactions in liquidation.*—This section permits the inclusion in the invested capital of a taxpayer of the amount of its investment in the stock of a subsidiary which has been liquidated, together with the earnings and profits or deficit in earnings and profits accumulated by the subsidiary after the acquisition of control of its stock by the taxpayer and attributable to such stock. The adjustments provided in this section are stated to be applicable to liquidations under section 112 (b) (6) and to transactions having the effect of liquidation, if gain or loss is not recognized and if the basis of the property received by the taxpayer is fixed by reference to the basis in the hands of the transferor. Mergers and consolidations of parent and subsidiary, including merger of parent into subsidiary, are defined to be liquidating transactions.

The effect of section 761 is the abandonment of the rule prescribed by the present law which increases or decreases the investment of the parent to accord with the invested capital of the subsidiary. The new rule prescribed by section 761 is stated to remedy the foregoing situation by including in the invested capital of the parent, after liquidation of the subsidiary, the amount of the original investment of the parent in the stock of the subsidiary and does not reduce that part of the invested capital of the parent to correspond with the invested capital of the subsidiary.

As section 761 is presently drafted, however, it is limited to the following situations:

1. The complete liquidation of another corporation under section 112 (b) (6);

2. The liquidation of another corporation, if gain or loss is not recognized because of the provisions of section 112 (b) (4) or (5), and if the property received by the taxpayer has a basis described in section 113 (b) (2) (A);

3. The liquidation of a subsidiary by a parent incidental to a merger of the subsidiary into the parent;

4. The liquidation of a parent incidental to the merger of the parent into the subsidiary; and

5. The liquidation of a parent and its subsidiary incidental to a consolidation of the parent and the subsidiary.

There is probably not covered by the provisions of section 761, however, a situation such as is hereinbefore described, in which a parent corporation is liquidated as an incident to the transfer of its assets to its subsidiary in connection with an exchange under section 112 (b) (3), and in which the parent is not merged into the subsidiary and in which there is no consolidation, but in which the subsidiary is the surviving corporation.

3. *Section 270 of the Bankruptcy Act, as amended.*—With special reference to corporate reorganizations, section 270 of the Bankruptcy Act (prior to the amendment hereinafter referred to) required the reduction of the basis of the debtor's property for income tax purposes by an amount equal to the amount of the canceled or reduced indebtedness, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return. This applied not only to property retained by the debtor but also property transferred to any person required to use the debtor's basis in whole or in part.

Section 270 was amended, however, retroactively to June 22, 1938, to provide that any reduction in the basis of property affected under the authority of the Bankruptcy Act shall not operate to decrease the basis of any particular property to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan of reorganization. The amendments were stated, at the time of their enactment, to be designed to eliminate the hardship or unfairness resulting under the former provisions whereby reduction of the basis of the property by the amount of the debt cancelation resulted in an adjusted income tax basis which was less than the fair market value of the property and in some cases zero.

It is respectfully submitted, however, that unless the term "basis" as used in section 270 of the Bankruptcy Act, as amended, and as used in closing agreements between a debtor in a corporate reorganization and the Commissioner of Internal Revenue, pursuant to the provisions of regulations 103, section 19.113 (b) (1)-3, be defined so as to distinguish the basis, for the purposes of determining gain or loss, of the assets of the reorganized corporation from the invested capital of such corporation equally great hardship or unfairness may result.

For example, if the term "basis" as used in section 270, as amended, should be deemed to mean, among other things, the invested capital of the debtor, then, in a situation such as that hereinabove described in which the parent transferred to the subsidiary its claim against the subsidiary in the sum of $3,000,000, the invested capital of the subsidiary or surviving corporation would be reduced to the fair market value of the debtor's property as of the date of entry of the order confirming the plan of reorganization which, in the illustrated case, was less than the debtor's invested capital. The application of the market-value formula to the determination of the invested capital of a reorganized corporation would not only increase the tax burden of the corporation but would, in effect, penalize it for the losses incurred during the years preceding the reorganization.

Furthermore, it is submitted that section 270 should be clarified so as expressly to except a situation in which a shareholder in a corporate debtor which is indebted to him forgives such debt. According to section 19.22 (a)-14 of regulations 103 promulgated by the Treasury Department, such a transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt forgiven or canceled. It is submitted that the principle embodied in this regulation is applicable to a debtor in a corporate reorganization and, therefore, that section 270 should be amended, as indicated in the addendum hereto, to provide accordingly.

Conclusion

In view of the foregoing, it is respectfully submitted that sections 760 and 761 of the excess-profits tax law should be amended, and section 270 of the Bankruptcy Act, as heretofore amended, be further amended, as indicated in the following addendum.

Respectfully submitted.

TOWNSEND & LEWIS.

NEW YORK, *August 12, 1942.*

ADDENDUM

Section 760 of supplement C in section 218 of the revenue bill of 1942, as approved by the House of Representatives, should be amended, in part, as follows (proposed additional provisions or modifications are printed in italic):

"SEC. 760. EXCHANGES.—

(a) DEFINITIONS.—For the purpose of this section—

"(1) Exchange.—The term 'exchange' means an exchange, to which section 112 (b) (3), (4), or (5) or so much of section 112 (c), (d), or (e) as refers to section 112 (b) (3), (4), or (5), or to which a corresponding provision of a prior revenue law is or was applicable, by one corporation of its property, *including stock or securities, whether its own or of another corporation*, wholly or in part for stock or securities of another corporation, or a transfer of property, *including stock or securities, whether its own or of another corporation*, by one corporation to another corporation after December 31, 1917, the basis of which in the hands of such other corporation is or was determined under section 113 (a) (8) (B), or would have been so determined had such section been in effect.

"(2) Transferee Upon an Exchange.—The term 'transferee upon an exchange' means a corporation which upon an exchange acquires property, *including stock or securities, whether its own or of another corporation*, in exchange, wholly or in part, for its stock or securities, or which acquires property, *including stock or securities, whether its own or of another corporation*, from another corporation after December 31, 1917, the basis of which in its hands is or was determined under section 113 (a) (8) (B), or would have been so determined had such section been in effect.

"(b) RULE.—In the application of section 718 (a) to a transferee upon an exchange in determining the amount paid in for stock of the transferee or as paid-in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis (for determining loss) in the hands of the *transferor* of the property of the transferor received by the transferee upon the exchange over the sum of * * *."

Section 761 of supplement C should be amended by adding at the end of paragraph (a) the following new subparagraph:

"(3) The complete liquidation of a corporation owning stock in another corporation incidental to a transfer of all of the assets of the liquidated corporation to such other corporation in exchange for stock or securities of such other corporation."

Section 270 of the National Bankruptcy Act, as heretofore amended, should be further amended by the addition of the following new paragraphs, the present section 270 being regarded as paragraph (a) thereof:

"(b) The provisions of paragraph (a) of this section 270 shall not be deemed to apply to the forgiveness of a debt or debts owing by the debtor to one or more of its shareholders, such transaction being deemed to amount to a contribution to the capital of the debtor to the extent of the aggregate principal amount of the debt or debts so forgiven.

"(c) The term 'basis' as used in this section 270, and in regulations promulgated hereunder by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, or in any closing agreements entered into hereunder between the debtor and the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury shall be deemed to be the basis of the debtor's property solely for the purposes of determining profit and loss and shall not in any way be deemed to affect or be determinative of the invested capital of the debtor for any purpose, including, but not by way of limitation, the computation of the excess profits tax credit."

The CHAIRMAN. Mr. Squires.

(No response.)

The CHAIRMAN. Is Mr. J. Duane Squires, of New London, N. H., in the room?

(No response.)

(The following statement was subsequently submitted by Mr. Squires:)

LIBERTY ANNUITY BONDS, A PROPOSAL OF A NEW TYPE OF UNITED STATES WAR BONDS, SUBMITTED BY J. DUANE SQUIRES, NEW LONDON, N. H.

Realizing the complexity and magnitude of the Treasury's task in providing funds for the national war program, I suggest that the United States fiscal authorities give serious thought to a new type of bonds which would simultaneously exercise a greater appeal to the public than do existing issues and at the same time provide a way for a gradual and regular reduction of the public debt. I believe that the type of bond indicated in this memorandum would accomplish both of these objectives.

While never attempted by the Government, it is actually closely related to term loans as developed in recent years by commercial banks. The similarity has been admirably set forth by Mr. Winthrop Aldrich in a memorandum on the same matter, dated January 28, 1942. This memorandum, I believe, has been submitted to Treasury officials. The basic proposition is that principal and interest would be returned to the purchaser in equal installments over a period of years so as to retire the bond at its maturity. As Mr. Aldrich has so clearly pointed out, existing bond issues—series E, F, and G alike—all have certain difficulties associated with their wide sale, either from the point of view of the buyer or from that of the Treasury. These objections would be met by the proposed type of Liberty annuity bonds.

A purchaser, let us say, of a $100 Liberty annuity bond would face the following situation: He would pay $100 in 1942. He would receive back $4 a year for 25 years and $3 a year for 25 years, making $175 in all. Thus he would have in return for his original investment, after the lapse of 50 years, $175, or a net annual interest of 1½ percent. Meantime, however, the bond itself would have been completely retired at the rate of $2 a year for 50 years. The national debt would thus steadily decrease, while the annual return to the individual would be higher than that now possible from any existing bond.

There are several definite advantages for this type of security now:

(1) Many elderly people would be glad to put their entire life savings into Government securities to aid in the war effort. But they must have more than 2½ percent annual return to live on, and it must come now. They cannot wait for 10 or 11 years for it to begin.

(2) Many people now owning stocks as their principal source of wealth to be transmitted to their heirs are appalled at the problems involved in settling an estate. Liberty annuity bonds would carry no such difficulties, and could be transferred as easily as though they were currency.

(3) Such bonds would always be redeemable by the Government at a regular schedule known and agreed upon at the time of purchase. To be precise, this redemption figure would always be at a point represented by the number of years the bond had left in it times the figure $2.

(4) Such bonds would have a most desirable return to private investors as the latter years of the bond's life approached. This would assure sale through the private security channels.

(5) Such bonds would make it possible for the Government to begin now to retire the gigantic debt that is being built up, and at the same time to do it in a way which would not be unbearable. One hundred billion dollars of such bonds would never require more than $4,000,000,000 in annual interest charges, and it is estimated that our taxes this year will raise several times that amount.

(6) Such Liberty annuity bonds would conform to the familiar financing plan

made known to millions of Americans through the sale of automobiles and homes, whereby interest and principal payments are combined in the same figure.

(7) Such bonds would avoid completely any danger of blanket repudiation of the national debt either through inflation or otherwise.

(8) Finally, such annuity bonds would prove to be both psychologically and financially more attractive to many types of investors than any existing national securities.

All questions of registration, exact payment dates, precise interest rates, and exact term for the bond issues are details to be settled by Treasury fiscal experts, or by Members of Congress. The important principles are two: (1) A larger payment than now made for war bonds to the individual purchaser, made up part of interest and part of principal; and (2) a steady reduction of the national debt, beginning even now while the war is in progress. If it be objected that these are revolutionary and unprecedented techniques for securing money to win the war, let it be remembered that this is a revolutionary and unprecedented war. Boldness and daring in financial policies are not less important than the same characteristics in military techniques.

J. DUANE SQUIRES,
Chairman, Department of Social Studies, Colby Junior College,
New London, N. H.

AUGUST 13, 1942.

The CHAIRMAN. Mr. Schultz.

STATEMENT OF RAYMOND H. SCHULTZ, ATTORNEY AT LAW, CHICAGO, ILL.

Mr. SCHULTZ. My name is Raymond H. Schultz. I am a lawyer of Chicago, and I represent a large group of subdividers of real estate. I appear before you and invite your attention to a situation which has arisen in respect to the return of income received upon the forfeiture of contracts.

Our clients subdivide real estate and sell it on a deferred basis, generally over a period of 5 years. The down payment is rather small, and the remaining payments are collected on a monthly basis. Our contracts provide that the vendor shall retain title to the real estate and upon the final payment the title is transferred to the purchaser. In the event of the failure of the purchaser to make his payments, the contract provides that there may be a forfeiture at the option of the vendor, and that the amounts paid shall be retained as liquidated damages.

Senator CONNALLY. Has the purchaser any option to insist on foreclosure rather than forfeiture absolute?

Mr. SCHULTZ. No, sir; he has no right to insist on foreclosure.

Senator CONNALLY. That is legal in Illinois?

Mr. SCHULTZ. That is right.

Senator CONNALLY. Even though he may have paid 75 percent of the purchase price?

Mr. SCHULTZ. That is right.

Senator CONNALLY. You take it all away from him?

Mr. SCHULTZ. Excepting on an appeal to court. It might be that a court would not permit a forfeiture under those circumstances. There is nothing in our law which prohibits it.

Senator CONNALLY. A court of equity?

Mr. SCHULTZ. A court of equity might.

Prior to 1938, upon the forfeiture of a contract, the taxpayer was required to return as income all amounts which he collected and had applied to the reduction of his cost. Therefore, upon a forfeiture, all the money which had been collected upon that contract had been returned to the Government as income. The installment payments at the time of the collection, to the extent that they were profits, were returned; and upon the forfeiture all moneys which had gone to the return of the investment were returned as income. That was a very simple method of handling the matter. It was accurate, the Government could check it, and it was not costly.

In 1938 the Treasury Department issued its Regulation No. 4832 because of the finding of the court that under section 44 (d) it was required that upon these forfeitures the taxpayer must compare his unrecovered cost with the fair market value of the property and determine either gain or loss.

At that time I took the matter up with the Treasury Department, and I may say to you that I believe the Treasury Department has always felt that the law should be changed in order to reestablish the basis which formerly was contained in the regulations.

May I give you a typical case that we handle?

A piece of property costs $600 and it is sold for $1,800. Assume that 10 percent is paid down, or $180. At the time of that sale two-thirds of that collection, or $120, is immediately put into profit, and the remaining $60 is taken as a return of capital. Of course, we have all of our expenses which have to be charged against that profit. As far as returning income, that is the basis that we must return on, on an installment basis.

If there is a forfeiture, we have $60 that we have collected and applied to return of cost. Now we must have our lot appraised and at our own risk determine whether or not the unrecovered cost compared with the fair market value creates a gain or a loss. We cannot use our own people to make appraisals. We must get independent appraisals. Then the Government comes along 2 or 3 years later, and the Government again must have the property appraised, and if there is any difference of opinion—and there is bound to be—we then have litigation.

In the case that I put, just assume that a lot had cost $600, and appraisers put a $500 valuation on it—that would merely mean that we had a $60 loss. If they put a $600 valuation on it, we would have a $40 profit.

As far as the tax involved is concerned, it would amount to practically nothing, but the expense which is involved, both to the taxpayer and the Government, is substantial.

As I say, the requested amendment will not reduce in any manner the amount of income tax that the Government will get; as a matter of fact it will increase it, because the costs which are required to be spent in determining the fair market value are completely eliminated. It will also save the Government considerable money and, inasmuch as the tax has to be paid in any event, it will be paid more quickly under the old regulation than it will under the present one.

I therefore ask that section 44 be amended either to provide that the old regulation shall be established for all installment sales, or at least that there be an alternative method provided where taxpayers may at their election accept one or the other methods.

Senator BARKLEY. If you have a $600 lot that you sell for $1,800, and then it is turned back and it is resold at $500 or $600 again, you indulge in a good deal of inflation between those two processes, don't you?

Mr. SCHULTZ. Senator Barkley, those figures do not in any manner take in our costs of advertising or selling or office expense, or anything else. In handling these installment contracts you take the raw cost and your sales price without reducing it for any of your other expenses.

Senator CONNALLY. If you get back a $1,800 lot and the down payment, too, you have made a little money on it; haven't you?

Mr. SCHULTZ. In the case that I put, if we have received on that contract 10 percent, or $180, I will say that in each one of those cases——

Senator CONNALLY (interposing). But you have gotten back a $1,800 lot that did not cost you but $600. You have made $1,200, haven't you?

Mr. SCHULTZ. We have another lot right beside it that cost us $600. We could not possibly increase the value of that lot to $1,800 with one that cost us $600 right beside it.

The CHAIRMAN. You make the sale and you get a profit on it, and then you get a profit back and the lot. How do you want to pay on it? You want to pay on the profit; don't you?

Mr. SCHULTZ. Immediately.

The CHAIRMAN. How do you want to do it?

Mr. SCHULTZ. When we receive our first $180 payment, two-thirds of it is profit. We want to put that in immediately. Whenever we cancel it, the additional $60 that we got, we want to put right into income the minute the forfeiture takes place, and then we have paid to the Government on 100 cents of every dollar that we have collected on that contract.

Senator BARKLEY. Where you took back a lot under forfeiture which you have sold for three times what you have paid for it, when you sell it again, you sell it again for three times what you paid for it?

Mr. SCHULTZ. Let us assume we would sell that lot on an installment contract again for $1,800, and if we collected $180 on that, after having returned the $180 we took in in the first instance, on the next sale we would return $120 as profit and $60 as return of cost, and on each collection that was made throughout the term of that contract we would make the same return, and when the last payment was made we would have returned to the Government $1,200, and recovered our cost of $600. In the meantime, our expense of operating is going on, our advertising, our sales expense, and that would be charged against the income.

Senator BARKLEY. If you sold it six times and got it back six times and got $120 each time, at the end of the process you would have your $1,800 and your lot also, wouldn't you?

Mr. SCHULTZ. If we did that, Senator, that would be true if we had no expense involved; if we did not maintain an office or advertising, but if we sold every lot and took a 10-percent down payment and that was all we got, if we never fulfilled one of those contracts our expenses would overcome the $120 we received, and we would go broke.

The CHAIRMAN. You put $60 to your capital investment?

Mr. SCHULTZ. Yes.

The CHAIRMAN. Then you come back and get the lot. How are you going to pay on it unless you treat it as a capital or something and find out what it is worth, whether it has gone up or gone down.

Mr. SCHULTZ. If we take that lot back, having collected $180 and having put in $120 as a profit, and put back the $60 immediately upon forfeiture as an additional profit, we then have paid a tax on every dollar paid on that contract and we should reestablish our cost at the $600 basis.

The CHAIRMAN. $600 less $60?

Mr. SCHULTZ. No, on the $600; on the full $600 basis.

The CHAIRMAN. You don't take anything off?

Mr. SCHULTZ. No. The minute we forfeit a contract and have paid on all we have taken in, our basis goes back to $600 because we have the same asset with the contract eliminated, and every dollar we have received we have returned for tax.

The CHAIRMAN. You simply want to have the property returned and retain your tax base as your cost base?

Mr. SCHULTZ. Yes, sir; and the only reason for it is the element of expense and uncertainty that we have in obtaining appraisals by outside people and waiting 3 or 4 years for the determination of the accuracy of those appraisals. What we are requesting is exactly the regulation that was in effect up to 1938. At the time the court upset that regulation the Treasury Department was arguing to sustain that position, and I think you will find that if this amendment is put in to cover all installment contracts the amount that is expended by the taxpayer and the Government to compute the tax will be materially less and the Government will receive every dollar of tax on every dollar of income.

The CHAIRMAN. You have set that out in your brief?

Mr. SHULTZ. Yes, sir; that is set out in my brief with the suggested amendments.

The CHAIRMAN. We thank you very much.

Mr. SCHULTZ. May I leave the brief?

The CHAIRMAN. Yes; and it may be inserted after your general statement.

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

SUPPLEMENTAL STATEMENT OF RAYMOND H. SCHULTZ, CHICAGO, ILL.

As representative of a group of subdividers in the metropolitan area of Chicago, we have heretofore called to the attention of the Government the unfortunate situation from both the taxpayers' and the Government's standpoint which has arisen because of Treasury Decision 4832, 1938-30-9470.

Under the present regulations, the taxpayer is required, in computing his gain or loss upon the forfeiture of installment contracts, to treat the forfeiture as an exchange and to measure the gain or loss thereon by the difference between the cost basis of the remaining installment obligations and the fair market value of the property, the cost basis of the property thereafter being its fair market value at the time of the forfeiture. Under the prior regulation, a taxpayer, upon the forfeiture of an installment contract, was required to include in income that portion of the payments received upon the installment obligation which had not theretofore been returned as income, the cost basis of the property thereafter being the original cost to the taxpayer.

The foregoing statement of the two methods of computation is not entirely accurate because it leaves out of consideration certain necessary adjustments, but it does state the basic difference between the two methods and is sufficient for the purposes of this communication.

Under the prior regulation, a taxpayer on the installment basis, without undue cost or any uncertainty, could compute his tax with complete accuracy and the Government could examine his return with the utmost facility and precision. The taxpayer at the end of each year could know without question his tax liability and the Government, upon examination of his return, could verify the tax by merely examining the taxpayer's books. Under the present regulation, a burdensome, costly, unfair, and complicated system is forced upon both the taxpayer and the Government.

The clients represented by us carry on extensive real-estate operations on the installment basis and deal in many thousands of lots each year. Necessarily they have numerous forfeitures. The amounts involved in the forfeitures are generally very small and most often the first or very early payments. Prior to the present regulation, the determination of income-tax liability in such cases was a simple mathematical problem determined solely through the books of account of the taxpayer and determined instantly and finally. Under the present regulation, the taxpayer is required to determine at his peril the fair market value of the lot involved and compare that fair market value to the unrecovered cost of the property. It is needless to say that there is no way of determining an absolute fair market value of any piece of real estate. At best it must be either an opinion or a guess. Fair market value of subdivision real estate, because of its type, location, and method of sale, is extremely and exceptionally difficult of ascertainment.

Generally the property, when acquired by the subdivider, is undeveloped, low-cost raw land located in outlying districts. Some properties are fully improved with streets, sidewalks, gas, electricity, and so forth. Some are partially improved and some have no improvements whatsoever. The sale prices usually are established at from two to four times the original cost. The ability of the subdivider, the selling methods used, and the terms offered are the material factors in obtaining sales at the stated prices. Should two subdividers each purchase and prepare a subdivision in the same locality for sale and should one commence and continue active selling and should the other make no effort to sell or abandon selling operations, the actions of the subdividers would have a tremendous effect upon the fair market value of the property. In the first instance, the lots might have a fairly substantial value compared with the selling prices, while in the second instance, the lots although close to or adjacent to the others, would have a very nominal fair market value.

It is a well-known fact that the majority of sales of subdivision property take place during the period in which the subdivider puts on an active sales campaign. So long as an active campaign is carried on, lots are sold with facility and at substantial prices. When the sales campaign in respect to any given piece of property is withdrawn, both selling and prices rapidly decline. Since the date on which the taxpayer would make his appraisal of a forfeited property would be a considerable period of time from the date on which the Government would make its appraisal in order accurately to examine the taxpayer's return, it would almost be a certainty that the appraisers would be examining the property under completely different conditions, and that there would be little likelihood that the same values would be arrived at no matter how able, honest, or intelligent the appraisers were.

In other words, the fair market value of this type of property depends mostly on intangible personal facts and not on the property itself. It therefore is obvious that the greatest differences of opinion as to the fair market value of subdivision property must arise.

Under the present regulation, the taxpayer, at an unwarranted expense, is obliged to determine a fair market value at the date of forfeiture, knowing that the valuation may and probably will be questioned at some future time. He must file his tax return, not knowing whether it is accurate or not. He must pay dividends to avoid excessive taxes without being at all sure that the payments properly represent the income. When the Government makes its examination of his return—generally a year or more later—it will be incumbent upon the examiner, or some other agent of the Government, to make as thorough and costly an investigation of the fair market value of the property as has been made by the taxpayer. However, the Government's examination and determination will be made at a time when conditions may have been entirely changed. While it is true the Government agency will try to make its examination as of the date of forfeiture, no one will deny that the changed conditions will make that task difficult if not impossible.

Should there be, and generally there will be, different fair market values determined by the taxpayer and the Government, then long-drawn-out, expensive, and annoying litigation must ensue. Such litigation will not only impair the ability of the taxpayer to earn profits on which to pay his taxes, but the expense will reduce materially the amount of tax to be paid to the Government and further, the expense which will be incurred by the Government will further reduce the amount of the taxpayer's payments which are available to the Government for the purposes for which the tax is assessed.

In order that the picture be made more clear, the following example, which is a usual and average one, is offered. Assume that a lot which cost $600 is sold in the year 1936 for $1 800 under an installment contract and the purchaser pays $60 on the purchase price during that year. During the year 1937 an additional $60 is paid, the purchaser thereafter fails to make any further payments and in December 1938 a forfeiture is declared. Under the former regulation the taxpayer would determine a gain of $40, being the amount of the payments received on which no tax had been paid and the taxpayer would continue to carry the lot on his books at a cost of $600. The computation could be made without cost or uncertainty. Upon examination by the Government, the agent would be able to verify the item with equal facility and accuracy. Under the present regulation, the taxpayer would be obliged to obtain an appraisal of the fair market value of the lot involved in the forfeiture. The mere fact that the lot cost $300 and was sold for $1,800 on extended payments demonstrates that the determination of a fair market value is not a simple one and one on which many honest differences of opinion will arise. The taxpayer, in order to be at all accurate, would be obliged to obtain the opinions of uninterested and competent persons at a large expense. The Government, at the time of the examination of the taxpayer's return, would likewise be required to make its own determination of fair market value with as great care and at as great an expense. Assume that one of the taxpayer's appraisers stated that the fair market value of the lot to be $500, another $600, and another $700.

If the first valuation were used, then the taxpayer would compare his remaining cost of $560 to $500 and take a loss of $60. If the second valuation were used, then the taxpayer would compare the remaining cost of $560 to $600 and return as income $40. If the third valuation were used, then the taxpayer would compare the remaining cost of $560 to $700 and return as income $140. In no one of the events would the taxpayer be sure that his choice was correct or that he had at the time of filing his return stated his true income. From 12 to 18 months later, the Government would be obliged to make its determination as of the date of forfeiture. However, at that time conditions would have materially changed. It would not be plausible to think that no differences of opinion would arise. And under the example given, the entire cost and attendant chaos would arise over a loss of $40 on one hand or a maximum gain of $140 on the other hand. Even though no consideration be given to the capital-gains section of the Revenue Act, the total maximum tax involved, if the taxpayer were a corporation, would be $26.

Consideration should be given to the exact facts involved in the transactions of the clients we represent, since the decisions which gave rise to the new regulation are in all cases different. In the case of *Boca Ratone Co.* v. *Commissioner of Internal Revenue* (C. C. A. 3d Cir., 1936; 86 Fed. (2d) 9), and allied cases, forfeitures were not involved but rather exchanges or settlements. Our clients sell lots under contracts where no title passes to the purchaser and the purchaser agrees that until all the payments are made, he has no right, title, or interest in the property. He is not entitled under the contract to possession until full payments have been made. The contracts contain a forfeiture clause substantially as follows (new matter printed in italic):

"Time is the essence of this contract, and in case of the failure of the second party to make any of the payments, or to perform any of the covenants to be made or performed by the second party, as herein provided, at the time and in the manner specified, this contract shall at the option of the first party be forfeited, determined and canceled, *and in that case all payments made hereunder shall be retained by the first party as liquidated damages.*"

Upon a forefeiture of such contracts, no exchange takes place, no title is returned and no possession regained. A vendor, by forfeiting the contract, cancels the contract and the rights of the purchaser thereunder. It is in effect a rescission of the contract except that the payments made by the purchaser are retained by the vendor as liquidated damages or as a penalty. The unpaid installment obligations are by such forefeiture nullified or rendered unenforceable but there is no exchange of the obligations for the property. The vendor, having canceled the contract and declared it to be null and void, cannot thereafter enforce the contract. The unpaid installment obligations are therefore unenforceable, not because they have been exchanged for the property but because enforcing them would be to enforce a canceled contract (*First National Securities Company* v. *Ward*, 1st Dist., 1934; 275 Ill. App. 521). No exchange is involved in a forfeiture. No court has ever held that a forfeiture constitutes an exchange. Neither the vendor nor the purchaser intends or understands that an exchange takes place. The vendor alone and at his election forfeits; the purchaser has nothing to do about it. It is a unilateral act, not bilateral. An exchange is a bilateral act. To call a forfeiture an exchange would be to explain what actually takes place by pure fiction.

When such a contract is forfeited, what actually occurs is that the contract is canceled and the payments made are retained by the vendor as liquidated damages or as a penalty. No sale of the property was completed. The vendor was continuously the owner of the property. He merely received an amount as damages and should be taxed on such amount. The method of computation under the former regulation does just that and therefore it is the true and correct measure of the vendor's gain or loss upon a forfeiture.

The cases of *Boca Ratone Co.* v. *Commissioner of Internal Revenue*, supra, and *Eggerman Investment Co.* v. *Commissioner of Internal Revenue* (1937), 36 B. T. A. 1196, are based entirely upon an application of section 44 (d) of the revenue acts. While it may be true that such application is correct under the existing law, it is obvious from reading reports of the Ways and Means Committee that section 44 (d) was not intended to cover cases of forfeitures such as are described herein. To meet the intention of Congress, section 44 must be amended. The report of the Ways and Means Committee, Seventieth Congress, first session, House Report No. 2, page 16, clearly shows what is meant by such clause and what Congress intended such clause to mean.

"*Gain or loss upon disposition of installment obligations.*—Subsection (d) contains new provisions of law to prevent evasion of taxes in connection with the transmission of installment obligations upon death, their distribution by way of liquidating or other dividends, or their disposition by way of gift, or in connection with similar transactions. The situations above specified ordinarily do not give rise to gain and yet at the same time it is urged that they permit the recipient to obtain a greatly increased basis in his hands for the property received, except in the case of gifts. It, therefore, seems desirable to clarify the matter. The installment basis accords the taxpayer the privilege of deferring the reporting at the time of the sale of the gain realized, until such time as the deferred cash payments are made. To prevent the evasion the subsection terminates the privilege of longer deferring the profit if the seller at any time transmits, distributes, or disposes of the installment obligations and compels the seller at that time to report the deferred profits. The subsection also modifies the general rule provided in subsection (a) for the ascertainment of the percentage of profit in the deferred payments, in those cases in which the obligations are satisfied at other than their face value or are sold or exchanged. The modification permits a compensating reduction in the percentage of profit in case the obligations are satisfied at less than their face value, or are sold or exchanged at less than their face value.

"Whether or not the gain or loss realized under the section is recognized for tax purposes depends upon general principles of law embodied in the income tax provisions, the exchange of installment obligations in connection with tax-free exchanges, for instance, being cared for by section 112."

The report of the Senate Finance Committee, Seventieth Congress, first session, Senate Report No. 960, page 24, is the same. Such clause in section 44 (d) does not include forfeitures and was not intended to include forfeitures. Congress intended to prevent vendors from realizing their profits on installment sales without paying income taxes thereon. It did not intend to tax vendors upon income which was not realized and would not be realized. It only intended to prevent evasion of tax by the realization of profit which was not taxed. Congress contemplated and section 44 (d) contemplates a completion of the installment sale as to the vendor. This is more clearly brought out by the provision: "Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received." By forfeiture the contract to sell is canceled or voided and the installment obligations are thereby rendered unenforceable. The sale is not completed as to the vendor; instead it fails entirely. The installment obligations are not satisfied, distributed, transmitted, sold, or otherwise disposed of; they are merely no longer enforceable because enforcement would be inconsistent with the forfeiture. The vendor has not realized his profit on the property. He has failed to realize that profit and he is still saddled with the property. Section 44 (d) obviously was not intended to apply to forfeitures.

There is attached to this communication a copy of the suggested amendments to section 44 of the revenue act which have heretofore been submitted by us and we respectfully submit that one of them should be adopted. It will be noted that one provides for an election by a taxpayer of using either the method provided by the former regulation or provided by the present regulation and requiring that when once the election has been made by the taxpayer the method shall be consistently continued until approval for any change has been secured from the Commissioner. Should it be considered that a return to the former regulation would work a hardship upon any group of taxpayers, then certainly the elective provision suggested would give to those taxpayers full protection and relieve all other taxpayers from the burdensome and expensive situation forced upon them by the present regulations.

Very truly yours,

RAYMOND H. SCHULTZ.

SUGGESTED AMENDMENTS SUBMITTED BY RAYMOND H. SCHULTZ TO SECTION 44 OF THE REVENUE ACT OF 1938 TO COVER FORFEITURES IN INSTALLMENT SALES

The following optional provisions are drafted to cover the termination or nullification of installment obligations resulting from forfeitures by vendors.

OPTIONAL PROVISION A (LIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR OF REAL PROPERTY.—If installment obligations are terminated by a vendor of real property upon default of the purchaser by forfeiture pursuant to the contract of sale under which the vendor has retained title to the property, no gain or loss shall result to the vendor under subsection (d) of this section, but gain or loss shall result to the vendor to the extent of the difference between (a) the sum of the payments actually received under the contract plus the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser, and (b) the sum of the profits taken into account in computing the vendor's net income for prior years plus an amount representing a reasonable adjustment for exhaustion, wear and tear, oblescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser and plus the expenses incurred by the vendor in connection with the sale, the forfeiture, and in regaining possession, unless otherwise allowed as deductions; and the basis of the property in the hands of the vendor shall immediately thereafter be the original basis of the property at the time of the sale increased by the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser and decreased by the amount employed as representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property in determining the vendor's gain or loss as hereinabove in this subsection provided.

Explanation:

Optional Provision A (Limited) is predicated upon article 44-3 of regulations 94 relating to sales of real property on the installment plan prior to its amendment by Treasury Decision 4832. 1938-30-9470. It is limited in its application to installment sales of real property by contract under which the vendor has retained title to the property. Though predicated on the former regulation, it differs from that regulation in several respects.

The former regulation covered all types of repossessions by the vendor whereas Optional Provision A (Limited) relates only to forfeitures by a vendor. The term forfeiture has a fixed meaning in law. It is the remedy often reserved in the contract of sale whereby the vendor may, upon default of the purchaser, terminate the contract and retain the payments made by the purchaser as liquidated damages or as a penalty. Any installment obligations outstanding at the time of the forfeiture are thereby terminated or nullified.

The former regulation provided that "the entire amount of the payments actually received on the contract and retained by the vendor" should be taken into account in determining the income of the vendor upon repossession of the property. That provision is changed to read "the sum of the payments actually received under the contract."

The former regulation provided that "the sum of the profits previously returned as income in connection therewith" should be deducted from the payments received in determining the vendor's income. That provision has been changed to "the sum of the profits taken into account in computing the vendor's net income for prior years." The suggested wording is derived from section 117 of the Revenue Act of 1938 which relates to capital gains and losses.

The former regulation provided for the deduction of "an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser had the sale not been made" in determining the vendor's income. That provision has been changed to "an amount representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser." The suggested change is to allow for the exhaustion, etc., which actually occurs while the purchaser is in possession.

Optional Provision A (Limited) provides that "the expenses incurred by the vendor in connection with the sale, the forfeiture and in regaining possession, unless otherwise allowed as deductions" should be deducted from the payments received in determining the vendor's income from the forfeiture. The former regulation contained no similar provision. This additional provision is suggested because it is believed that such expenses must be deducted before the vendor can be said to have realized income from the forfeiture. A vendor who is a dealer in real estate would deduct such expenses as business expenses and would not, under the suggested provision, be entitled to another deduction because of such expenses.

Optional Provision A (Limited) also provides for deducting the allowance for exhaustion, etc., made in computing the vendor's income from the forfeiture in determining the basis of the real estate after the forfeiture. The former regulation contained no similar provision but in practice such deduction was probably required.

It is believed that Optional Provision A (Limited) would establish a true measure of the gain or loss realized by a vendor upon a forfeiture and would accurately adjust the basis of the property in his hands.

OPTIONAL PROVISION A (UNLIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR.—If installment obligations are terminated by the vendor upon default of the purchaser by forfeiture pursuant to the contract of sale, no gain or loss shall result to the vendor under subsection (d) of this section, but gain or loss shall result to the vendor to the extent of the difference between (a) the sum of the payments actually received under the contract plus the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser, and (b) the sum of the profits taken into account in computing the vendor's net income for prior years plus an amount representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property, or for damage and use of the property for the period during which the property was in the hands of the purchaser and plus the expenses incurred by the vendor in connection with the sale, the forfeiture, and in regaining possession, unless otherwise allowed as deductions; and the basis of the property in the hands of the vendor shall immediately thereafter be the original basis of the property at the time of the sale increased by the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser and decreased by the amount employed as representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property or for damage and use of the property in determining the vendor's gain or loss as hereinabove in this subsection provided.

Explanation:

Optional Provision A (Unlimited) is substantially the same as Optional Provision A (Limited) except that it is not limited to forfeitures of real property installment sales, but covers forfeitures of personal property installment sales as well as real property installment sales. It contains the same provisions as to measuring the vendor's gain or loss and establishing the basis of the property in the hands of the vendor, except that it provides for deducting "a reasonable adjustment * * * for damage and use of the property for the period during which the property was in the hands of the purchaser" in both instances. That provision is taken from article 44-1 of regulations 94 prior to its amendment, which related to sales of personal property on the installment plan.

OPTIONAL PROVISION B (LIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR OF REAL PROPERTY.—If installment obligations are terminated by a vendor of real property upon default of the purchaser by forfeiture pursuant to the contract of sale under which the vendor has retained title to the property, no gain or loss shall result to the vendor under subsection (d) of this section, but gain or loss shall result to the vendor to the extent of the difference between (a) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of forfeiture of fixed improvements placed on the property by the purchaser and (b) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser had the sale not been made; and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of forfeiture of fixed improvements placed on the property by the purchaser.

Explanation:

Optional Provision B (Limited) is limited to forfeitures of real-property installment sales by the vendor who has retained title to the property. It differs from Optional Provision A (Limited) in that the provisions relating to gain or loss and the basis of the property are taken directly from article 44-3 of Regulations 94 prior to its amendment without modification or change.

OPTIONAL PROVISION B (UNLIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR.—If installment obligations are terminated by the vendor upon default of the purchaser by forfeiture pursuant to the contract of sale no gain or loss shall result to the vendor under subsection (d) of this section, but gain or loss shall result to the vendor to the extent of the difference between (a) the entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of forfeiture of fixed improvements placed on the property by the purchaser and (b) the sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser had the sale not been made; and the basis of the property in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of forfeiture of fixed improvements placed on the property by the purchaser.

Explanation:

Optional Provision B (Unlimited) is the same as Optional Provision B (Limited) except that it covers forfeitures of personal property installment sales as well as forfeitures of real property installment sales.

OPTIONAL PROVISION C (LIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR OF REAL PROPERTY.—If installment obligations are terminated by a vendor of real property upon default of the purchaser by forfeiture pursuant to the contract of sale under which the vendor has retained title to the property, the vendor may elect to compute his gain or loss thereon either under subsection (d) of this section or as hereinafter provided at the time of the first forfeiture had after ————, 19—, and shall consistently thereafter compute his gain or loss upon termination of installment obligations by forfeiture in accordance with such election. The alternative method for computation of gain or loss which may be elected as hereinabove provided shall be as follows: Gain or loss shall be deemed to result to the vendor from the forfeiture to the extent of the difference between (a) the sum of the payments actually received under the contract plus the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser, and (b) the sum of the profits taken into account in computing the vendor's net income for prior years plus an amount representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property for the period during which the property was in the hands of the purchaser and plus the expenses incurred by the vendor in connection with the sale, the forfeiture and in regaining possession, unless otherwise allowed as deductions; and the basis of the property in the hands of the vendor shall immediately thereafter be the original basis of the property at the time of the sale increased by the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser and decreased by the amount employed as representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property in determining the vendor's gain or loss as hereinabove in this subsection provided. The provisions of section 117 shall not apply to the gain or loss computed under the alternative method hereinabove in this subsection provided. If a vendor has elected to compute his gain or loss resulting from a forfeiture either under subsection (d) or under the alternative method hereinabove in this subsection provided he may change to the other method only with the approval of the Commisisoner. If a vendor has prior to ————, 19—, employed either the method provided in subsection (d) or the alternative method hereinabove provided in computing his gain or loss upon any forfeiture occurring prior to such date and in determining the basis of the property in his hands immediately after the forfeiture, or a method substantially similar to either of such methods, the method employed by the vendor shall be deemed to have been the correct method of computing the gain or loss resulting to the vendor from any such forfeiture and of determining the basis of the property in the hands of the vendor immediately thereafter.

Explanation:

This optional provision differs from Optional Provisions A (Limited) and B (Limited) in that it permits the vendor to elect the method which he will use in determining his gain or loss upon forfeiture. The election must be made at the time of the vendor's first forfeiture and he must thereafter consistently follow the method then elected unless a change is approved by the Commmission.

The measure of gain or loss and of the basis of the property after forfeiture is the same as that contained in Optional Provision A (Limited).

The last sentence is intended to protect vendors who have followed the regulations of the Commissioner before the enactment of the suggested amendment.

OPTIONAL PROVISION C (UNLIMITED)

[To constitute a new subsection of sec. 44]

(e) GAIN OR LOSS UPON TERMINATION OF INSTALLMENT OBLIGATIONS BY FORFEITURE BY A VENDOR.—If installment obligations are terminated by the vendor upon default of the purchaser by foreiture pursuant to the contract of sale, the vendor may elect to compute his gain or loss thereon either under subsection (d) of this section or as hereinafter provided at the time of the first forfeiture had after ————, 19—, and shall consistently thereafter compute his gain or loss upon termination of installment obligations by forfeiture in accordance with such election. The alternative method for computation of gain or loss which may be elected as hereinabove provided shall be as follows: Gain or loss shall be deemed to result to the vendor from the forfeiture to the extent of the difference between (a) the sum of the payments actually received under the contract plus the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser, and (b) the sum of the profits taken into account in computing the vendor's net income for prior years plus an amount representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property or for damage and use of the property for the period during which the property was in the hands of the purchaser and plus the expenses incurred by the vendor in connection with the sale, the forfeiture and in regaining possession, unless otherwise allowed as deductions; and the basis of the property in the hands of the vendor shall immediately thereafter be the original basis of the property at the time of the sale increased by the fair market value at the time of forfeiture of any fixed improvements placed upon the property by the purchaser and decreased by the amount employed as representing a reasonable adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property or for damage and use of the property in determining the vendor's gain or loss as hereinabove in this subsection provided. The provisions of section 117 shall not apply to the gain or loss computed under the alternative method hereinabove in this subsection provided. If a vendor has elected to compute his gain or loss resulting from a forfeiture either under subsection (d) or under the alternative method hereinabove in this subsection provided he may change to the other method only with the approval of the Commissioner. If a vendor has prior to ————, 19—, employed either the method provided in subsection (d) or the alternative method hereinabove provided in computing his gain or loss upon any forfeiture occurring prior to such date and in determining the basis of the property in his hands immediately after the forfeiture, or a method substantially similar to either of such methods, the method employed by the vendor shall be deemed to have been the correct method of computing the gain or loss resulting to the vendor from any such forfeiture and of determining the basis of the property in the hands of the vendor immediately thereafter.

Explanation:

This optional provision is the same as Optional Provision C (Limited) except that it covers forfeitures of personal property installment sales as well as forfeitures of real property installment sales. The measure of gain or loss and of the basis of the property after forfeiture is the same as that contained in Optional Provision A (Unlimited).

The CHAIRMAN. Mr. Joseph Selby.

(No response.)

The CHAIRMAN. Is Mr. Selby in the room?

(No response.)

The CHAIRMAN. Mr. Capehart.

STATEMENT OF HOMER E. CAPEHART, PRESIDENT, PACKARD MANUFACTURING CO., INDIANAPOLIS, IND.

Mr. CAPEHART. Mr. Chairman and members of the committee, I am appearing in regard to House bill 7378, which fails to grant relief to corporations organized after January 1, 1940, or inactive prior to that date.

I am Homer E. Capehart, president of the Packard Manufacturing Corporation of Indianapolis, Ind., which corporation was organized in 1932; operated for only a few weeks at that time; discontinued its operations and remained inactive until June 1940. From June 1940 to January 1, 1941, it designed, engineered, and prepared for production a line of accessories and parts for automatic phonographs, losing during that period some $40,000.

On January 1, 1941, it started production of said line and had a successful year running from January 1 to December 30 and made, before Federal taxes, a profit of approximately $150,000.

On January 1, 1942, it discontinued the manufacture of civilian goods and proceeded to convert its factory 100 percent into the manufacture of war materials. This conversion was accomplished in about 4½ months at a loss to the corporation of approximately $75,000.

The corporation is now operating on a profitable basis and has some $3,000,000 worth of unfilled orders for aviation, gun, and tank parts, all carrying the highest of priority ratings, which orders and more will be filled within the next 12 months, with additional orders for the same type of parts being received weekly.

In addition to losing $75,000 in converting from civilian goods to war materials, the corporation likewise purchased some $150,000 worth of new machinery in order to carry on the war work.

The corporation has received no advances on any of its war contracts. However, the corporation was forced to borrow some $200,000 on its own credit and that of its stockholders from local commercial banks in order to handle this war business.

I am attaching a computation showing the taxes this corporation will be required to pay under House bill 7378 if same be passed, based upon various estimates of possible earnings.

The corporation has approximately $200,000 in invested capital and a declared stock valuation of $2,500,000 for capital stock tax purposes but has no base period net income. Therefore, under the proposed House bill 7378 should it earn $100,000 it will pay $64,750 in excess profits. Should it earn $200,000 it will pay $152,250 in excess profits. Should it earn $300,000 it will pay $239.750 in excess-profits taxes. Should it earn $400,000 it will pay $327,250 in excess-profits taxes, and all of this in addition to the normal and surtaxes and the declared value excess-profits tax. It will pay about 88 percent of its net income in taxes.

While we believe it is the intention of House bill H. R. 7378 to give corporations under such conditions as we describe proper and adequate relief in order that their taxes may be no more in proportion to those of corporations who were in business during the base period, we fail to find any relief for our specific situation and we believe this to be true of thousands of other corporations organized after January 1, 1940, or corporations such as our own which were inactive during the base year periods but had normal earnings in 1941.

Therefore we pray that House bill H. R. 7378, section 722, heading "General relief—Constructive average base-period income," clause (a), be amended by inserting after the word "earnings" in line 10, the following: "which may be for a period other than the base period."

While it seems logical to assume, and we believe it to be true that the House, in paragraph (a) under section 722, intended that corporations who had no base period net income were entitled to set up such a constructive average base period net income for the purpose of arriving at their excess-profits tax, yet the clause is very vague in this respect and we believe by the addition as stated above it will be made perfectly clear that the intention of Congress was that a constructive average base period net income period may be set up over periods covering earnings other than the years 1936, 1937, 1938, and 1939 as applied to corporations who were organized after January 1, 1940, or corporations which were completely inactive during the years 1936, 1937, 1938, and 1939.

We further pray that House bill H. R. 7378 be amended on page 208, section 722, by adding after "December 31, 1930," line 18, the following:

where it is impossible because of a relatively new industry or because the development of its business had not reached a normal productive state to establish a constructive base period for a corporation otherwise entitled to relief under this provision, then and in that event not to exceed 60 percent of its earnings shall be subject to the excess-profits tax.

H. R. 7378 gives relief to corporations having abnormally low earnings during the base period of 1936, 1937, 1938, and 1939 by providing for a constructive base period, but it fails to provide a workable method of relief for corporations having no earnings at all during said base period due to inactivity or nonexistence.

This is an unwarranted discrimination against the latter class of corporations that we do not believe was ever intended, and should be clearly corrected.

Now, in this respect, either one of the amendments that we have offered, particularly No. 2, would correct the situation that Mr. Straus was just talking about. Either one of the amendments that we have offered would correct the situation that the gentleman who was representing the Boeing Airplane Co. yesterday testified about.

What we are asking for is that corporations who were not in existence or organized prior to January 1, 1940—and it likewise covers situations similar to the one that Mr. Straus described here a few minutes ago—we are asking that Congress set up a specific remedy for those corporations rather than leaving it up to a thousand and one or more examiners of the Treasury Department who will have a thousand and one or even more ideas of what this base period should be.

Now, the corporations that I am talking about are definitely set out—they are like a sore thumb. It is easy to decide who they are—it is the corporation that was not organized until January 1, 1940; it is the corporation that was inactive. The State records or the court records or the incorporation records, the records of the income tax bureau, will definitely tell you who they are. There is nothing left for the imagination of anybody.

Since January 1, 1940—I don't know how many, but my guess is that there have been several thousand corporations organized, because since January 1, 1940, up to this time is about 3 years. Under normal times, I would say it would amount to 25,000 or 30,000 or 40,000 corporations that were organized in the United States during a period of 3 years, and we are asking that Congress specifically specify what relief these corporations should and will receive.

We are not objecting to the tax—while we think it is too high. We think that the tax as written by the House will hurt the war effort, but we are not objecting to the tax; we are objecting to the fact that our destiny is going to be left in the hands of thousands or hundreds of examiners when our case covers thousands of corporations that Congress could definitely prescribe the method of arriving at our base period of paying the excess-profits tax.

The Chairman. We thank you, Mr. Capehart.

Mr. Capehart. Just one other word, Mr. Chairman. Our case likewise would be covered 100 percent as would the other two that I mentioned whom I listened to when they were testifying on your 6-percent net profits plan. We would have absolutely no objection to that, and a 6-percent net profits on volume after taxes would cover the situation that I am describing and talking about here. It would cover it 100 percent.

I have been in the manufacturing business for some 20-odd years. The average profit of a manufacturer will, year in and year out, be approximately 10 to 12½ percent. If he were permitted to retain 6 percent, and my opinion is that all corporations during this war effort should be considered on the same basis——

Senator BARKLEY (interposing). On sales, you mean?

Mr. CAPEHART. On sales. It should be figured on sales and not on investment and not on the profit you made in 1936, 1937, 1938, and 1939, but on what you are doing at the moment for the war effort, because a corporation with a small amount of capital may be able to get out twice as much merchandise for the War Department as a corporation with a lot of capital and lacking the enthusiasm and push of one which is mismanaged

I say that a fair tax is a 6-percent net profit on volume after payment of taxes.

Senator HERRING. That is a fair tax in normal times, too, is it not?

Mr. CAPEHART. Yes.

Senator HERRING. If it is a fair tax in normal times, then because your business has pyramided and multiplied because of the war effort you don't think you should pay any more? Your profit increases as your volume increases does it not?

Mr. CAPEHART. I was using the 6 percent because your chairman suggested 6 percent. Maybe it should be 5 or 4 percent.

Senator BARKLEY. He was speaking about a 6-percent limitation on profits and not a tax.

The CHAIRMAN. That is what I suggested—a 6-percent limitation on war contracts, or some fixed percentage.

Mr. CAPEHART. I agree with you.

The CHAIRMAN. There is no guaranty that you would make it.

Mr. CAPEHART. I understand that. You would have to make it, earn it.

Senator BARKLEY. That does not prevent you from having to pay taxes even on that 6 percent as a profit. If you limit your profits to 6 percent you still have to pay some tax on what you make.

Mr. CAPEHART. You could not pay very much and have very much left.

I would like to file this table in connection with my statement.

The CHAIRMAN. That may be done.

(The table referred to is as follows:)

Federal income taxes under H. R. 7378 for a corporation with $200,000 invested capital and no base period for excess-profits tax purposes

	A	B	C	D
Income before taxes	$100,000	$200,000	$300,000	$400,000
Declared value capital stock	2,500,000	2,500,000	2,500,000	2,500,000
Invested capital	200,000	200,000	200,000	200,000
Invested capital credit, 8 percent	16,000	16,000	16,000	16,000
Specific exemption	10,000	10,000	10,000	10,000
Excess-profits credit	26,000	26,000	26,000	26,000
Net income	100,000	200,000	300,000	400,000
Excess-profits credit	26,000	26,000	26,000	26,000
Adjusted excess-profits net income	74,000	174,000	274,000	374,000
Normal tax base	26,000	26,000	26,000	26,000
Excess-profits tax:				
Adjusted excess-profits net income	74,000	174,000	274,000	374,000
Excess-profits tax at 87½ percent	64,750	152,250	239,750	327,250

Federal income taxes under H. R. 7378 for a corporation with $200,000 invested capital and no base period for excess-profits tax purposes—Continued

	A	B	C	D
Normal tax:				
Normal tax, base	$26,000	$26,000	$26,000	$26,000
Normal tax, 24 percent	6,240	6,240	6,240	6,240
Surtax:				
Surtax, base	26,000	26,000	26,000	26,000
Surtax, 21 percent	5,460	5,460	5,460	5,460
Declared value excess-profits tax:				
Net income	100,000	200,000	300,000	400,000
Credit, 10 percent declared value capital stock	250,000	250,000	250,000	250,000
Taxable			50,000	150,000
Tax at 6.6 percent and 13.2 percent			3,300	11,550
Total tax:				
Excess profits	64,750	152,250	239,750	327,250
Normal tax	6,240	6,240	6,240	6,240
Surtax	5,460	5,460	5,460	5,460
Declared value excess-profits tax			3,300	11,550
Total taxes	76,450	163,950	254,750	350,500
Net income after taxes	23,550	36,050	45,250	49,500

The CHAIRMAN. Mr. James J. Forstall.

STATEMENT OF JAMES J. FORSTALL, REPRESENTING MICKELBERRYS FOOD PRODUCTS CO., MILWAUKEE, WIS.

Mr. FORSTALL. My name is James J. Forstall. I am a director of the Mickelberrys Food Products Co., which is a processor of food products. It is a family company, started out as a family company with just one man carrying a basket of sausage around on his arm, and developed over a period of over 40 years. Capital, therefore, was not the chief factor of income—it was built up very largely out of personal services and so we have a very serious growth problem, and also a loss problem. I will give the facts very frequently.

By 1929 and 1930 and 1931, the company was earning rather a stable and satisfactory earning of over $150,000 a year. In 1929 there was a change of management. In 1930, they invested about $700,000 in cash and stock in a cooky concern which had cooky plants in 10 cities of the United States.

Soon thereafter, it began to appear that the new management was not efficient. The president began having quarrels with the other executives, the earnings began to drop very rapidly. In 1933 they lost money; in 1934 they lost more money; and in 1935 they lost about $120,000. The loss of the 3 years amounted to about $200,000. In the meantime they lost 9 out of the 10 cooky plants, so they lost over nine-tenths of their total investment in the cooky company.

In 1935, they changed the management and got a very efficient management and started to pull the earnings up again. The earnings were very low in 1936, and by 1941 they had gone up over 10 times but still below the stable rate of the 1930's. The total earnings from 1936 to date are not enough to make up for the loss in the cooky investment, and not even particularly for the loss in the cooky investment but plus the operating losses in 1936; so the company is behind what it was in 1932. In that 10-year period, the stockholders have received a total of 55 cents in dividends against 60 cents they were getting annually in 1929, 1930, and 1931; so the company is behind where it was—it has not yet got up to where it was in 1932, and yet under the law it will be faced as it stood in 1940 or 1941 with very heavy taxes.

Fortunately, section 713 (f) came along, which helped materially; and of course we had a very substantial loss in the cooky investment which could have been taken, and was taken in a very slight degree, but a lot of it was needed to equalize the situation.

Now, a few suggestions as to the relief we ask you to consider: This is a typical growth situation, but it has complications—it is not new growth, it is just catching up to where we were before, but it begins when our base years were very low, our invested capital very low, because of the character of the company, and our base-year earnings are very low.

The four points I would like to make are these:

First. Along with so many other people that have appeared before you, we feel decidedly that the income tax should be deducted before the excess-profits tax is figured. I won't argue that at all; it seems to us rather simple, logical, and fair and should be done.

Second. The trouble with section 713 (f) is that it stops all credit at 1939, and we get no benefit beyond that. We believe with Mr. Stiles and Mr. Hargrave and others that have appeared that something ought to be done about that.

I will file a little statement covering the exact details of it to save your time, rather than to elaborate upon that now.

In addition to that, the in-some-way-admirable provisions of section 722 that have been presented by the House Ways and Means Committee we feel should be clarified a little. It should be made clear that the taxpayer is not being given an impossible burden, and also it should be made clear that the limitations of section 713 do not apply to section 722. That already has been presented, and I will cover it in my statement.

Finally, on the question of capital losses, Professor Fisher had a little to say about that this morning, and I agree heartily with him. As a matter of fact, I was a member of a firm that carried in 1920 four cases to the Supreme Court of the United States in which we claimed that the sixteenth amendment did not allow the taxation of the increased value of capital realized by a sale. The British income-tax laws dating back to 1799 never had such a principle in them. The income-tax laws of the Civil War had no such provision, and as a matter of fact the trust laws of this country have always recognized, and still recognize, that increased capital applies to the trust fund and not to the beneficiaries. In principle, therefor, I agree heartily with Professor Fisher that there never should be a capital-gains tax, and that the country would be better off without it.

Secretary of the Treasury Mellon on repeated occasions said that the country was losing money by that system.

But I would like to state emphatically that if you allow the taxation of capital gains, it follows as the night does the day that you will have to allow capital losses, to be logical and fair.

Take our case here—we have less capital now than we had in 1932, and yet our entire income has not been sufficient to build back the capital that we had then, and now under the law you are going to say that we have no chance to take a loss for that capital loss, and we are taxed on excess profits even though we are behind where we were 10 years ago.

May I just add one word? It is not in our own company situation—it will only be a minute—and that is the fiscal-year provision.

I did not have the benefit of hearing all of the testimony that has been given here, and if it has not been brought to your attention, I want to call attention to the fact that that is not only retroactive taxation, which would mean a lot of additional administrative work as the Treasury Department knows, but that it taxes a great deal of 1941 income at 1942 rates. The way the law now stands, if a company has earned substantial money in the first half of its fiscal year and none after the 1st of January, it nevertheless has to pay the 1942 rates on the 1941 income, and if that provision is to be left in at all, I think you will agree that some different method of calculation should be made, allowing the company to figure its income up to the first of the year and not be compelled to pay 1942 taxes on 1941 income.

Just one word, in closing, if I may, and that is that as a student of Federal taxation for 20 years, I feel very strongly that the most important thing that this committee can do for the country is to do something to appoint a commission or something the way the British would appoint a royal commission and have it work 10 or 15 years if necessary to simplify these tax laws. I do not think you could do anything better for the country than initiate such a commission.

The CHAIRMAN. Thank you very much.

Mr. FORSTALL. Have I permission to send in a statement? Will it be time enough if I get it in by Monday morning?

The CHAIRMAN. It will be time enough if it gets here by Monday.

Mr. FORSTALL. Thank you, sir.

(The statement referred to is as follows:)

STATEMENT OF JAMES J. FORSTALL ON BEHALF OF MICKELBERRY'S FOOD PRODUCTS CO. OF CHICAGO, ILL.

The pork-processing business now carried on by Mickelberry's Food Products Co. (hereinafter called "Mickelberry") was started by William M. Mickelberry before 1900. Incorporated in Illinois in 1920 and reincorporated in Delaware in 1926, the company's earnings after taxes for the years 1926 to 1931, inclusive, averaged over $140,000 a year. Mickelberry underwent a change of management in 1929, and early in 1930 it paid $700,000 in cash and stock for all of the capital stock of the Mama Cookie Bakeries, Inc., a prosperous cookie-bakery chain with plants in 10 cities.

In spite of the depression, Mickelberry's consolidated net income after taxes in 1930 was at a new high, and that for 1931 was greater than that for any other year except 1930. Soon after, however, friction arose between the new president of Mickelberry and the officials of the cookie company and earnings began to drop rapidly. Both companies lost money in 1933, 1934, and 1935, the total loss for those 3 years being over $280,000. Moreover, all the cookie company plants except one were lost, and thus the investment in the cookie company stock lost most of its value.

Another change in management, in 1935, just managed to save Mickelberry from forced liquidation. Ever since then its earnings have increased steadily, and are now approaching the levels of 1929 and 1930. After Federal taxes they are as follows:

1936	$13,545.50	1939	$83,217.03
1937	27,510.85	1940	111,011.46
1938	70,437.14	1941	137,959.91

The total of the earnings of these 6 years is less than the decrease in value of the investment in the stock of the cookie company, and much less than the such of that decrease and of the substantial operating losses of 1933–1935. In other words, Mickelberry is still behind where it was in 1932. Moreover, in the last 10 years Mickelberry's common stockholders have received in all only 55 cents a share in dividends, less than the 60 cents a share they were receiving annually from 1930 to 1932.

Not 1 cent of the earnings in 1940 or 1941 came from defense or war orders, and in fact 1941 earnings would have been much larger had it not been for lend-lease buying of pork.

As Mickelberry's business was built up gradually as a family business over a period of more than 25 years, and as both rapid turn-over and service are important factors in it, invested capital is not the most important income-producing factor, and, therefore, were invested capital used as the excess-profits tax base, most of its income would be taken by excess-profits taxes, even though the above facts show that its profits have not been, in any true sense, excess profits at all.

Even the earnings base does not save it from heavy so-called excess-profits taxes, even under section 713 (f), because even in 1939 its earnings were still far below the levels of 1929–31 and 1941–42.

This case presents a growth company problem, as did the cases concerning which Messrs Stiles, Hardgrave, Ringer, Frazier, Connally, and others have recently addressed you, but this case is unusual in that the growth came from such a depressed level that even rapid growth for 6 years through 1941 has not been enough to bring the net income after taxes back up to the average earning level of 1926–31. But this case also involves an investment of $700,000 in stock of a subsidiary, and later the loss of most of the value of that investment.

To protect Mickelberry and other companies similarly situated from manifestly excessive and discriminatory taxation, we respectfully urge that:

1. The present method, of computing the excess-profits tax before computing income taxes, be abandoned, and the previous method, of calculating income taxes first, be readopted. The new method is wrong in principle. The income taxes should be deducted first, as otherwise substantial amounts are taxed as excess profits which are in no real sense excess profits at all.

2. The base period (at least under sec. 713 (f)) be extended to include 1940, and the taxpayer (at least under sec. 713 (f)) be permitted to use the last 4 years of that period.

3. Section 722 (a) and (b) as contained in H. R. 7378 be modified as follows (as already suggested to you by Mr. Hardgrave):

(*a*) 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 would 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."

(*b*) Immediately after the amended sentence discussed in (*a*) 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."

(*c*) Add the following words to the last sentence of section 722 (a): "except as hereinafter in this section provided."

(*d*). 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."

(*e*). 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 italicized words constitute the suggested amendment.

4. The provision of section 136 of H. R. 7378 which amends section 117 (d) of the Internal Revenue Code so as to allow corporate capital losses only to the extent of capital gains should be stricken out; or at the very least materially modified so as to allow corporations some substantial relief for capital losses.

A recurrence to the fundamental principles of income taxation is sometimes important to prevent injustice. If realized appreciation of capital is taxed as income, every principle of logic and fairness demands that capital losses be allowed to offset ordinary income to the same extent. If Mickelberry's earnings, which during the last 9 years have not yet sufficed to bring it back up to its capital position of 1932, were to be heavily taxed by both income and excess profits taxes, without it being allowed any relief (other than the small part of the loss it has already taken) for the huge capital loss it suffered in the loss of its cookie plants, those unrelieved taxes would not only be manifestly unjust and discriminatory but would be really equivalent to a capital levy.

Respectfully submitted.

MICKELBERRY'S FOOD PRODUCTS CO.,
JAMES J. FORSTALL.

AUGUST 14, 1942.

The CHAIRMAN. Mr. Harnischfeger.

(No response.) (See p. 2241 for statement.)

The CHAIRMAN. Mr. McFarland.

STATEMENT OF ELDEN McFARLAND, WASHINGTON, D. C., REPRESENTING THE FIRM OF MURPHY, LANIER & QUINN

Mr. McFARLAND. Mr. Chairman and members of the committee, my name is Elden McFarland. I am representing the firm of Murphy, Lanier & Quinn, who are tax specialists with offices in New York, Chicago, Cincinnati, and Washington.

I will present three or four matters very briefly and ask that my remarks may be extended by the filing of a brief which will be somewhat more at length.

The first subject I would like to discuss is section 185 of the House bill which amends section 115 (a) of the Internal Revenue Code by further defining personal holding company dividends.

We urge that the amendment be retained in the bill. It is designed to cover a situation such as the following which is an actual case:

For the year 1938 a personal holding company had taxable net income of $33,000. It had sold securities at a loss of $43,000 but was allowed only a $2,000 capital-loss deduction. Its income tax amounted to $822. But it had no actual net earnings for 1938. It actually had an $8,000 loss. However, in order to avoid the personal holding company surtax of $24,000 the corporation paid out to its stockholders a dividend of $37,500. This was paid out of capital surplus. It had no earned surplus because it had currently distributed all prior year's earnings. The dividend was a lawful dividend under the State law.

The Treasury Department, however, refused to recognize the dividend as a section 115 dividend and asserted a personal holding company surtax of $24,000 based upon the failure to pay a dividend.

So here was a corporation that had a loss in its operations of some $8,000 that is being called upon to pay a surtax of $24,000 in addition to its income tax.

The Treasury Department has recognized this peculiarity in the definitions of a personal holding company dividend, and the Treasury Department has recommended this amendment.

We want to bring this illustration to the attention of the committee because we realize that in the rush of business that some things might possibly be overlooked, and we urge that this amendment be retained in the bill. As I say, it has the endorsement of the Treasury Department.

The CHAIRMAN. All right, sir.

Mr. MCFARLAND. The next point is the question of capital losses incurred in the sale of a business.

Many businesses are being sold today; some are being converted to various and sundry war efforts. Section 136 of the House bill amends section 117 (d), relating to losses from sales or exchanges of capital assets, and we urge that the amendment be broadened so as to require a corporation selling its business to pay tax only on the amount of its actual profit.

For example: A bus transportation company selling its business could not offset a gain from the sale of its busses against a loss from the sale of its bus terminal. The land and buildings, under the amendment, constitute capital assets, but the busses being depreciable assets do not constitute capital assets. Thus a corporation having a gain from the sale of the latter would be taxed upon that gain, even though it made no profit whatever in connection with the entire transaction.

We propose the addition of the following words to the amendment:

and gains from the sale of assets held for more than 15 months, except stock in trade of the taxpayer or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

The next subject I would like to discuss is the question of nontrade or nonbusiness deductions.

Section 118 of House bill amends section 23 (a) of the Internal Revenue Code by adding a paragraph numbered (2).

We believe the amendment is somewhat ambiguous and could be clarified by the addition of the word "management," so that the amendment will read as follows:

(2) NONTRADE OR NONBUSINESS EXPENSES.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production, collection, or management of income, or for the management, conservation, or maintenace of property held for the production of income.

This amendment was suggested by the Treasury Department and we feel that the proposed change will clarify the amendment so as to permit the deduction of costs for annual audits of income and disbursements, preparation of income-tax returns, and salaries of employees handling reinvestment income, all of which come within the proper scope and function of the amendment, but which we feel should be more specifically included in order to avoid an ambiguity.

Those costs, I might say, the costs of preparing income-tax returns and things of that sort, are important not only to taxpayer but are important to the Government from an administrative standpoint, because a properly prepared return saves a great deal of time in the investigation of returns, and it is a deduction which properly should come within the scope of the amendment as proposed by the Treasury Department.

The next point I wish to cover is the question of fiscal-year taxpayers. Section 129 of the House bill amends the Internal Revenue Code by adding a new section (108) which imposes a tax at the 1942 Revenue Act rates for that portion of the fiscal year falling in the calendar year 1942.

Many corporations have declared dividends and have made other commitments on the basis of the tax law in effect at the close of their fiscal years. The retroactive application of section 129 produces a particular hardship upon such corporations through no fault of their own. Moreover, the retroactive application of the section will require the filing of amended returns by many fiscal-year corporations, thus adding to the administrative difficulties of the Bureau of Internal Revenue.

I believe that the Bureau did not ask or request that this amendment be incorporated in the bill, and I believe that the reason was the difficulty of administering and reexamining these returns that will be required to be filed.

Senator BARKLEY. You have no objection to the calendar-year provision if it is prospectively administered? It is the retroactive feature you object to?

Mr. McFARLAND. That is right. If the committee feels that the amendment be included in the bill that it be given prospective and not retroactive application. It should be applied to fiscal years ending in 1943, or at most to fiscal years ending after the passage of the act.

The CHAIRMAN. We have your point on that, and it has been very well covered by a great many witnesses.

Mr. McFARLAND. I am through with that.

The last point I wish to present is this:

Section 610 of the 1942 revenue bill as passed by the House amends section 3404 (d) of the Internal Revenue Code so that the excise tax on musical instruments shall not apply to organs sold under a written contract entered into before October 1, 1941.

A supplementary limitation order, L-37-A, paragraph (c) (4), set out in volume 7 of the Federal Register, page 4036, dated May 29, 1942, stopped all production of pianos in the United States, effective at the end of July 1942, with the exception of a few which may be manufactured during August; and after September 1942 there will be no further production of pianos. During the last war, pianos were one of the last articles taxed and one of the first upon which the excise taxes were terminated. We now find ourselves in a situation where the law requires an administrative tax on products which are no longer and cannot be longer manufactured.

In view of the foregoing, we suggest that pianos and other musical instruments, the manufacture of which has ceased, should be excluded from taxation under section 3404 (d) of the Internal Revenue Code.

I thank you.

(A memorandum submitted by Mr. McFarland is as follows:)

MEMORANDUM BY MURPHY, LANIER & QUINN, NEW YORK, N. Y., ON PROPOSED 1942 REVENUE ACT

RELIEF FOR PERSONAL HOLDING COMPANIES

Section 185 of the House bill amends section 115 (a) of the Internal Revenue Code and section 115 (a) of the 1938 and 1936 Revenue Acts by inserting at the end of the definition the term "dividend," the following new sentence:

"Such term also means any distribution to its shareholders, whether in money or in other property, made by a corporation which, under the law applicable to the taxable year in wheih the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504 (c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year."

This amendment, together with related amendments to the personal holding company tax law proposed in the House bill, is a matter of the utmost importance to personal holding companies which have made distributions to their stockholders during recent years, equal to the amount of their personal holding company income, but which have been unable to obtain any credit for such distributions because of the fact that they had no earnings or profits at the time of such distributions.

In many cases, personal holding companies had no earned surplus at the beginning of the year and their current earnings from interest and dividends were offset on the books by losses on the sale of investments. In many instances such corporations endeavored to comply with the spirit of the personal holding company tax law by distributing an amount equal to their personal holding company income, determined by deducting only $2,000 of such losses from their ordinary income. Yet, because they had no earnings or profits within the meaning of section 115, they were held by the Internal Revenue Bureau to be subject to the extremely heavy rates of the personal holding company tax. An instance in point, in which the undersigned represented the taxpayer, is that of the Copco Trading Company, of 15 Exchange Place, Jersey City, N. J., for 1938, 1939, and 1940.

The relief afforded by the House bill is satisfactory, and we wish to urge that these provisions or similar provisions be adopted by your committee.

CAPITAL LOSSES INCURRED IN THE SALE OF A BUSINESS

Section 136 of the House bill amends section 117 (d), relating to losses from sales or exchanges of capital assets, to read as follows:

"(d) LIMITATION ON CAPITAL LOSSES.—(1) CORPORATIONS.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges."

This provision would result in a serious hardship, in many cases involving the sale of a business, since the corporation would be unable to use the losses upon the sale of certain assets to offset the profits on the sale of other assets. For example, if a bus company sold its business it might have a profit on the sale of the busses and a loss on the sale of the bus terminal and other real estate used in the business. In some cases the loss on the sale of such real estate is substantial and yet it cannot be used, under the new provision, to offset an equally substantial gain on the sale of the other assets.

The new provision as it stands is undesirable because it would constitute a substantial interference with the normal course of business in such instances. In fact in many cases it would render the sale of the business impossible.

It is suggested that this situation might be met by adding to section 117 (d) (1), quoted above, the following words:

"and gains from the sale of assets held for more than 15 months, except stock in trade of the taxpayer or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business."

Any other language of the same general effect, which would apply to the sale of all the physical assets of a business, would be acceptable.

NONTRADE OR NONBUSINESS DEDUCTIONS

Section 118 of the 1942 revenue bill as introduced in the House amends section 23 (a) by adding the following paragraph:

"(2) NONTRADE OR NONBUSINESS EXPENSES.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

This provision was inserted because the language of section 23 (a) of the Internal Revenue Code had been held by the courts not to permit the deduction of necessary expenses incurred by individuals and trustees having large investments, because such expenses were not incurred in connection with a trade or business.

The language of the provision proposed by the House bill, quoted above, is not sufficiently broad to cover some of the necessary expenses incurred in connection with the income of this character, since it only permits the deduction of expenses incurred "for the production or collection of income." Examples of ordinary and necessary expenses not covered by this language are the cost of accountants' annual audits of income and disbursements, the cost of preparation of income-tax returns covering such income, and the salaries of employees handling the reinvestment of income.

In the case of trustees, whose returns are prepared in the same manner as those of individuals, not only are the foregoing expenses not deductible but a part of the trustees' fees would also be nondeductible. For example, in New York a trustee is allowed a fee of 1 percent upon receiving income and 1 percent upon paying out. The trustee's fee upon paying out income is an ordinary and necessary expense of the trust, but it is not deductible under the present law because it is not incurred in connection with a trade or business, and it is not deductible under the proposed new provision, since it is not incurred "for the production or collection of income."

It is thought that the desired effect could be secured by inserting the word "management," so that section 23 (a) (2) would read as follows:

"(2) NONTRADE OR NONBUSINESS EXPENSES.—In the case of an individual all the ordinary and necessary expenses paid or incurred during the taxable year for the production, collection, or management of income, or for the management, conservation, or maintenance of property held for the production of income."

Even if the language proposed in the House bill were looked upon as possibly sufficient to permit the deduction of expenses of the type described above, it would still be very desirable to make the language more explicit, so as to avoid new litigation as to the meaning and effect of the provision.

MURPHY, LANIER & QUINN.
By ELDEN MCFARLAND.

(The following letter was received from Mr. McFarland and ordered incorporated in the record:)

MURPHY, LANIER & QUINN,
Washington, D. C., August 21, 1942.

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR MR. CHAIRMAN: We respectfully urge that the relief provisions contained in section 213 of the pending revenue bill (H. R. 7378), amending section 722 of the Internal Revenue Code, be made retroactive.

When the 1941 revenue bill was pending before this committee, a number of meritorious relief suggestions were submitted by several witnesses, but inasmuch as a subsequent "technical bill' was then contemplated, these relief measures were not incorporated in the Revenue Act of 1941. The so-called technical bill never materialized, with the result that many of the relief provisions which otherwise would have been made applicable to the Revenue Act of 1941 were not included therein.

Section 213 of the pending bill incorporates a number of relief provisions, which, under the circumstances, quite properly should be made retroactive to cover the years 1940 and 1941. The same motives and circumstances which impel the adoption of these provisions in the current tax bill are applicable as forcefully to these prior years as to 1942.

We, therefore, respectfully urge that section 213 be made retroactive.

Very truly yours,

MURPHY, LANIER & QUINN,
By ELDEN MCFARLAND.

The CHAIRMAN. Mr. A. Harding Paul.

STATEMENT OF A. HARDING PAUL, WASHINGTON, D. C.

Mr. PAUL. My name is A. Harding Paul; I am an attorney-at-law, and located at Washington, D. C. I have specialized in tax law since 1920.

I have one or two suggestions in connection with the pending bill which I would like to submit to the committee.

The first one relates to the question of how you should treat the miners of strategic minerals. You have had some discussion of depletion with respect to natural resources, and I am sure the committee is fully acquainted with the necessity for continuing the percentage method of depletion.

I should, however, like by example to point out to you that the percentage for depletion now allowed is not one calculated to produce strategic minerals. Strategic minerals, as we all know, are generally those minerals which are mined primarily during a period of war emergency, such as tungsten, quicksilver, manganese, antimony, chromite, and so forth.

In 1918, the revenue law specifically exempted profits from the mining of such minerals from excess-profits taxation. In 1940 a more current edition of our legislative body, that is, the Congress previous to the present one, also provided for such an exemption. In 1941, because some people tried to extend the exemption to other metals which perhaps were not deserving of it, the House Ways and Means Committee at the behest of the Treasury struck out the exemption entirely.

This committee, however, upon the motion of Senator Clark, restored it, and the Senate passed the bill as recommended by the committee, but it was not agreed to in conference. There is therefore no present exemption and the miner is subject to the 90-percent excess-profits tax as proposed in the House bill.

The whole reason for not allowing an exemption, it seems to me, arises from the strong representation of the Treasury that there should be no exemptions from excess-profits taxes for corporations organized for profit. With that viewpoint I am not attempting to collide, because I believe it would probably prove to be unprofitable, but I do have a suggestion which I think will help you and help the country in its efforts to stimulate the production of these minerals. They are absolutely necessary in the war effort, and every effort is being made, except through some form of tax relief, to increase their production. However, as has been pointed out by Dr. Wilbur Nelson, the Administrator of Mining of the War Production Board, and I think by Mr. Donald Nelson, War Production Board chairman, and also by Mr. DeWitt

Smith, who is a mining adviser of the Metals Reserve Co. of the Reconstruction Finance Corporation, the production is not being obtained by the methods now invoked.

One of the methods being used is the purchase by the Metals Reserve Co. of the equipment and perhaps even the mine itself for the miner and then renting it to the miner, so that he gets the benefit of a rent deduction, eliminates his entire risk and accordingly receives some profit for his work.

I would like now, by an example, to point out to the members of the committee just what happens in the case of a tungsten miner who, acting upon the impetus and stimulus of the demands of the Government, removes the entire ore bodies of his mine in 1 or 2 years of production in place of his normal production, which it is assumed would take a period of 10 years.

I have some pads of paper here and I have some pencils, and I would like the members of the committee who would care to follow this example to do so because it will very simply show exactly what is happening in such cases.

The example I have in mind is that of a tungsten miner with an investment of $1,500,000, who expects a normal life for the mine of 10 years. The $1,500,000 is divided one-half between working capital and cost of mine and the other one-half or $750,000 as a cost of depreciable equipment. The normal annual production of the mine is assumed to be $500.000 in money, that is 25,000 units at $20 per unit price. The mine owner would be entitled under the present laws to an annual percentage depletion deduction of 15 percent of $500,000, or $75,000, and would also be entitled to recover depreciable assets at the rate of 10 percent per year or $75,000. Thus he has an annual allowable deduction for depreciation and depletion of $150,000.

His expense of operation would probably be around $200,000, and he would thus have a profit of $150,000 ($500,000 less $200,000 expenses and $150,000 depreciation and depletion). While I use here the personal pronoun, in my illustration I am dealing with corporation taxes as the mine would doubtless be incorporated.

An average normal tax based upon past history would probably be under 20 percent but taking that rate as normal the miner has a net average annual profit after all expenses and taxes of $120,000. Adding back annual depletion and depreciation of $150,000 he would receive over a 10-year life $2,700,000 which, with respect to his investment, would represent a 10-year profit of $1,200,000, or at the rate of 8 percent per annum. This would be regarded as a profitable mine and is the type of profit which might cause people to risk money to go into a mining venture. However, not 1 in 10 mines will prove to be as profitable, so that the total amount which is received in this case is not inordinate and I am sure upon investigation you will find that it is customary in order to obtain the necessary risk capital in a venture of this kind that a promise of a higher profit than 8 percent must be held out. Even good veins of ore have a habit of disappearing.

Now, the war comes along, and there is a Government urge for increased production. The War Production Board says: "Get it out and get it out fast—in 1, 2, or 3 years. It is vital in the war effort and we need the tungsten." The miner complies with his Government's request and produces in 1 year all the tungsten the mine contains. The

Government pays a bonus price for this mineral and that bonus price is now about 20 percent, so at $24 a unit for his normally 10-year's supply of 250,000 units he receives $6,000,000. His depletion is 15 percent of that figure or $900,000, and he also would obtain a stepped-up depreciation—say this is $225,000—which would leave $4,875,000. Because of increased costs, working his labor overtime, and so forth, expenses will probably be $3,000,000, leaving $1,875,000 after depletion, depreciation, and expenses. The invested capital credit would be $130,000 (8 percent of $1,500,000 plus $10,000), leaving $1,745,000 subject to excess-profits tax; and at a rate of 90 percent the tax is $1,570,500, leaving $304,500 in profit before normal and surtaxes. The normal and surtax is computed on $130,000 at 45 percent and is $58,500, leaving net profit for the year of $246,000. As the mine is now completely depleted there is to be added to this latter figure the depletion and depreciation allowed of $1,125,000 to bring the total money in the miner's hands to $1,371,000 or $129,000 less than his investment.

It is quite obvious that under such a stimulus, or rather lack of stimulus, he will not feel encouraged to produce. It is only his patriotism that persuades him to produce any tungsten above normal.

My suggested amendment is that you allow him for excess-profits tax purposes only an additional 10 percent depletion for any production over his highest production of any previous year. Under the example given this bonus or special allowance would be figured as follows: Normal gross income from production is $500,000, which when subtracted from total gross income from production in the taxable year of $6,000,000, gives an increased gross income from production of $5,500,000. The special depletion allowance is 10 percent thereof or $550,000; but he must pay the 45 percent normal tax and surtax thereon, or $247,500, leaving him an additional return of $302,500. Subtracting the loss of $129,000 he is otherwise confronted with from such additional return, he has left a net over-all profit of $173,500

I am advised that under some such stimulus miners will explore for and produce more tungsten. I happen to represent, and know the facts connected with, the Yellow Pine mine of Idaho, which is the largest single producer of tungsten in America today, and which mine produced in 1941 approximately one-third of all of the domestically produced tungsten. I know that under the proposed law the owners in all probability will not be able to recover their entire investment without some additional allowance for depletion or its equivalent. It could hardly be said that these people would be lacking in patriotism, therefore, if they were reluctant to put their whole effort into getting out the tungsten quickly. I don't say that they are not putting forth every effort to that end, because they are, but it seems to me unfair, and I believe the committee will consider it unfair, to urge the miner to bend his entire efforts to sell to the United States the entire product of his mine at a net price after taxes which will be less than enough to replace his capital.

The second matter that I would like to take up deals with corporations generally, and it is a subject which the committee has considered thoroughly. The subject I have reference to is to provide for a present credit against the excess-profits taxes an amount recoverable by the United States in the post-war adjustment period.

I suggest that you tie your credits to some such asset as plant or inventory. In this way, you can obtain an automatic tax recovery of the allowance now made, whereas if you just allow the credit with respect to a certain amount of debt or a certain amount of insurance, or in other ways, the recovery later will perhaps be more difficult. My suggestion is that you permit the corporation to deduct 20 percent of its plant and/or inventory, limited to whatever percentage of the net income you think will be proper to protect the revenue. This would simply mean that the corporation is deducting in advance some depreciation or inventory loss which it will take later and which will reduce the revenues of the Treasury Department later. We all know that the law permits an amortization deduction at the rate of 20 percent a year of the cost of the new war facilities, but they are the ones which will be retained for years. You should allow a credit against the tax for them because the corporations were urged to go out and buy them to help stimulate the war effort, but it is those machines and those machine tools which will be continued in use, and it is the old machines and the older machine tools which will be discarded.

If you permit a corporation to deduct the normal depreciation, or at its option to take 20 percent of its plant as a deduction provided it will invest that 20 percent in war bonds, you will get more revenue; that is, you will get more cash to the Government than you get today; and at the same time you will permit the corporations to keep their plants sound. It will give them a fund that they can use to buy from these makers of new machine tools and from the present users of the new machine tools some new equipment, and in that way keep the plants of America sound.

While adoption of this suggestion will aid in keeping the plants of America new and sound, I also believe you should endeavor to keep the corporations themselves sound. This brings out my final suggestion. It is to permit stockholders to obtain some return. I recommend that you reinstate the provision of the 1936 law which permits a credit for dividends paid, and allow such a credit against the normal and surtaxes, or against either of such taxes. In that way, the corporation will be permitted to pay the money out to its stockholders and keep them interested in their corporation. The Treasury will get some return, because the stockholders will pay income taxes on the dividends received. The least tax which the bill provides for an individual subject to normal and surtax is 19 percent. So that there will be no net loss in revenue if you adopt some such credit provision for dividends except to the extent that the corporation can continue to pay the dividends in question without receiving a credit.

Thank you very much.

The CHAIRMAN. Has Mr. Harnischfeger returned to the room?

(No response.)

Senator LA FOLLETTE. Mr. Chairman, I would like to have permission to communicate with Mr. Harnischfeger, and if he desires to have a statement inserted in the record and can get it here by Monday, I would like to have permission to put it in.

The CHAIRMAN. Very well, Senator La Follette. He may come in before we finish with the other witnesses.

(The statement referred to by Senator La Follette is as follows:)

STATEMENT OF THE HARNISCHFEGER CORPORATION, MILWAUKEE, WIS.

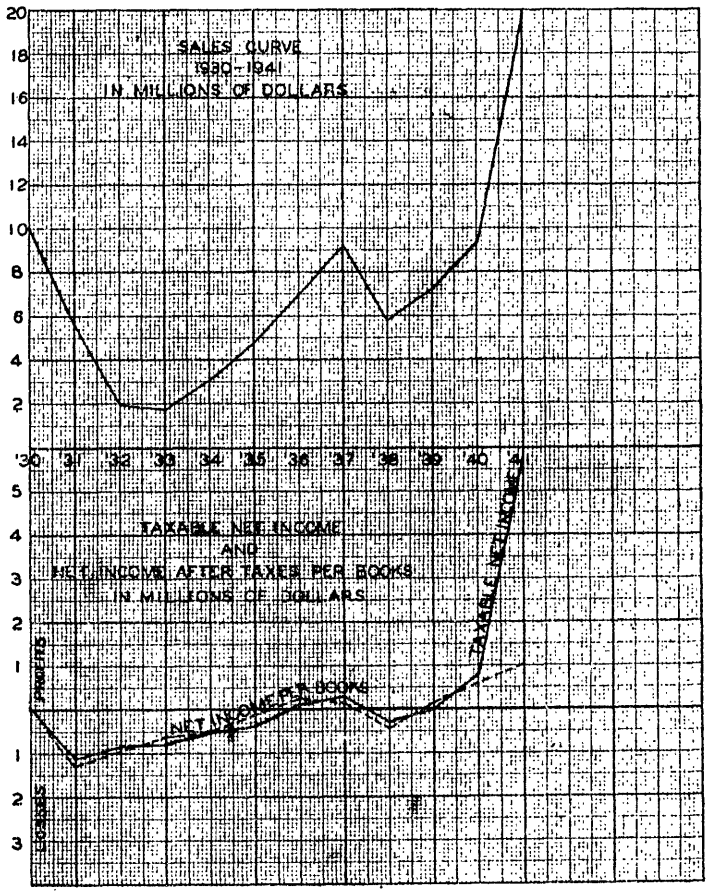
FOREWORD

It is a well-recognized fact that the war is causing many serious dislocations in the economic structure of our country at the present time. It will cause far greater problems when the war is over.

The Congress and Senate have a very complex problem in drafting a tax bill which will raise the necessary revenues, prevent inflation and yet preserve a solvent business economy which can survive the reconstruction period after the war.

We believe that it will aid those responsible for drafting the tax laws if they know the problems that confront various types of industry.

We are therefore presenting the problem of our own company not for our individual benefit but because we believe it is typical of the problem that will confront many heavy machinery manufacturers.



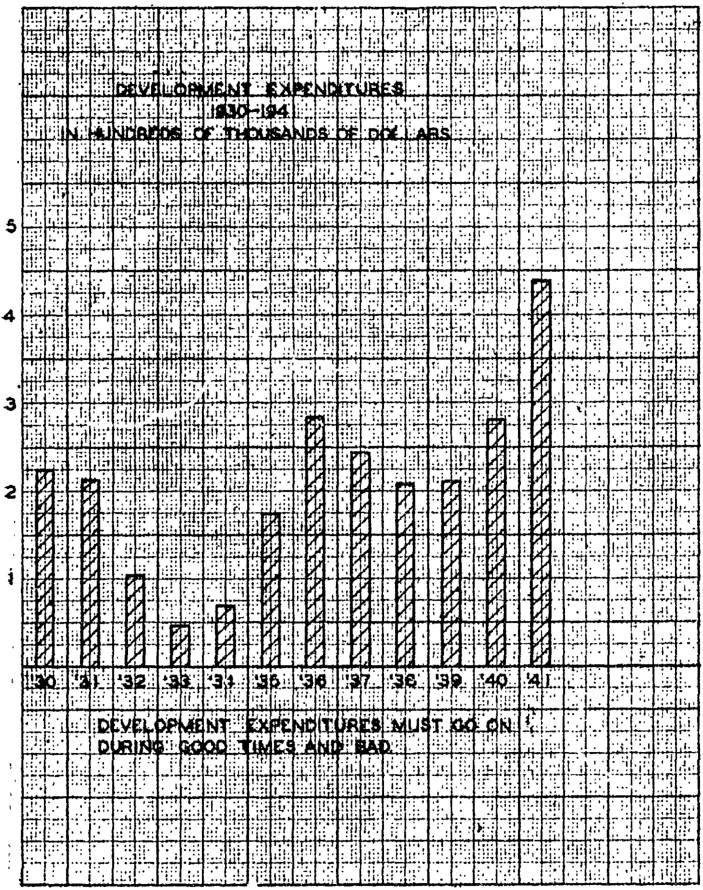
THE HEAVY MACHINERY BUSINESS IS HIGHLY CYCLICAL

The heavy machinery business runs in cycles. After the crash of 1929 it slumped radically and went to very low levels, then staged a slow come-back after the bottom was reached in 1933. The chart at the top of the opposite page shows the sales curve of this company from 1930 to 1941.

Profits also fluctuate widely

The profits of heavy machinery companies fluctuate widely. Our own business showed substantial losses for a 5-year period from 1931 to 1935 inclusive, small profits in 1936 and 1937, a loss in 1938 (due to a strike) and then increasing profits in 1939, 1940, and 1941.

Taking our net profit after taxes as per our books the combined profit and loss for the 12-year period from 1930 through 1941 was a loss of $1,406,822.



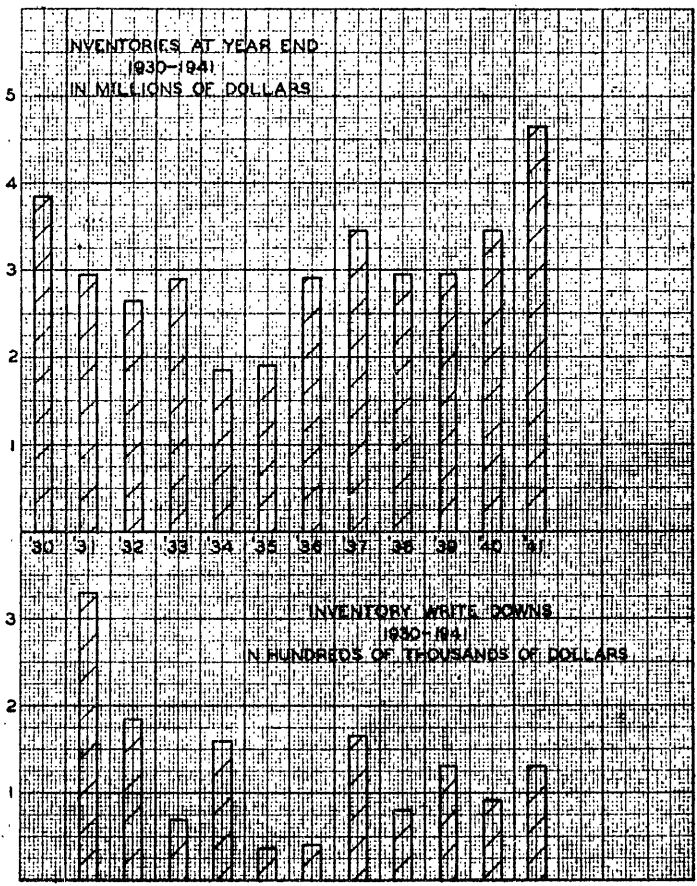
There is a wide divergence between the taxable net income reported on tax returns and the net profit per books after taxes. To show our stockholders what we consider our actual net profits to be we must deduct from the taxable net income not only the taxes but also reserves not allowable as deductions against taxes but which experience has shown to be necessary.

CONSTANT IMPROVEMENT OF EXISTING LINES AND DEVELOPMENT OF LIGHTER LINES ARE ESSENTIAL TO THE CONTINUED EXISTENCE OF HEAVY-INDUSTRY COMPANIES

Up until 1930 this company was exclusively engaged in building heavy machinery.

Though the company was incurring operating losses, we recognized that we must nevertheless spend considerable money for two general purposes.

One was the improvement and expansion of existing lines of equipment. Machine desig is can never remain static but must be constantly changed to take



advantage of new materials, new processes of manufacture, and new inventions of various kinds. In the case of this company the development of electric arc welding has made a profound change in our products. We changed the design of our traveling cranes and excavating machines from cast and riveted construction to welded construction. This required a radical change in our tool equipment and manufacturing processes and in fact in a rearrangement of our whole plant. It resulted, however, in a lighter, stronger, and better product that has saved hundreds of tons of critical materials for the war effort.

The other purpose was to develop lighter lines of equipment and articles of daily consumption in industry which are not classed as capital expenditures. We also decided to make something to sell to the general public. We knew that we had to have something to carry us along again when the heavy machinery line reached its periodical low ebb. In accordance with this policy we brought out among other things the following new lines:

Small electric monorail hoists and light cranes.
Electric arc welders.
Welding electrodes.
Prefabricated steel houses.

It is fortunate for the war effort that we developed these products. We have had to expand our capacity many times to meet the demands for these light cranes and hoists, arc welders, and welding electrodes, and all these divisions are working at full capacity.

After spending a great deal of money on the prefabricated steel house and bringing it up to a point where it began to make money, we finally were forced to give it up because of our inability to get the necessary priorities for the steel and develop a reasonable working arrangement with the unions. However, it cannot be expected that every new venture will turn out well.

As will be noted from the chart, these developments were carried on during the entire depression. We had to dip heavily into surplus to finance them.

INVENTORIES

At the present time inventories represent one of the greatest sources of potential loss to manufacturers of heavy machinery.

Due to the length of time of procurement and large volume of business, inventories of many companies in the heavy machinery line are the largest they have ever been.

Upon cessation of hostilities there will probably be an epidemic of cancelations which will leave manufacturers with large inventories purchased at high cost and materials in process and completed units fabricated at high labor rates.

Large reserves will probably be needed to safeguard against loss when the war ends. At the end of last year our company set up a reserve of $500,000 against possible future inventory price declines.

That such a reserve may be needed is shown by our own past experience. The chart on page 2243 shows that at the end of 1930 our inventory was valued at $3,870,000. At the end of 1931 we had to write this inventory down by $329,000 and at the end of 1932 by another $187,000 to bring it to its realizable value.

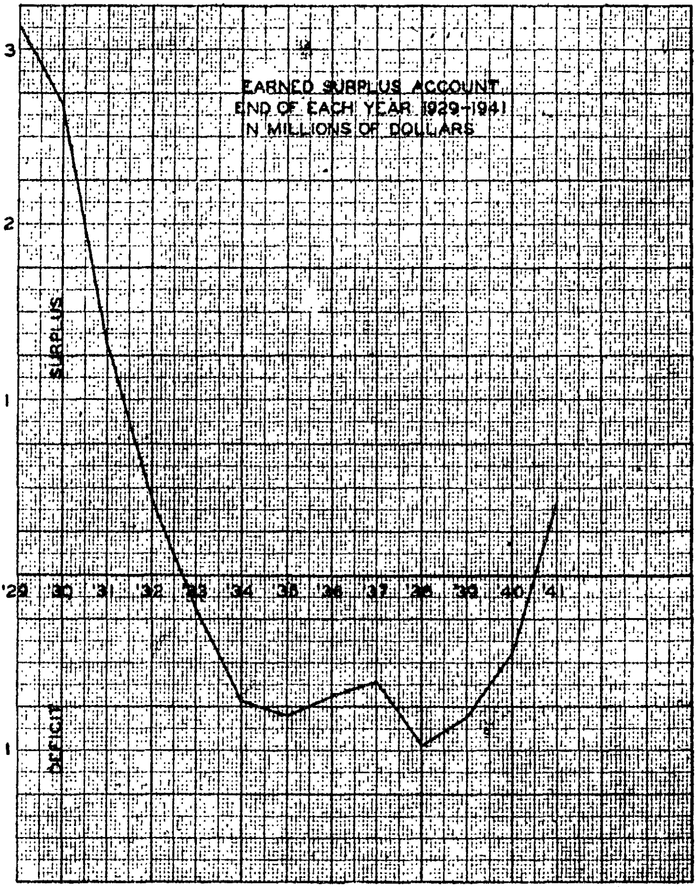
Since reserves are not deductible for tax purposes it is quite obvious that many manufacturers are paying high taxes on profits that may turn out to be only paper profits when their inventories have been liquidated.

MAINTENANCE

Many companies turning out products for the war effort are running their machine tools almost continuously with very little time out for maintenance. Furthermore many machine operators are comparatively inexperienced and as a result machine tools and other equipment will have to be thoroughly overhauled after the war. For this purpose our company has set up a reserve of $150,000.

A BUSINESS CONCERN MUST HAVE A SURPLUS TO CARRY ON THROUGH A DEPRESSION

We were able to carry on through the long depression that followed 1929 because we had been able to build up a comfortable surplus in the good years preceding.



The chart above shows how the surplus was used up and turned into a deficit by reason of inventory losses, necessary new developments, maintenance expense, and operating losses.

To show that we did not dissipate the surplus in large dividends or excessive officers' compensation, we are listing below the dividends paid and the total compensation of all officers including bonuses for each year from 1930 to 1941.

Year	Dividends paid	Total compensation of all officers	Number of officers	Year	Dividends paid	Total compensation of all officers	Number of officers
1930	$540,052.75	$47,293.56	5	1936	$113,204.25	$49,513.60	8
1931	102,051.25	33,159.94	7	1937	79,660.00	71,811.16	7
1932	None	31,582.14	7	1938	38,830.00	55,320.55	7
1933	None	26,278.76	8	1939	None	61,124.82	7
1934	None	37,140.00	8	1940	199,007.50	79,374.72	7
1935	None	34,912.00	7	1941	220,109.50	158,375.00	7

ALL OF OUR REGULAR PEACETIME PRODUCTS ARE NEEDED FOR THE WAR EFFORT

All of our regular products are vital to the war effort. Cranes and hoists are particularly necessary. In addition to the large sums we have spent on capital additions, the Defense Plant Corporation is spending approximately $600,000 for new tools to increase our capacity for building cranes by 50 percent.

We began building traveling cranes on a commercial scale in 1892. In the 47 years between then and the outbreak of the second World War in 1939 we had sold 10,589 cranes, or an average of 220 cranes per year.

From January 1, 1940, to May 20, 1942, we have sold 2,132 cranes, or an average of approximately 900 cranes per year, or more than 4 times the annual average.

Since cranes last indefinitely it is quite obvious that during these past few years we have sold most of the cranes that this country can use for the next 8 years at least.

Naturally, while operating at this high capacity our taxable net income has been high. We believe that since we are crowding most of our next 8 years' crane business into a few years because the war effort demands it, some provision should be made whereby we can recover some of the taxes now being paid after the war to help tide us over the low period that must necessarily follow.

THE TAX LAWS PROPOSED BY THE TREASURY DEPARTMENT AND ALSO BY THE HOUSE WAYS AND MEANS COMMITTEE WILL NOT PERMIT US TO BUILD UP ENOUGH SURPLUS TO CARRY ON THROUGH A PROLONGED DEPRESSION

In round figures, our taxable net income for 1941 on $20,000,000 of sales was $5,650,000.

The tabulation below shows the total Federal income taxes, including normal, surtax, and excess-profit taxes, and the amount remaining for dividends, reserves, and surplus under the 1941 laws, and the amounts that would remain under the Treasury Department proposal, and the House Ways and Means Committee proposal.

	Total Federal taxes	Balance available for dividends, reserves, and transfer to surplus after all State and Federal taxes
1941 law	$3,773,000	$1,877,000
Plan recommended to Ways and Means Committee by U. S. Treasury Department, including 55 percent combined normal and surtax and excess-profits tax graduated from 50 to 75 percent	4,761,000	889,000
Plan proposed by House Ways and Means Committee, using 90-percent excess-profits tax then 24-percent normal and 21-percent surtax	4,816,350	833,650

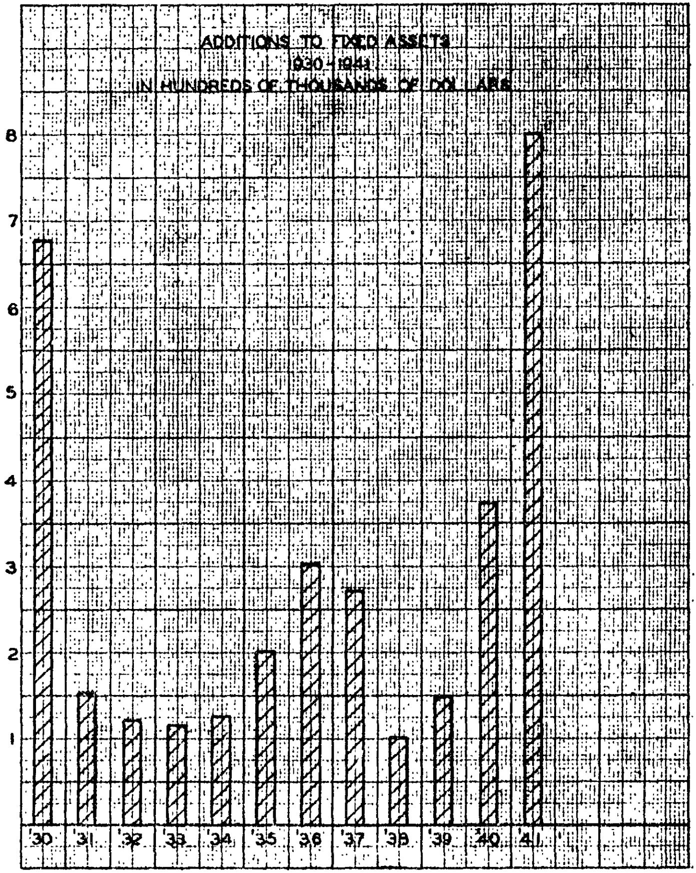
We are not protesting against the amount of the taxes which we paid on 1941 income although after necessary reserves we had a net income of $1,094,000, according to our books, or approximately 5 percent of our sales.

We recognize the need of the Federal Government for very high taxes but we are sure that the proposals of the Treasury Department and of the House Ways and Means Committee are so high that they will not permit the setting up of sufficient reserves to carry companies like ours through the post-war period.

During the last depression we created employment for labor by our development program and deferred maintenance work. We think that after this war is over the necessity will again arise and believe that we can provide employment at useful work at much lower cost than the Federal Government can with Works Projects Administration or Public Works Administration work.

You will note from the chart on the opposite page that we spent large sums for additions to fixed assets all through the last depression. We will do so again when this war is over, if we are left with sufficient liquid resources.

HARNISCHFEGER CORPORATION,
Milwaukee, Wis.



The CHAIRMAN. Mr. Harry M. Rider.
(No response.)
The CHAIRMAN. Mr. Arthur Johnson.
How much time do you desire, Mr. Johnson?
Mr. JOHNSON. Seven minutes. I just want to read this statement.
The CHAIRMAN. Very well, you may proceed.

STATEMENT OF ARTHUR L. JOHNSON, WASHINGTON, D. C., NATIONAL EXECUTIVE AND LEGISLATIVE SECRETARY, GENERAL WELFARE FEDERATION OF AMERICA

Mr. JOHNSON. Mr. Chairman and gentlemen of the committee, I deeply appreciate the privilege of being allowed to present the tax views of the General Welfare Federation of America at this hearing. I shall take but a few minutes of your very valuable time.

I merely want to call your attention to the gross-profit or "value added" tax as a potential source of revenue if other sources are found to be insufficient to raise what is considered necessary in this greatest crisis ever to face our Nation.

By gross profit or "value added" I mean whatever one has taken in over and above the cost of the material or property sold. If no material or property is involved then the entire amount taken in is, of course, gross profit under the tax we propose.

We feel that in addition to the cost of the thing sold there should be a deduction of the first $80 per month, or $960 per year, from gross income so as not to tax the purchasing power of the very poor and so as to cut down on the number of taxpayers who would be liable for very small amounts each quarter.

We feel that the tax could be collected quarterly along with the social-security tax, thus avoiding the complicated withholding tax and installment payments. The quarterly collection has worked no hardship in the case of social-security taxes and the tax we propose is just a little broader than the pay-roll tax, as it reaches just a few items over and above the pay-roll cost.

The successful operation for over a 5½-year period of the pay-roll tax system constitutes a precedent approved by your committee and established by Congress for the somewhat broader tax we propose along this line.

This broader tax, extended to all in America over the $960-a-year class, would be a much more acceptable and much more equitable tax than the proposed sales tax, which would have its main and direct impact upon the poor.

We ask you to consider our proposal as a compromise that might satisfy all factions in this matter of raising the sorely needed revenue for our war effort—for our all-out effort to survive and preserve all that we hold dear in life.

We also ask you to consider it as a possible base for the universal social-security system that is to come when the world is free. Some just method must be devised of assessing all the annuity premiums that will be necessary under such a system, and we feel that we have worked out such a method in our 5½-year study of the problem, during the course of which we have improved upon this tax base to the extent that we have overcome every objection raised to it by the experts called by the House Ways and Means Committee.

We do not say that this tax base is perfect, as no tax can be devised that will not meet with objections from some source, but we do claim that it is just, that it is based on sound tax principles, and that it will yield a stable and enormous revenue.

One of its features is that it never taxes a person who has not taken in sufficient revenue with which to meet the levy.

Another feature is that it forces all who use the public market to pay their fair share of the cost of government. The net income tax reaches just the man who makes a net profit and forces him to carry the tax load for a competitor who may sustain a net loss because of chiseling tactics of the worst sort and yet has had the same protection and service from Government as the man who carries his tax load for him. We trust that you will give this angle to the case some thought in your efforts to levy a just tax upon the Nation.

We want it distinctly understood that we are fundamentally opposed to a gross income, gross receipts, turn-over, or transaction tax. We feel that such a tax is many times more vicious than a sales tax, as it taxes the goods not only on the final sale, as a sales tax does, but every time the goods change hands, going clear back to production. It is nothing more or less than a snowballing or pyramided, multiplied, magnified, or glorified sales tax under another name; that is, it is a tax upon tax upon tax on the same product.

The distinction between the gross income tax and the gross profit or "value added" tax which we propose is that we never tax the goods themselves but just the mark-up, commission, or value that has been added by the handling of the goods by the particular taxpayer.

If, for instance, a man buys a house for $9,500 and sells it for $9,000, we would levy no tax on the $500 loss, as the advocates of a gross-income tax would. If, however, he sells the house for $10,000 and makes a $500 commission, we would tax him on this mark-up or "added value."

It is the simplest tax that could be devised, as all one would have to do would be to subtract the cost of materials from his gross revenue, then deduct $240 as a basic exemption for the quarter and pay the tax on the balance.

The tax could be dovetailed into the social-security system by the simple expedient of giving a tax credit to any employer or employee for any tax paid to the Federal Government under any retirement annuity system.

The cost of collection would be small, as about 50,000,000 people are already paying social-security taxes each quarter in the manner that we propose, and it would take but very little enlargement of the system to collect a somewhat similar tax from the remainder of the people of the Nation earning enough to be liable as direct taxpayers.

As to the probable tax yield, we feel that it would bring in about $6,000,000,000 per year if levied at a 3-percent rate. If levied at a 5-percent rate it would make about $8,000,000,000 directly available for war purposes and leave $2,000,000,000 that could be set aside for social security after the war is over and used in the meantime for war purposes.

In this connection, Mr. Chairman, I would like permission to file for the record a table giving our figures as to the probable tax yield of the tax we propose, also two tables showing the inequities that would arise if a gross income tax were levied, as well as a table showing just how a gross-profit or value-added tax would operate.

The CHAIRMAN. You may file them.

Mr. JOHNSON. I want to add, in closing, that a tax base such as we propose has met with favor on the House side to the extent that I have here in my hand the actual signatures of 175 Congressmen to a resolution urging it as a tax base for an extended social-security system such as is proposed by the General Welfare Act, H. R. 1410, introduced by Congressman William H. Larrabee, of Indiana. This is the document to which I refer. It consists of seven pages—7 feet of Congressional signatures.

Senator BARKLEY. Why didn't some of them think of that when this bill was before the House?

Mr. JOHNSON. We presented the matter to the Ways and Means Committee and a number of them have urged it, and they are joining with me in appearing here today to request the consideration of it over here.

Senator BARKLEY. Was your proposal submitted to the Ways and Means Committee?

Mr. JOHNSON. Yes, sir; it was, but it was not gone into fully. This whole matter was gone into very thoroughly 3 years ago by the House Ways and Means Committee at the time they had their hearings on social security, at which hearings the gross income tax was definitely proved unsound, and the tax experts called by the committee not only advocated but suggested the gross profit, or value added tax as a tax for general purposes.

Senator BARKLEY. Are any of these signatories members of the Ways and Means Committee?

Mr. JOHNSON. Yes, sir; there are five of them.

Senator BARKLEY. Very well.

Mr. JOHNSON. This indicates that the tax would meet with considerable favor on the House side as a compromise tax base, as but 43 more would be needed to have a majority of the House committed to this tax base. We hope therefore that your honorable committee will give serious consideration to this proposed gross profit or "value added" tax base.

I thank you.

The CHAIRMAN. Thank you very much. That completes the list, unless someone has come in here whose name was previously called and who did not respond.

Mr. JOHNSON. I will hand the reporter the tables which I understand are to be in the record with my statement.

The CHAIRMAN. They comprise just one page?

Mr. JOHNSON. It is all on one page.

The CHAIRMAN. You may file them.

(The tables referred to are as follows:)

EXHIBIT 1.—*Tax table showing inequities in taxing materials in addition to gross profit or "value added"*

[BASIS: In each case it is assumed that the man paying the tax has earned $10,000 per year over and above the cost of any goods or property he sold]

Nature of tax	Labor only taxed (tax where no goods or materials involved, as in the case of an attorney. Added value $10,000).	Inequity illustrations in cases where labor plus materials taxed		
		Case No. 1.—Goods sold cost $15,000, or 60 percent of total gross income of $25,000. Added value $10,000.	*Case No. 2.*—Goods sold cost $90,000, or 90 percent of total gross income of $100,000. Added value $10,000.	*Case No. 3.*—Goods sold cost $990,000, or 99 percent of total gross income of $1,000,000. Added value $10,000.
General Welfare Federation tax: Tax of 2 percent on "added value or gross profit (gross income less cost of materials, goods or property sold), less first $900 per year.	$180.80, or 1.8 percent of added value or real income.	$180.80, or 1.8 percent of added value or real income.	$180.80, or 1.8 percent of added value or real income.	$180.80, or 1.8 percent of added value or real income.
Full gross income tax: Tax of 2 percent on gross or total income, including cost of materials or goods sold.	$200, or 2 percent of added value or real income.	$500, or 5 percent of added value or real income.	$2,000, or 20 percent of added value or real income.	$20,000, or 200 percent of added value or real income.

EXHIBIT 2.—*Table showing how a gross income tax levy would tax a loss*

[BASIS: A real-estate man buys a house for $9,500 and sells it at the price indicated]

Nature of tax	Selling price $9,000—Loss of $500	Selling price $10,000	
		Gain of $500	Tax of—
General Welfare Federation tax (2 percent)	None	$10	2 percent.
Full gross income tax (2 percent)	$180	200	40 percent.

NOTE.—It is unsound and grossly inequitable to tax a loss in any case. An added value tax never taxes a loss, as there is no added value in the case of a loss. It is true that a man may be taxed under it whether he makes a net profit or not (after paying his operating expenses), but it must be remembered that he has had just as much protection and service from the Government as has the man who makes a net profit. It is but fair that he be taxed, otherwise he gets the services of the Government free of charge and the successful businessman pays the tax for his unsuccessful competitor, who may have sustained the loss through chiseling tactics or unfair trade practices of the worst sort. A net-income tax puts a double load on the successful businessman, whereas a tax on value added taxes all in proportion to the use made of the public market.

EXHIBIT 3.—*Federation's estimate of tax yield of a gross-profit tax*

[Estimate based on best available U. S. Government statistics for year 1930]

Group	Gross income	Cost of materials	Taxable balance
Manufacturing	$56,828,807,223	$32,118,242,488	$24,710,564,735
Retail sales	42,039,138,000	27,325,439,700	14,713,698,300
Wholesale sales	55,265,640,000	46,975,794,000	8,289,846,000
Real estate, including rentals	48,000,000,000	20,400,000,000	27,600,000,000
Construction	8,000,000,000	4,000,000,000	4,000,000,000
Service establishments	22,970,000,000	250,000,000	22,720,000,000
Agriculture	9,620,000,000	1,520,000,000	8,100,000,000
Forest products	100,000,000	65,000,000	35,000,000
Mining (except petroleum)	3,500,000,000	1,400,000,000	2,100,000,000
Petroleum	3,000,000,000	1,000,000,000	2,000,000,000
Fisheries	50,000,000	10,000,000	40,000,000
Tanneries	50,000,000	30,000,000	20,000,000
Electric light, power and gas	3,000,000,000	400,000,000	2,600,000,000
Transportation	6,000,000,000		6,000,000,000
Communications	1,400,000,000		1,400,000,000
Finance	100,000,000,000	80,000,000,000	20,000,000,000
Wages and salaries	60,000,000,000		60,000,000,000
Interest and dividends	10,000,000,000		10,000,000,000
Inheritances	9,000,000,000		9,000,000,000
Gifts	4,000,000,000		4,000,000,000
Miscellaneous	25,000,000,000	5,000,000,000	20,000,000,000
Total	467,823,585,223	220,494,476,188	247,329,109,035
Exemption of first $80 per month ($960 per year) income			42,329,109,035
Total taxable gross profit or value added			205,000,000,000
5-percent tax on this would bring in			10,250,000,000
Estimated cost of administration (a little over ½ of 1 percent or $5,000,000 per month)			60,000,000
Net tax yield (per year)			10,190,000,000
Directly available for war purposes			8,190,000,000
Balance for social security, indirectly available for war purposes			2,000,000,000

EXHIBIT 4.—*How "value added" tax would operate*

[In a typical establishment subject to Social Security Act (such as the General Welfare Federation of America)]

Total gross income per year	$12,000
Less cost of material or products sold (publications)	6,000
Value added or gross profit	6,000
Less first $80 per month	960
Balance that is taxable	5,040
5 percent new tax would yield	252
Less credit for Social Security Act tax of 2 percent (1943) on $5,000 pay roll	100
Total new yield for war purposes	152

[For a typical individual now under Social Security Act (like Secretary Johnson)]

Total gross income per year, at $50 per week	$2,600
Less cost of material	None
Value added or gross profit	2,600
Less first $80 per month	960
Balance that is taxable	1,640
New tax at 5 percent	82
Less credit for Social Security Act tax of 2 percent (1943) on $2,600	52
Total new yield for war purposes	30

[For a typical individual not now under Social Security Act (like Reverend Smith or Attorney Jones]

Total gross income per year, at $50 per week	$2,600
Less cost of material	None
Value added or gross profit	2,600
Less first $80 per month	960
Balance that is taxable	1,640
New tax at 5 percent	82
Earmarked for his own social security, at 2 percent on $2,600	52
Total new yield for war purposes	30

Mr. INGEBRETSEN. Mr. Chairman, I requested an opportunity to be heard later this morning. My name is James C. Ingebretsen, and I am the Washington representative of the Los Angeles Chamber of Commerce. If my name was called, I was not in the room.

The CHAIRMAN. Do you wish to be heard now?

Mr. INGEBRETSEN. Very briefly—about 1 minute.

The CHAIRMAN. We will be glad to hear you for a minute. We did want to close the hearings at the earliest possible moment.

STATEMENT OF JAMES C. INGEBRETSEN, WASHINGTON REPRESENTATIVE, LOS ANGELES CHAMBER OF COMMERCE

Mr. INGEBRETSEN. I am the attorney and Washington representative of the Los Angeles Chamber of Commerce. We have certain recommendations to make to your committee. Since they have been made to you by many other business groups and have been supported by elaborate arguments, I will state them very briefly and ask permission to include with my remarks about a five-page summary of our arguments in support of the proposals.

First, that a provision should be included in the bill for a Federal retail-sales tax to be levied uniformly without exemptions except for direct Federal, State, and local governmental purchases. We think the rate for that tax should be made high enough at the outset so as to produce not less than the difference between the amount requested by the Treasury and the amount raised under the House bill.

Second, we think the excess-profits provisions of the bill should be fixed low enough so that they will not destroy the incentive to produce. We think that relief provisions incorporated in the House bill should be retained so as to minimize the inequities which would otherwise result.

Next, we think that if you find it necessary or desirable to include some form of post-war credit in the tax bill in connection with your excess-profits tax provisions, that there should be no restrictions upon the use of those credits after the war.

The CHAIRMAN. You may file your statement if you wish.

Mr. INGEBRETSEN. I will; thank you, sir.

(The statement of the Los Angeles Chamber of Commerce referred to is as follows:)

RECOMMENDATIONS OF THE LOS ANGELES CHAMBER OF COMMERCE UPON THE 1942 REVENUE BILL

The Los Angeles Chamber of Commerce, by action of its board of directors, makes the following recommendations with respect to H. R. 7378, as passed by the House of Representatives:

1. RETAIL SALES TAX

Provision should be made for a Federal retail sales tax to apply uniformly, without exemptions, except for direct Federal, State, and local governmental purchases.

2. EXCESS-PROFITS TAX

(*a*) The excess-profits tax should be fixed low enough that it does not destroy the incentive to produce; relief provisions to minimize inequities, should be provided.

(*b*) Our best guess is that 80 percent is about as high an excess-profits rate as can be levied without actually impairing the war effort, except that with a post-war credit of amounts in excess of that figure, the rate might be as high as 90 percent.

(*c*) If the post-war credit is used, it should be in the form of Government bonds, nonnegotiable and non-interest-bearing during the war, but negotiable and interest-bearing after the war, and having fixed maximum maturity dates. There should be no restrictions upon the use of post-war credits.

COMMENTS

Retail sales tax.—The suggestion of a retail sales tax is made only because of the urgent necessity of obtaining additional revenues for war purposes and because such a tax, by acting as a levy upon spending and by absorbing purchasing power, would be a deterrent to inflation.

Even under the personal exemptions and rates provided by the House measure, a high percentage of the national income will entirely escape taxation for war purposes. According to the statements made by the Treasury last year, normal and surtaxes in the higher income brackets have approached, if not exceeded, the point where higher levies will, in the long run, continue to produce more revenue. In the small and medium brackets, recent and proposed tax increases are sufficiently heavy to require a substantial readjustment of living habits. Nonetheless, the amount of the anticipated revenues is wholly inadequate for the war effort. It is, therefore, imperative that new tax sources be found.

Notwithstanding its so-called regressive feature, i. e., its disproportionately heavy effect upon those with small incomes, no suitable substitute except possibly a manufacturers' excise or withholding tax appears to be readily available. It should be pointed out, moreover, that the exceedingly heavy levies upon taxpayers in high and medium income brackets largely offset any theoretical discrimination against individuals with lower incomes.

If used by the Federal Government, the sales tax would divert into the Treasury large amounts of war generated and other spending which otherwise cannot readily be reached and, at the same time, would offer no insuperable problems of collection.

It is believed that the sales tax should apply uniformly and without exemptions except in the case of sales direct to governmental agencies. The rate should be high enough, at the outset, to produce not less than the difference between the amount raised under the House bill and the sum requested by the Treasury.

Excess-profits tax.—There seems to be no clear-cut sentiment either in favor of a high excess-profits tax and some form of post-war credit or, alternatively, a somewhat lower tax and no credit. Sound arguments can be made for either procedure. Whatever decision is finally reached, however, should be predicated upon the necessity both of leaving reasonable incentive for top-notch efficiency in war production and assuring the preservation of the business structure for post-war reconstruction. In our judgment, it does not seem that the excess-profits rate should exceed 80 percent unless some form of post-war credit is to be made of amounts in excess of that figure, and in no case should the total figure exceed 90 percent, if the above-mentioned objectives are to be met.

In suggesting the maximum limits to which the excess-profits tax might go, it is contemplated that provisions contained in the House bill and currently under discussion before the Senate Finance Committee will, of course, be included to minimize the numerous types of hardship which result from taxes of this magnitude.

The idea of a post-war credit with restrictions upon the use of such credit after the cessation of hostilities, has been supported in some quarters. In our judgment, it would be a serious mistake to tie any strings upon individual businesses in the use of moneys received in the form of post-war credits. Apart from the opportunities that would be afforded to exercise governmental control over the policies of individual business institutions, restrictive clauses upon the use of post-war credits would also needlessly complicate the operations of those concerns which were endeavoring to reestablish peacetime production or to discontinue activities which may have no place in the peacetime economy.

If some form of post-war credit is to be adopted, it is believed the credit should be in the form of bonds which would be nonnegotiable and non-interest-bearing during the war, but, after the war, would become negotiable and bear a stated maximum rate of interest and definite maturity dates.

AUGUST 12, 1942.

The CHAIRMAN. Are there any others whose names have not been called, or who have not previously responded?

Mr. DRIESEN. I represent Mr. Joseph Selby, of the American Communications Assocation, whose name was called, as I understand, previously.

The CHAIRMAN. Yes. Do you wish to make a statement in his stead?

Mr. DRIESEN. Yes, Mr. Chairman.

The CHAIRMAN. Proceed.

STATEMENT OF DANIEL DRIESEN, REPRESENTING AMERICAN COMMUNICATIONS ASSOCIATION, CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. DRIESEN. I am the international representative of the American Communications Association, affiliated with the Congress of Industrial Organizations.

The American Communications Association, C. I. O., is a union of workers engaged in a vital war industry—communications. At sea many of our members have gone down to the bottom, remaining at their posts in the radio shacks of the vessels, sending distress signals. On land our members employed in the telegraph and radio offices throughout the country are exerting every effort to "get the message through."

Our union, adopting the recommendations of Donald Nelson, of the War Production Board, has evolved a production program which if adopted will avert an impending bottleneck in the communications industry. Victory committees, initiated by our union, composed of management, labor, and representatives of Government in almost every major city in the United States, have met and adopted many proposals which have speeded production in the communications industry.

At our convention in April, a resolution adopted on production and a balanced war-time economy stated the following with regard to taxation:

> Wars must be paid for. Economic stabilization requires a tax program based on equality of sacrifice and ability to pay—a tax program which will prevent scandalous war profiteering. Necessary features of this program are the enactment of the principle embodied in the projected United States Treasury tax program calling for excess-profits taxes and higher income taxes in the upper brackets and the defeat of the program of the National Association of Manufacturers for wage and sales taxes to place the burden of the war on labor and farmers.

President Roosevelt has enunciated a seven-point program to achieve this end. Our union wholeheartedly supports this seven-point program. We believe that the following specific measures must be enacted in the taxation legislation being considered by this committee to fulfill this objective:

1. Increases in individual income-tax rates, particularly in the range above $3,000, should be made.
2. Excess profits must be eliminated.
3. The loopholes provided for the protection of special privileges, such as tax-exempt securities, must be eliminated.
4. There must be a limit of $25,000 on net personal income.

We must reject any proposals to raise income through sales taxes, the burden of which falls almost entirely on the lowest income groups.

I just want to quote a sentence from the Nationwide broadcast of Mr. Reid Robinson, vice president of the C. I. O., on the 1942 tax bill, as follows:

> Why are the Congress of Industrial Organizations and all responsible Government agencies opposed to the sales tax? Because it is the most undemocratic, unfair, and unsound system of taxation yet devised. It makes the poor man pay the same tax on the things he buys as the rich man. It takes food and other basic necessities away from the people who can least spare them. An 8 percent sales tax, as proposed by the National Association of Manufacturers, would take about 6 weeks' groceries out of the food budget of the average worker. Now, how is that deficit going to be made up? By eating less? By going without the food and other needs that workers must have to keep on working for victory? Nothing more harmful to the victory effort could be done than this—take away food that workers and farmers need to be able to produce at top efficiency.

The victory in this war depends upon soldiers in production as well as upon soldiers in the battlefield. These production soldiers must receive enough for themselves and their families to produce the material of war. We must have a taxation program which does not hinder America's ability to produce.

Mr. ARTHUR MOHR. Mr. Chairman, I desire to be heard for just a few minutes.

The CHAIRMAN. How long?

Mr. MOHR. Five minutes at the outside. I am an attorney at law from Los Angeles, Calif., and represent an association operating pinballs and other games. Mr. Robinson here is the executive vice president and I am the attorney for the association.

Senator BARKLEY. Are you against the tax?

Mr. MOHR. We are.

The CHAIRMAN. You may make a statement, briefly.

STATEMENT OF ARTHUR MOHR, ATTORNEY, AND SAMUEL ROBINSON, EXECUTIVE DIRECTOR, ASSOCIATED OPERATORS OF LOS ANGELES COUNTY, INC., LOS ANGELES, CALIF.

Mr. MOHR. Under the Internal Revenue Code, section 3267, as amended at the last session of the legislature, a tax of $10 was put on pinball games. Unfortunately the Internal Revenue has ruled that pinball games operated in a certain manner are chargeable at the rate of $50——

Senator CLARK (interposing). As gambling machines.

Mr. MOHR. That is a new interpretation put on about the 1st of July of this year.

Senator CONNALLY. Are they gambling machines?

Mr. MOHR. They are not. In the State of California, we have decisions from the court in which free plays are ruled to be amusement games, and therefore do not violate the penal code of the State of California, nevertheless it has been ruled that they are taxable at $50. That means that practically 90 percent of the pinball games will be put out of business in the State of California and instead of receiving $6,500,000 in revenue——

Senator CONNALLY (interposing). Is it a skin game or a pin game?

Mr. MOHR. A pinball game. This is a serious matter to us. What we desire is that section 3267 (d) (1) be amended to read as follows:

> So-called pinball or other similar amusement machines of whatever kind or nature and which are operated by the insertion of a coin, token, or similar object, whether used for purposes of amusement or any other manner—

and leave the States to decide whether or not they should eliminate them. If that is put in, you will get a $10 tax from each and every machine regardless of how it is operated, because a pinball machine is a machine which can be operated in one manner or another, just the same as a deck of playing cards can be operated for gambling or amusement. Let the States decide as to how they should be regulated.

Mr. Robinson has here a list of other games which would come under the same category and which are not taxed at the present time and which would produce a revenue to the Federal Government of approximately $40,000,000, and those are not taxed at this time. The taxes from the amusement devices have rendered to the Government $6,500,000 last year. I think the committee is interested in getting that and knowing just how they can get another $34,000,000.

Senator BARKLEY. What sort of machines are these that you run into as you go along the highway on the edge of town at a restaurant, with two or three rooms with men and women playing there. What are they? Are they pinball games?

Mr. ROBINSON. Ours is a most serious mission, I assure you.

Senator BARKLEY. I am serious in this question, because I happened to drive over a territory of three or four hundred miles the other day, and wherever I stopped to get a drink of Coca-Cola or a ham sandwich, great crowds of men and women were playing them, and somebody said they were gambling devices, although I did not go close enough to see what they were.

Mr. ROBINSON. What States were these in?

Senator BARKLEY. Indiana and Kentucky. And I was told that those machines could bear a tax of $1,000 and still operate.

Mr. ROBINSON. Those are amusement devices, mostly.

Senator BARKLEY. They must have been very amusing, judging by the number of people that were crowded around them.

Mr. ROBINSON. In California there is a penal code prohibiting gambling. In Nevada, though, they license gambling of all natures and all kinds of devices. The consideration that must be taken regarding these devices is as to their cost, their life, and their earning capacities. The Internal Revenue Department itself has ruled that pinball amusement games have a life of approximately 6 months, and you are allowed to write it off on your income-tax return.

There is the slot machine, the automatic pay-out game and the amusement device known as the marble game that has been ruled legal in the State of California. Rightfully you have taxed the slot machine $50. We have none of those things in California unless they are in places where they should not be. The automatic game which returns your money as you play the machine, that has rightfully been ruled as $50.

Senator BARKLEY. It may return your money?

Mr. ROBINSON. It will return your cash. It automatically delivers your premiums, tokens, or cash.

Senator BARKLEY. Now and then.

Mr. ROBINSON. Now and then.

Senator BARKLEY. Usually then.

Mr. ROBINSON. Possibly.

The amusement device known as the marble machine amusement, that returns nothing but it has a continuous play of the machine itself, and has what is termed as free plays, and free plays only, automatically you keep on playing the machine, without inserting any extra coins, and that has been ruled by your body, I presume, in the $10 category. Unfortunately, the Internal Revenue Department has ruled overnight that these machines were under the category of $50, which has worked a hardship upon the operators, the men who have these machines, and the locations that derive a small amount of income from these machines.

It is needless for me to tell you that the small, wayside inn is slowly going out, and these have been the mainstay of the small business there. It is not a big business enterprise.

In Los Angeles County we have approximately 4,800 of these games running. We have been complimented by the Internal Revenue in the manner in which we have cooperated with them in the proper interpretation of the law. Unfortunately, they were not coin-machine-minded. Take Skee balls, where you manually throw a ball and register scores upon a blackboard. Possibly some of you gentlemen have seen them. There is no tax on them, and that is unfair.

There is the rapid-fire gun, the pistol range, the airplane, the submarine chaser—there is no tax on them.

Definitely, in my humble opinion, we can show you gentlemen where approximately $30,000,000 more can be derived from these different contraptions of coin-machine automatic devices, phonographs, wired music, wall boxes, machines which you have ignored completely—and punch cards which in the last war you had a 10-percent excise tax on and quite a few million dollars derived from them.

We are here primarily to seek relief as to the proper interpretation of this law and also to give you gentlemen some idea of where more moneys can be obtained by the Federal Government by the proper taxation of these devices and place them in their appropriate custody. If we can help on that, we have done our mission.

The CHAIRMAN. Have you a list of those you think should be taxed?

Mr. ROBINSON. Unfortunately not. We were supposed to be here yesterday, but I was unfortunately taken sick on the way. We could make up a list.

The CHAIRMAN. Please make up the list and hand it in to the clerk and we will be glad to consider it.

Mr. MOHR. And the proper interpretation of the law.

The CHAIRMAN. Yes.

Mr. MOHR. Thank you, sir.

(The following statement was submitted by Mr. Mohr:)

WASHINGTON, D. C., *August 14, 1942.*

Honorable COMMITTEE ON FINANCE,
United States Senate, Washington, D. C.

MR. CHAIRMAN AND GENTLEMEN OF THE SENATE FINANCE COMMITTEE: Pursuant to committee hearings this morning with regard to the proposed new tax levy on coin-operated machines, the purpose of which is to amend section 3267 of the Internal Revenue Code of 1941 act, the undersigned witnesses hereby give you a brief résumé of the effect of the new proposed amendment to this section upon novelty pinball games.

The proposed amendment originating in the House of Representatives, in the Revenue Act of 1942, known as section 617, "Coin-operated amusement and gaming devices" which amends section 3267-(b) of the Internal Revenue Code, giving the definition of pinball and gaming devices, will automatically place in clause 2 of said act the hundreds of thousands of pinball games in operation throughout the country, and thereby subject them to a $50 annual tax as a gaming device.

Your witnesses testified before your committee this morning stating that they represented the operators and merchants in whose business establishments these games are operated throughout the State of California. The cost of these pinball games averages approximately $140. They have a life span of approximately 4 months and an income not exceeding $12 per week, and in many cases much less. The merchants in whose establishments these amusement games are located have come to depend upon them as a trade stimulus, and to subject the owner of the establishment to the payment of a $50 tax with a correspondingly minute profit as stated above, would practically eliminate this source of revenue from the merchant and put the operators of these machines out of business.

By reason of close cooperation of the owners and operators of these devices, the Treasury Department in the fiscal year of 1941–42 realized some 6½ million dollars in revenue based upon the special tax under section 3267 of the Internal Revenue Code. To place a $50 tax upon the pinball machines would eliminate fully 90 percent of those devices from operation and would thereby correspondingly reduce the annual income derived therefrom. It is a well-known fact that the comparative earning power or capacity of pinball games is about 5 percent of that of a gaming device, commonly known as a slot machine, and to put them on the same level of tax would be highly inequitable.

Your witnesses therefore proposed that an amendment to section 3267 (b) of the Internal Revenue Act be enacted as follows:

"SEC. 3267 (b). As used in this part, the term 'coin-operated amusement and gaming devices' means (1) so-called pinball and other amusement machines, of whatever kind or nature, which are operated by the insertion of a coin, token, or similar object, whether used for the purpose of amusement or in any other manner; and (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. 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 retail value, or entitles a person to receive a prize of a retail value of more than 15 cents, shall be classified under clause 1 instead of clause 2.

"Coin-operated counter games, incorporating amusement or gaming features, which entitle persons playing to receive merchandise prizes, not exceeding in value one package of cigarettes, shall be classified under clause 1—rate $10 annual tax."

The Internal Revenue Bureau has recently ruled that the operation of pinball games or machines which entitles the player to receive compensation for unused free games, such games are taxable under the classification of gaming devices and, therefore, at the rate of $50 per machine per year. Since section 3267, subsection B, clause 1, of the Internal Revenue Act, appears to be ambiguous as to the exact meaning of a pinball machine, and, by implication, would seem to tax, not the physical characteristics of the game, but the use or operation of the same, which in our opinion is contrary to the intent of the lawmaking body, we respectfully suggest that to overcome any further confusion as to the use or characteristics of the game, that the foregoing amendment be adopted.

The obvious reason for enacting these special revenue statutes, is for raising finances with which to meet the war effort; your witnesses therefore suggest that appropriate legislation be adopted to cover the following devices which also are amusement games and that they be taxed at the rate of $10 per unit so that the revenue derived therefrom will augment the Treasury Department to the extent of approximately $40,000,000.

For the purpose of illustration, hereunder is a schedule compiled as of December 31, 1941, showing the various games which could be taxed, and are in operation in the United States.

	Number in operation	Proposed rate of taxation
Amusement (pinball) games	250,000	$10
Counter amusement devices	600,000	10
Jackpot slot machines	(1)	50
Console amusement games	200,000	50
Miscellaneous amusement machines	100,000	10
Automatic phonographs	400,000	10
Cigarette-vending machines	128,500	5
Beverage-vending machines	28,000	5
Candy-bar vendors	250,000	3
Penny vending machines	3,000,000	3
Miscellaneous vending machines	25,600	3

[1] No estimate.

With regard to the phonographs listed above, of which there are approximately 400,000 in operation throughout the country, cognizance should also be taken by your committee of what is known as "wall boxes" and "wired music" so that the maximum returns can be derived by reason of their operation without throwing the burden upon other amusement machines.

In conclusion we would again urge your honorable committee that in order to derive the greatest income from these sources that an amount consistent with the ability to pay be exacted rather than an arbitrary and confiscatory amount. The pinball machines are at the present time subjected to a county and municipal tax as well as a Federal tax and an aggregation of all of them is far in excess of our ability to pay the same. Consequently we urge upon the gentlemen of the Senate Finance Committee to recommend the adoption of the proposed amendment so that the pinball games may remain in the category of the $10 amusement tax classification, and at the same time preserving the businesses of thousands of roadside and small merchants who would be fatally affected were amusement machines to be withdrawn from their establishments by reason of inability to pay these taxes.

Respectfully submitted.

SAMUEL ROBINSON,
Executive Director, Associated Operators of Los Angeles County, Inc., Los Angeles, Calif.
ARTHUR MOHR,
Attorney for the Corporation.

The CHAIRMAN. I believe that completes the public hearing. The witnesses who have not appeared are only one or two this morning.

Now we will ask the members of the press and the witnesses to please let us use the room. Retire as quickly as possible, because we have one matter we wish to discuss in executive session.

(Whereupon, at 1:10 p. m., the committee went into executive session, after which the record was completed as follows:)

The CHAIRMAN. Senator Connally desires placed into the record the following memorandum regarding estate taxes on community property.

(The statement referred to is as follows:)

MEMORANDUM SUBMITTED IN BEHALF OF COMMUNITY TAXPAYERS, IN RE SECTION 402, SUBSECTION (G) (4) OF SECTION 404, AND SECTION 453

ESTATE TAXES ON COMMUNITY PROPERTY

There are three new sections in H. R. 7378 relating to community property which ignore local State property laws in the community property States and grossly discriminate against the rights of community taxpayers.

The three sections are:

Section 402, on pages 251 and 252 of the bill relating to the estate tax on community interests.

In section 404, subsection (g) (4), on page 258 of the bill; this subsection (4) relates to life insurance in cases where the insurance premiums are paid from community property.

Section 453, subdivision (e), on page 277 of the bill, relates to gifts from community property and enacts that all such gifts shal be considered gifts made by the husband.

All three of these new sections were evidently incorporated at the time when it was thought that the bill as a whole would require mandatory joint returns by husbands and wives throughout the entire United States. Although it is difficult for us to see under what theory these three sections were placed in the bill in connection with mandatory joint returns, in any event they surely have no rightful place in the bill since the elimination of the Nation-wide joint-returns provisions.

We proceed to discuss briefly the provisions of these three sections seriatim.

SECTION 402, RELATING TO ESTATE TAX ON COMMUNITY INTERESTS—PAGE 252 OF BILL

This proposed section is manifestly and seriously unjust to residents of the community property States. As the section is written (p. 252 of the bill), it applies to the estate tax on community interests, whether the husband dies first or the wife dies first. It ignores entirely the definite provisions of the statutes of community-property States under which each spouse, whether the husband or wife, owns one-half of the community property and has a vested interest in that one-half.

Notwithstanding the fact that the ownership of property and the effects of the marriage relation are now, and have been ever since the adoption of the Federal Constitution in 1787, subjects purely within the control of the several States and outside of the control of Congress, this section arbitrarily creates a Federal statute for estate taxation on a theory of ownership which does not exist under the law of any of the 48 States, whether community-property States or common-law States.

Further, one of the great injustices of this section would be that on the death of the husband the entire community estate (both the half owned by the husband and the half owned by the wife) would be treated and taxed as the estate of the husband except to such extent as the surviving wife might be able to produce affirmatively legal proof showing the origin of all the community assets throughout the long period of married life and proving what particular items are attributable to the wife's efforts or to her separate property. Not satisfied with this, the section goes on to state that in no case shall the decedent's interest in the community estate be treated as less than the part that was subject to testamentary disposition of the decedent. Under this proposed section, as now in the printed bill, if the wife dies first the entire community-partnership property would be taxed to her estate under the same conditions, without regard to any question of the extent of the real ownership under State laws. Under the laws of all of the community-property States the part of the community property subject to testamentary disposition by decedent spouse is one-half thereof. Consequently the artificial presumption created by this section yields to State law where such yielding is favorable to an increase of the estate tax and refuses to follow the State law when that law is favorable to the taxpayer.

In other words, although the husband and wife in community-partnership States each own one-half of the community-partnership property, the new provision recommended by the Treasury and now in the printed bill would, for estate-tax purposes (with an exception permitting certain deductions, which is of little value in practical legal operation and is a mere gesture), treat all of the community-partnership property as the taxable estate when the husband dies first and also all of the community-partnership property as the taxable estate when the wife dies first. The only possible explanation of the purpose of the Treasury in treating all of the community-partnership property as belonging to whichever spouse dies first (instead of the one-half of the partnership property which in fact and law belongs to each spouse under local State law) is evidently to collect the largest possible estate tax in either case without regard to either fundamental local law or to equitable principles. This means that irrespective of whether the husband or wife dies first, the entire community-partnership property would be deemed to belong to and be taxed as a part of the decedent's estate although under local law and in fact only one-half of the property belongs to the decedent.

Under the present Federal estate tax law (which is consistent with local State law and equity) only one-half of the community-partnership property is taxable for estate-tax purposes if the husband dies first and only one-half if the wife dies first.

As stated above, the proposal of the Treasury now in the bill is that all of the community property shall, for taxation purposes, be deemed the property of the spouse first dying except to the extent the surviving spouse may affirmatively show a contribution thereto made by the surviving spouse. This creates a Federal presumption which the surviving spouse will find it very hard practically to meet in ordinary cases, with the result that the exception stated in the proposed language would seldom be of any real benefit to the surviving spouse because of the difficulty in making legal proof. In most cases the surviving spouse would be up against the ironclad Federal presumption practically impossible to overcome, particularly in those cases where both spouses had separate earnings.

It is hard to discuss with patience these proposed unjust provisions. Their language implies an animosity toward the community property system as if it were to be penalized for being different regardless of any question of justice.

We submit that the statement made in the last four lines set forth in the printed report of the Ways and Means Committee at page 160 under the heading, "Section 402. Community interests," is plainly erroneous and not justified in reality. In these four lines it is said:

"The statute (meaning the proposed section 402) establishes a uniform Federal rule for apportioning the respective contributions of the spouses regardless of varying local rules of apportionment. State presumptions are therefore not operative against the Commissioner."

We submit that section 402 as written in the bill would utterly fail to establish a uniform rule, and would arbitrarily and capriciously impose on the estates of married persons in the community-property States iron-clad presumptions and tax requirements which give no recognition to the true ownership or to the established rules of property, in those States. Far from making a uniform rule throughout the United States the section would impose on married persons in the community-property States a novel and discriminatory basis of estate taxation in defiance of all precedent. It would have no basis in the law of any of the States, but the so-called common-law States would escape its rigors because it is confined to "community interests."

SUBDIVISION (G) (4) OF SECTION 404, PAGE 258 OF THE BILL, RELATING TO INSURANCE PREMIUMS PAID FROM COMMUNITY PROPERTY

The purpose of this subsection (4) is to avoid the effect of the decision of the Supreme Court of the United States in the case of *Lang* v. *Commissioner* (304 U. S. 264). The identical point on which this new subsection now proposes to legislate was decided by the Supreme Court in the *Lang case* by unanimous opinion of that Court only a few years ago. Lang was for many years a merchant doing business in Seattle. He was married for a long period. He carried a substantial amount of life insurance on which, through a period of years, the premiums were paid from the community income arising from the mercantile business. On his death the Commissioner attempted to include the entire amount of the life insurance in the assets of Lang's estate for Federal estate tax purposes. The representatives of his estate contested this claim of the Commissioner on the ground that since the insurance premiums were paid from community property, the wife had in fact paid one-half of those premiums and consequently only one-half of the life insurance was an asset of the estate. The case was carried to the Supreme Court of the United States, where the Court in a unanimous opinion overruled the contention of the Commissioner. The Court said:

"Under the community-property statutes of Washington, as interpreted below, one-half of the amounts of community funds applied to payment of premiums was property of the wife. To that extent she paid these premiums."

Not a single Judge dissented from this holding. How unfair, therefore, it would be for Congress to attempt to overrule both the Supreme Court of the United States and the statute law of a community-property State by setting up an arbitrary rule. State laws must control the ownership of property in the States. There is no clause in the Federal Constitution that gives courts the right to regulate the ownership of property.

The provision in question, which is now part of section 404 subdivision (g) namely, subdivision (4) headed "Community Property," printed at page 258 of the bill should go out.

SECTION 453, HEADED "GIFTS OF COMMUNITY PROPERTY," PRINTED ON PAGE 277 OF THE BILL SHOULD GO OUT

As printed in the bill this section would insert a new subsection in existing revenue laws relating to the taxation of gifts. This new section would provide that all gifts of community property shall be considered to be gifts of the husband except gifts of such property as may be shown to have been received as compensation for personal services actually rendered by the wife or derived originally from such compensation or from separate property of the wife.

Here again there is an attempt to have Congress legislate on a matter that is purely within the domain of State law. Since under the community-property statutes the wife is the owner of one-half of the community property by what right, or with what justice, can a Federal statute declare that when a gift is made of community property the gift shall be treated as wholly a gift of the husband?

The clause is unjust in that it applies to donors in community-property States, a rule of discrimination not applicable in the common-law States where a joint gift may be made by a husband and wife without penalization, subject only to the usual gift taxes.

All of section 453 on page 277 should go out.

IN CONCLUSION

In presenting the ideas incorporated in this memorandum we have not lost sight of the fundamentals involved in these matters. In addition to all that is said above we assert that the idea that the Federal Government can single out the community-property system for discriminatory treatment in the States which have seen fit to adopt it, in contradistinction to taxation imposed on other types of property and property rights, violates the letter and the spirit of the Constitution of the United States. Such legislation would be an unauthorized assumption of power by the Federal Government.

Under our Constitution there was left to the local States the complete power and right to determine and regulate property rights within the respective boundaries of these States and the marriage relation and all of its effects. Neither by the original grant of power to the Federal Government nor by any amendment to the Constitution that has been adopted have the people of the respective States delegated to the Federal Government any right to determine or regulate property rights within the States or to determine or regulate the marriage relation and its results. Such power was and is jealously preserved to the exclusive jurisdiction of the State governments.

We respectfully urge that the particular provisions of the pending bill pointed out above would violate the principles that were, are, and we believe always will be fundamentals in our government, and responsible for much of the greatness that is America's.

Respectfully submitted.

GEORGE DONWORTH,
Seattle, Attorney for Taxpayers' Committee in the State of Washington.

CHARLES E. DUNBAR, Jr.,
New Orleans, Attorney for Louisiana Community Property Taxpayers' Committee.

JOSEPH G. MONTAGUE,
Fort Worth, Tex., General Counsel, Texas and Southwestern Cattle Raisers' Association.

JAMES C. INGEBRETSEN,
Los Angeles, Calif., Attorney and Washington Representative, Los Angeles Chamber of Commerce.

ZACH LAMAR COBB,
Los Angeles, Attorney on Behalf of Community Property Committees of Idaho, Nevada, and New Mexico; Phoenix, Ariz., Chamber of Commerce; Tucson, Ariz., Chamber of Commerce.

The CHAIRMAN. Senator Connally also desires placed in the record the following memoranda regarding estate and gift taxes on community property.

(The memorandum referred to is as follows:)

DALLAS, TEX., *August 1, 1942.*

Mr. DALE MILLER,
Mayflower Hotel, Washington, D. C.

DEAR DALE: Mr. Hyman Pearlstone has asked me to write you outlining in brief form some of the more pertinent objections to the estate and gift-tax amendments in the pending tax bill as affecting community-property States. It was his thought and mine that, in view of the turn taken in the Senate Finance Committee, under which the committee is dropping the mandatory joint income-tax-return provision and concentrating its fire on the community States, it will be necessary to consider the estate and gift-tax provisions together with the proposed income-tax provision, and the same objections to taxing the community income of husband and wife for income-tax purposes would apply equally to taxation of community estates at the death of either member of the community.

There are three amendments to the estate and gift-tax laws that should be opposed:

1. The first is section 402 of the bill as introduced into the House, which amends section 811 (e) of the Internal Revenue Code by inserting at the end thereof a new paragraph, as follows:

"(2) COMMUNITY INTERESTS.—To the extent of the interest therein held as community property by the decedent and surviving spouse under the law of any State, territory, or possession of the United States, or any foreign country, except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse, or derived originally from such compensation or from separate property of the surviving spouse. In no case shall such interest included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition."

There are a number of objections to this provision:

(*a*) This amendment ignores entirely the legal rights and incidents of ownership of property in community States. In Texas and the other community States the wife is the full legal owner of one-half of the community property. During the lifetime of the spouses the husband may make no conveyance of community property in defraud of his wife's rights. Upon divorce the wife is entitled to receive, not alimony as in the common-law States, but a property settlement whereby there is delivered to her of right her full one-half interest in the community property accumulated during the marriage. On the death of the husband he may dispose only of his one-half interest in the community property. He may not convey his wife's one-half interest. If he dies without a will, the wife still owns her one-half interest in the community property. If the wife should die, she may dispose of as she sees fit her one-half of the community property, and if she leaves no will, her half interest descends to her heirs-at-law, as provided for in the statutes of descent and distribution.

This bill ignores entirely these principles and taxes the decedent on the entire community interest without regard to his or her ownership thereof, excluding only such property as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse. If the community estate is entirely the product of personal services of the decedent, whether it be the man or his wife, the decedent is taxed on the full value thereof, even though at his death he is the owner of only one-half of the same and even though at his death he may dispose of only one-half of the same.

(*b*) The amendment is discriminatory and unfair, in that it taxes 150 percent of the value of the community estate. It provides that the full value of the community property shall be included in decedent's estate unless the decedent's executors or personal representatives can show that the property was the product of the personal services actually rendered by the survivor or derived from the separate property of the survivor. At the same time it provides that in no case shall the interest included in the estate of decedent be less than the value of such part of the community property as was subject to decedent's power of testamentary disposition. This means that if the husband, through his personal efforts, builds up a large community estate, at his death, although he is the owner of only one-half thereof, his estate will be taxed on the full 100 percent of the value of the property. Under Texas law and the law of the other community States, he may dispose of only his half interest in these properties. The other one-half belongs to the wife and his wife's half he may not dispose of. Since his wife has power of testamentary disposition over her half, and since the amendment provides that in no case shall there be included in the decedent's estate less than the value of her part of the community property as was subject to decedent's power of testamentary disposition, upon the wife's subsequent death her one-half is again subject to the tax. Thus the community property is taxed on two occasions to the extent of 150 percent of the value thereof. This despite the fact that the wife's half did not pass to her on her husband's death, and despite the fact that the husband could not divert his wife's one-half to his beneficiaries, even if he desired to do so.

The converse is equally true. If the wife dies first and her executors are unable to show that the entire community estate was received either as compensation for personal services actually rendered by the surviving husband or derived originally from such compensation or from separate property of the husband, she would be charged on the full value of the community estate on her death, despite the fact that she may not dispose of his one-half of the same. Upon the husband's subsequent death he would again be charged, under the last sentence of the amendment, with one-half of the same community property. It is no answer to say that the provision allowing credit of property previously taxed eliminates this duplication of taxation. In the first place the credit for property previously taxed is not a full credit and does not equal the tax itself. In the second place the credit applies only if the surviving spouse dies within 5 years of the death of the other. The requirement that compels the surviving spouse to die within a 5-year period in order to avoid the double tax on the same property seems hardly reasonable.

The House committee in its report on the amendment, page 35, states that for the purpose of Federal estate taxes the husband and wife living in community States enjoy a preferential treatment over those living in non-community-property States. It is submitted that there is no preferential treatment when the rights of ownership in the property are duly regarded. Certainly any assumed preferential treatment would not justify a discrimination against the community property States that would tax only the properties in those States one-half as much again as some of the properties are taxed in the common-law States.

(*c*) The bill is ambiguous and will create considerable confusion and litigation. It provides that the decedent's estate shall be taxed on the full value of the community property of both spouses, except such part thereof as may be shown to have been "received as compensation for personal services actually rendered by the surviving spouse, or derived from such compensation or from separate property of the surviving spouse." Confusion will result from an attempt to apply the language, "derived originally from such compensation or from separate property of the surviving spouse." The wife in the community estate almost invariably comes into the community with some property of her own, even though it may be small in amount. This property may enhance in value and more frequently than not is disposed of during the marriage and the proceeds reinvested. The income from this property is likewise frequently invested at a profit. In some of the community States, for example in Texas, the income of the wife's separate property is still the community property of both spouses. In other community States the income from the wife's separate property is still her separate property. The property on hand at the death of one of the spouses represented by investments of income from separate property—community property in some States and separate property in others—should be considered as derived originally from separate property. The explanation in the House committee's report, page 160, is that the property "derived originally from" compensation or from separate property of the surviving spouse includes (1) property acquired in exchange for property received as compensation or in exchange for separate property, (2) community income yielded by such property and property acquired with such income, and (3) property which may be traced back to property received as compensation, separate property, income from property received as compensation, or income from separate property. The report states that the statute establishes a uniform Federal rule for apportioning the respective contibutions of the spouses, regardless of varying local rules of apportionment, and that the State presumptions are therefore not operative against the Commissioner.

This understanding of the committee as to what is meant by the phrase, "derived originally from" separate property, does not appear in the statute. The somewhat ambiguous phrase, "derived originally from," might well cause litigation and confusion when attempted to be applied to dividends, rents, and other receipts from separate property which have been reinvested in other property, which under some State laws would be community property and in other States the separate property of the particular spouse.

In any event any attempt to trace the origin of the particular property on hand at death back through the various mutations and changes that have occurred during long married life presents an accounting problem of extreme difficulty. At the outset of marriage both spouses may have some separate property. These properties are converted into new investments, and the proceeds from sales are mingled with the income from the separate estates. New acquisitions are made out of the mingled funds consisting of earnings of one or the other spouse, income from their separate properties and proceeds from sales of their separate properties. Over many years of married life the separate estates are fused, and the whole, under our community laws, becomes community property, and any attempt to trace the origin of funds that went into the purchase of the many items of properties on hand at a decedent's death presents insurmountable problems both to the Treasury Department in attempting to make any fair apportionment between the spouses and to the executors of the decedent. This attempt is particularly burdensome and unfair in the light of the fact that the tax is imposed and the determination must be made after the death of the very person who is most familiar with the circumstances surrounding the acquisition. Any rule that requires taking audits of every transaction occurring during perhaps 50 years of married life and requires the tracing of every dollar of earnings, revenues, and proceeds of sale back over a period of many years presents administrative difficulties and intolerable burdens upon the Government and the taxpayer and is wholly unjustified. The rule in community States cuts through this necessity by presuming that all property acquired during marriage is community property of husband and wife, such as is derived by way of gift, devise, or inheritance of either spouse. This presumption has long been recognized by the court as a very sane and practical rule, and yet the committee asserts that such presumptions are not operative against the Commissioner. The statement that the statute establishes a uniform rule of apportionment of the respective contributions of the spouses, regardless of the varying local rules of apportionment, is unrealistic and wholly impracticable, in view of the above complicated situation.

(*d*) The bill is an unjustified interference with the rights and obligations of the husband and wife in other respects. While the amendment undertakes to exclude from the decedent's estate property received as compensation for services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse, it fails to take into account the very common situation of property which is the product both of services and of separate property of one of the spouses. Very frequently the assets on hand at death may be the product of capital and labor both combined, and often the wife's separate property may be the original stake by which the husband is enabled to build up an estate. I have in mind particularly one client of ours who, 30 years ago when he was first married, had no money whatever. He was staked in his first venture in the oil business with money given to him by his newly married wife, this money being obtained from the sale by her of her piano and other personal properties of a similar character. With this money the man was enabled to start out in the oil business, and his first investment grew extremely profitable. From this small beginning he, with his wife's counsel and advice, has now created an estate of over $5,000,000. And it could be said that all of these properties were solely the product of services actually rendered by the husband. The cases are legion in which, during the vicissitudes of a long married life the wife or the wife's family have made substantial contributions to the husband's efforts, which contributions made the difference between success and failure. Any attempt to put any value on such contributions or to trace the funds on hand at death back to these various contributions would be impossible, and yet to assume that the property on hand is solely the product of the husband's efforts is wholly unrealistic. It ignores entirely the close relationship that should exist between husband and wife, and assumes without foundation that one or the other of the spouses is wholly responsible for the many sundry items of property on hand at the time of the death of one of the members of the marital community. When the amendment attempts to tax the first decedent with all the community property except such as may have been derived from compensation for personal services actually rendered, it assumes merely the typical case of the small wage earner or salaried man, and assumes that he alone, or the wife alone if she happens to be the employed person, actually renders the service and is solely responsible for the increases of marriage. But the average middle-class businessman whose property is the result of sundry investments and business enterprises of one kind or another does not derive his wealth solely from personal services. The extent to which his wife's counsel and advice contribute to the accumulation of property cannot be fixed by any statute of this kind. The degree to which contributions of one or the other of the spouses, either in the form of money, services, counsel, or advice go toward building up an estate, is a matter that cannot be reduced to mere mathematical formula, and any attempt to weigh these various elements over a period of a long married life cannot help but result in injustice and inequity. The whole basis of the community system is that it is the joint efforts of these two persons living together in a close relationship, and not merely the efforts of one of them, that result in the products on hand at the end of the marriage. In all respects it is a close partnership. The arbitrary rule that attempts to assign to one or the other full credit for these increases is as unreasonable as would be a statute which would attempt on the death of a partner in a commercial partnership to tax the decedent for the full value of the surviving partner's interest merely because the decedent was the active member of the partnership and the other partner merely lent his counsel and advice.

The bill also makes no provision for the very important fact that in common-law States debts acquired during marriage are community debts. The wife's interest in the property is charged with the payment of these debts. As the bill is now written, the husband could be taxed for the full value of the community estate unless the executors could show that the wife's separate property or services were solely responsible for some particular item of property, and yet, while charging the husband the full value of the community estate, no allowance is made for the fact that one-half only of these debts represented the husband's liability, the other half being a charge against the surviving one-half interest in the property over which the husband has no power of disposition. It may well follow that the husband is charged with 100 percent of the community property and is permitted, however, to deduct only his half of the community debts. This despite the fact that the executor of the spouse dying takes over the community property as statutory trustee for the purpose of discharging the community debts on hand at the death of the spouse.

Moreover, the rule in Texas is settled that where, in community property estates, property is acquired by incurring a community debt, the property acquired through the creation of this indebtedness is community property, that where property is acquired not as the result of personal services of either spouse, and not derived from compensation or from separate property of either spouse, it will be joint property because it has acquired a joint debt. Under the bill such property would be included in the estate of the first spouse to die, and later, on the death of the second spouse, half of it would be taxed again. An oversimplified statute of this kind cannot possibly take into account the many ramifications of property rights of spouses in a community-property State.

There are two kinds of community property: Community property which is under control of the husband as manager of the community, and community property which is under control of the wife. This latter type of community property includes property derived from the separate earnings, income from her separate estate, and all community property in cases where the husband has become insane, or where he is out of the jurisdiction, or where he has deserted his wife. In such instances she has control over the community property. Nonetheless, the properties while in the wife's control are owned one-half by the husband. It has been held, for example, in Texas that where a husband deserts his wife for perhaps 20 years, on his wife's death he may still have one-half of the personal earnings of the wife during the period of his desertion. It seems hardly fair that a wife should be taxed on all of the efforts of her earnings in cases such as desertion where she and her children may have and enjoy only one-half of the fruits thereof. Nor is it proper that the incidents of the estate tax should be made to depend on an impossible tracing of funds back to their origin, ignoring the element of control, which may be in the hands of one or the other of the spouses, and ignoring entirely the joint ownership of the property.

(c) It seems from the foregoing that the proposed amendment is a direct discrimination against the community-property States. It lays down, for instance, in Texas, a rule different from that in other States where ownership is the general rule of taxability. It is therefore probably unconstitutional on the ground that it violates the due-process law and on the ground that it is lacking in geographical uniformity. Whether constitutional or not, it is certainly discriminatory, capricious, unfair, and not equal and uniform in its operation.

2. The second provision that is objectionable to the community States is section 404 of the bill, which amends section 811 (g), relating to life insurance for estate-tax purposes.

At the present time life insurance is included in a decedent's estate to the extent that the decedent paid the premiums on the policy on his own life. Where the premiums were paid with community funds, it is well settled, by a decision of the Supreme Court in the *Lang case*, that only one-half of the proceeds of such insurance is to be included in the decedent's estate. This is because the premiums being paid for with community funds results in the wife's paying one-half of the premiums and the husband the other one-half. The amendment proposes to change this rule, making premium payments the test of taxability, and proposes that either payment of premiums or the possession of the legal incidents of ownership at death will result in inclusion of insurance proceeds in the decedent's estate. By possession of the legal incidents of ownership is meant the right to cash values, the right to change beneficiaries, the right to surrender the policy, and borrow on the same. If the decedent either paid the premiums on the policy on his own life or possessed these rights, he is to be taxed to the full extent of such insurance.

So far as the community-property State is concerned, the amendment contains this objectionable provision:

"(4) COMMUNITY PROPERTY.—For the purposes of this subsection premiums or other consideration paid with property held as community property by the insured and surviving spouse under the law of any State, Territory, or possession of the United States, or any foreign country, shall be considered to have been paid by the insured, except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse; and the term 'incidents of ownership' includes incidents of ownership possessed by the decedent at his death as manager of the community."

It will be noted that this section corresponds in its essential provisions to the amendment contained in section 402 described above, and is objectionable for the same reasons. It is even more objectionable, however, in that by making the test of taxability to hang either on the payment of premiums or on the possession of legal incidents of ownership, and by assuming that possession of incidents of ownership is in the husband as manager of the community, it means that the insurance on the husband's life, even though paid for entirely with the wife's separate funds, is to be included in the husband's estate if the insured, as is the case in most insurance policies, possessed the legal incidents of ownership.

Here again this provision ignores the essential property rights of husband and wife. It is the settled law in Texas that, where a policy of insurance is taken out on the husband's life during marriage and premiums are paid for with community funds, the wife is the owner of one-half of such policy. It has been repeatedly held in community-property States that, where a husband takes out a policy on his own life during marriage and makes some person other than his wife beneficiary and pays the premiums with community funds, the wife has an interest in such policy and may, in proper circumstances, recover on the policy at the husband's death, even though other parties are beneficiaries. This law which ignores these legal rights and which attempts to tax the husband on the full value, even though he alone is responsible for and is owner of such policy, not only ignores the indemnification feature of the insurance, but ignores the respective legal rights of the parties in such a contract.

The difficulty in trying to determine who paid these premiums and out of what, and trying to trace the many annual premium payments over a period of a long married life would give rise to grave administrative problems, and would create insurmountable questions of accounting and result in hardship and injustice.

The rule being one established now that payment of premiums should be taxed, and the Supreme Court having settled that on premiums paid with community funds each spouse makes one-half of the payments, I should think that no amendment to the statute is required at this time. If any amendment is made, it would seem that the recommendation of the American Bar Association that ownership of the policy be the sole test of taxability be adopted and the twofold test proposed by the Treasury Department be discarded. In any event, under subsection (4) dealing specifically with community property, those features should be eliminated for the reasons set forth more fully above.

3. The third objection is to section 453 of the bill relating to gifts of community property, which amends section 1000 of the code by inserting at the end the following new subsection:

"(e) COMMUNITY PROPERTY.—All gifts of community property shall be considered to be the gifts of the husband except that gifts of such property as may be shown to have been received as compensation for personal services actually rendered by the wife or derived from such compensation or from separate property of the wife shall be considered to be gifts of the wife."

Here again the basic rights of husband and wife in community property are ignored, and the same objections apply to this section as are presented in opposition to section 402. Here again we have the same difficulty in determining how the property in question was originally derived. This section presents the strange anomaly that all gifts of community property (with the certain exception named in the bill) shall be considered to be gifts of the husband, and yet, if the gift had not been made, one-half of the value of the same properties would be taxed at the wife's death to her estate under the last sentence of section 402. If the husband makes a gift in his wife's lifetime, the wife's one-half interest in the property is taxed to him. If the wife dies, the same half interest is taxed to her estate. It is a strange rule that taxes the wife's testamentary power of disposition over the property and yet ignores the same rights when a gift is made prior to death.

Under section 452 of the bill a gift tax is laid on the exercise or release of power of appointment. The wife's interest in community property is a much greater interest than that of a mere power of appointment. Under the gift of property right which the wife has, these greater rights include an absolute right of testamentary disposition, yet the husband, not the wife possessing these rights, is charged with the gift item. If the gift be not made, the wife, and not the husband, at her death is charged with the estate tax.

This curious inconsistency is directly contrary to the repeated insistence frequently made by the tax authorities, including the learned Treasury adviser, that the income, gift, and estate-tax provisions be correlated. Instead of correlating the gift and estate-tax provisions, the bill creates a curious inconsistency that hinges upon the property rights of husband and wife in community-property States.

I trust this brief outline of some of the objections of the provisions in question may give you a few ideas that can be developed before the committee.

With best wishes and kindest regards, I am

Sincerely yours,

J. P. JACKSON.

The CHAIRMAN. I desire to put into the record a statement of Mr. Sidney M. Ehrman, chairman, State-wide tax committee, California State Chamber of Commerce.

(The statement referred to is as follows:)

STATEMENT OF SIDNEY M. EHRMAN, CHAIRMAN STATE-WIDE TAX COMMITTEE, CALIFORNIA STATE CHAMBER OF COMMERCE

While the primary purpose of the Federal tax bill now pending before the Senate Finance Committee is to raise badly needed revenue to assist in financing the cost of war, it is evident that Congress is striving to temper the impact of this increased tax burden by taking into account all possible factors bearing on its successful application to the Nation's economy. In furtherance of this objective, I am taking this means of transmitting to your committee a number of observations and suggestions concerning the bill and I believe that they are representative of business opinion in the State of California:

CAPITAL STOCK AND DECLARED VALUE EXCESS-PROFITS TAXES

The Treasury Department has recommended the repeal of the capital-stock tax and the declared value excess-profits tax. The bill, however, has not taken this recommendation into account, although provision is made for a declaration of capital-stock value every year instead of every 3 years. While annual declarations remove part of the uncertainty connected with computing tax liability under these taxes, there is still too much guesswork involved to make them operate fairly. These taxes are a nuisance to taxpayers, they needlessly duplicate the tax machinery of the regular excess-profits tax, and their effectiveness as a revenue producer is to an extent nullified through deductibility from taxable income. The capital-stock tax and the declared value excess-profits tax have no place in the Federal tax structure and I strongly urge that they be repealed.

CORPORATION INCOME TAX RATES

The revenue bill of 1942 proposes to impose a combined normal tax and surtax of 45 percent on all corporations earning more than $50,000. In addition, a 90 percent excess-profits tax would operate, and the usual number of other Federal, State, and local taxes would apply. If income taxes dry up too great a portion of the income of corporations, the effect may be ruinous to many companies. Excessively high income taxes tend to impair working capital, to reduce the amount of money available for reinvestment in plant, to encourage wasteful and extravagant use of funds, to destroy the profit incentive, and in all probability to impede the war efforts of the American business structure. If business is to remain healthy and of maximum productiveness during and following the war, its life blood must not be dried up through excessive taxation. I would recommend, therefore, that the rates of the corporation normal tax and surtax be a lesser figure than proposed in the bill as amended on July 20, 1942.

CONSOLIDATED RETURNS

Under present law, consolidated returns may be filed in connection with the excess-profits tax, but in the case of the corporation income tax this privilege is limited to railroads and pan-American trade corporations. The new bill proposes to allow all affiliated corporations to file such returns for the corporation income tax. It proposes, however, to place a penalty on corporations filing such returns by increasing their surtax by 2 percent. Affiliated companies should be regarded as an economic unit and there should be no penalty attached to their filing consolidated returns. The penalty is particularly unfair to railroads, these companies already having the right to file consolidated returns without penalty. Moreover, it would penalize compliance with State laws which require separate corporations in certain instances. Accordingly, I would recommend that your committee oppose the imposition of a penalty upon affiliated companies for the privilege of filing consolidated returns.

CAPITAL GAINS AND LOSSES

The new revenue bill proposes to deny to corporations the right to use long-term capital losses as an offset against ordinary income, but in lieu thereof would permit such net losses to be carried forward for 5 years and during such time to be applied as an offset against capital gains. Insofar as corporations are concerned, capital gains and losses are customarily incurred in the normal conduct of business and cannot be dissociated from ordinary profit-making activities. Therefore, net capital losses should be allowed as an offset against ordinary income and in order to make this possible I would suggest that the present system of taxing capital gains and losses of corporations be retained in the law.

FISCAL YEAR CORPORATIONS

The new revenue bill proposes that corporations now paying taxes on a fiscal year basis be required to prorate their taxes so that the portion of their fiscal year income falling in the succeeding calendar year shall be taxed at the rates then prevailing. Thus corporations whose fiscal years closed after December 31, 1941, and whose books are now closed, would be required to reopen their books and recompute their tax liability for that portion of the fiscal year falling in the 1942 calendar year, upon which the new tax rates will apply when the bill becomes law. This transition may be in the interests of uniform application of new tax rates as between calendar year and fiscal year corporations, but coming without advance notice it will work a serious hardship on many fiscal year corporations. I believe, therefore, that if fiscal year corporations are to be required to compute their tax liability on the calendar year basis, that the change should be made effective at the time the bill is passed rather than as of January 1, 1942.

TAX CREDIT FOR DEBT REDUCTION

Consideration is being given to the question of allowing corporations some kind of a tax credit as a means of encouraging or facilitating the reduction of indebtedness. Unless corporations with large debt structures use a part of their presently flush income to pay off at least a part of their indebtedness, they may find themselves in serious difficulty following the war. Thus, as a precaution against needless business distress, and its consequent effect on employment in the post-war period, it should be in the national interest to get rid of debt while business is booming. A tax credit, the details of which have not been worked out, would help to achieve this end. I fully concur in the views of your chairman on this subject, and urge that some form of tax credit be allowed to encourage and facilitate the reduction of debt.

TAX ON TRANSPORTATION OF FREIGHT

The new revenue bill proposes to levy a 5-percent tax on the transportation of freight, which is a tax not now levied. While this tax might ordinarily be as acceptable as any other tax, it is in absolute conflict with the price-ceiling legislation now in operation. This tax would add to the cost of goods sold but it could not be passed on through price increases and thus it would indirectly have to come out of business income. California and other Western States would be especially hard hit by this tax because of their dependence upon long-distance transportation to and from the population centers of the East. Accordingly, I recommend that your committee oppose the proposed tax on the transportation of freight.

POST-WAR TAX REFUND

There has been discussed in Congress a proposal that a high excess-profits-tax rate should be accompanied by some provision for refunding a percentage of this impost in the form of a post-war credit. The medium suggested is that the refund be handled through the issuance of nonnegotiable bonds redeemable after the war, the proceeds then restricted to certain corporation uses. While a lower excess-profits-tax rate without provision for a refund would allow a greater degree of flexibility, from the standpoint of the taxpayer, it would reduce the amount of revenue immediately available for war purposes. If the higher rate of tax is retained in the bill, it would be helpful to business to allow for a post-war credit but the proceeds of the refund should not be so restricted as to nullify their free use to the best interests of the business concerns involved. I advocate, therefore, that in the event an exceedingly high excess-profits tax is provided for in the new tax bill as finally enacted, provision be made for a post-war credit to be handled through the issuance of bonds redeemable after the war but without restrictions as to the purposes for which the proceeds may be spent.

WITHHOLDING AT SOURCE

In order to facilitate the collection of the individual income tax, the new bill provides for the withholding at the source of fixed percentages of the income of individuals, taking into account certain allowances for personal exemptions. While the application of the withholding principle to earnings of employed persons will doubtless make it easier for wage earners to pay their income taxes, and will assist in speeding up the flow of money into the Federal Treasury that otherwise might contribute to inflation, it is doubtful if the same advantages would operate in the case of dividends and bond interest. Holders of stocks and bonds are not unaccustomed to handling income-tax returns and would probably not require the facilities of a withholding provision. Moreover, no machinery could be provided to take care of personal exemptions in the case of dividend and interest payments. Finally, the task of keeping records would be especially costly to corporations with large numbers of stock and bond holders and confusing to taxpayers. This would more than offset the advantages of withholding. I strongly recommend that the withohlding provisions contained in the new tax bill be confined to salaries and wages.

REDUCTION OF NONESSENTIAL EXPENDITURES

The Federal revenue bill of 1941 contained a title devoted to the question of curtailing nonessential expenditures and provided for the creation of a joint congressional committee to investigate this subject. That committee has developed many wise recommendations, most of which have been put into operation. I am confident that there is further opportunity for economy and I urge that some expression along this line be included in the Federal revenue bill of 1942. Such an expression of policy would be in harmony with the efforts of Congress to direct our resources and energies into war channels and away from peacetime pursuits.

The CHAIRMAN. I wish to put into the record a letter, addressed to the chairman of the committee, by the representatives of the grape, fruit, and berry growers, and wineries throughout the country on wine taxes.

(The letter referred to is as follows:)

WASHINGTON, D. C., *August 12, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: We, the undersigned, representatives of grape, fruit, and berry growers, and wineries, composing more than 90 percent of the Nation's wine industry, present herewith the industry's position respecting wine excise levies.

Attached is a tabulation presenting a brief summary of proposed House rates as compared with unprecedented congressional action in the past 2 years. This schedule reflects an over-all average increase in wine taxes of nearly 300 percent in these 2 years.

Although these are unprecedented times, which call for extraordinary sacrifices, we feel that the wine growers, after 9 unprofitable years and just beginning to regain their pre-prohibition market, should not be asked to assume a burden which represents a disproportionate percentage increase as compared to others. We fail to find where any other commodity or product is assuming such a high percentage increase.

After learning of the rates adopted by the House, we planned to ask the Senate committee for a hearing and make a plea to reduce the House rates on at least some of the wine classifications. Notwithstanding our feeling that there exist some inequalities, the wine industry has concluded that it will endeavor to further adjust its operations so as to accept the increased load provided for in the House bill.

Therefore, in the spirit of fairness and justice, we earnestly request you to dismiss any suggestion, if one should arise, to provide further increases at this time. The amount involved (about $11,000,000) is infinitesimal as compared to the total called for in the bill. Yet, to the 150,000 growers, it is an exceedingly large sum.

We desire to remind you that the wine industry is essentially, fundamentally, and wholly an agricultural one. Unlike other beverages, the finished product is derived from the soil. Moreover, to these 150,000 growers, each acre of grapes represents an investment of $300 and 4 years of labor.

Although the industry is basically agricultural and is rapidly, through assistance of the Federal and various State governments, providing the farmer with a much needed new cash crop, it is likewise making a substantial and important contribution to the war effort. At the request of War Production Board, the industry has already made available 28 pieces of distilling equipment for production of ethyl alcohol so vitally needed in the manufacture of smokeless powder and synthetic rubber. Wineries are the only source of tartrates required in modern warfare in manufacturing parachutes, medicines, photographic chemistry, textile dyeing, and metal coloring. The industry produces thousands of tons of raisins used in the diet of the armed forces. The wine industry is thus far from being a nonessential one.

Further, a fact frequently overlooked is the right of an individual to produce 200 gallons of tax-free wine per year. Based on the Department of Agriculture reports, the production of this tax-free wine has been estimated to range as high as 30,000,000 gallons annually—an amount equivalent to 30 percent of tax-paid wine production. Certainly too much of an increase in wine tax will result in a corresponding increase in so-called home-made tax-free wines, thus opening the door still wider to illicit sales.

Respectfully yours,

California: Wine Institute: by Harry A. Caddow, secretary-manager.
Georgia: Southern Georgia Wine Growers Association; by William H. Key, counsel.
Illinois: Associated Vintners of the Middle West; by Sam Adams, president.
Iowa: Council Bluffs Grape Growers Association; by Harry Martin, manager.
Massachusetts: Massachusetts Wine Council; by Edward A. Laven, president.
Michigan: Michigan Wine Institute, Inc., by M. R. Twomey, president.
Missouri: American Wine Co.; by Adolph Heck, vice president.
New Jersey: Associated Wineries of New Jersey; by Herman A. Kluxen, president.
New York: American Wine Association; by J. Campbell Moore, president.
Finger Lakes Wine Growers Association; by Louis B. Montfort, counsel.
North Carolina: North Carolina Association for Wine Control; by John W. Coffey, director.
Ohio: Ohio Wine Growers Association; by B. V. Granfield, trustee.
Oregon: Oregon Wine Council; by Ralph W. Staley, secretary.
Pennsylvania: Pennsylvania Wine Association; by John A. Margolis, secretary.
Texas: Texas Wine Association; by Irvin M. Shlenker, president.
Virginia: Monticello Grape Growers Cooperative Association; by Bernard P. Chamberlain, president.
Washington: Washington Wine Council; by Warren L. Dewars, secretary.

HOUSE WINE RATES (H. R. 7378)

The additional levies proposed by the House, compared with Congressional action during the last few years, is shown in the following tabulation (based on the gallon unit):

	1939 rates	1940 rates and percent increase over 1939	1941 rates and percent increase over 1940	1942 House rates and percent increase over 1941	Total percentage increase since 1939
	Cents				*Percent*
Table wines (under 14 percent).	5	6 cents=20 percent.	8 cents=33 percent.	10 cents=25 percent.	100
Dessert wines (14 to 21 percent).	10	18 cents=80 percent	30 cents=67 percent	40 cents=33 percent.	300
Industrial wines (21 to 24 percent).	20	30 cents=50 percent.	65 cents=117 percent.	$1=54 percent ...	400
Sparkling wines (under 14 percent).[1]	40	48 cents=20 percent.	$1.12=133 percent	$1.60=42 percent..	300
Carbonated wines (under 14 percent).[1]	20	24 cents=20 percent.	56 cents=133 percent.	80 cents=43 percent.	300

[1] Statutory unit of taxation is the ½-pint bottle rather than the gallon.

The CHAIRMAN. I wish to put into the record a letter and statement from Frank C. Page, New York, of the International Telephone & Telegraph Corporation, with reference to the American companies doing business in Latin America. That is a matter which has not been covered.

(The letter and statement referred to are as follows:)

INTERNATIONAL TELEPHONE & TELEGRAPH CORPORATION,
New York, August 13, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: One of the major problems of the American companies doing business in Latin America is the question of double taxation in one form or another. England and other European countries have given favorable tax relief to their national companies operating in Latin America which places American companies at great disadvantage. This subject of course becomes greatly accentuated with increased taxes in American companies as contemplated in the present bill. While other branches of the Government are encouraging the activities of American corporations in Latin America, the tax problem increases the difficulty of maintaining or starting local American companies in those countries.

I am enclosing herewith a memorandum on the subject and respectfully request that this memorandum be incorporated in the hearings of the Senate Finance Committee and the contents of it be given consideration.

Faithfully yours,

FRANK C. PAGE, *Vice President.*

SPECIAL TAX REGIME FOR CORPORATIONS DEVELOPING INTER-AMERICAN BUSINESS

The developing in the other American republics of strategic and other raw materials, agricultural products, and basic industries which do not compete with our own industries should be carried out insofar as possible by local enterprises and labor and, where this is not practicable, by combining local enterprises with the initiative, capital, and technical facilities available in the United States. The ideal arrangement for such an undertaking sought by the present administration is in substance a partnership between the citizens of the other American republics where the undertaking is established and of this country.

Apart from the instances where the laws of the other American republic may require the organization of a local company, the American entrepreneur may be in a position to choose between forming a corporation under the laws of the other country, or organizing a corporation in the United States which would qualify to do business in the other country. If the latter method is followed, the management and financing of the enterprise is greatly facilitated, and its activities can be more readily coordinated with those of related American companies. The ideal of partnership can be realized through giving citizens of the other country a fair opportunity to invest in the American corporation and representation on the board of directors. For example, in the case of an American company operating in Cuba, the cream of the earnings goes to the holders of the preferred stock, practically all of whom are residents of Cuba, and about 40 percent of the common stock is held by residents of that country.

Needless to say, a foreign company has the advantage, from a tax viewpoint, of bearing only the taxes of the country in which it operates and of being in a position to plow back its earnings in the development of the business without having to pay any tax to the United States. Liability to the income taxes of this country does not arise until the domestic parent receives dividends from the foreign company.

In contrast, if the business in a Latin-American country were carried on by a corporation organized in the United States, the profits would at once become subject to the high United States normal tax and surtax, even though they were utilized in the business in the Latin-American country or distributed to shareholders resident there, and no part thereof was brought to the United States. Moreover, the corporation would become subject to the United States capital-stock tax on the basis of its entire capital employed in the foreign country. The corporation would not become subject to the United States excess-profits tax insofar as it kept within the narrow limitations of section 727 (g), Internal Revenue Code, but the cumulative burden of the other taxes would be so great as to discourage recourse to such an organization.

The question therefore arises whether it is sound policy on the part of the United States to prevent an American-owned business from operating in Latin America on terms of equality with British corporations, as well as those organized under section 4 (k) of the Canadian War Income Tax Act, or under substantially equivalent provisions of the laws of various other countries.

The pertinent provision in the United Kingdom Income Tax Act is found under rule 2, case V, schedule D, of said act, as construed in *Egyptian Hotels, Ltd.* v. *Mitchell* (6 Tax Cases (United Kingdom) 542, House of Lords), affirming *Mitchell* v. *Egyptian Hotels, Ltd.* ((1915) A. C. 1022). Rule 2 provides that "the tax in respect of income arising from possessions out of the United Kingdom, other than stocks, shares, or rents, shall be computed on the full amount of the actual sums annually received in the United Kingdom from remittances payable in the United Kingdom." The case cited held that a business carried on entirely abroad was a foreign possession, with the consequence that the profits derived from such business are taxable only when received in the United Kingdom (Dowell's Income Tax Law, 9th ed., 1926, pp. 655 and 660; Konstam, The Law of Income Tax, 8th ed., 1940, p. 246). An essentially similar provision is found in section 4 (k) of the Canadian Income War Tax Act, which stipulates that no liability to taxation under said act shall arise in respect of—

"(k) BUSINESS AND ASSETS SITUATE ABROAD.—The income of incorporated companies (except personal corporations);

"(i) Whose business operations are of an industrial, mining, commercial, public utility, or public service nature, and are carried on entirely outside of Canada, either directly or through subsidiary or affiliated companies, and whose assets (except securities acquired by the investment of accumulated income and such bank deposits as may be held in Canada) are situate entirely outside of Canada, including wholly owned subsidiary companies which are solely engaged in the prosecution of the business outside of Canada of the parent company; or

"(ii) whose business operations are of an investment or financial nature and carried on entirely outside of Canada, and whose shares have been offered for public subscription or are listed on any recognized stock exchange in Canada or elsewhere, and whose assets (except such bank deposits as may be held in Canada and except shares of other companies conforming to the requirements of this paragraph (k)) are situate entirely outside of Canada. Shares, stocks, or bonds of Canadian companies shall, for the purposes of this paragraph (k), be deemed to be assets within Canada notwithstanding that they may be or have been transferred on any register outside of Canada: *Provided*, That such companies file annually a fully completed return, on the form prescribed, and also pay an annual filing fee of $100, within four months from the close of their fiscal period. If any such company, without reasonable cause therefor, of which the Minister shall be the judge, should fail to file the said annual return or to pay the said filing fee, in each case within the time prescribed, it shall be liable to the tax provided for in either paragraphs C or D of the first schedule of this Act and the said filing fee."

When the profits are brought to Canada and distributed, they are taxable to the extent that dividends are taxable.

The Italian Law No. 4021 of August 24, 1877, as amended by article 9 of law No. 1463, dated August 12, 1927, provides that, where an Italian company has an establishment abroad which keeps entirely separate accounts from those of the head office, the income properly allocable to the branch shall be exempt from the profits tax in Italy (League of Nations, Taxation of Foreign and National Enterprises, vol. II, p. 245).

Under French law, the tax on industrial and commercial profits is payable only on profits made by industrial and commercial enterprises operated in France, with the consequence that, where a French company has establishments situated abroad, the profits allocable thereto are not taxable in France (General Code of Direct Taxes, 3d ed., 1939, title I, ch. I, sec. 1, art. 2; League of Nations, Taxation of Foreign and National Enterprises, vol. I, p. 67). The same principle has been followed in numerous treaties to which the European countries are parties, including Germany, as well as the income-tax laws of practically all the Latin-American countries, and countries of the British commonwealth of nations not previously mentioned.

The credit for foreign taxes allowed under section 131, Internal Revenue Code is very beneficial in that it allows the tax imposed on profits in a Latin-American country, for example in Brazil at the rate of 6 percent to be credited against the United States income taxes, but it leaves the American corporation subject to the tax on the difference between the American effective rate and the Brazilian rate (apparently a difference of about 39 percent under the income tax bill of 1942) which constitutes a tremendous disadvantage from the viewpoint of competition with the corporations of the countries previously mentioned, as well as with corporations organized under the laws of the Latin-American country itself.

It is therefore suggested that, in order to place an American corporation operating exclusively in the countries to the south on a basis of equality, from a tax viewpoint, with corporations of such countries and of the leading commercial countries of the world, amendments to the Internal Revenue Code be adopted along the following lines:

1. A credit should be allowed against net income subject to the American tax insofar as net income is produced in the foreign country and either utilized in the business or distributed to shareholders resident in the foreign country. Such income would of course bear the full taxes imposed by the laws of such country and, except for the United States capital-stock tax, the American corporation would be on a tax basis equivalent to that of a local corporation or of British, Canadian, and other foreign corporations carrying on the same activities.

2. When income is remitted to the United States and distributed to shareholders resident in this country a credit for such income should be allowed against the net income of the corporation, but, of course, the amounts distributed as dividends would be included in full in the taxable income of the shareholders in this country. The purpose of such a provision would be to treat the income as if it were passing from the local corporation in the foreign country direct to the American shareholder. The operation of the above-cited provisions in the British and Canadian law is essentially similar.

3. To prevent double taxation where the corporation operating in Argentina is the subsidiary of an American corporation, section 131 (g) should be amended so as to include a subsidiary of this type within the purview of section 131 (f), Internal Revenue Code, and thereby permit the parent corporation to derive the benefits now accorded where a domestic corporation has as a subsidiary another domestic corporation entitled to the benefits of section 251 or 262, Internal Revenue Code.

PROPOSED AMENDMENT

The suggested regime could be formulated by utilizing the concept of a domestic corporation engaged solely in the active conduct of a trade or business in Central or South America, to which should be added the West Indies so as to include

Cuba, Haiti, and Santo Domingo. Such a corporation is termed in section 152, Internal Revenue Code, a pan-American trade corporation. Even if its earnings may be consolidated with those of a domestic parent corporation under section 152 of the code and under the contemplated amendment in section 142 (a) and (b) of the revenue bill of 1942, consolidated returns do not offer the desired advantages of equality of competitive conditions from a tax viewpoint with local, or British or Canadian companies. Substantial equality of treatment may be provided by granting such a domestic corporation a credit against net income essentially similar to that allowed under section 262, Internal Revenue Code. The allowance of this credit could be limited by the proportion of stock held by residents or citizens of the American republic in which it operates and of the United States, thus encouraging joint participation by nationals of both countries. The credit might be allowed only if the corporation certifies it has utilized its earnings from the carrying on or developing of its business, or has distributed them as dividends. If the dividends are distributed to residents of the American republic in which the company operates, they should be subject only to the taxes of that country as the income is earned there and goes to residents of the country.

If dividends are distributed to citizens or corporations of the United States, the recipients would include them in their taxable income. However, credit for foreign taxes should be allowed to the same extent as it is now granted in the case of domestic taxpayers receiving dividends from domestic corporations, such as the credit now allowed a domestic corporation owning a majority of the voting stock in a corporation entitled to the benefits of section 251 or of section 262 (sec. 131 (g), Internal Revenue Code).

SEC. 153 (new). CREDIT FOR PAN-AMERICAN TRADE CORPORATIONS.

(a) ALLOWANCE OF CREDIT.—For the purpose only of the taxes imposed by sections 13, 14, 15, 600, and 710 of this title, a domestic corporation which is engaged solely in the active conduct of a trade or business in a country in Central or South America or the West Indies, herein referred to as a Pan-American trade corporation, may elect to file a separate return without prejudice to the rights of other members of an affiliated group to make a consolidated income and excess-profits tax return under section 141, and in such case such corporation shall be allowed, in addition to the credits against net income otherwise allowed such a corporation, a credit against net income of an amount equal to the proportion of the net income derived from sources within such country which the number of shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in such country, the United States or possessions of the United States, and (2) individual citizens of the United States or such country wherever resident, bears to the whole number of shares of stock of the corporation outstanding on such date, provided that the taxpayer shall certify by June 15 of each year to the Commissioner that the entire net income of the taxable year has been in whole or in part utilized or reserved for the carrying on or development of the business of the corporation in such country and the balance, if any, has been distributed as dividends.

(b) OWNERSHIP OF STOCK.—For the purposes of this section, shares of stock of a corporation shall be considered to be owned by the person (which term includes a corporation) in whom the equitable right to the income from such shares is in good faith vested.

(c) CREDITS AGAINST THE TAX.—A corporation enjoying the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 131.

OTHER SECTIONS TO BE AMENDED

SEC. 26. CREDITS OF CORPORATIONS. (New language in italics.)

* * * * * * *

(b) DIVIDENDS RECEIVED.—The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922 (42 Stat. 849 U. S. C., title 15, ch. 4), *or from a pan-American trade corporation as defined in section 153.*

SEC. 116. EXCLUSIONS FROM GROSS INCOME—

* * * * * * *

(l) (New) DIVIDEND FROM PAN-AMERICAN TRADE CORPORATION.—In the case of a person (which term includes a corporation), amounts distributed as dividends to or for his benefit by a pan-American trade corporation as defined by section 153, if, at the time of such distribution, he is a resident of a country in which such corporation is engaged in business and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him (modeled after sec. 116 (f)).

SEC. 131. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.—

* * * * * * *

(f) TAXES OF FOREIGN SUBSIDIARY. * * *

(g) CORPORATIONS TREATED AS FOREIGN.—

* * * * * * *

(3) (New) A pan-American trade corporation entitled to the benefits of section 153.

The CHAIRMAN. I wish to put into the record a statement of John J. McCurry, legislative representative, on behalf of the International Brotherhood of Electrical Workers, affiliated with the American Federation of Labor, on the proposed tax on radio broadcasting.

(The statement referred to is as follows:)

STATEMENT BY JOHN J. MCCURRY, LEGISLATIVE REPRESENTATIVE, ON BEHALF OF THE INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS (AFFILIATED WITH THE AMERICAN FEDERATION OF LABOR)

PROPOSED TAX ON RADIO BROADCASTING

This statement is submitted to the Senate Finance Committee on behalf of the International Brotherhood of Electrical Workers, affiliated with the American Federation of Labor, and its quarter of a million members, a large number of whom are employed in the various phases of the radio-broadcasting industry. The statement is in opposition to the proposal to levy a special tax on radio broadcasting and, inasmuch as the position of the International Brotherhood of Electrical Workers has been made known previously to the House Ways and Means Committee when the 1941 Revenue Act was before that committee for consideration, much of the information contained herein will be a repetition of that previously given. However, it is being restated for the purpose of emphasis and in the hope that it will be of some benefit to the members of the Senate Finance Committee in arriving at a proper conclusion with regard to the subject of taxing the radio-broadcasting industry.

Undoubtedly every member of the committee fully realizes that a radio station, like a newspaper, magazine, or any other business, must compensate its employees with income from some source. A radio station, like a newspaper or magazine, derives its principal income, with which its employees are paid, from advertising time sales. In the advertising field, while utilizing an entirely different type or form of sales appeal, radio must compete with other advertising mediums. To tax one medium of advertising without taxing all others would certainly be discriminatory and unjust, both to the employer and the employee in the particular field taxed.

We want to make our position clear as to the matter of raising revenue necessary to prosecute the war effort, and that is: We do not object to any fair and equitable tax applied to all alike. Further, we realize that the need for revenue is serious, and it is not our intention to oppose the levying of a tax on radio broadcasting merely on the grounds that someone else should assume the burden. We only seek to have the necessary taxation applied equitably and without discrimination.

Therefore, if a tax is to be applied on advertising there can be no justifiable reason for taxing radio broadcast advertising unless there is an equal rate of taxation on all other forms of advertising. If we can take the record of the number of members on which the unions, comprising the Allied Printing Trades Association, have paid per capita tax to the American Federation of Labor as a standard of comparison, we find that their membership actually increased during the period of radio's greatest expansion. The following figures, with respect to the number of members reported, are taken from the official proceedings of the American Federation of Labor for the years shown:

	Name and membership of respective unions				
	Typographical	Printing pressmen	Bookbinders	Photoengravers	Stereotypers
1925	71,600	40,000	13,600	7,200	6,800
1930	77,600	40,000	13,900	8,000	7,800
1935	73,400	32,000	11,700	6,700	7,900
1940	[1] 76,400	43,700	18,700	10,700	8,400

[1] Figure in 1939. This union not affiliated with American Federation of Labor in 1940.

For purposes of comparison it is interesting to note the number of standard broadcast stations licensed for operation during the above period. From reports of the Federal Communications Commission we find that the number of standard commercial broadcast stations were as follows:

	Stations licensed
1925	571
1930	612
1935	605
1940	811

In the field of advertising the largest volume is expended for printed media: newspapers, magazines, periodicals, and direct advertising. Cost for radio-broadcast advertising constitutes only a fraction of the total expenditure for advertising in this country today. We could list authentic figures to show the tremendous increase in circulaion, and the establishment of hundreds of additional newspapers and magazines during the past 20 years. The printing-industry workers, in attempting to have the committee recommend a punitive tax on radio advertising, have selfishly disregarded these obvious facts. They also apparently ignore the fact that the radio-broadcasting industry each year spends several millions of dollars for printed promotional activities. In addition to the amounts expended by the broadcasters for printing, much additional advertising has been used by the radio-manufacturing industry for its sales and promotional work.

In submitting his proposal the representative of the printers endeavored to convince the committee that a tax on radio-time sales would not be a tax on advertising. Such contention is, of course, contrary to any sound reasoning, and it fails to explain why a client would pay to have a program broadcast by radio unless it had an advertising value.

The printers make the point that radio is entertainment. and should be taxed on that ground. If this should be true a properly formulated tax on amusement or entertainment would impose the tax burden upon those who are the beneficiaries of the particular entertainment or amusement. The tax proposed would be imposed upon the broadcasting stations and networks—upon the producer—not upon the consumer, and would have a detrimental effect directly upon employees in the broadcasting industry. The only measure of the amount of tax would be the amount of revenue, irrespective of quantity or quality afforded to any listener. While radio perhaps offers more entertainment with the advertising it carries than do newspapers with their advertising, there is no substantial basis upon which an amusement tax levy could be made upon radio.

Another fact regarding radio advertising that is frequently overlooked is the type of advertising carried by the radio. It must, because of regulations already imposed on radio, choose very carefully the advertisements accepted, and the service of many vocations including not only technicians and engineers, but musicians, announcers, script writers, artists, and others. The annual wage bill of radio is several millions of dollars.

Reduced to a simple statement, the proposal of the Printing Trades Association is nothing more or less than an attempt on their part to have enacted a tax on radio broadcasting that would cause advertising to revert to the printed page. This fact was recognized by the executive council of the American Federation of Labor in August 1941, when it adopted the following motion relative to a proposal to tax radio advertising at that time:

"While labor believes that the United States Government should levy extra taxes on the people to pay for defense work, we do not believe in punitive or discriminatory taxation as a special levy on radio-advertising broadcasts."

The American Federation of Labor further stated at that time that—

"The tax advocated is punitive and discriminates in favor of newspapers as against radio stations and is designed to take work away from a new industry and throw it to an old one."

A tax on radio advertising alone would have a seriously adverse effect upon the earning opportunities of the members of the International Brotherhood of Electrical Workers employed in the broadcasting industry. Such a situation would ont prevail if the tax were made applicable to all forms of advertising. In view of these facts we submit that there can be no justifiable reason for taxing radio-time sales, unless there is an equal rate of taxation on all other advertising.

We would like to reemphasize our statement that we are not opposing any tax that may be necessary—so long as the tax is equitable and applied to all alike. We submit that the tax proposed on radio broadcasting is a punitive tax, unreasonable, discriminatory, and partaking of the character of class legislation, violative of the fundamental democratic principle of equality under law. It should not be passed.

In addition we desire to have the committee know that we subscribe heartily to the statement submitted to the Senate Finance Committee on August 12, by W. C. Hushing, chairman of the American Federation of Labor national legislative committee, with which committee our organization cooperates.

The CHAIRMAN. I submit for the record a letter from Mr. F. Eberstadt, chairman of the Army and Navy Munitions Board, recommending depletion allowance for the lumber industries.

(The letter referred to is as follows:)

ARMY AND NAVY MUNITIONS BOARD,
Washington, D. C., August 3, 1942.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: In perusing H. R. 7378, 1942 revenue bill, it was noticed that section 711 provides that there shall be excluded income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of a product, the exhaustion of which gives rise to an allowance for depletion under section 23 (m).

The military is confronted with a serious shortage of certain important lumber products which are cut from selected timber, necessary to the war effort. Considerable stands of this timber are located in districts where the logging costs are abnormally high. Consequently large bodies of timber of this character are not cut at this time because the lumber mills find it possible to keep running at a profit and to full capacity on other items. The strategic importance of these items is not as important as that of the products from choice logs.

It has been the principle of the War production Board and the Office of Price Administration to stimulate production of key strategic materials by offering premium prices on quantities produced in excess of specified quotas, established on the basis of 1939-41 production, or some other recent period. The Ways and Means Committee's proposal provides that such bonuses be deductible from excess-profits net income and subject solely to normal and surtaxes.

Inasmuch as it does not seem practicable to increase the Office of Price Administration price schedules covering critical lumber items, it is believed that this proposed tax provision will give the necessary incentive to a large number of timber owners to increase their output of logs of high quality in localities of high logging cost.

This Board expresses the hope that the Senate Finance Committee will give serious consideration to the adoption of the provision referred to above.

Sincerely yours,

F. EBERSTADT, *Chairman.*

The CHAIRMAN. I submit for the record a brief of Mr. Robert B. Dresser of Edwards & Angell, Providence, R. I., on capital-gains tax provisions of the House bill.

(The brief referred to is as follows:)

BRIEF BY ROBERT B. DRESSER, PROVIDENCE, R. I., IN REGARD TO CAPITAL-GAINS TAX

I. PROVISIONS OF EXISTING LAW

The major provisions of the existing law relating to capital gains and losses are contained in section 117 of the Internal Revenue Code. After defining the term "capital assets," section 117 establishes a distinction between long-term and short-term capital gains and losses. Short-term capital gains and losses are those resulting from the sale or exchange of capital assets held not more than 18 months, and long-term capital gains and losses are those resulting from the sale or exchange of capital assets held more than 18 months. Long-term capital gains and losses, in turn, are subdivided into two classes: (1) Those resulting from the sale of capital assets held between 18 months and 24 months, and (2) those resulting from the sale of capital assets held more than 24 months.

In the case of both individuals and corporations, short-term capital gains in excess of short-term capital losses are taxed as ordinary income, and short-term capital losses are deductible only from short-term capital gains, with a right to carry forward net losses 1 year.

In the case of individuals, long-term capital gains are taxed at the maximum effective rates of 20 and 15 percent, depending upon whether an asset has been held between 18 and 24 months or more than 24 months, and where there are long-term capital losses the tax on ordinary income is reduced by exactly the same percentages of the loss as those applied to capital gains.

In the case of corporations, long-term capital gains are taxed as ordinary income, and long-term capital losses are deductible in full from any income of the corporation.

II. PROVISIONS OF HOUSE BILL

The more important changes made in the existing law by the House bill are as follows:

A. *In the case of individuals.*—(1) The distinction between long-term and short-term capital gains and losses is retained and a single holding period of 15 months is prescribed instead of the 18 and 24 months' periods under the present law.

(2) Short-term capital gains are taxed as ordinary income.

(3) One-half of net long-term capital gains is included in net income subject to normal and surtax rates, with a maximum effective rate on net gains of 25 percent instead of 15 and 20 percent in the present law.

(4) Losses, whether short or long term, are allowed as an offset against gains, whether short or long term, and as a deduction from other income to the extent of $1,000.

(5) Losses may be carried forward for 5 years against future gains, and also up to a $1,000 maximum in each year, against other income.

B. *In the case of corporations.*—(1) The same change in the definition of short-term and long-term capital gains and losses as in the case of individuals is made with the same holding period of 15 months.

(2) Long-term gains are taxed at a maximum rate of 25 percent and short-term gains at the regular corporate rate of 45 percent.

(3) With certain exceptions applying to banks and insurance companies, capital losses are not allowed as a deduction from ordinary income, but such losses, whether short or long term, are allowed as an offset against capital gains, whether short or long term.

(4) A 5-year carry-over of net losses against future gains, but not against ordinary income, is permitted.

III. CHANGES PROPOSED IN HOUSE BILL PROVISIONS

The following changes in the House bill provisions are hereby proposed, applying to both individuals and corporations:

(1) That the holding period and the distinction between short-term and long-term capital gains and losses be abolished.

(2) That all net capital gains be taxed at a flat rate of 10 percent.

IV. ARGUMENTS IN FAVOR OF PROPOSED CHANGES IN HOUSE BILL

In support of the changes proposed in the House bill it is submitted that—

1. Capital gains are not income in any true sense of the term, and the fact that they are defined as income in a revenue law does not change their real character.

2. The economic effects of a high capital-gains tax are decidedly harmful.

3. The capital-gains tax, if imposed at high rates, produces but little revenue. On the other hand, if the rate is low, very substantial revenue will be produced.

4. Tax avoidance under the proposed changes would be inconsequential.

I will discuss these points in their order.

1. *Capital gains are not income in any true sense of the term, and the fact that they are defined as income in a revenue law does not change their real character.*—The mere holding of an asset for a period of time does not of itself add anything to its value, and the same is true of a change in title. The gain resulting from a sale is in reality capital, and, except for the purpose of taxation under our tax laws, is commonly so treated. Take, for example, the case of a trustee who sells property belonging to the trust estate at a gain. The gain is not treated as income and paid to the life beneficiary, but is added to the capital of the trust estate. Conversely, capital losses suffered by a trust estate are charged against capital and not against income. A tax on capital gains can, therefore, be regarded only as a capital levy. To tax it as income is misleading and unsound.

If, however, notwithstanding their true nature, capital gains are to be treated as income for tax purposes, it is submitted that every consideration of equity and justice requires that capital losses shall be treated as the direct negative of income and that their deduction from income, of whatever character it may be, shall be permitted.

Our income-tax laws, in order to arrive at the net income to be taxed, permit the taxpayer to deduct from gross income of all sorts such items as interest paid, taxes paid (with certain exceptions), depreciation, and various other items. What would be said if it should be proposed that interest paid should be deductible only from interest received, that taxes paid should be deductible only from income from the property on which the taxes are paid, that depreciation should be deductible only from income from the property depreciated? The taxpayer might have no interest receivable or income from the property taxed or depreciated. Certainly any one of these proposals would be summarily rejected. And yet, why should capital losses be treated differently? If short-term capital gains are to be taxed as ordinary income, what possible justification is there for not permitting short-term capital losses to be deducted from ordinary income? Manifestly, there is none, and a contrary rule amounts to virtual confiscation. It is a capital levy, and not an income tax.

In short, capital gains are either income or they are not income. If, for tax purposes, they are regarded as income, capital losses, which are the direct converse of capital gains, should be deductible from income. If capital gains are not income they should not be taxed as income, and, conversely, capital losses should not be deducted from income.

If capital gains are taxed as income and capital losses are allowed as deductions from income, in the light of past experience it is not unreasonable to expect that the net revenue over a period of years would be nil.

2. *The economic effects of a high capital-gains tax are decidedly harmful.*—The capital-gains tax operates as a serious deterrent to the investment of capital in the equities of business enterprises, and its effect is to reduce steadily the fund of venture capital available for that purpose, since the tax comes out of this fund. It lessens the incentive to invest capital in existing and in new enterprises, and thereby reduces the number of jobs for those seeking employment.

In a statement filed with the House Ways and Means Committee on March 20 of this year by the tax committee of the executive council of the American Federation of Labor it is said:

"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 credits against other profits if the new venture is not successful."

Attention is also called to the following resolution of the National Association of Commissioners, Secretaries, and Directors of Agriculture, adopted March 31, 1942, which was filed with the House Ways and Means Committee:

"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 capital-gains tax lessens the stability and liquidity of markets, and by so doing seriously deters new capital issues which are so essential for expansion, recovery, and employment.

The tax creates frozen positions in securities and real estate, and thereby restricts business activity and the taxable income normally resulting from such activity and checks shifting into bonds for defense. For some years the real-estate market has been most seriously depressed, and where sales have been made they have usually been made at a great sacrifice.

Writing in the Tax Magazine, for September 1937, the late Morris S. Tremaine, comptroller of the State of New York, referring to the capital-gains tax, said:

"The law dams up the normal ebb and flow of trade. It affects commodity markets, especially real estate. Because of this, many real-estate owners have refused attractive offers of purchase, with the result that, in addition to sellers missing a sale, brokers miss commissions; the buyer is prevented from buying and improving property; contractors miss a job; a materialman misses the market; building construction labor and building service labor remain unemployed; the city misses an increased tax on proposed new building; and, lastly, fantastically enough, the Government collects no capital-gains tax."

The holding period is an artificial and unsound distinction between speculation and investment. There is nothing in accounting, in economics, or in fiscal policy which justifies the distinction between speculation and investment on the basis of time. Time does not lessen risk. It increases risk. The time factor is meaningless.

Three foreign witnesses, who testified before the Ways and Means Committee about the laws of their respective countries—Mr. Istel for France, Mr. Andriesse for Holland, and Mr. VanBuuren for Belgium—presented very interesting and informative testimony. Mr. Istel, who was technical adviser to the French Ministry of Finance under Paul Reynaud, stated that prior to the German invasion France had no capital-gains tax. In March 1941 the Vichy government introduced a tax on capital gains from stocks at a rate of 33 percent, and without limit as to the period of holding. In the words of Mr. Istel:

"The effect of the law was exactly contrary to expectation. The buyers of shares became more reluctant than ever to sell, as they wished to avoid paying the tax. Owing to the scarcity of offerings, the market thereupon rose even more sharply. In fact, owing to the complete absence of shares offered for sale, some stocks were not quoted at all, for days at a time.

"As a result, the Vichy government was compelled to relax the provisions of the law. In July 1941 the rate was reduced from 33 to 20 percent, and the holding period which was unlimited was reduced to 1 year from the date of purchase. After 1 year, capital gains were free of tax.

"In February 1942 the law was relaxed further 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 months' holding period."

Mr. Andriesse testified that even in periods of urgent need for additional revenue the Netherlands Government never taxed capital gains, believing that it would check the development of new businesses.

Mr. VanBuuren testified that there was no tax on capital gains in Belgium for individuals, that the state took the position that fluctuations in prices of securities, of real estate, and other capital assets were too uncertain to be made a source of Government revenue.

3. *The capital-gains tax, if imposed at high rates, produces but little revenue. On the other hand, if the rate is low, very substantial revenue will be produced.*—This is due to the fact that the taking of capital gains is discretionary. When the tax rates are high the owner elects not to sell unless the sale will result in a loss. Senator Connally brought out this point very clearly when he said at the hearings before the Senate Finance Committee on the Revenue Act of 1938:

"It seems to me there is a differentiation between ordinary income and income from capital gains. In the case of ordinary income the taxpayer has to pay it [the tax]; he has no choice. But in the case of capital gains he has a choice; he does not have to realize unless he wants to. * * * If the holder does not sell, you do not get any tax. * * * 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."

According to a statement made by the late Morris S. Tremaine, while he was comptroller of the State of New York, a State in which capital gains, if any, should be large, "the tax positively has never produced a dollar of net revenue for the State." The transactions of course were subject to both the Federal and the State taxes.

Our experience under the various revenue acts in effect since 1913, evidence of which was introduced before the Ways and Means Committee, amply supports the conclusion that the lower rate produces the large revenue. From the Treasury Department's own figures it appears that if the 5-year boom period, 1925–29, is excluded, the taxpayers of the United States had no net capital gains, but huge capital losses amounting to over $8,000,000,000, during the period from 1917 to 1940. For the year 1940 the revenue produced by the capital-gains tax, according to the Treasury figures, was $12,868,000, and I suspect that the revenue for the year 1941 was a minus quantity. From a revenue point of view, therefore, the capital-gains tax has been very disappointing.

Mr. Elisha M. Friedman, consulting economist, of New York City, who has made a most thorough and enlightening study of this problem, the results of which were presented by him to the Ways and Means Committee, estimates that under the provisions of the Boland bill (H. R. 6358), providing for the abolition of the holding period and a flat 10-percent rate on all capital gains, the Treasury would probably receive in a single year between $100,000,000 and $650,000,000 from the tax on capital gains on New York Stock Exchange securities alone traded within the year, the actual amount depending upon the fluctuations and activity. To this should be added tax receipts on securities held for longer periods, besides the tax receipts from capital gains on the billions of dollars of other assets outside of those listed on the New York Stock Exchange, including billions of dollars of farm lands and buildings and other real estate. Added to this would be the additional receipts of the Federal and State Governments from stock-transfer taxes, which, if they doubled, as they might well do, would amount to $18,000,000 for the Federal transfer tax and $21,000,000 for the New York State transfer tax.

It should be added that, in addition to the increased revenue derived from the capital-gains tax itself and from the stock transfer taxes, there would undoubtedly be an increase of substantial proportions resulting from the stimulus given to our entire economy by the proposed changes in the law which would lead to larger national income and hence larger revenue from income taxes on ordinary income, an effect which might not be pronounced during the present period of war-stimulated activity, but which would be decidedly pronounced in the period following the war.

In the light of all this, it is submitted that while the taxation of capital gains is unsound in principle and cannot under normal circumstances be justified, nevertheless very substantial revenue would undoubtedly be produced from such a tax if the rate were made low enough to remove the barrier which exists to the taking of gains under the present law and which would exist under the House bill, that a rate of 10 percent would in all probability have this effect, and that the present emergency justifies the temporary imposition of such a tax.

In this connection it is of the utmost importance to bear in mind that to secure the maximum revenue from the capital-gains tax the holding period must be completely eliminated. The holding period, with its high rate of tax, creates an artificial barrier to the sale of property during that period, thereby greatly reducing the revenue to the Government. Elimination of the holding period and a low rate of tax applicable to all capital gains are both important if the maximum revenue is to be obtained.

4. *Tax avoidance under the proposed changes would be inconsequential.*—In his statement to the Ways and Means Committee on March 30, 1942, regarding the capital-gains tax, Mr. Randolph Paul, speaking for the Treasury Department, contended that the adoption of the provisions of the Boland bill with its 10 percent rate on all capital gains would facilitate tax avoidance. He argued that the imposition of a tax rate on capital gains substantially below that levied on other sources of income would give taxpayers a strong incentive to convert other income into capital gains. As one method of accomplishing this—the method to which the principal consideration seems to have been given—he suggested that—

"* * * 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."

Careful scrutiny of this suggestion, however, indicates that this would not constitute a means of tax avoidance. As a matter of fact, in the vast majority of cases, even apart from any fluctuation in price, the expense of making the purchase and sale would exceed the income tax payable on the dividend if the taxpayer had continued to hold the stock. To test the question, let us take as an example the following case:

Suppose a stock selling at $60 a share and paying a quarterly dividend of $1 per share, and suppose that this stock is purchased at 60 immediately after the payment of the dividend and that 3 months later immediately prior to the payment of the next dividend the stock is sold cum dividend so that the dividend would be paid to the buyer rather than the seller, and suppose the very unlikely contingency that the stock is sold at 61 so that the gain on each share is $1, the exact amount of the dividend. In such a case the Federal and New York State transfer taxes and the broker's commissions payable by the taxpayer would amount to 65¼ cents per share. This sum, deducted from the gain of $1, would leave a net taxable gain of 34¾ cents which, under the Boland bill, would be taxable at 10 percent. This tax, amounting to 3½ cents, deducted from 34¾ cents would leave 31¼ cents net gain to the taxpayer. Let us assume that this taxpayer is a man of substantial means with a taxable income of between $50,000 and $60,000. The maximum rate of tax under the present law on his ordinary income would be 61 percent. If he had held the original stock and received the dividend on it, he would have paid a tax of 61 cents on each dollar of the dividend. This would have left him a net of 39 cents, or 7¾ cents more than he would have had if he had tried the tax-avoidance scheme suggested by Mr. Paul and had sold the stock cum dividend. This is shown more clearly in the following table:

I. *Results per share under tax avoidance plan*		II. *Results per share if no tax avoidance attempted*	
Purchase at 60—sale at 61: capital gain	$1.00	Dividend	$1.00
Less expenses:		61% income tax	.61
Commission on purchase	.27½	Net income	.39
Commission on sale	.27¾		
Federal transfer tax on sale	[1] .06		
New York transfer tax on sale	.04		
Total	.65¼		
Balance	.34¾		
Less 10% tax on capital gain	.03½		
			.31¼
Net gain	.31¼		
Difference between net gain under I and II			.07¾

[1] If $100 par value or no par value.

If the taxpayer's maximum rate of tax under II had been less than 61 percent, the difference in the net gains under the two plans would have been still more favorable to II.

If the taxpayer's maximum rate of tax had been 70 percent instead of 61 percent, he would have been 1¼ cents a share better off under I, the tax-avoidance plan, than under the other, and if his maximum tax rate had been

81 percent, the highest rate assessable under the present law, he would have been 12¼ cents better off. Is it conceivable that any person, for this possible trivial gain of a few cents a share on a $60 stock, would incur the risk of a fluctuation in the price of the stock during the time he holds it that might be many times the amount of the possible saving? Furthermore, it should be observed that it is not by any means the fact that when a stock goes ex dividend its market price is reduced by the amount of the dividend. The reduction is frequently less.

So far as the matter of tax avoidance through any means is concerned, it is believed that this would be inconsequential. To refrain from adopting a low rate which would produce the largest revenue merely because of this would be like burning down the house to get rid of the mice.

V. CONCLUSION

In conclusion, it is submitted that—

1. The taxation of capital gains is unsound and can be justified only by the great need of revenue in the present emergency. As soon as the emergency is over the tax should be repealed.

2. If, as I assume, the purpose of the tax is to raise revenue, there can be no doubt in my opinion about the wisdom of adopting the 10-percent rate and abolishing the holding period with its prohibitive rates, as is herein proposed. However, if any doubt exists in the minds of the committee on this point, why not give the proposal a trial? If after a reasonable period it is found that a mistake has been made, the law can readily be changed. There is not much to lose in giving the proposal a trial, since the present law produced but $12,000,000 from capital gains in 1940 and I suspect even less in 1941, to say nothing of the disproportionately high cost of collection due to the large amount of litigation regarding the tax.

Respectfully submitted.

ROBERT B. DRESSER.

AUGUST 1, 1942.

The CHAIRMAN. I submit for the record a brief by Arthur G. Drefs, vice president of the McQuay-Norris Manufacturing Co., St. Louis, Mo., on the general provisions of the tax bill.

(The brief referred to is as follows:)

BRIEF PREPARED BY ARTHUR G. DREFS, VICE PRESIDENT, McQUAY-NORRIS MANUFACTURING CO., ST. LOUIS, MO.

Senator WALTER F. GEORGE, chairman, Senate Finance Committee: Tax bill, in addition to providing revenue for the current fiscal year, should also, as far as practicable, consider the long-range effect on the taxed individual or corporation and on the national economy.

It is now evident that the wave of optimism that swept this country after the bombing of Cologne, the initial success of the Russians at Kharkov, and the successful stand of the British in Egypt, created a false hope for the early termination of the war.

The tax bill that is presently enacted should consider the probability of a long war, with severe taxation on all types of income but without destroying the instruments of production.

The bill as passed by the House will have disastrous results on many corporations. The tax rates are so severe as to eliminate opportunity of debt repayment. The House tax bill provides no incentive for low-cost operation. The House tax bill destroys the incentive to embark in further war effort, especially "hard jobs."

The report of the National City Bank, just issued, shows the effect of the House bill taxes on 180 prominent manufacturing organizations. Briefly, the first quarter reports of 1942 as compared to the same quarter of 1941 showed a reduction in net income of 32 percent. The second quarter of 1942 showed a reduction of 42 percent when compared to the same quarter of 1941.

The inevitable result must be widespread reductions of corporate dividends.

Those corporations with heavy bonded indebtedness, bank loans, or high rate preferred stocks, or all three, will probably have to substantially reduce or completely eliminate the dividends on junior shares, such as common stocks.

With reduced earnings, maturing bonds and bank loans will be difficult to extend or refinance. Equity capital will be unobtainable except at prohibitive rates.

Reduction in corporate dividends reduces taxable income of individuals, offsetting in part the yield from corporations.

Likewise, reduction in dividends will cause decline in security prices, reducing revenue from capital gains, and increase capital losses, with consequent reduction in taxable income.

Gift, estate, and inheritance revenues will likewise decline.

Serious consideration should be given to the impact of the House taxes on the financial condition of corporations.

In the case of McQuay-Norris Manufacturing Co., the value of our output will have increased from $9,400,000 in 1941 to $40,000,000 in 1942; number of employees from an average of 1,700 in 1941 to between 7,500 to 8,500 in 1942; gross profit of $1,066,800 in 1941 to an estimated profit of $1,700,000 in 1942; Federal taxes in 1941 of $522,600, to $1,282,500 for 1942; net profit (using exemption base of $550,000 in 1942—actual in 1941), at House rates, $541,817 actual in 1941, $417,500 in 1942, or a decrease of $124,317 in spite of $30,530,000 greater business.

McQuay-Norris dividends this year will probably be $2.50 per share of common, or a total of $285,872.50. This leaves for plant expansion, increased inventory, reduction of bank loans capital-stock taxes, Missouri taxes, $131,627.50.

Result is choice of (a) reduction of dividend; (b) complete secession of plant and inventory expansion; (c) impair working capital and financial position of company; (d) continue bank loans with no reduction.

House tax bill is particularly vicious to small and moderate size corporations who have done an outstanding war job.

Suggestions:

First. Provide incentive. Fix the maximum total tax (including normal, surtax, and excess-profits tax) that can be levied against a corporation at from 66⅔ to 70 percent.

Second. Establish accelerated depreciation rates. Example: Corporation normally works 51 weeks per year at 40 hours per week. Depreciation allowance by Treasury Department to us on machinery now averages 8 percent. If company works 80 hours per week 51 weeks, recommend rate increase of 15 percent. Eight percent rate would thus be increased to 9.2 percent. If hours worked were 120 per week, 51 weeks, depreciation rate would be increased 30 percent; thus 8 percent would become 10.4 percent.

Such a formula would eliminate hundreds of tax cases which will inevitably result. Corporations know that three-shift 7-day-week operations increase wear and tear. Treasury should recognize this by accelerated depreciation formula.

Third. Change section 719 of Internal Revenue Code, Borrowed invested capital, so that advances by Government, including those without interest, can qualify for invested capital the same as a bank loan. Paragraph (a) 2 of section 719 permitted loans from foreign governments to so qualify. There should not be discrimination if loans are made by our Government.

Fourth. If no maximum total tax rate is established, there should be provided some method for recovery of excess-profits tax over 80 percent, and for combined normal and surtaxes, over 40 percent.

Unless this is done the adjustment from war to peace will result in a financial catastrophe. There will be few if any profits during the adjustment period. Debts, including taxes, will have to be paid. This would result in wholesale liquidation of assets to provide cash.

The Chairman. The following was submitted by Hon. Hattie Caraway, Senator from Arkansas, for insertion into the record on the effect of the gasoline tax increase upon the precarious financial position of Arkansas.

(The statement referred to is as follows:)

STATEMENT OF HON. HATTIE CARAWAY, A SENATOR FROM THE STATE OF ARKANSAS

EFFECT OF THE GASOLINE TAX INCREASE UPON THE PRECARIOUS FINANCIAL POSITION OF ARKANSAS

Mr. Chairman and gentlemen of the committee, I fully appreciate the stupendous task which faces you in the writing of a tax bill to raise the huge amount of revenue which is called for to finance our present war program. Nevertheless, I know that you approach this task with full realization that the financial load must be distributed as fairly and equitably as possible so that no individual or group will be called upon to bear more than its proportionate share of this burden. I know that you have those considerations foremost in your minds at this time, but due to the stress of the present situation I wonder if you have given due consideration to the effect of Federal encroachment upon the limited field of State revenues. I refer particularly to the principal revenue source of all the States, namely, the gasoline tax, and to the Treasury Department's proposal to increase the present duplicating Federal motor fuel impost from 1½ cents to 3 cents per gallon.

I am greatly concerned as to the effect which such a move would have upon the solvency of the State of Arkansas. But I may say that its effect would be equally disastrous to the financial position of several other States.

During the 1920's, Arkansas embarked upon a tremendous program of highway improvement. Millions were borrowed to finance new roads and when the crash came in 1929 the State was deeply in debt. Relief was sought through negotiations with the bondholders but before these could be consummated so much time had elapsed that the State was on the brink of repudiation. Motorist taxpayers were faced with saving the financial integrity of the State. The gasoline tax rate was increased to 6½ cents a gallon—the second highest rate in the Union. The State was returned to a sound financial footing but only by a narrow margin. The State's bonded indebtedness as of January 1, 1942, amounted to $139,106,557 and so much of the State gasoline tax has been required for bond payments and road maintenance that nothing has been available for new construction. In recognition of this fact, the Federal Government, itself, during the 4 years from 1936 to 1939, allowed Arkansas to obtain its Federal highway aid without matching—a practice without precedent under the Federal Highway Act. After many vicissitudes the highway fiscal situation was materially improved through refunding the highway debt in 1941, but the hoped for relief was short-lived. For now the stoppage of automobile sales and tire rationing again has curtailed highway revenues and an additional cloud looms on the horizon. This new cloud is the threat of gasoline rationing and the decline in the use of all passenger vehicles.

Under the terms of two refunding agreements made with Arkansas' bondholders in 1934 and 1941, the State agreed to set aside each year for bond amortization a minimum of $7,175,000. Also under the terms of these agreements the State must provide an additional $3,075,000 annually to assure the bondholders that their physical investment will not be unduly depreciated.

During the calendar year 1941 the State received $13,219,000 in gasoline tax revenue. From this amount $1,500,000 is allocated to the counties, or three-quarters of a cent of the tax. This share is depended upon to provide funds to finance the improvement and maintenance of county roads so that their secondary road system upon which maintenance costs naturally are larger than upon the more highly improved State system also seriously are affected by the diminishing revenue upon which they must depend for the duration.

The cities, too, are vitally interested in the State-collected gasoline tax revenue, for at the recent legislative session they were allocated a portion of the collections. Under the provision of this enactment, however, the cities share only in the event that collections exceed a certain prescribed minimum. Last year the yield just began to approximate this figure. If it falls slightly below current levels, the cities will receive nothing and it is conceivable that if the Federal Government encroaches upon this tax source upon which State, counties, and municipalities now are dependent, it may well be guilty of depriving the cities of any revenue whatever from this source.

As I said previously, Arkansas is not the only State which will be affected by a further invasion of the gasoline-tax field, for nearly all have resorted to borrowing for highways. Currently almost every State has some outstanding highway debt, as shown in the attached table. This debt totals approximately $1,800,000,000. In reliance on the gasoline tax as a stable revenue source, many States have pledged future receipts for payment of principal and interest on their highway obligations. One State used 73 percent of its share of gasoline-tax revenues to service State highway bonds and its counties used 12 percent of the share granted to them by the State. No less than eight States use more than 40 percent of their gasoline-tax revenues for principal and interest charges on highway indebtedness.

The States face a grievous problem during the period of curtailed automobile operation. But if this tax is enacted, that problem will be carried over to the post-war era, for if the Federal tax is increased it will be continued at the higher rate long after the war, and its effect will be felt through the curtailed consumption of gasoline and in lower State revenues. This would have a disastrous effect upon the States, for, following the armistice, existing State highways obviously will be in need of repair and because of the curtailment of new construction many new roads will be needed. This new State highway construction will be a tremendous factor in bridging the gap of unemployment while the Nation reverts to a peacetime economy, and we cannot afford to jeopardize the principal revenue source for this program.

In view of these factors, it is urged that the Federal Government should not increase the rate of its gasoline rate now.

Appendix

State highway debt

State	Highway debt outstanding [1]	Annual debt service charges paid from highway-user taxes [2]	Percent of State share of gas tax funds used to service debt [3]	Percent of local share of gas tax funds used to service debt [3]
Alabama	$36,854,000	$2,627,000	15.3	
Arizona	None		None	
Arkansas	139,106,557	9,850,000	73.0	12.2
California	111,574,000	3,695,000	None	
Colorado	22,620,000	1,907,000	26.6	
Connecticut	21,498,000	1,987,000	15.0	
Delaware	8,312,000	655,000	19.4	
District of Columbia	None		None	
Florida	108,318,562	9,627,000	40.5	
Georgia	25,330,856	83,000	(4)	
Idaho	357,500	101,000	(4)	
Illinois	111,014,000	11,435,000	None	7.3
Indiana	None		None	
Iowa	62,261,000	8,302,000	44.0	
Kansas	18,052,110	1,335,000	11.4	
Kentucky	4,486,500		None	
Louisiana	101,965,000	7,214,000	65.8	
Maine	22,777,500	2,770,000	31.4	
Maryland	25,712,000	1,404,000	None	12.7
Massachusetts	11,452,625	6,092,000	34.3	15.7
Michigan	31,950,000	4,031,000	15.9	
Minnesota	33,008,618	4,273,000	None	
Mississippi	55,497,000	3,523,000	51.6	
Missouri	84,990,000	8,869,000	37.8	
Montana	3,000,000	947,000	18.2	
Nebraska	None		None	
Nevada	None	88,000	(4)	
New Hampshire	10,305,000	1,148,000	25.2	51.5
New Jersey	74,740,000	5,952,000	17.2	19.4
New Mexico	23,555,000	1,897,000	41.3	
New York	92,000,000	11,819,000	36.5	
North Carolina	71,619,000	8,788,000	25.9	
North Dakota	600,000		None	
Ohio	4,084,000		None	
Oklahoma	None		None	
Oregon	12,679,250	2,700,000	21.6	
Pennsylvania	55,426,000	5,758,000	8.1	
Rhode Island	5,087,000	215,000	8.5	
South Carolina	64,220,592	2,750,000	21.9	
South Dakota	None	2,000	(4)	
Tennessee	67,885,000	8,528,000	45.0	
Texas	81,741,872	7,287,000	21.5	
Utah	None	118,000	None	
Vermont	5,015,000	1,337,000	26.1	25.4
Virginia	3,428,000	221,000	(4)	
Washington	6,034,000	350,000	2.5	2.0
West Virginia	76,467,000	7,939,000	44.7	
Wisconsin	13,331,906	3,887,000	35.2	
Wyoming	2,520,000	117,000	3.2	
Total	1,803,979,448	156,838,000	18.2	2.9

[1] All figures in this column from American Association of State Highway Officials, American Highways, July 1942, p. 11.
[2] Actual charges for calendar year 1940.
[3] Represents only share of tax actually available to State government itself for use on highways; hence excludes entirely all allocations to localities and also all authorized diversions of gasoline-tax funds to nonhighway purposes. Based upon official releases of U. S. Public Roads Administration, table G-3, 1940.
[4] Less than 1 percent.

The CHAIRMAN. Mr. G. Donald Kennedy, president of the American Association of State Highway Officials, who has been present for 2 days, has agreed, in lieu of personal appearance, to file a brief on behalf of the State highway officials of 48 States in opposition to increase in Federal excise tax on gasoline. The brief will be held by the committee for reference and consideration if the committee decides to consider any increase in the gasoline tax.

(Whereupon, at the hour of 1:50 p. m. the hearings were closed.)

APPENDIX

(The following communications have been ordered printed in the record:)

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance, United States Senate,
Washington, D. C.

MY DEAR MR. CHAIRMAN: I respectfully request, in lieu of a personal appearance before your committee, that this communication be extended in and made a part of the record of the hearings being held before your committee on the pending revenue bill.

When the revenue bill was pending before the Committee on Ways and Means, United States House of Representatives, I addressed a letter to Hon. Robert L. Doughton, chairman of the committee, presenting such information as we believed would be helpful in framing those sections of the revenue bill affecting the American jeweled watch industry.

This letter contains, in addition, information covering more recent developments.

We are gratified to inform your committee that the American jeweled watch industry has made material progress on its vital war activities and we are confident that our performance of the duties assigned to us will meet with the approval of the military establishments.

Recently, the production of civilian watches has been materially curtailed by order of the War Production Board. We have recognized that the necessities of war production would inevitably lower the production of civilian watches, but it is essential that the remaining capacity of our industry be protected and developed to insure a continued supply of needed civilian watches for an efficient war economy.

We believe your committee and the Congress should be informed that a very large percentage of the so-called civilian watches are purchased by or for and used by citizens actually engaged in vital war activities.

Relatively few members of the armed forces are supplied with watches by our Government, but an accurate watch is essential to a properly equipped soldier, sailor, marine, or coast guard man. These watches are usually purchased by the man personally, or for them by friends or relatives, and are classified as "civilian watches," which seems a sort of solecism.

Watches are essential for railroad employees, commercial air-line pilots and personnel, and the personnel of other transportation facilities; for civilian air-raid defense workers; doctors, Red Cross, Army, Navy and civilian nurses; laboratory and scientific research workers, and for the vast army of industrial and office workers, both in Government service and private industry.

It will require the diligent thought and effort of our industry to meet the combined requirements of war production and civilian needs, but with the cooperation of our Government and with full understanding of the requirements by the responsible officials of our Government, we can and will successfully perform this duty. We ask only for the helpful cooperation of our Government.

The American jeweled watch industry is dedicated to the single purpose of service to our Nation in this war.

We recognize that new and heavy taxes are an imperative necessity and we prefer fully to bear our proper share of the burden.

The duties of your distinguished committee are onerous and it seems fitting to us that we cooperate with your committee and the Congress by refraining from offering our suggestions on the minutes of form of taxation at this time.

Our confidence in the ability and fairness of your committee and the integrity of the judgment of the Congress and our assurance of their faithful consideration of the requirements of the Nation impel this decision.

We believe it is proper, in order that you may have the facts before you, to call to your attention the vital war activities of the American jeweled watch industry. They are as follows:

Chronographs for Army and Navy; chronometers for the Navy and merchant marine; chronometric tachometers for air corps; clocks for Army tanks; deck watches for the Navy; hang-fire recorders for small-arms munition testing; jewel-making machinery for War Plant Corporation; jewel-making plants for war instruments; machine-gun camera watches for Navy flyers; map measurers for Army Engineer Corps; military camera and radio parts; navigational master watches for bombers and long-range flights; stop watches for naval gun turrets; time and impact fuzes for Army ordnance; waterproof watches for Marine Corps. Also—

> Aviation watches and clocks; escape wheels for ship's clocks; fine gages; instrument parts for tanks and trucks; jewels for watches and other precision instruments; military and naval watches; parts for aviation instruments; parts for arsenals, navy yards, and high-priority war instrument makers; and stop timers for Army and Navy.

Also vital are the following:

> Railroad watches to keep transportation rolling; watches to coordinate civilian air-raid defense; watches for doctors, Red Cross, Army, Navy, and civilian nurses; watches for enlisted personnel of armed forces; watches for workers in industry and distribution; watches for commercial air-line pilots and personnel; watches for laboratory and scientific research; and watches for Government employees and other office workers.

We have called these activities to the attention of the responsible branches of the executive departments and independent offices, agencies, and establishments of the Government. We did so because it is essential that the industry be allowed sufficient material for the manufacture of civilian watches to maintain our organizations during the period of tooling up for war production.

It should be observed that 95 percent of the work that has been assigned to this industry for the war program are articles for which we are presently not tooled to make, many of them formerly imported from Europe. It is, therefore, most imperative that this industry be permitted to operate on its commercial lines to maintain our skilled help, so that they will be available when the tool-up is completed and we are on an all-out war production basis.

In determining an appropriate tax on watches it should be borne in mind that a large proportion of the so-called civilian watches, both strap and pocket, we are permitted to make are being sold to the boys entering the armed forces, and an exorbitant tax would reduce the demand for the utility watch and again interfere with our employment program.

In comparison with most of the industries vital to our national life the American jeweled watch industry is small, employing approximately only 10,000 men and women, many of whom are highly skilled and whose individual training required from 6 months to 5 years.

The total amount of material that actually goes into the making of watches is relatively insignificant and for 1,000,000 watches would approximate 15½ tons net. The bulk of the material used in the manufacture of watches is retrieved from scrap and returned to refineries for reuse.

The industry is devoting its entire research, engineering, drafting, and tool and die-making facilities to Government work. It has erected new buildings, installed new machines, and trained employees to new skills.

If permitted to keep its facilities intact, the American jeweled watch industry can be of great service to the United States and the United Nations during the war period and of service to all of the Americas and the United Nations during the years of reconstruction.

Should our organizations be dispersed through lack of work during the period of tooling up for war work it would not be possible to reassemble them or replace them, and our assignment in the war would be marked by failure. It is this that we wish to avoid. It is this that we must prevent. Accordingly we believe it is our duty to lay the essential facts before the responsible heads of our Government.

The official Government figures on imports are no longer available to us, but our Government and the American jeweled watch industry know that at the present time Swiss watches are being received in the United States in larger quantity than ever before. While permitting Nazi-dominated Switzerland to enjoy this privilege, our Government is allowing Switzerland to refuse to export jewel bearings to the United States—both watch and meter jewel bearings—needed by us not only for watches but for many vital war implements.

Switzerland, from whom we have always imported the vast bulk of our jewels, has had a near monopoly on jewel bearings for 100 years.

During the present emergency, the American jeweled watch industry has expended large sums of money and our Government has advanced additional large sums for the erection of jewel bearing plants in an effort to relieve the shortage.

It creates an anomalous situation when a nation, embracing so great a privilege as Switzerland presently enjoys in the watch market of the United States (due to curtailment of American watch production), seeks to stalemate our Government by refusing to export jewel bearings to us. We believe this warrants the prompt and thoughtful attention of our Government.

At another time, when peace and security have been recovered and the Nation's requirements permit, we will ask the privilege of appearing before your committee to request a more equitable reclassification of watches.

At that time we will again call your attention to the fact that for purposes of taxation, under normal conditions, watches should be segregated under two classifications: (1) The luxury class watch, ornamented with precious or semiprecious stones, etc., which is properly classified as "jewelry," and (2) the utility watch, which certainly is not jewelry and should not be taxed in similar manner, but recognized as the one precision instrument indispensable in the life and work of every citizen. A man's watch is his most constant companion and reliable guide.

Very respectfully,

(Signed) C. M. Kendig,
President, American Jeweled Watch Manufacturers' Association of the United States.

THE EFFECT OF TAX PROPOSED IN H. R. 7378 ON WISCONSIN POWER & LIGHT CO., A UTILITY OPERATING COMPANY, 86-PERCENT ELECTRIC, SERVING A RURAL TERRITORY IN WISCONSIN

This company is typical of many electric utility operating companies in the United States serving small cities, villages, and farmers.

The Wisconsin Power & Light Co. supplies utility electric service to one-fourth the area of the State of Wisconsin; to 300 communities at retail with population of 266,000, or an average of 900 per community; to 33 communities at wholesale; to 20,000 farmers.

The company is truly a rural-type company and typical of many utility companies located west of the Allegheny Mountains.

The Wisconsin Power & Light Co. was largely developed from the beginning of World War No. 1 to the beginning of World War No. 2; brought 24-hour electric service to 201 communities that previously had no electric service; brought 24-hour electric service to 48 communities that previously had part-time service; brought 24-hour electric service to 20,000 farmers; reduced the average cost per unit of service by 50 percent to its residential, commercial, and rural customers; spent millions of dollars for new generating plants, transmission lines, and distribution systems.

This performance is also typical of a large number of utility companies located outside large cities.

The Wisconsin Power & Light Co. has made this development under the regulation of the regulatory commission of the State of Wisconsin; has not issued and sold any of its securities without authorization and approval of such commission; has sold its preferred and common stocks at par or higher; was first utility in the United States to file its property accounts with Federal Power Commission on the original cost basis; is now furnishing power to 106 industries working on war orders; is furnishing power to the Badger Ordnance Works, to be one of the country's large powder plants requiring electric power equal to one-third of the company's entire output in 1941.

The Wisconsin Power & Light Co. secured the money to finance this development by selling $80,000,000 of first-mortgage bonds, sold to investing public; $5,442,500 of notes, maturing serially over next 10 years, sold to banks and life-insurance companies; $16,819,300 of preferred stock, sold largely to customers of company (85 percent owned in Wisconsin); $7,309,250 of common stock, sold principally to North West Utilities Co.

Due to the speed of the development, large amounts of money had to be borrowed and the above is quite typical of many utility companies located in rural districts.

The preferred stockholders number 16,500, are largely customers of the company, make up one-sixth of the company's residential customers, own an average of 10 $100 shares each, are 32.2 percent housewives (many of whom are widows), are 20.2 percent retired people (largely farmers), are 11.1 percent skilled workmen, are 10.1 percent professional people, and are found in nearly every walk of life.

One out of six customers of the company is a preferred stockholder who has invested $1,000 on the average.

Similar conditions prevail in many electric utility companies located in rural territory.

Earnings of company

	Year 1940	12 months ending June 1942 if taxes as proposed in H. R. 7378 are used
Total revenue	$10,652,115	$11,652,759
Operating expenses	3,986,640	4,228,167
Taxes other than income	1,416,392	1,568,029
Depreciation	1,316,696	1,388,403
State income	143,398	132,238
Federal normal and surtax	516,560	826,250
Federal excess-profits		1,204,000
Total operating expenses and taxes	7,379,686	9,347,087
Gross income	3,272,429	2,305,672
Other income	39,925	6,850
Total income	3,312,354	2,312,522
Interest on long-term debt, including amortization, etc	1,704,065	1,240,500
Net income	1,608,289	[1] 1,072,022

[1] A decrease of $536,000 from 1940 net income and not equal to the amount of full preferred stock dividends and, therefore, nothing for common stock. An excess-profits tax should take excess profits and not decrease net income so low that even full preferred dividends cannot be paid.

Retiring of debt.—The company has a debt-retirement program of about one-half million dollars a year for the next 10 years to which it is obligated.

The taxes proposed in H. R. 7378 will so reduce the net income that the only way to meet this obligation is to further slash dividends to preferred stockholders. This is highly undesirable and will work severe hardships in many cases.

This company has not earned, in any years during the past 10 years, after taxes and depreciation, 6½ percent on the depreciated value of its tangible property and should not now be forced through taxation to such a low net income that its ability to meet its obligations are jeopardized.

Wisconsin Power & Light Co.—Taxes (including those proposed in H. R. 7378) compared with pay roll and earnings of company before bond interest for 12 months ending June 1942

Taxes	$3,730,517
Total operating pay roll	2,359,942
Total earnings (after taxes and depreciation but before any deductions for interest)	2,312,522

Total taxes exceed pay roll by $1,370,575, or 58 percent.

Total taxes exceed the amount earned for bondholders and stockholders by $1,418,000, or 61 percent.

Over 60 percent of total taxes are Federal taxes.

When taxes of a utility company exceed total pay roll by 50 percent or exceed by 60 percent the total earnings to the people who put up all the money to finance the company, the company is weakened to a dangerous point and may not be able to efficiently and effectively carry its war obligations.

Wisconsin Power & Light Co.—Taxes per dollar of revenue

Year:	Cents
1925	6.13
1930	9.14
1935	14.20
1940	19.49
1941	25.19
Ending June 30, 1942, taxes proposed in H. R. 7378	32.01

The Wisconsin Power & Light Co. carried a tax burden in 1941 which was four times as heavy per dollar of revenue as in 1925 and wants to pay its fair share of taxes but feels sure that the taxes proposed in H. R. 7378 are too high when applied to companies with high ratio of investment to income such as utility companies that are regulated by Government commissions.

CAPACITY OF UNITED STATES ELECTRIC UTILITY COMPANIES

The electric companies of the United States have built and are now operating electric generating stations having a capacity five times the capacity in World War No. 1.

The electric companies of the United States now operate stations with more capacity than the capacity of the generation stations of all Axis nations combined.

The war loads of the United States are being largely carried by power from the stations of these electric companies in the United States.

More demands will be put on these companies to furnish more power. It is important to the war effort that nothing be done which will so cripple these companies that they cannot continue to efficiently and effectively carry on their part in the war effort. Bill H. R. 7378, as now drawn, would seriously cripple many utility companies.

Suggested source of additional taxes.—Approximately seven-eighths of electric utility business in the United States is done by electric companies and one-eighth by so-called Government-owned utilities (Federal, State, municipal). Under present law and under bill H. R. 7378, one-eighth of the electric-utility business pays no Federal income and excess-profits tax.

Under the two types of ownership the service is similar, the customers are similar.

Why not tax the entire business in a uniform manner?

If this is not done, then either the customers of Government-owned utilities are not paying their fair share of the war effort or the Government-owned utility is keeping profits that should be paid to the Federal Government to help win the war. Electric companies should not have their taxes increased until this one-eighth of the electric-utility business is made to do its fair part in carrying the war burden. This would produce about $50,000,000 of additional taxes for the Federal Government and would treat the entire electric-utility business in the United States on a uniform basis.

There is no apparent reason why Government-owned utilities should not also pay the Federal Government the 3⅓-percent sales tax now paid by electric companies.

Suggestions.—1. Restore the excess-profits tax to its original position—namely, apply it to net earnings after other taxes have been deducted—or lower the percentages.

2. Permit the deduction from earnings of payments on debt (within reasonable limits) to which a company has been committed.

3. In some way make tax load uniform on whole industry and not have seven-eighths of it carry it all and one-eighth none.

The above changes would in most cases permit a utility company to continue to function efficiently and effectively in the war effort.

BRIEF SUBMITTED BY WILLARD P. PALIN FOR THE CONSIDERATION OF SENATE FINANCE COMMITTEE

(Prepared by Willard P. Palin, owner and operator of an oil-reclaiming plant, and secretary of the National Association of Re-Refiners)

PRESENTING ARGUMENTS AGAINST THE TAXING OF THE RECLAIMING OF USED OIL

The question before the Senate Finance Committee regarding the taxation of lubricating oil every time it is reclaimed is a very involved question and it does warrant the careful and thoughtful consideration of the committee.

By act of Congress a tax was placed upon lubricating oil, which tax was to be collected at the source. The original refiner pays this tax and in turn collects the tax through the different handlers of its products until ultimately the tax is paid by the purchasing consumer. Upon payment of the purchase price, plus the Federal tax, all property rights accrue to the purchaser.

A concerted effort has been made upon Congress by first the major oil interests and then some of the so-called independent oil marketeers to have legislation passed that would tax oil every time it is reclaimed. H. R. 3071 laid before the House Ways and Means Committee for the past 2 years. That bill exempted the railroads, who have been one of the country's largest oil reclaimers. That it was never passed out of committee is certainly to the credit of the Ways and Means Committee. This year greater pressure was brought upon this committee to have them pass some sort of taxation that would in effect tax oil every time it was reclaimed. When any group approach Congress to have a tax put upon a competitor obviously it is for a selfish purpose.

We who are in the oil reclaiming business grant that the reclaiming of oil does decrease the market for new oil to the extent of the amount of oil that is reclaimed, although the amounts of oil reclaimed has been grossly exaggerated by the proponents of this taxation. But surely the reclamation of oil is of far more importance to our Nation than are additional profits for the oil interests. The War Production Board tells us "Oil is ammunition—Use it wisely." The War Production Board recommend the reclamation of oil. We cannot believe that Congress has any desire now of all times to place an impediment to the conservation of any material so vital to this Nation as oil. This conservation is not limited to the oil itself, but it saves entirely the transportation item, which is, as you know, one of this Nation's vital problems. Now that we are engaged in a life and death struggle to see if our way of life is to survive, it is no time to waste our resources. If any legislation is needed, Congress should reward effort to save.

Oil reclaiming is carried on by three different groups, all of whom must be considered if an intelligent decision is to be reached by this committee.

First, by the consumer who places an oil-reclaiming unit upon his equipment. Here oil reclaiming is carried on continuously. Obviously it would be impossible to tax this reclaiming operation.

Second, by the consumer who withdraws the oil from his equipment and reclaims same by running through a separate oil-reclaiming machine. There are thousands upon thousands of these machines in use by private owners, garages, service stations, fleet operators, industrial plants, etc. It would be practically impossible to collect the tax from this group of reclaimers.

Or, some of this group may elect to have their oil reclaimed by a custom reclaiming plant where this work may be carried on in a more scientific manner. Here we find the first reclaimer who could be caught for a reclaiming tax. However, his profit from this operation would not allow him to pay the tax himself, and to attempt to tax his customer would drive the business from the reclaiming plant back to the consumers' own equipment. The custom reclaiming plant would certainly go out of business if oil reclaiming were taxed.

Third, the consumer who has used or partly used oil, who elects to sell same on the open market. Some of the custom plants mentioned above, and some plants who do not do custom work, buy this oil and re-refine it into a marketable product. This reclaimer could also be caught for the tax. Whether the property rights that would accrue to him as purchaser could be set aside, so that he would not have the same rights as the original purchaser had, would unquestionably be a question for the United States Supreme Court.

Here we have three different conditions. All reclaiming oil upon which the Federal tax has been paid. Can Congress pass a tax that will tax one group and let the others go? Can property rights be set aside in one case and not in the other?

The question here is entirely different than that of the manufacturer of tires who uses some reclaimed rubber in his product. In the first place the value of the original tax-paid tire has been all used up. Here it was the tire that was taxed, not the rubber. Then, too, the rubber is but one of the component parts of a tire, whereas oil is reclaimed by removing the foreign ingredients leaving the oil as it was.

Arguments for the placing of this taxation upon the oil reclaimers have been that the oil reclaimer gets his raw-material supply for little or nothing. The facts are that the average cost of the reclaimer's oil delivered to his plant is more than the highest price paid by the refiners of virgin crude.

They claim our low cost of production allow us a profit that could pay this taxation. The facts are that the average reclaiming cost is much higher than the original refiners' cost because of the small volume put through by the reclaiming plant. Less than 2 percent of all the refining plants have large enough volume to get down to the original refiners' cost. There are some large reclaimers in the eastern district. My own operation is a very small one.

Certainly, our cost of sales are very high. This is due to the propaganda that is continuously used against us by the major oil interests. All in all, we have our troubles, without having a taxation problem that would put us out of business, to face.

We recognize the fact that taxes must be raised to carry on the war effort and to finance the increased cost of government. We are willing that income taxes be raised to any point necessary, or for a general sales tax, or for an earnings tax, but we do not want a tax put on our industry that will put us out of business.

The foregoing arguments—and many more could be made in favor of our industry and against taxation on oil reclaiming—have been made as a result of my own personal operation of an oil-reclaiming plant for the past 21 years and because I have been interested enough to travel over 8,000 miles, to visit other oil reclaimers, in order that I might know what the situation really was, and that I might know what I was talking about.

I respectfully request that this brief be considered by your committee and properly filed for the reference of those interested.

WILLARD P. PALIN.

AUGUST 11, 1942.

OFFICE OF THE ATTORNEY GENERAL,
Washington, D. C., July 24, 1942.

HON. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR GEORGE: Section 504 of the new revenue bill, H. R. 7378, as passed by the House of Representatives, purports to change the official designation of the United States Board of Tax Appeals to the United States Tax Court and to designate its members as judges, without changing the powers and jurisdiction of the Board, the appointment and tenure of its members, or the practice and procedure before it.

On June 5, 1942, I wrote to the Secretary of the Treasury opposing a legislative proposal to convert the Board into a full-fledged court. This letter was presented to the House Ways and Means Committee. When this proposal was modified merely to change the name of the Board, I wrote the chairman under date of July 3, 1942, expressing my disapproval of that proposal also.

I am still of the opinion that it is not in the public interest either to make the Board a real court, as was first proposed, or to designate it as a court in the executive branch of the Government, as the House bill proposes to do. The reasons for my opposition are set forth in detail in the two letters above referred to, and in order that you and the other members of your committee may have my views before you, I am enclosing copies of those two letters.

I need add only a few words to supplement these two letters. In the first place it should be observed that the report of the Ways and Means Committee advances no reasons to support the action taken. No showing is made that necessity or public purpose will be served by the change. In the second place it should be noted that the House bill makes specific provision for the practice of laymen before the proposed court. As applied to an administrative agency such a provision would, of course, be entirely appropriate. But its application to a body designated a "Court" is an anomaly and will only serve to add to the confusion which the basic proposal will engender.

This letter and its two enclosures are submitted in the hope that your committee may agree that the proposed change is inadvisable. I ask that these communications be made a part of the record of the public hearings before your committee.

Sincerely,

FRANCIS BIDDLE,
Attorney General.

Enclosures.

[Copy]

OFFICE OF THE ATTORNEY GENERAL,
Washington, D. C., June 5, 1942.

The honorable the SECRETARY OF THE TREASURY,
Washington, D. C.

MY DEAR MR. SECRETARY: I understand that Randolph E. Paul, your tax adviser, has discussed informally with Assistant Attorney General Clark a legislative proposal to make the Board of Tax Appeals a Federal court. In view of the importance of this matter, I feel that I should express my views to you.

The Revenue Act of 1926 continuing the Board of Tax Appeals as created by the Revenue Act of 1924 provides specifically that it shall be "an independent agency in the executive branch of the Government." It has become one of the most successful of the Federal administrative agencies. It has met with general acceptance and approval during its existence of almost 20 years, and enjoys an excellent reputation for impartiality and fairness. In view of the Board's successful record it is difficult to understand why any change should be made in its status, particularly during this time of national emergency. I am not aware of any public demand that the Board be transformed from an administrative agency into a Federal court. Indeed such a change would seem to reverse the prevailing trend toward the creation of administrative bodies to deal with specialized and technical problems. I fear that the critics of the administrative process would welcome the proposal as a confirmation of their views.

A change as far reaching as this should not be made until the proposal has been fully explored at public hearings before both Houses of the Congress and then only if the proponents of the legislation advance convincing arguments in its support. This Department has not been apprised of any substantial reasons why the proposed transformation should be made. In my opinion, the interests of neither the Government nor the tax-paying public would be advanced by making this change. On the other hand it seems clear that as a court, the present flexibility in the handling of tax cases before the Board would be lost. Moreover, confusion and delay would result during the period required for the members of the reconstituted body and the Government and private lawyers who practice before it to adjust themselves to the new status. It would seem inappropriate to change the machinery which has proved so satisfactory for the settlement of tax disputes, especially at a time when new and increased taxes will inevitably increase the number of such disputes.

Although I believe the Board of Tax Appeals should be continued in its present status, I do want to point out that its constitution as a Federal court would involve a change in the representation of the Government before that body. Under existing statutes and Executive Order No. 6166 the function of representing the Government in any United States court is vested in the Department of Justice. In the interest of a unified control over the Government's litigation in such courts, all Attorneys General have consistently opposed any suggestion that this power be lodged elsewhere. As chief law officer of the Government I feel that I must urge before the appropriate committees of Congress that the handling of tax litigation before the proposed court be a responsibility of this Department.

I shall be glad to discuss this matter with you further at any time you desire.

Sincerely,

FRANCIS BIDDLE,
Attorney General.

[Copy]

OFFICE OF THE ATTORNEY GENERAL,
Washington, D. C., July 3, 1942.

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

MY DEAR CONGRESSMAN DOUGHTON: I have been informed that the Ways and Means Committee has approved in principle a proposal to change the official designation of the United States Board of Tax Appeals to United States Court of Tax Appeals. I understand that the change of designation is the full extent of the present proposal and that the "court" is to remain "an independent agency in the executive branch of the Government." (Sec. 1100, Internal Revenue Code.) I think that this change is not in the public interest and that I should advise you of my views.

A court which operates as an independent agency in the executive branch of the Government is an incongruity in our system of Government. It ignores the basic principle upon which this Government was founded that a clear line of demarcation should be preserved between the three great branches of Government, legislatixe, executive, and judicial. The creation of such an organization will not only result in confusion and uncertainty in the mind of the public, but is likely to be seized upon as evidence of an attempt to establish a court under executive supervision and restraint.

On June 5, 1942, I addressed a letter to the Secretary of the Treasury opposing the conversion of the Board into a full-fledged court, which letter, I understand, has been brought to the attention of your committee. The present proposal merely to change the name from "Board" to "court" is so illogical that it must be regarded as the first step in an attempt to bring about the larger change piecemeal. This is confirmed by references in Committee Print No. 12, dated June 25, 1942, containing some data submitted to the Committee on Ways and Means in connection with this proposal. These references are to give the Board authority at a future date to enforce subpenas, to exercise jurisdiction over tax refunds, and to designate commissioners.

My attention has been called to the statements in Committee Print No. 12 that the Board is already a court and that its name should be changed to accord with the existing situation. I do not agree with this charactedization of the Board's status.

The Board has been in existence since 1924 and its status is well understood. It is an administrative agency which reviews administrative determinations. Like other administrative agencies, its decisions are subject to judicial review. The Supreme Court has repeatedly characterized it as an administrative body exercising quasi-judicial powers (*Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716; *Goldsmith* v. *Bd. of Tax Appeals*, 270 U. S. 117). Its administrative status has been held sharply to distinguish it from a court. Cf. *Blair* v. *Oesterlein Machine Co.* (275 U. S. 220), with *Williamsport Co.* v. *United States* (277 U. S. 551). Its jurisdiction is limited by statute. It does not have authority to enforce its decisions (*U. S. ex rel. Girard Co.* v. *Helvering*, 301 U. S. 540, 542); nor does it possess any of the inherent powers of a court. It is in no sense a part of the judicial branch of the Government.

At the cases cited above show, the status of the Board and its powers have in the past been the subject of much litigation. Controversies of this character, however, have reached the courts infrequently in recent years. Undoubtedly the proposed change in name will revive these old questions and will, I fear, breed additional litigation. The present emergency is scarcely an appropriate time to make a change which will reopen questions previously settled or which will furnish occasion for renewal of controversy over the nature and powers of the Board.

Its proponents offer no substantial reasons for the proposed change. The plan is not supported upon the ground that it will aid in any substantial sense in the performance of the functions for which the Board was created. No benefit to the Government is indicated, nor can any be perceived. It is not suggested that taxpayers generally are demanding the change, nor that it is calculated to serve any significant need.

I must respectfully urge for the reasons set forth that the present proposal should not be enacted into law.

Sincerely,

FRANCIS BIDDLE,
Attorney General.

WASHINGTON, D. C., *August 20, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States, Senate, Washington, D. C.

DEAR SENATOR GEORGE: I desire to invite your attention to section 504 of the 1942 Revenue Act as it passed the House. This section proposes to change the name of the Board of Tax Appeals to United States Tax Court but the court is to remain an administrative tribunal in the executive branch of the Government where it is now. I notice on page 122 of the hearings before your committee on July 24, there was some discussion of this provision. It does not seem to me from this discussion that very careful consideration has been given to the enactment of the proposed provision into law. For your information I enclose an advance proof of an article which will appear in the September issue of Law Notes upon the proposal.

It would be most unfitting in my judgment for Congress to confer the title of judge upon officers who are not judges nor a part of the Federal judicial system. Judges generally hold office for life and can be deprived of office only through the difficult process of impeachment. This makes for impartiality and independence of decision, and in my opinion more than any one thing else has led to the high esteem in which the people of this country generally hold Federal judges. On the other hand, members of the Board of Tax Appeals may be removed by the President for misconduct or inefficiency. Federal judges are appointed with regard to particular localities, and thus the people of such locality and the local bar have some voice in the fitness of the appointee. Members of the Board of Tax Appeals, however, may be appointed from the country at large and there is no check of local public opinion upon their choice. Indeed they do not even have to be lawyers. The Board is also unlike a court in that persons other than members of the bar may practice before it. Why create confusion in the mind of the public on these vitally important distinctions between courts and administrative tribunals? The distinctions are fundamental, because our system of Government is founded upon the separation of powers. The maintenance of this principle obviously depends upon the proper classification of functions. They cannot be kept separate without distinctions in nomenclature.

The idea of Congress naming administrative officers judges without creating them such is like marching up a hill for the sake of marching down again. But this proposal is more serious than that. The bill has been drawn as if it did nothing more than effect a harmless little change in name, but it seems to me that in fact it does more. Section 1 of article III of the Constitution provides, "The judicial power of the United States shall be vested in one Supreme Court and in such inferior courts as Congress may from time to time ordain and establish." The word "court" in the Constitution has no use and no meaning different from the use and meaning which it has in the section I have quoted from. Likewise, the title judge has always been associated with that use and meaning. Therefore, to call an administrative tribunal which is not a part of the judiciary a court, or a member thereof a judge, is, to say the least, deceptive. The term "court" or "judge" has traditional meaning in our system of government and the people should not be deceived into believing a tribunal is something which it in fact is not. I should think that a member of the Board of Tax Appeals would be the last person in the country who would wish to be placed in such a false light. It is an absolute negation to provide in one breath for the establishment of a court and judges, and in the next breath provide that the court shall remain an administrative tribunal.

The Board of Tax Appeals as presently named and constituted has been doing excellent work and the members thereof are generally held in respect. I would not oppose conferring the exalted title of judge upon the members of the Board if I thought it could be done under our Constitution in a way that would add to their dignity and prestige. I oppose it because I think it will have just the opposite result. Since they are not in fact to be judges, it seems to me calculated to bring them into disrepute to hold them up to the public as something they are not. It adds nothing to the stature of the Board and may very well detract from the prestige of the regular Federal judiciary.

There is no real precedent for this legislation. The change of the old Board of General Appraisers into the Customs Court is not comparable. That change was required in order that the old board might continue to serve its purpose.

It was obliged to secure much of its evidence in most of its cases from abroad and several important foreign governments refused to honor commissions to take testimony unless issued by a court. Thus reasons of vital necessity impelled the change of name to Customs Court. The proposal to change the name of the Board of Tax Appeals cannot be justified on any such showing of public necessity. There is nothing to indicate that it cannot continue to function as a board as efficiently in the future as it has in the past.

There are many other considerations which it seems to me would make it extremely unwise to try this experiment of creating a court which is not a court, although I think what I have said is rather conclusive. To sum up, I am unable to see any public advantage whatever in the present proposal. It is without precedent or justification. The Board now performs its functions well, and it has won public approval. Its members are as well paid as United States district judges and, being less numerous and having country-wide jurisdiction, their position is certainly not inferior in dignity to that of a district judge. Indeed, I should say that to be a member of the Board is just as distinguished as to be a district judge.

This legislation evidently emanates from the Board itself and has been prompted by nothing more than a little vanity—excusable perhaps if that were all—but the risks which are entailed by having the status of the Board misrepresented to the public in my opinion vastly overbalances the feeling of gratification some of the members of the Board would have if they were to be called judges.

Sincerely yours,

ROBERT F. KLEPINGER.

Enclosure.

[From Law Notes, September 1942]

UNITED STATES BOARD OF TAX APPEALS OR UNITED STATES TAX COURT?

By ROBERT F. KLEPINGER, of the Ohio and District of Columbia Bars

The revenue bill of 1942 [1] now before the Senate, contains a proposal [2] to change the name of the present United States Board of Tax Appeals to United States Tax Court. The bill further provides that members of the Board shall hereafter be known as the presiding judge and the judges of the United States Tax Court. The jurisdiction, powers, and duties of the Board remain unchanged. It also provides that no qualified person shall be denied permission to practice before such court because of his failure to be a member of any profession or calling. The court remains an independent agency in the executive branch of the Government by the terms of section 1100 of the Internal Revenue Code.[3]

By this proposal we would have an administrative body the members of which may masquerade as judges. Such an anomalous situation has, naturally, attracted the attention of the press. Some articles have appeared ridiculing the proposal.[4] Some commentators have found the change unobjectionable.[5]

Lawyers, however, will readily recognize objections of a substantial nature. They will not agree that the proposal is merely amusing and without any substantial significance. After a little thought they will realize that the proposed change is not altogether innocuous. If adopted, it will constitute a precedent by which traditional distinctions between courts and administrative tribunals might be destroyed.

One of the cornerstones of our Government is the system of checks and balances by which authority of the Federal Government is divided between three great branches—legislative, executive, and judicial. Three separate and independent branches were thought to be essential to the preservation of our liberties.

Roscoe Pound, in his Administrative Law, says:[6] "But it is the separation or

[1] H. R. 7378.
[2] Sec. 504.
[3] 26 U. S. C. A. sec. 1100.
[4] Wall Street Journal, July 6, 1942; Washington News, July 7, 1942; Washington Evening Star, July 24, 1942.
[5] Washington Evening Star, July 16, 1942; New York Times, July 12, 1942; New York Evening Sun, July 8, 1942; Wall Street Journal, July 8, 1942.
[6] Pp. 65, 66.

distribution of powers that is the significant feature of our constitutional policy and the concentration of them in a fourth is objectionable, not 'in the light of numerology' but because it brings back the type of government that our constitutions were set up to avoid."

The new provision would scramble two of the branches together by establishing a tribunal which will be an administrative agency in the executive branch of the Government but which would be designated misleading as a court whose members would be judges.

Disregarding the long history of abortive attempts to undermine the judiciary, and in the face of the jealous regard of the legal profession to maintain, in all its vigor, the doctrine of separation of powers, it is asserted that the proposed change would avoid confusion. On the contrary more and worse confusion might be expected to follow from the proposed change.

The Congressional Record for July 17[7] contains a statement by Congressman Dingell which foreshadows this confusion. He said that the purpose of his remarks was "to circumvent any technical or erroneous interpretation on the part of the courts." This was a tacit admission that the change is expected to produce confusion, not alone in the mind of the public,[8] but also in the mind of the judiciary.

Attorney General Biddle, in his position as chief law officer of the Government, was quick to sense the dangers inherent in the creation of such a hybrid tribunal, and promptly voiced his opposition. Every lawyer who has pride in his profession and is interested in the preservation of the integrity and independence of the judiciary will approve the sentiments expressed by the Attorney General in the letter of July 3, 1942, which he adressed to the chairman of the Ways and Means Committee.

The Attorney General said: "A court which operates as an independent agency in the executive branch of the Government is an incongruity in our system of government. It ignores the basic principle upon which this Government was founded that a clear line of demarcation should be preserved between the three great branches of government: Legislative, executive, and judicial. The creation of such an organization will not only result in confusion and uncertainty in the mind of the public, but is likely to be seized upon as an evidence of an attempt to establish a court under executive supervision and restraint."[9]

An administrative agency masked as a court will clearly detract from the dignity and public esteem enjoyed by bodies which are truly judicial. Certainly it is not calculated to inspire public confidence for a tribunal engaged in condemning deception on the part of taxpayers to be sailing under the wrong flag itself.

Historically the terms "court" and "judges" are reserved for designating bodies and individuals who belong to the judicial branch of the Government. They are terms which the legal profession cherishes. The public has come to associate them exclusively with the judiciary. If it is mportant to find a new desgnation for the members of the Board of Tax Appeals, there is no more reason for invading the judiciary than there is for borrowing the nomenclature of the sporting world and calling them umpires or referees.

As a board, this administrative tribunal has functioned efficiently for over 18 years, and it is only recently that a handicap has been discovered in its present name. "Board" also has been found good enough for most comparable State bodies.

However, if it is desirable to rechristen the Board, it might appropriately be called a commission and the members commissioners. The separate opinion of Mr. Justice McReynolds in *Old Colony Trust Company* v. *Commissioner*[10] states that the Board "performs administrative functions—the assessment of taxes." This statement suggests that an appropriate name might be "Board of Tax Assessors."

But, in any event, it seems extremely inappropriate to select a name which the Supreme Court has explicitly held would be misleading. The majority opinion in the *Old Colony Trust Company case* stated unequivocably: "The Board of Tax Appeals is not a court." With all of the rest of the English

[7] Vol. 88, No. 135, 77th Cong., 2d sess., p. 6534.

[8] In a letter appearing in the Washington Evening Star of July 24, 1942, "John A. Advocate" says: "Now I am confused, and I wasn't confused before, so let's stop this nonsense: There is a war going on and silk, even synthetic silk, can be better used for parachutes than for robes for synthetic judges."

[9] Ways and Means Committee Miscellaneous Data, Print No. 13, p. 109.

[10] 1929, 49 S. Ct. 499 279 U. S. 716, 73 L. Ed. 918.

language to choose from, it is unfortunate that some appropriate term could not have been found which is not a misnomer under the decision of the Supreme Court.[11]

The individual members of the proposed court would continue to be appointed upon the recommendation of the Treasury Department for definite terms, not for life. Their reappointment might possibly depend upon the willingness of the Treasury Department to recommend it. As members of the court they would continue to review administrative determinations made by this same Department, and officials thereof would appear before the court representing the United States. This is a common practice in the case of administrative tribunals whose decisions are subject to judicial review, but it is wholly novel and dangerous precedent in the case of an organization designated as a court. Public confidence in courts generally will certainly suffer by the spectacle of a court in which the reappointing authority appears in every one of the cases before the tribunal as a litigant.[12]

Furthermore the membership of this proposed court may be composed of laymen and laymen may practice before it. This is expressly stated in the report of the Ways and Means Committee on the bill,[13] where it is said: "The Board continues as an independent agency in the executive branch of the Government, and its membership is not, through this change, necessarily confined to lawyers."

It is doubtful if lawyers will be willing to accept with complacence this radical innovation to have laymen, untrained in the law, function, or at least be designated, as judges in important tax controversies.

Roscoe Pound, in his Administrative Law,[14] that one of the checks upon courts which do not obtain, or in our practice are ineffective, as to administrative agencies is that "the decision of a court is subject to criticism by a trained profession to whose opinion the judges, as members of the profession, are keenly sensitive."

While calling the Board a court does not, of course, make it a court, the proposed new designation does constitute an encroachment of an insidious sort upon the judiciary which lawyers will hardly view with equanimity.

The great doctrine of separation of powers "is not merely a matter of convenience or of governmental mechanism. Its object is basic and vital;[15] namely, to preclude a commingling of these essentially different powers of government in the same hands."[16]

There is a tendency to confuse the power of a court with the quasi-judicial power of administrative agencies. This confusion will not be dissipated, but will rather be increased unless meticulous care is used in selecting names for administrative bodies. The decision of any controversy usually involves the taking of evidence and the conducting of a hearing in such a manner as to satisfy the due process clause, but that does not mean that every administrative agency which has the authority to decide controversies in accord with due process is performing the function of a court. No one would suggest that the Interstate Commerce Commission, the Securities and Exchange Commission, or the National Labor Relations Board act as courts when they decide controversies and issue orders. Yet they possess the same kind of authority as the United States Board of Tax Appeals. The Commissioner of Internal Revenue decides in the first instance the same questions which the Board of Tax Appeals is called upon to decide. In addition, the Commissioner can assess penalties and distrain on a taxpayer's property to satisfy his claim. These circumstances would not furnish any support for a proposal to call him a one-man court.

Such a proposal, of course, has not been made, but if the present duties of the Board of Tax Appeals should be thought to be sufficient basis for the proposal to call it a court, the movement may ultimately result in attempting to convert many other administrative agencies into courts. The United States Processing Tax Board of Review would clearly be indicated for a change of designation. It performs in the field of processing taxes the same functions which the Board of Tax

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[11] For an excellent statement of the reasons for confining the term "court" to judicial bodies composed of lawyers, see "The Place of the Administrative Tribunal in Our Legal System," by Hon. Arthur T. Vanderbilt, American Bar Association Journal, vol. XXIV, No. 4—April 1938—pp. 267, 271–272.

[12] *Cf. O'Donoghue* v. *United States*, 1932, 53 S. Ct. 740, 289 U. S. 516, 77 L. Ed. 1356.

[13] H. Rept. No. 2333, 77th Cong., p. 60.

[14] Pp. 60–61.

[15] *Springer* v. *Philippine Islands*, 1927, 48 S. Ct. 480, 277 U. S. 189, 72 L. Ed. 845.

[16] *O'Donoghue* v. *United States*, 1932, 53 S. Ct. 740, 289 U. S. 516, 77 L. Ed. 1356.

Appeals performs in the field of income, gift, and estate taxes. This suggests that if the name of the Board of Tax Appeals is to be changed, its new designation should not be so broad as to indicate that it embraces all kinds of taxes.

If the clear line of demarcation referred to by the Attorney General is to be preserved between the executive and judicial branches of the Government, it should not be weakened by a confusion of names.

UNITED STATES BOARD OF TAX APPEALS,
Washington, August 10, 1942.

Senator WALTER F. GEORGE,
United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: Since I last communicated with you some additional information has reached me on one of the subjects of our discussion.

I thought that the last sentence of section 504 (b) of the House bill was put there to satisfy some members of the Ways and Means Committee who wanted to be sure that the change in the name of the "board" to "court" would not automatically disqualify certified public accountants for admission to practice. My discussion with you and my confirming memorandum were written with that thought in mind. I now discover the purpose of the sentence was somewhat different. My new information came about as a result of communications which I have had with Representative Dingell, of Michigan, a member of the Ways and Means Committee.

The sentence provides: "No qualified person shall be denied admission to practice before such court because of his failure to be a member of any profession or calling." Mr. Dingell expressed his views on this subject before the House. See Congressional Record of Friday, July 17, page 6534. He was apparently under the erroneous impression that the board has been admitting any qualified persons to practice regardless of whether or not they were attorneys or certified public accountants. But, in any event, he was definitely of the opinion that admission should not be limited to attorneys and certified public accountants but should be thrown completely open so that any qualified person could have that means of livelihood open to him.

The Board is unanimously of the opinion that this sentence should be eliminated in the Senate. The Board was created primarily for the benefit of the taxpayers and not merely to provide a means of livelihood for practitioners. Therefore, it is of primary importance that taxpayers be properly represented so that their rights may be adequately disclosed in the proceedings before the Board. It is also important that the practitioners, as officers of the court, should assist it as far as possible in the efficient and just disposition of the problems arising. The Government is represented solely by attorneys. They should be intelligent, qualified, and responsible. They should have the benefit of intelligent, qualified, and responsible opponents, fully aware of their important duties and obligations. Subordinate to the above, persons who are capable of rendering satisfactory services to taxpayers in presenting their cases should have a right to render those services and earn a livelihood in that way.

Not only would it be extremely difficult for the Board to sift out "qualified persons" if they are to include others than attorneys and certified public accountants, but after their admission it would be difficult for the Board to keep them within proper bounds. Lawyers are subject to a code of ethics and I believe the same is true of certified public accountants. For example, it is unethical for them to advertise or to solicit litigation directly. Lay practitioners would not be restricted since the Board could not prescribe and enforce a complete code of ethics for practitioners before it. Thus, lay practitioners would not only have an advantage over their professional competitors in obtaining the business, but those advantages would be of a most undesirable kind.

The Board is aware of the fact that many unqualified persons have set themselves up as tax consultants, experts, and specialists. Now that the tax base has been broadened, thousands of new taxpayers in the lower brackets will be fair game to such people. Their cheap prices will attract clients and the latter will pay heavily in the end because of inadequate representation. Unqualified and undesirable persons, prompted by selfish interests, will be the first to apply for admission under the new provision. They should not be encouraged. They could probably get several people to swear to their good moral character and to the fact that they have been devoting themselves to tax matters for years, and they could probably satisfy any other general requirement which the Board could provide and enforce.

The Board has tried to avoid complications and technicalities in its procedure. Nevertheless, Congress has wisely recognized that some formality is essential for clarity and efficiency. Practice before the Board, from the time a notice of deficiency is received until decision has become final, and this may include appeal to the courts, requires the kind of training which lawyers are expected to have. Anyone who does not have that kind of training is bound to be at a considerable disadvantage in properly presenting his client's case to the Board. Good common sense and judgment, although of primary importance in all individuals, cannot make up for lack of training.

The court, in enrolling persons to practice, holds them out as "duly qualified to represent others." It should not mislead the taxpayers to their damage. It has a responsibility in the matter of whom it will admit to practice. No doubt there are a few laymen who could be safely admitted to practice before the Board if they could be sifted out. But the Board has not the time, money, or organization for investigating and passing upon applicants which this new provision would require. It would mean investigation of each applicant to find that he was of good moral character and a responsible person, and it would mean an examination of some kind to determine his mental qualifications to properly represent taxpayers. The Board has never followed any such plan and it does not feel that it could follow such a plan without a costly increase in its employees and expenses.

It has, instead, taken advantage of certain investigations made by other responsible organizations. Lawyers and certified public accountants, before being admitted to practice their profession in the States, are required to pass searching examinations under the direction of responsible authorities, and are required to furnish other satisfactory evidence of their qualifications, such as responsibility and good moral character. Their professional activities continue to be subject to scrutiny in the States where they are actually living and known. The Board, being unable to devise and carry out a better scheme for protecting taxpayers, has taken advantage of the safeguards set up by the States and has limited applicants for enrollment to parctice before it to lawyers and certified public accountants duly admitted to practice and in good standing in the States. See rule 2.

This rule is not perfect. What rule is? It may admit some improper persons and it may exclude some qualified ones. Nevertheless, it is justified as a safeguard along the right lines. There has been no serious objection to it during the entire 18 years' existence of the Board. The classes from which applicants may apply for admission to practice before the Board should not be increased but should remain, as at present, confined to lawyers and certified public accountants.

Chief Justice Taft, speaking for the Supreme Court in the case of *Ely Goldsmith* v. *United States Board of Tax Appeals* (270 U. S. 117) recognized the propriety and wisdom of the rule as is shown in the following quotation:

"We think that the character of the work to be done by the Board, the quasi judicial nature of its duties, the magnitude of the interests to be affected by its decisions, all require that those who represent the taxpayers in the hearings should be persons whose qualities as lawyers or accountants will secure proper service to their clients and to help the Board in the discharge of its important duties."

Hon. John D. Martin, one of the judges of the United States Circuit Court of Appeals for the Sixth Circuit, has an article in the American Bar Association Journal for August on The Problem of Reducing the Volume of Published Opinions. There is a paragraph on page 530 which I believe more or less indicates the attitude of the Federal judges toward the Board. He says the Board of Tax Appeals "in all but name, is essentially a court" and goes on to say: "The members of the Board are experts in their field. Their opinions are generally concise, but sufficiently comprehensive. * * * When the court agrees with the reasoning and conclusions of the Board, an order of affirmance is the order of the day." Many other circuit judges have expressed similar views. I thought this might be of interest in connection with the change in name of the Board to court.

Yours very truly,

J. E. MURDOCK,
Chairman.

SPECIAL DIVISION OF THE BOARD (SPECIAL ASSESSMENT CASES)

The House bill in section 213 (d), amending section 732 of the Internal Revenue Code, requires the creation of a special division of the Board to consider and decide certain relief or special assessment issues. The division is to consist of three or more members of the Board. The members of the division are to have exclusive jurisdiction over certain relief issues. They are to hear and decide all such issues.

The Board has given this subject consideration and unanimously recommends:

First, that the whole matter of hearing and deciding special assessment cases be left entirely to the Board.

The statute at present provides that the Board designate the place of hearing of all cases to meet the convenience of the taxpayers. Its system of hearing cases has been upon a decentralized basis for many years. It hears cases in 50 or more cities scattered all over the United States. Section 213 (d) provides that a small group of three or more members of the Board shall assume the task of hearing the evidence in all cases involving relief issues. The task would present many practical difficulties and might even be impossible. The main purpose in the legislation was apparently to provide for a method of review in which the same three or more members would be the final arbiters over all of the relief issues. If Congress would merely indicate its wishes, leaving the details to the Board, the Board and the Chairman would be better able to meet the problems as they arise. The more elastic the provision and the more that is left to the judgment of the Board and the Chairman, the better the Board will be able to handle these cases efficiently along with the many other cases which it will also be called upon to handle.

The second recommendation is that if the statute is to require the creation of a special division within the Board, then Congress should make it clear that the "sole duties" of the members of the division shall not "be the determination of issues arising under the relief provisions," as a comment in the Ways and Means Committee report now indicates, and Congress should also make it clear that the members of the division need not all sit to hear the evidence in every case and act as a group at every other stage of the proceedings.

I have been informed that the words "sole duties" were inadvertently and mistakenly used in the Ways and Means Committee report, and there never was an intention to limit the duties of the members of the division. Thus, all agree apparently that a statement should be made in the Finance Committee report, if this provision is adopted by the committee, counteracting the erroneous statement in the Ways and Means Committee report.

But there should be no mistake about the fact that it would be undesirable to limit the duties of any members of the Board to the determination of issues arising under the relief provision. All the members should be generally available, as they are at present, to consider any and all issues arising in cases before the Board, even though the primary concern of a few may be the prompt disposal of the relief issues. There will not be enough of the relief issues at all times to keep the members of the division busy. The Chairman should be free, as at present, to assign all members to hearings so that they can be kept uniformly busy at all times.

Those drafting section 213 (d) may not have realized the implication of the use of the word "division." The Chairman has always been authorized to divide the Board into divisions of one or more members (sec. 1103 (c), Internal Revenue Code). The Board is actually divided into 16 divisions, one member to a division. Occasionally, a special multiple division is created to hear and decide a particularly important case. Section 1118 (a) provides "a division shall hear" and decide any proceeding assigned to it by the Chairman "and shall make a report of any such determination which constitutes its final disposition of the proceeding." This provision has been uniformly interpreted as meaning that the entire division, whether it consists of one or more members, shall hear the evidence in each case assigned to it, and make a determination and a report disposing of that proceeding. The division of three members provided in section 213 (d) would be required to sit en banc in every proceeding coming before it and to take every other step as a whole.

This is undesirable. While it might be well to have all members of the special group sit in some cases, there would probably be a great many others in which this would not be necessary or desirable. It would be impossible to hear the cases which will come before the Board if this group has to sit to hear the evidence in every case involving relief issues. Decision as to how many members should sit in a given case should be left to the Board. I will not labor this point because I am informed that it was not the desire or intent in drafting this provision to require that the special division sit en banc. On the contrary, the intention was to make the provision as elastic as possible and leave all such matters to the discretion of the Board.

Section 213 (d) should be relieved of this implication. Some satisfactory word other than "division" should be substituted in the provision for the word "division."

MEMORANDUM SUBMITTED BY LOUIS V. SUTTON, PRESIDENT, CAROLINA POWER & LIGHT CO., RALEIGH, N. C.

We would like to outline the effect of the House tax bill upon the utility industry in general and upon the Carolina Power & Light Co. in particular.

The theory of taxation embodied in the House bill is that any excess profits resulting directly or indirectly from the war should be taxed drastically, but that corporate taxpayers should be allowed to retain in the aggregate about the same amount of income after taxes as during the years prior to 1940. The proposed bill may perhaps accomplish these purposes so far as industry in general is concerned. So far as the utility industry is concerned, however, the effect of the bill would be to levy almost confiscatory taxes and to reduce sharply below the pre-1940 level the net income of utilities after taxes.

Many industries, especially those engaged in direct or indirect war production, may be able to maintain their earnings at pre-1940 levels even though required to pay the heavy increases in taxes contemplated in the House bill. During the last 2 years a typical unregulated industry has been able to increase its prices in order to recoup increases in costs, including higher taxes. Even with the imposition of price ceilings, it is still possible for such an industry to obtain relief to meet cost increases. The utility industry, on the other hand, is a regulated industry, and its rates have been fixed during all this period. An industry, like the utility industry, with fixed prices, high capital, low turn-over, and increase in costs, will have its earnings cut far below the 1940 level and will be financially crippled by the system of taxation embodied in the House bill.

Utility rates have been set on the premise that they would permit a fair return on invested capital and no more. In determining such rates regulatory commissions took into consideration all elements of costs, including taxes. It is not practicable at this time, and in any event is against governmental policy, to raise utility rates to reflect increased taxes, and in any case, under the House bill, extensive rate increases would have to be put in effect in order to bring about a slight increase in return to the utilities. The tremendously increased tax burden which the House bill proposes to saddle on utilities will, therefore, result in drastically reducing the net return to utilities below the level of fair return on investment already set by regulatory commissions.

The House bill, in many instances, will endanger the ability of the utilities to maintain their common dividends and, in some cases, to maintain their preferred dividends. The immediate brunt of this burden will, of course, be borne by utility company stockholders, who, in many cases, are charitable, educational, and other institutions and small investors.

From a long-range point of view the imposition of this confiscatory burden will have other unfortunate consequences. We shall undoubtedly see an acceleration of the rapidly increasing trend toward the acquisition of private utilities by governmental agencies of various character. Public agencies enjoying exemption from high Federal taxes will be able to outbid private groups for numerous utility properties that may be placed on the block to comply with orders of the Securities and Exchange Commission under the Public Utility Holding Company Act. Apart from the other implications of such a trend, its continuance will result in a drastic reduction of tax revenue to the Federal Government by placing many more operating utilities beyond the pale of Federal taxation. In other words, the House bill, if applied to utilities, will almost certainly result in a long-run loss of revenue to the Federal Government, and may well result in a loss of revenue to the Federal Government in the relatively short run.

SUGGESTED REVISIONS

We have to suggest the following revisions in the House bill which, if adopted, would help to ameliorate the situation of the utilities:

1. Permit utilities to deduct normal income taxes and surtaxes in computing excess-profits net income, as originally provided in the Second Revenue Act of 1940.

2. In the computation of invested capital for excess-profits tax purposes, permit utilities to include borrowed capital to the extent of 100 percent rather than to the extent of 50 percent under existing law.

3. Grant a credit against net income for payments made in the reduction of debt to industries such as utilities with a high ratio of plant investment and debt to gross revenues.

4. Grant utilities a credit against net income equal to preferred and common dividend declarations, at least in computing surtaxes and excess-profits taxes.

While these suggestions would tend to relieve the condition of utilities, they would not strike at the basic problem; namely, the bill's effect in reducing the income of utilities far below the pre-1940 level. The basic purpose of the new bill was well expressed by Secretary Morgenthau in a statement to the House Ways and Means Committee. In the course of that statement, the Secretary said:

"A substantial share of the increased corporation tax should fall on excess profits. Taxes paid from such profits have less disruptive 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-earnings 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."

The basic fault in the proposed bill, so far as utilities are concerned, is the excessive normal tax and surtax imposed on their operations. Whatever the merits of this rate so far as other industries are concerned, this high rate operates to confiscate utility earnings because of the inability of utilities, unlike unregulated industries, to increase substantially their earnings before taxes. This company therefore respectfully suggests to your committee that the normal tax and surtax rates, at least with respect to industries like the utility industries, be substantially reduced from the 45-percent rate proposed by the House.

CAROLINA POWER & LIGHT CO.,
By LOUIS V. SUTTON, *President*.

AUGUST 15, 1942.

STATEMENT SUBMITTED BY JOSEPH E. KELLER, WASHINGTON, D. C. ON BEHALF OF NATIONAL PETROLEUM ASSOCIATION, PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION, WESTERN PETROLEUM REFINERS ASSOCIATION, AMERICAN PETROLEUM INDUSTRIES COMMITTEE

My name is Joseph E. Keller. I make this statement today on behalf of the National Petroleum Association, the Pennsylvania Grade Crude Oil Association, the Western Petroleum Refiners Association, and the American Petroleum Industries Committee, in opposition to the Treasury proposals for the increase of the lubricating oil tax.

When the Ways and Means Committee of the House of Representatives was considering the revenue revision bill of 1942 (H. R. 7378) I appeared before that committee on April 13, 1942, in opposition to increasing the lubricating oil tax, pointing out at that time that these petroleum associations were not opposing increased taxation as such but that we were opposing the imposition of a tax such as this which can only have the effect of burdening war industry directly, of burdening agriculture and transportation directly, and of leading to ruinous inflationary results. The Treasury proposal to increase the lubricating oil tax to 10 cents per gallon was rejected by the Ways and Means Committee, but that committee did recommend that the tax be increased from its present rate of 4½ cents per gallon to 6 cents per gallon. We are opposed to this increase in the tax rate for exactly the same reasons which lead us to oppose the original Treasury proposals and it is our purpose to set forth here again the reasons for our position in this matter. Developments since April 13, 1942, have made them even more compelling and confirm our conclusion more definitely than ever before that the lubricating oil tax should not be increased at this time.

The petroleum industry has always borne more than its equitable share of taxation. Gasoline and lubricating oil and other automotive taxes have yielded over $17,000,000,000 in revenue since their inception only a little more than two decades ago. It is our purpose to point out the fact that the proposed tax falls upon a war necessity and upon the rank and file of the lower-income groups least able to bear it and also that under present conditions it heavily burdens war industry, transportation, and agriculture. The cost of administration is unreasonably high and the tax on lubricating oil should be abandoned entirely, rather than be increased, at this time.

The emergency has made lubricating oil an absolute war necessity. Our entire war effort, either in the actual combat phases or in our essential industrial operations, depends upon this vital petroleum product. Not a wheel turns without the proper lubricating oils to insure operation. American industry today is being entirely converted, either to outright production of war materials or to production of essential civilian goods. The machines of industry are taking a mounting proportion of the total lubricants in the battle of production.

It is not easy, under the limitations placed on the dissemination of military information, to determine what proportion of lubricating oils produced in American refineries go into direct Government sales. Included here are the fuels and lubricants which are required for the fleets, the land forces and the air forces of the United Nations and for the operation of certain essential industries which, under existing revenue laws, are designated as being for Government purposes.

We have been considering so far the volume uses of lubricants under present conditions. There are in addition certain very important specialized calls for high quality lubricating oils. Present military and naval requirements take a large percentage of the finished products made by Pennsylvania grade crude oil, which is approximately 2 percent of the total annual production of the United States. This oil can be refined in tailor-made fashion to the exact specifications of the Air Forces, the Navies, and the Armies of the 23 United Nations. Hundreds of little-known and unsung petroleum products are meeting war's demands.

Maintaining the motorized equipment of America's war equipment is no small task. In the Louisiana maneuvers last summer the greatest armed force ever assembled in the Western Hemisphere for a single engagement, totaling half a million men and equal in number to the American troops in the Meuse-Argonne conflict of 1918, had motorized equipment entirely fueled and maintained by the American petroleum industry without visible difficulty. And the number and types of mechanized equipment was colossal, including command reconnaissance cars, tanks, heavy artillery, armored scout cars, mobile machine shops, automotive kitchens, and personnel carriers. We are indeed fortunate in the quantity and demands of our peacetime automotive transportation, for it has built the plants, encouraged the research, and forced exploration for petroleum resources of all grades and qualities which now make possible this quick response to war's demands.

Probably the outstanding example of war demand for high-quality lubricants is in modern airplane engines. These light-weight power plants represent the achievements of cooperative research work by both the engine designers and the petroleum chemist. This is true just as much of the lubricating oils as of the type and octane rating of the gasoline.

The efficiency of piston cooling can easily control the degree of success or failure in aircraft engine operation. The amount of heat which may be carried away through the fins of a radial air-cooled engine is definitely limited. Hence a greater proportion of heat must be carried off by the oil in these high-output engines. In most 1,000-horsepower engines 11 to 25 percent of the heat generated at full speed is imparted to the oil. The general method to effect this removal of heat is to spray oil against the underside of the piston from jets in the crankshaft. The point has already been reached in some engines of this type using compound oils show less ring and cylinder wear, that is where certain suitable chemicals are added.

Some of you gentlemen may recall the Franklin air-cooled automobile. Mechanically it was a beautifully built machine, but because of its high lines and cumbersome appearance it gradually lost favor with the buying public. Yet if the owner of a Franklin took care of it and, particularly, if he used the high-grade lubricants which the manufacturer specified, this car seemed to last almost forever. There is a rough parallel between the low-powered air-cooled Franklin of some years ago and the modern aviation engine; they both needed good lubricants to carry off the excess heat and to protect the working parts adequately. The importance of proper lubrication is that the pistons of an improperly lubricated airplane engine will stick or "freeze," as the expression is, and a plane will be lost if the oil fails to provide the necessary protective film between fast moving metal parts.

Under modern combat conditions the cooling system and the flow of lubricants are probably the most important factors in continued aircraft engine operation, fully as necessary as the supply of fuel. High-quality and specialized lubricants are indispensable to avoid undue accumulation of carbon deposit and valve sticking in today's aviation engine. Designers recognized the importance of carrying off the excess heat from the tip end of the exhaust valve. With the use of proper lubricating oil the exhaust valve stems of one well-known air-cooled radial engine are practically as clean after 700 hours as when assembled. In some instances, valve stems have been kept in operation for 3,000 to 5,000 hours of service.

Purchase of lubricating oil by all United States Government departments and branches throughout the continental United States, Panama Canal, and Hawaiian Islands are made against the Navy contract, with two major exceptions; aircraft oils for the Army Air Corps and special Diesel engine oils. Actual purchases and present estimates of annual consumption are as follows:

	Barrels		*Barrels*
1939	238,000	1941	357,000
1940	252,000	1942	475,000

This 100-percent increase in demand in but 3 years is caused largely by the great increase in Army-owned vehicles, from 14,000 early in 1940 to 75,000 at the beginning of this year, to 190,000 by July 1, 1942, and to 286,000 by the end of this year. It seems probable that total consumption, including Navy contracts, Army Air Corps, and all Government agencies, may increase to approximately 830,000 barrels a year.

One of the first actions of the War Department committee on liquid fuels and lubricants was to create a common language by standardizing an army nomenclature for lubricants and related products. The Army will not use only six all-purpose standardized lubricating oils. But it is doubtful if all the specifications of the chief United Nations can be completely standardized. It is plainly the duty of the lubricating oil producers and refiners to bend their efforts toward the production of motor oils which will guarantee the satisfactory operation of every piece of motorized equipment, including automotive gasoline, automotive Diesel, and aviation gasoline, in the armed services of the United Nations.

The time is long past when a bucket of axle grease and a can of sewing machine oil were all the lubricants needed by the farmer. Farmers are among the principal users of lubricating oil, for today farmers use more machinery than any other class of people and are entirely dependent upon it. The farmers who survived the decade of low prices are those who reduced their production costs through the intelligent use of machinery. The United States Department of Agriculture estimates that 27 percent of the butter, 39 percent of the eggs, 65 percent of the poultry, 40 percent of the fruit and vegetables, 62 percent of the cattle, 68 percent of the hogs, and 50 percent of the horses and mules are moved by trucks from farm to market. Almost all cereal grains are moved from farm to elevator by truck.

According to the United States Bureau of the Census for 1940 there are 4,144,136 motor vehicles on farms. Farmers operate 1,047,084 trucks and 1,567,430 tractors, and parenthetically it is interesting to note that the cars and trucks are not late model streamlined vehicles, nor are the tractors the last word in power-operated equipment. On the contrary, the average age of this equipment is 7 years. The fact that it is still in operation is itself testimony to careful lubrication. Farmers also have much other equipment requiring lubricating oils; stationary engines, cream separators, choppers, grinders, milking machinery, grain separators, mowers, rakes, binders, loaders, and so forth.

Quantity figures for lubricants covering all these needs are not available, but quite accurate figures can be projected for the major uses, as the following table shows:

Annual lubricating oil consumption

	Gallons
Farm cars	49,000,000
Farm trucks	12,000,000
Farm tractors	26,000,000
Miscellaneous uses	3,000,000
Total	96,000,000

If the tax on lubricating oil is increased as the Treasury proposed, it would cost American agriculture $9,000,000 on the basis of 1940 production. However, the figure will be much higher for 1942. The Secretary of Agriculture has said recently that "our farmers have the means and machinery with which to merge their individual efforts into the greatest total contribution to the war effort * * *. Farmers must produce more and they must produce more widely than ever before." The wartime farm program calls for increases over 1940 of:

5,000,000 tons of milk.
6,000,000 hogs.
1,000,000 cattle.
15,000,000 cases of eggs.
9,000,000 chickens.
10,000,000 cases of tomatoes.
13,000,000 cases of peas.
4,000,000 cases of beans.
9,000,000 cases of corn.

Most of the normal production plus this vast increase must get to market, to processing plants, and to distribution points by truck.

The fact that American agriculture is so highly mechanized is particularly important at the present time. Unprecedented production goals have been established under the war program. The farmers of the Nation must put every acre of land, every hour of labor, and every bit of machinery to work to meet these goals.

The farmer's task will become increasingly difficult, for a shortage in farm labor is developing. More and more farm workers are being attracted by higher industrial wages, and great numbers of the rural male population are joining the armed services. It has been estimated that the manpower employed on farms on March 1, 1942, had decreased 25 percent since June 1940.

It is inevitable, therefore, that American farmers must utilize mechanized equipment to its full capacity if the agricultural production goals are to be attained despite the scarcity of farm help. Past experience has shown that the use of mechanized implements makes it possible to produce crops with substantial savings in farm labor. It has been estimated that in recent years the agricultural tractor annually has saved 200,000 man-hours which otherwise would have been required in field operations.

Today, as we approach the maximum activity in our industrial plants—so vital to the successful conclusion of the war—it must be recognized that the current level of industrial output would be impossible without the labor made available over the last 20 years through the mechanization of agriculture. This same mechanization now is a vital factor in the current program to produce a greater volume of foodstuffs and raw materials than ever has been produced on American farms in history. It is also noteworthy that this widespread mechanization would have been impossible without the availability of low-cost lubricating oils.

From the foregoing facts it is evident that lubricating oil is a necessity to the farmer whose food production is necessary to the Nation's war effort. Thus an increase in the tax on oil will be reflected in the cost of farm production, in the price of food, in the cost of living that in turn will bring demands for higher wages. Hence, an increase in this tax would be simply another influence to hasten the upward spiral of inflation.

Under present conditions, and under the conditions which will exist so long as this war is being fought, the remaining consumption of lubricating oils necessarily will be confined to automotive and industrial operations only slightly less important to the war effort. Nonessential industries are steadily being converted to war production in order that the requirements for the primary war needs can be met. Rationing of automobiles, tires, and gasoline will have the effect of reducing to a minimum the movements of cars—and hence the consumption of lubricating oil—by other than for war workers and essential civilian services. These consumers—the doctors, the arms-plant workers, the farmers, the highway transporters—become in the nature of things the only portion of our population who will pay this tax.

There is no means at hand of estimating what this consumption will be, but it appears certain that whatever cars are in operation for the war emergency will be essential cars put to essential uses. The proposed increase in taxes on the lubricating oils consumed by these industries and these individuals can only have the effect of increasing the cost to the Government of the services which they perform. They are highly inflationary and therefore undesirable.

The Chief of the Vehicle Maintenance Section of the Office of Defense Transportation has just recently stated that "In a total war every vehicle is a part of war transportation." Transportation facilities are demanding large quantities of lubricants, either in transporting raw materials and finished products to and from factories or in transporting defense workers to their places of employment and back again. The motor vehicle is indispensable in transporting labor to the job.

During the past year highway truck mileage increased 15 percent. It is reliably estimated that truck traffic for 1942 will increase another 15 percent over 1941. If we consider the typical situation in Michigan as clearly surveyed and outlined by the Michigan State Highway Department, the cause of this abrupt rise in volume readily is apparent.

In ascertaining the transportation requirements of 749 defense plants it was found that every one moved some part of both incoming and outgoing freight by truck. 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 factories studied 90 percent of the incoming shipments are made by truck; while in 43 percent, 90 percent of the outgoing shipments are over the highways. In short, truck transportation is an essential component of our war-production program. And these for-hire carriers that move the raw materials, the parts, and the finished products must pay the existing lubricating-oil tax. They pass it on to the manufacturer in their bill for transportation charges, and the company passes it on to Uncle Sam. This is one element in how much the war-production program is going to cost the people.

Furthermore, even with active "car clubs" and local planning, defense workers must use a huge number of automobiles to get to work. These who have access to the public carriers, largely busses, are unaware that an increase in the Federal tax on lubricating oil will tend to increase the cost of necessary transportation to them. It will increase these costs inevitably because of the scarcity of replacement parts and the necessity on the part of the fleet operators of busses to consume more lubricating oils and higher quality oils in order to maintain his equipment at the faster pace. But the man who does conserve and run his car will feel the pinch of higher maintenance costs wherever he may be.

With the Nation-wide tire rationing and gasoline rationing in 17 States, nonessential consumption of all lubricating oils is falling off abruptly. Not only is the proportion of the total consumption attributable to industry on the increase, but also the civilian part of the consumption of lubricating oils is now undergoing a sharp decrease. Automobile owners have curtailed driving to conserve their tires. Gasoline rationing in many States is automatically reducing passenger-car driving. But in rural and semiurban communities all over the country there is a heavy and lasting segment of necessity driving. People must get to work and farmers to market. As long as there are private automobiles in operation they will be used for these essential purposes.

The study of the defense plants in Michigan disclosed that one out of every five of the workers in the plants live more than 10 miles from the factory. Three out of four come to work by private automobile every day. In fact, out of 850,000 wage earners in Michigan industries, 635,000 are dependent upon the private automobile. Even as adjustments are made to the over-all transportation problem—and we have one—these citizens and war producers should not be burdened with an increase in the Federal tax on lubricating oil, which is necessary to the maintenance of their means of transportation. There is no question of curbing inflation in this instance; tire and gasoline rationing and the deflationary trend in private car movement at one time decreases the volume of traffic and at the same time makes the present Federal lubricating oil tax inequitable in its effect.

Not everyone is aware of the deep-rooted prevalence of essential civilian driving. In a recent analysis of over 12,000 records of individual car use by persons belonging to the "wage-earner category" [1] it was found that two-thirds

[1] Published 1941 by Automobile Manufacturers Association.

of the car-owning workers sampled use their cars regularly in driving to work. Combining mileage recorded as "business trips" with "driving to work" (as in the case of journeymen on field jobs as against plant workers), 44 percent of the total annual mileage for all purposes was attributable to earning a living. This was and is to a great degree under present conditions the principal purpose purpose of wage-earner car ownership. When all driving that comes within the definition of necessity use is grouped together exactly 50 percent of the annual mileage of the predefense period was for these purposes—work, business trips, shopping, taking children to school, going to church. Regularity and frequency of short trips are the determining factor in any consideration of car usage.

Large population groups, estimated by the census to exceed 18 million persons, are almost entirely dependent upon automotive transportation. They may now be engaged in war work, but they do not live in cities. They live in unincorporated suburbs and villages, or in open country, but are not engaged in farming. These nonfarm rural people, representing virtually all occupations, own 14 percent of all passenger cars.

As against the 67 percent necessity mileage of the farmer, the nonfarm rural proportion of the total mileage driven is 63 percent. While their necessity mileage is comparable with that of passenger vehicles owned by farmers, in terms of actual total miles this use is much greater, averaging 5,085 miles per year. Greater distances are an important factor in the high mileage of nonfarm rural cars, for the average trip exceeds 15 miles. Since these persons will be mobilized in the total war economy of the United States and since they are so dependent upon their passenger cars, it is no more just to increase the tax on the lubricating oil which they must consume than in the case of the defense worker or the farmer.

The trend of consumption of lubricating oils has been upward since 1933 and in direct proportion to industrial activity. There was a marked drop in consumption in late 1938 and early 1939. But industrial plants have taken an increased share of all lubricating oils since September 1939.

In the past decade industry has paid $95,265,000 in Federal lubricating-oil taxes. Last year the tax cost to all industry was $20,205,000, as against $3,285,000 in 1933, or over six times as much and yet the Federal rate had only been increased from 4 to 4½ cents per gallon. A large part of the use of lubricating oils in industry in 1941 was in connection with work on Government contracts or on war projects. American industry used 46 percent of all lubricating oil consumed. Even under the existing tax rate this represents an increase in the cost of war production and a direct increase of governmental expenditures. A table showing the industrial consumption of lubricating oil is attached as appendix "A."

Since Pearl Harbor war contracts have multiplied, the whole pace of industrial production is being speeded up. It is apparent that the industrial consumption of lubricating oil will mount accordingly. The greater proportion of the Federal lubricating-oil tax will be paid directly by industry engaged in essential and war production.

Adequate lubrication is indispensable to many industries including mining, the production of electric light and power, metal working and processing, the manufacture of textiles, the preparation of food products, building tanks and ships, making s[illegible]ls, and the aviation industry. Without the high-grade lubricants which the petroleum industry has succeeded in making available at reasonable prices, modern industry with its high speed machines, and the modern motor car and airplane engine simply could not operate. Modern warfare depends on modern lubrication and the Nation which first suffers a shortage of this essential will be the first to face defeat.

One use of high-grade lubricants, produced especially in the Pennsylvania region, which is of particular importance to us now, is in machine tools. War production and that speed so essential to the Nation's welfare would not be possible but for a variety of ball and roller bearings, trains of carefully cut gears, and sliding surfaces which must be continuously in perfect alinement. Thus, lubrication is vitally important to machine-tool conversion and expansion of industry.

Gearing is an important part of a lathe assembly, for the speed of the lathe is usually considerably lower than the speed of the driving motor. Bath or splash-feed lubrication insures against the possibility of abnormal wear and renders operation relatively noiseless. The higher the speeds the more attention must be given to the bearings and to their lubrication. Slides and guides involving major parts of the lathe assembly also require special lubricants because of heavy pressures, even though the motion is slow. The carriage is usually held in position on the lathe bed by means of V-shaped projections which travel in corresponding grooves in the bed. V-lubrication is important due to the fact that abnormal wear will contribute to operating difficulties and the possibility of misalinement.

Gear lubrication is regarded by many as the salient factor in efficient planer operation. The occurrence of rolling and sliding friction between the respective teeth as they pass into and out of mesh is fully recognized. The continued occurrence of solid friction would tend to supplant rolling friction with sliding friction. Wear would then tend to increase proportionately. The substitution of fluid friction for solid friction which is brought about by the use of a suitable lubricant which will permit the formation of the proper film over the gear teeth, will enable rolling contact to predominate. The accuracy and degree of perfection of such machines in war industry will depend upon the maintenance of proper alinement in the V-guides through adequ[illegible] lubrication.

Massive milling machines, shapers and slott[illegible], drills and boring mills, used extensively in war production require high-grade oil lubricants as well as nontaxable greases. While the use of independent oil and grease cups will often be the most economical and satisfactory equipment, automatic or flood lubrication is also provided for by certain designers of important tools. This and hence the quantity of lubricating oils consumed depends on the speed at which the machine is to operate and the bearing or frictional pressures which may be involved. Only where there is a direct contractual relationship between industry and the Government are war producers exempt from payment of the tax on lubrication oils.

The tremendous demand for lubricants of all kinds being made by the Army, the Navy, and the Air Corps, serves to indicate the current need for lubricants and to illustrate the essential uses to which they are put in this era of intensified mechanization of war, industry, agriculture, and transportation. The tax on lubricating oil, of course, ultimately is borne by the consumer. The indirect effect on the oil industry itself, while burdensome, is not the subject of this discussion. This effect, whatever its hardships and sacrifices, is no more than any industry must expect and which the whole Nation must share—for the duration.

This committee has always recognized the wisdom of levying its highest taxes on only nonessential products. Lubricating oil is not a nonessential product. This tax will not fall on the carefree pleasure driver out for a Sunday outing, or on the vacationist who is off to the mountains or the seashore. The tax unfairly must fall on those "civilian soldiers" who are fighting the war on the home front and doing it in a far less dramatic but none the less essential way.

These taxes will in now way limit nonessential activies or nonessential expenditures. That function already has been performed by existing administrative orders. Accordingly, the effect will be inflationary in the worst sense. The direct burden will fall upon the Government itself. The imposition of these taxes, therefore, not only is needless, but the high administrative cost necessary to the collection of the tax—probably the highest proportionate cost in the whole tax schedule—becomes a wasteful effort.

Let us examine this administrative cost and its relation to revenues. The gasoline tax yielded approximately $371,000,000 in 1941. The lubricating oil tax yielded less than $44,000,000. The lubricating oil tax costs twice as much to administer while yielding only one-eighth as much revenue. The proportionate cost of collecting the smaller revenues to be anticipated in 1942 and 1943 will be disproportionately higher.

[illegible] of the principal reasons why the collection of the lubricating oil tax is extraordinarily high as compared with any other excise in the statute is that numerous exemptions must be provided. Lubricating oil is taxable only when actually used for a lubricating purpose. Exemptions are granted whenever it is used for other purposes. Thus many perplexing problems have harassed the Bureau of Internal Revenue ever since the enactment of this tax. This elaborate in a period of exemptions is both unwieldy and costly and ought to be eliminated in a period of emergency when the tax system should be streamlined to conform to the demands of the emergency. Under current conditions the tax on lubricating oil might well be eliminated entirely, in the interest of efficiency, economy, and the net social result.

The present lubricating oil tax applies to all types of lubricants at a fixed rate, irrespective of sales value. The inequalities and oppressive burdens already present in such a program would be increased greatly by the enactment of the Treasury recommendations. In some instances these increased taxes would be 250 percent of the sales price for heavy-duty lubricants used by railroads and some industrial uses. Many other lubes would be taxed at the rate of 100 percent of the sales price. These few examples make the inequities shockingly apparent.

The lubricating-oil tax, which was written into the revenue law without benefit of public hearings and careful consideration of this committee, was adopted because it was thought to be a tax only on motorists. As a matter of fact, it is a tax on every industrial plant of the United States today and on the most essential manufacturing projects of our Government. The tax therefore falls on war functions and not on nonessentials and adds greatly to our war costs.

While the more specialized quality lubricating oils sold directly to the armed services or Governmental agencies are not subject to the lubricating-oil tax, it remains true that no other necessity except gasoline is as heavily taxed as lubricating oil. Nearly all of the States which levy sales taxes exempt necessities and the rates of such taxes on articles of common consumption never exceed 2 or 3 percent. Against the price of the most used industrial lubricating oils, the proposed 6 cents per gallon Federal excise is equivalent to a sales tax of 100 percent and the Treasury proposals run as high as 250 percent. The Government taxes all types of lubricants except heavy greases at a fixed rate irrespective of sales value. Since there are any number of different kinds of lubricants developed to serve different industrial performance requirements, the flat rate causes many inequalities and places oppressive burdens on individual industries.

Congressman John W. McCormack, a member of the Ways and Means Committee which originally considered this tax, once told the Senate Finance Committee that they never intended to impose a 4-cent tax on lubricating oil used in industry and on the farm. In 1940 the rate was increased to 4½ cents per gallon. Is it now equitable or consistent to jump the rate to 6 cents per gallon?

The Federal tax on lubricating oil is one of the 10 emergency excise taxes which were recommended for removal in 1938 by the special congressional subcommittee on revision of the revenue laws. The desire of this subcommittee was to free all commodities in general and essential use from unduly heavy taxes and to remove those levies which have caused serious administrative difficulties out of all proportion to the revenue yield. The lubricating oil tax possesses both of these undesirable characteristics in high degree.

CONCLUSIONS

The petroleum industry is already heavily and inequitably taxed. Lubricating oil is now paying a disporportionately high rate of tax. Yet the Treasury proposes to increase this tax 122 percent. In the total war economy of the United States, the Federal tax on lubricating oils rests chiefly upon war uses. This would greatly increase the cost of the war program. Lubricating oils are essential to war workers in cities and to farmers in the country. People must get to work and farmers to market.

The Federal tax on lubricating oil was one of the few emergency taxes which were recommended for removal in 1938 by the special congressional subcommittee on revision of the revenue laws. The desire of this subcommittee was to free all commodities in general and essential use from unduly heavy taxes and to remove those levies which have caused serious administrative difficulties out of all proportion to the revenue yield. The lubricating oil tax possesses both of these undesirable characteristics in high degree. The reason for the removal of the lubricating oil tax are greater now than they were in 1938.

Therefore, the application of the tax on lubricating oil, its administration, and the high cost of collection, make this an item definitely classed as a "nuisance tax." It has been shown that the tax is a definite burden on war industry and it creates a great burden on agriculture and transportation, both vital to the war effort. In view of these conclusive facts, the tax on lubricating oil ought not to be increased. It should not even be maintained. Equity, justice, and wise tax administration would indicate that the lubricating oil tax be removed entirely.

JOSEPH E. KELLER.

AUGUST 15, 1942.

APPENDIX A.—*The industrial use of lubricating oil*

Year	Total consumption	Industrial use	Industry	Tax paid by industry
	Gallons	*Gallons*	*Percent*	
1933	557,250,000	82,100,000	14.7	$3,285,000
1934	621,100,000	137,100,000	22	5,485,000
1935	720,600,000	244,600,000	33.9	9,785,000
1936	724,650,000	238,050,000	32.9	9,520,000
1937	824,050,000	337,875,000	41	13,515,000
1938	762,400,000	275,650,000	36.2	11,025,000
1939	745,900,000	251,225,000	33.7	10,050,000
1940 [1]	806,925,000	290,550,000	36	12,395,000
1941	974,475,000	449,050,000	46.1	20,265,000

[1] Tax increased from 4 to 4½ cents, effective July 1, 1940.

ALABAMA HIGHWAY USERS CONFERENCE,
Montgomery, Ala., July 30, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR: I note that although the Ways and Means Committee and the House refused to increase the Federal gasoline tax to 3 cents per gallon, and the lubricating-oil tax to 10 cents per gallon as requested by Secretary Morgenthau, he has recently renewed this request before your committee.

On May 17, when the tax bill was in the Ways and Means Committee, I wrote you giving you for consideration by your committee a statement entitled "Effect of Proposed Additional Federal Gasoline Tax." In that statement, an additional copy of which is attached to the enclosed statement for ready convenience, it was pointed out that our State and county highway funds were destined to suffer dangerous reductions due to automobile and tire rationing. However, no constructive actual figures were available at that time except as to our highway debts and maintenance. The object of this letter is to give you and your committee the benefit of figures affecting our highway revenues and now available. This statement bears out our contentions as outlined in our statement last March.

With these facts staring us in the face, and knowledge that further increases in the Federal gasoline and lubricating oil taxes will not only add to the motor vehicle owners burdens and thereby accentuate our difficulties, but definitely will not bring in the amounts of revenue promised by Mr. Morgenthau, we are still of the firm opinion that Congress should forget these rapidly dwindling sources of revenue. Certainly any increases in them at this time would be very ill-advised.

We realize fully and sympathetically the problems you and your committee are confronted with and I am sure that all highway user groups are ready and willing to pay greatly increased tax bills to win the war. However, we feel that the burden should be placed upon every citizen and strongly recommend a general sales or manufacturers excise tax.

Very truly yours,

ALABAMA HIGHWAY USERS CONFERENCE,
By FRANK C. HURLEY,
Vice Chairman.

(The statement referred to above is on file with the clerk of the committee.)

STATE OF ARKANSAS, OFFICE OF LIEUTENANT GOVERNOR,
Little Rock, July 29, 1942.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR GEORGE: I have read with deep apprehension the proposal now before Congress to double the present Federal gasoline tax of 1½ cents per gallon.

I agree fully that we must have heavier Federal taxation to help finance America's war effort. However, may I respectfully call to your attention the fact that State governments are tremendously dependent upon the gasoline tax. In Arkansas we have a State road debt of $136,000,000, and our gasoline funds are pledged for the payment of interest and principal upon this huge debt. Out of our gasoline funds $750,000 is set aside for the payment of bridge improvement bonds and interest thereon, and for aid to cities and towns for construction, repair, and maintenance of streets and county roads in and immediately adjacent to such cities and towns. Approximately $1,250,000 is returned to the county governments for the construction of local roads.

Because of the curtailment in the use of automobiles we expect to experience a heavy reduction in receipts from gasoline tax in 1943. Any additional Federal tax upon gasoline will reduce this source of revenue even more.

The Federal gasoline tax is comparatively new and to increase that tax now will make it even more difficult than it currently is to finance local and State governments, and I know that you agree with me that these governments must be permitted to remain intact if our system of democracy is to prevail. Further, it is only reasonable that gasoline should not be singled out for special tax treatment along with luxuries and non-essential commodities. This consideration is more important today than ever because highway transportation is becoming more and more limited to essential purposes.

Sincerely yours,

BOB BAILEY, *Lieutenant-Governor.*

Similar communications have been received from the following individuals and concerns in Arkansas:

Louis Tarlowski, Little Rock, Ark.
C. N. Bellingrath, chairman, Arkansas Highway Users' Conference, Little Rock, Ark.
John Allen, manager, Associated Motor Carriers of Arkansas, Inc., Little Rock, Ark.
M. F. Dickinson, president, Arkansas State Farmers' Union, Little Rock, Ark.
C. G. Hall, secretary of state of the State of Arkansas.
Robert W. Griffith, Jr., representative in the House of Representatives of the State of Arkansas.
William L. Humphries, secretary-treasurer, Arkansas Wholesale Grocers' Association, Inc., Little Rock, Ark.
Willis V. Lewis, secretary-treasurer, Independent Bus and Truckers' Association, Little Rock, Ark.
Roy E. Ragsdale, secretary-treasurer, Order of United Commercial Travelers of America, Little Rock, Ark.
R. C. Moody, secretary, Arkansas Bottlers of Carbonated Beverages, Little Rock, Ark.

KENTUCKY AUTOMOBILE DEALERS ASSOCIATION,
Louisville Ky., July 27, 1942.

Senator ALBERT B. CHANDLER,
United States Senate, Washington, D. C.

DEAR SENATOR CHANDLER: The Kentucky Automobile Dealers Association, composed of 825 dealers, wishes to go on record as opposed to the increase in gasoline tax from 1½ to 3 cents per gallon which is recommended by the Secretary of the Treasury.

The "freezing" order issued by the Office of Price Administration on January 1 just about destroyed the automobile industry. Many Kentucky dealers have been forced to close their business, and if this increase in gasoline tax is enacted it will force them all to close their doors.

Some of us dealers have been fortunate enough to remain open under the most adverse conditions. We may be able to weather the storm by selling a few parts, servicing cars, and selling gasoline. But if the proposed gasoline tax increase becomes law, it will crush the industry.

The automobile industry wants to be a good soldier; in fact, it has been a good soldier, but it cannot win battles without equipment. Despite "freezing" of our equipment, we have been able to "thaw" enough to exist, not live. We can, and will continue to exist provided we are not confronted with additional obstacles. You can assist us by doing everything possible to prevent the enactment of the gasoline tax proposed by the Secretary of the Treasury.

Any effort on your part to prevent the enactment of this tax will be very much appreciated by automobile dealers from Mills Point to the Big Sandy.

Very truly yours,

TURNER A. SUMMERS, *President.*

(A similar communication was received from Mr. Lew Ullrich, Motor Truck Club of Kentucky, Inc., Louisville, Ky.)

GASOLINE RETAILERS' ASSOCIATION OF METROPOLITAN CHICAGO,
Chicago, Ill., July 24, 1942.

Hon. C. WAYLAND BROOKS,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: It is noted the 1942 revenue measure finally passing the House is now in the Senate Finance Committee approximately 2½ billion dollars short of the sum requested by the Treasury. It is hoped the Senate will not attempt to override the Ways and Means measured decision on the item of gasoline excises.

At present, by virtue of curtailed use of automotive equipment due to rubber shortages, etc., sale of gasoline is decreasing rapidly in Illinois and estimates are that even though the threat of gasoline rationing never becomes an actuality consumption of gasoline by October or November will have fallen to about one-half of that of a year ago, continue sharply to fall through 1943 and be only a fraction of the present volume in 1944.

Because of this it seems plain that if the Treasury hopes to derive increased revenue from gasoline in 1942, the levy would have to be raised in the present bill to more than double the current rate and to approximately 7 or 8 cents a gallon in 1943. I should like most respectfully to suggest that a program of taxation that would seek to overcome progressively decreased productivity in a shrinking tax base by increasing the tax rate would be unique and wholly impractical.

Probably a more important aspect of the threat to increase the gasoline tax in the Finance Committee is found in the effect such an increase would have on State highway funds which in our State, as you know, come entirely from license fees and State motor-fuel taxes. The situation in Illinois is doubtlessly familiar to you, but I should like to restate a few salient facts that are currently disturbing to State finances:

Bonded obligations.—On June 30, 1942, total Illinois highway bonds outstanding were $106,080,000, $10,080,000 remaining to be paid in the $60,000,000 issue and $96,000,000 remaining to be paid in the $100,000,000 issue. These bonds, as you know, are retired out of automobile license fee money.

On the same date two emergency relief issues had outstanding a total of $28,400,000. Of the first emergency relief issue of $20,000,000 a total of $5,200,000 remains to be paid; of the second emergency relief issue of $30,000,000 the unpaid balance amounted to $23,200,000. These two issues are being retired out of the motor-fuel tax fund at the rate of about $3,600,000, principal and interest, annually.

Falling motor-fuel tax receipts.—Net motor-fuel tax receipts in Illinois in May 1941 was $4,514,109.73; in May 1942 receipts had fallen to $3,624,912.52, indicating a decrease in gasoline consumption on the highways of approximately 30,000,000 gallons. It should be noted this decrease has come at a time when the sale price of gasoline has been frozen. The consensus is that if the present Federal excise tax were increased and the amount passed on to the consumer as a price advance the fall in the rate of consumption would be considerably augmented.

In this connection the State highway department, attempting to plan for the future, has projected anticipated annual receipts compared with annual fixed expenditures for the years 1942 to 1945, both inclusive, and on the basis of that analysis expect to have available for highway construction during the current year a total of $10,445,000; in 1943, due to continued rationing and decreased motor-fuel tax and license receipts, the amount is expected to fall to $3,961,500, becoming a deficit of $2,764,000 and $7,250,500 in 1944 and 1945, respectively. So you may compare these figures let it be noted the cost of normal peacetime highway improvements in Illinois has averaged around $20,000,000 annually for several years.

On the basis of these facts and assumptions, and calculating on the proved expectancy that consumption of gasoline will fall as the price rises, it is not difficult to foresee that an addition to the Federal excise tax at present would add sharply to the financial difficulties facing our highways. The matter surely has become so serious as to demand the best thoughts and efforts of every political and economic force in the State.

The above information appears to us to be important and would appreciate having the contents of this letter placed in the hands of Chairman George of the Finance Committee.

Very truly yours,

GASOLINE RETAILERS' ASSOCIATION OF METROPOLITAN CHICAGO,
B. M. PROVIS, *President*.

RESOLUTION OF NORTHERN ILLINOIS RETAILERS ASSOCIATION

Whereas the Finance Committee of the United States Senate is considering the Treasury's proposal to increase the Federal excise tax on gasoline by 1½ cents per gallon, and

Whereas the motor-fuel tax receipts to the State of Illinois, due to curtailed use of automobiles, has been reduced by approximately $1,000,000 monthly, and

Whereas further loss of sale to gasoline retailers and loss of revenue to the State would follow a tax increase, be it therefore

Resolved, That the Northern Illinois Retailers Association assert its wholehearted opposition to the imposition of further Federal taxes on gasoline, and be it further

Resolved, That a copy of this resolution be forwarded to the Illinois delegation in Congress and to members of the Finance Committee of the Senate.

NORTHERN ILLINOIS RETAILER ASSOCIATION,
W. R. GIRLING, *President*.

STATE OF INDIANA,
INDIANAPOLIS, IND., *July 28, 1942*.

Hon. RAYMOND E. WILLIS,
United States Senate, Washington, D. C.

DEAR RAY: It has come to my attention that an effort is being made to add 1½ cents to the Federal gasoline tax. Because of the necessary rationing of tires and the fact that automobiles are not being used, it seems to me that farmers will be bearing an unjust share of any increase in the gasoline tax. We must ask the farmers to produce more in order to wage a successful war. This means that farmers will use more gasoline in driving their tractors. Furthermore, our farmers must use their automobiles to haul produce to market.

During the year of 1941 we collected $28,000,000 in State gasoline tax and approximately $15,000,000 was distributed to the town, State, and county units of government for local use. The rationing program has already brought about a substantial decrease in gasoline taxes and the States and local units of government will suffer even more if the Federal tax is doubled at this time. I know that you agree with me that State and local government must be permitted to remain intact if our system of representative government is to prevail.

With kindest personal regards, I am

Sincerely,

RICHARD T. JAMES,
Auditor of State.

OFFICE OF DEPARTMENT OF REVENUE, STATE OF LOUISIANA,
Baton Rouge, La., July 28, 1942

Hon. JOHN H. OVERTON,
United States Senator, Washington, D. C.

DEAR SENATOR OVERTON: I notice from newspaper accounts that the new Federal tax bill is presently before the Senate Finance Committee for its consideration and that the Treasury Department has again urged an increase in Federal gasoline and lubricating oil taxes. I am certain that you are familiar with the outcome that such proposals would bring about and, therefore, will not burden you with figures. However, I do wish to call your attention to the fact that Louisiana citizens are already paying a tax of 8½ cents per gallon on gasoline and 12½ cents per gallon on lubricating oil.

As director of revenue I wish to likewise call your attention to the fact that during the month of April gasoline taxes collected by my department declined 24.2 percent over April of last year and further that these taxes have continued to decline since April. It is safe to say that by the end of this year collections from these two sources will decline by at least 40 percent. An increase at the present time in Federal gasoline and lubricating oil taxes, therefore, will not raise any substantial additional amount of revenue and will only tend to speed up inflation.

I feel sure that you will use your influence in having the Finance Committee reject Mr. Morgenthau's recommendation to increase the present Federal rates on gasoline and lubricating oil because of the high rates that are being paid by Louisiana citizens and the adverse effect that such increase would have on our State's finances.

With best wishes, I am

Sincerely yours,

RUFUS W. FONTENOT, *Collector.*

HELENA, MONT., *August 1, 1942.*

Hon. WALTER F. GEORGE,
Chairman, Finance Committee, Senate of the United States,
Washington, D. C.:

Reference is made to H. R. 7378, revenue bill 1942, now in hearings before your committee, and particularly appearance before you of Secretary Morgenthau renewing recommendations made before House Ways and Means Committee. Due to possibility of separation and immediate enactment of these proposed large increases in Federal gasoline and lubricating oil taxes we wired you March 12 setting forth our objections thereto. Proposed increase gasoline tax, counting 1940 increase, would bring total increase to 200 percent over tax prior to 1940. Consider it more equitable to look to increased taxes of nonessential commodities rather than necessities like gasoline and lubricating oils. Gasoline, an essential commodity, already is taxed higher than most nonessential luxuries. Lubricating oils and gasoline are necessary on both production and battle fronts for ultimate victory. State tax of gasoline, major source of highway income, has already suffered large decrease due to rationing tires, reduced use of cars, reduced speed limit, and other factors. We are positive proposed increase of Federal tax will further reduce consumption, jeopardize highway finances.

On behalf of the Nation, our State, and its citizens, we beg to renew our protest of March 12 to additional Federal taxes of gasoline and lubricating oil proposed by Mr. Morgenthau. Please bring this before your committee and file as part of record.

SAM C. FORD,
Governor of Montana.
SAM W. MITCHELL,
Secretary of State.
HOWARD M. GULLICKSON,
Attorney General.

Communications of a similar nature were received from the following individuals of the State of Montana:

Clifford L. Walker, deputy secretary of state.
W. A. Brown, State bank examiner.
Charles L. Sheridan, supervisor, Montana Highway Patrol.
J. E. Henry, State purchasing agent.
Elizabeth Ireland, State superintendent of public instruction.
Albert H. Kruse, commissioner, agriculture, labor and industry.
William Hasking, State accountant.
Howard W. Holme, chief engineer, Montana State Highway Commission.

STATEMENT OF SENATOR CHARLES W. TOBEY OF NEW HAMPSHIRE

THE TREASURY'S PROPOSAL TO INCREASE GASOLINE AND LUBRICATING OIL LEVIES AND THE EFFECT UPON NEW HAMPSHIRE

The citizens and the essential revenues of New Hampshire are suffering at the hands of gasoline rationing. There is of course an underlying transportation problem thrust upon us by our enemies, but there are economic and domestic difficulties, too. New Hampshire and the other New England States are willingly cooperating in our war effort and are anxious to make every direct contribution to that end. At the same time, it is indeed necessary that the essentials of civilian life, of agricultural production be provided, and that every State should continue to function at peak efficiency. There is a definite minimum quantity of gasoline, lubricating and fuel heating oil which New Hampshire must receive. It cannot be claimed that an increase in the Federal tax on gasoline and lubricating oil will in any way aid the difficult transportation problem which must be faced in getting petroleum products to the Atlantic States, to New England, and to our ally, Canada. To the people of New Hampshire there is no justification for additional Federal levies upon gasoline and lubricating oil; in fact, in our opinion, to increase these taxes at this time would be unfair, and contrary to sound principles of taxation. This opinion is based upon a careful examination of the fundamentals of this wartime situation.

The citizens of my State are particularly dependent upon automotive transportation. The rural population is high; 42.4 percent of the people live outside of any cities, towns, or incorporated places of over 2,500 population, according to the latest United States census, as compared with about 24 percent for all the New England States. Public transportation facilities such as the railroads, streetcars, and busses are not highly developed. The proportion of necessity driving in New Hampshire has always been high, and with present gasoline rationing and the rubber situation car owners find it absolutely necessary to restrict their driving to essential needs. Now that dairy, poultry, and general agricultural products are in heavy demand for our armed forces and in assistance to our Allies and when mineral, pulp, and sugar demands have also increased, the farm and industrial demand for gasoline has risen markedly. Range oil for heating and lubricating oil are just as necessary as ever. Thus the necessity demand for petroleum products is increasing as a result of the war while the transportation facilities for bringing them into the State are under great strain.

In the face of these obvious difficulties which somehow must be solved, it is proposed by the Treasury Department that the Federal gasoline tax should be increased 100 percent and the lubricating oil excise 122 percent. Aren't car owners, their families, farmers, truck and bus operators suffering enough? Everyone in this country should know by now that we must get along on the tires we now have for the duration. I don't know what is going to happen to the farmers and essential workers in the South and West, but I do know that the automobile situation has hit us already in New Hampshire. It is not selfish for public officials in the New England States to firmly express and look out for the essential needs of their electorate; in fact, it is our duty to do so. I therefore present these facts to this distinguished committee.

It seems to me that it is the bounden duty of both the Treasury and the Congress to consider carefully the present financial difficulties of the States, particularly as these are intensified by declining automotive revenues. While it is indeed difficult to find equitable means to meet unprecedented Federal revenue needs, that fact is no justification for the adoption of an unstable tax base and in the same action create additional financial difficulties for the States. The normal functions of State government must be continued for they are an integral part of the American system of government. Automotive imposts, particularly the gasoline taxes, always have been one of the chief sources of State revenues and have made possible the construction and maintenance of our magnificent system of highways. These highways have become the very warp and woof of our everyday life. They are even more necessary in war than in peace. They must be kept open, usable and safe for traffic through storms and floods, through snow and sleet. War workers must travel, munitions must move, the Army must be transported. The upkeep of the roads is the duty of the States and one of their principal contributions to victory.

It is self-evident that year-around highway maintenance, especially in the Northern States is costly and even with the elimination of new construction the States can only fulfill this obligation with the utmost difficulty. When you ration gasoline you automatically impose a moratorium upon a principal source of State revenue. But even that is not the chief difficulty with which New Hampshire and her sister States are faced. The rubber shortage imposes an even greater restriction. Month by month, irreplaceable tires are wearing out; month by month cars and trucks are being laid up; and month by month revenue will decline, not only gasoline tax revenue but other established sources of State revenue, too.

Because no new cars are being made, no new tires are available for civilian use and because gasoline is being rationed profound dislocations in business are the order of the day. The small filling station, garages, and automobile repair shops, normally fixtures in the American scene, are disappearing.

Summer resorts are being hard hit and are gloomy over their prospects. They are caught between shorter vacations on the one side and the lack of gasoline on the other. The requests for reservations have been reduced through public fear that bus and train travel will be further curtailed. In some places black-outs aggravate the problem and many hotel keepers, both large and small, may be unable to survive.

Attendance at public beaches and outlying golf courses has fallen off 50 to 65 percent. Roadside stands located in outlying districts report a loss of trade of about 80 percent. While the average loss of restaurants and roadside stands has reached 45 percent. Perhaps the hardest hit have been the tourist homes. Many of them will find it difficult to survive as homes without tourists.

Already with gasoline rationing only 2 months old, the Port of New York Authority reports passenger traffic on six river crossings has dropped 38 percent and toll collections off 30 percent compared with the same period last year. The effect of the tire shortage is yet to make itself felt. The effect of this loss of normal business will be reflected in a corresponding loss of State revenue from established sources, a loss sufficiently great to seriously affect both the State government and local community finances.

But of greatest significance is the loss of revenue from gasoline taxes and motor-vehicle fees. In the fiscal year ending June 30, 1941, these two sources accounted for 54.6 percent of New Hampshire's revenues. In May of this year with gasoline rationing in effect for only half the month, gasoline consumption was off 31 percent. Both these revenues and those from motor vehicle fees will drop precipitously at the end of the present fiscal year as tires wear out and the older cars and trucks are immobilized by lack of replacement parts.

But New Hampshire is not complaining. State and municipal officials as well as the citizens themselves are willing to tighten their belts. New Hampshire will work her way out of this crisis just as she has worked her way through others in the past. But she can do this only if her limited taxing power is left reasonably unimpaired. She cannot be expected to maintain highways which are essential to the war program if the Federal Government insists upon usurping her principal source of revenue. Neither can she see the wisdom of the Federal Treasury's proposal to further infringe upon this field when it is so apparent that the spring is drying up at the source.

Furthermore, in the opinion of New Hampshire, gasoline taxes are entirely unsuitable as a revenue source for any purpose other than the construction and maintenance of highways. As a tax by the mile for the use of roads it is nearly ideal for it is a benefit tax. But as a benefit tax it has no relation to ability to pay nor to any other accepted tax yardstick. So convinced is New Hampshire of the soundness of this principle that at its constitutional convention in 1939 it amended its fundamental law to prohibit the use of gasoline tax revenue for other than highway purposes.

As a matter of fact the Federal Government penalizes States which use their gasoline tax revenue for nonhighway purposes by withholding a portion of their Federal highway aid.

I respectfully urge that the committee give careful and earnest consideration to the facts herein presented and with assurances of my esteem, I remain.

CHAS. W. TOBEY.

STATE OF NEW HAMPSHIRE, HIGHWAY DEPARTMENT,
Concord, N. H., July 31, 1942.

Senator CHARLES W. TOBEY,
Washington, D. C.

DEAR SENATOR: The State highway department's income to July 1 of this year is $336,477 less than that of the same period last year. A continuance of reduction in the funds received from motor-vehicle fees and gasoline income may be expected due to lack of tires, cessation of the manufacture of passenger cars, and gasoline rationing.

It seems rather inconsistent to us, therefore, for the above reason alone, to increase the Federal gasoline tax and further jeopardize what income we will be fortunate enough to collect.

It will be a very serious matter, indeed, for New Hampshire if our income is reduced more than one-third, as it will not be possible to extend any aid to the towns, and, if further reduced, interest payments and bond retirements now charged to the 1-cent fund would be payable out of our regular income, already reduced to approximately the amount necessary to maintain those highways already constructed.

May we have your support in opposition to this measure, and we also request that our opposition be inserted in the records of the Senate Finance Committee.

Yours truly,

F. E. EVERETT, *Commissioner.*

NEW YORK, *August 11, 1942.*

The Honorable W. F. GEORGE,
United States Senate, Washington, D. C.

Urge your support Guffy amendment to H. R. 7378, providing Federal tax on reclaimed lubricating oil.

L. SONNEBORN SONS, INC.,
RUDOLPH G. SONNEBORN.

AUTOMOBILE LEGAL ASSOCIATION,
July 31, 1942.

Senator THEODORE FRANCIS GREEN,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: When the 1942 revenue bill was being prepared by the House Ways and Means Committee, I asked your valued assistance in opposing any step which would place an additional Federal tax on gasoline, lubricating oil, or on the production of petroleum products. I feel that the statements which were made by me at that time might well be placed by you before the Senate Finance Committee at this time. Consequently, I am embodying some of them in this letter.

The average highway user in Rhode Island today pays an annual local, State, and Federal tax on his motor vehicle of approximately $65, despite the fact that the United States Department of Commerce surveys show the average automobile owner to be in the low-income group.

Highway users and the related highway transportation industry, who, in the past, have contributed one out of every six tax dollars to local, State, and Federal Governments, will, of they are permitted, continue to do their share in the financing of road costs, general governmental expenses, and war expenditures. However, they cannot be expected to pay an overproportionate share of any of these things; otherwise, they will be taxed beyond the point of diminishing returns.

While highway users do not wish to shirk their duty as patriotic, taxpaying citizens in their contribution to our war effort, they believe that their motor vehicles, parts, or gasoline should not be classified as luxuries and taxed as such. The recommendations which were made when the revenue bill of 1942 was being considered by the House Ways and Means Committee, calling for an increase of 100 percent in the Federal tax on gasoline and an increase of 144 percent in the Federal tax on lubricating oil, were a definite attempt to tax gasoline as a luxury.

I am aware of the fact that the House of Representatives, in their wisdom, declined to place an additional tax on gasoline. I lament, however, the fact that lubricating oil, so essential in the operation of motor vehicles, but now absolutely necessary in the operation of industrial plants manufacturing munitions for war, was singled out and taxed. It is with this thought in mind that I am calling this matter to your attention now, lest, perhaps, someone may request the honorable Senate to make additional increases in the tax on petroleum products.

We have also noticed, frome accounts in the press, that Secretary Morgenthau has personally appealed to the Senate for an increase in the gasoline and lubricating-oil taxes and for the elimination of the percentage now allowed for depletion in the production of these products. This recommendation of the Secretary of the Treasury contains no grain of consolation for the motorists of America, because if the depletion percentage be eliminated, this fact will be sharply reflected in the cost of production and will be tantamount to a further Federal tax on gasoline and lubricating oil.

Twenty-five percent of the gasoline consumed today is used in trucks, the greater percentage of which are now handling war materials. Surveys show that 55 percent of all mileage driven and 75 percent of the trips made in passenger cars in 1940 were for necessary purposes. As passenger-car tires wear out and gasoline is rationed, all future passenger-car driving will be for necessity purposes, especially here in Rhode Island, where so many war workers are finding it necessary to use their motor vehicles in riding to and from war plants which have no housing facilities.

Rationing of tires and gasoline and increased gasoline costs brought about by tanker shortages make it increasingly difficult for highway users to use their motor vehicles. Highway users believe that it would be most unfair, undemocratic, and harmful to our war effort to increase further the Federal tax on gasoline and lubricating oil, which constitute the lifeblood of highway transportation.

Anything that you can do to inform other members of the Senate Finance Committee of the plight in which Rhode Island citizens and war workers find themselves at the present time, or anything that you can do to defeat any proposals to increase the tax on these commodities will be greatly appreciated.

I would also be very much pleased to have you file this protest in the record of the hearings before the Senate Finance Committee.

Very truly yours,

LEO R. CAVANAUGH, *District Manager.*

Communications of a similar nature were received from the following individuals of the State of Rhode Island:

Mrs. Nellie V. H. Taylor, secretary, Richmond Grange No. 6.
Miss Hattie L. O'Bryan, secretary, Union Grange No. 13.
Miss Jean C. Weldon, secretary, Darlington Grange No. 55.
Mrs. Ethel L. Sprague, secretary, Gaspee Grange No. 56.
Miss Margaret Park, secretary, Portsmouth Grange No. 29.
Miss Daisy I. Kettelle, secretary, Rocky Hill Grange No. 27.
Miss Emma L. Greve, secretary, Rumford Grange No. 52.
John A. Arnold, secretary, Ashaway Grange No. 50.
Miss Kathryn Wimer, secretary, Little Compton Grange No. 32.
John A. Bennett, director, Rhode Island State Grange.
Leo R. Cavanaugh, district manager, Automobile Legal Association.
Joseph P. McEvoy, president, Rhode Island Automobile Dealers Association.
John J. Daigle, executive secretary, Retail Petroleum Dealers' Association of Rhode Island, Cranston, R. I.
Wilfred J. Paquin, Register of Motor Vehicles, State of Rhode Island and Providence Plantations.

STATE OF SOUTH DAKOTA, EXECUTIVE DEPARTMENT,
Pierre, S. Dak., March 10, 1942.

HON. CHAN GURNEY,
Senate Office Building, Washington, D. C.

DEAR SENATOR GURNEY: I have just been studying the proposal made last week by Secretary Morgenthau as his fiscal program for the next Federal fiscal year. I note that among his proposals to raise revenue in the new revenue bill is an increase in the present Federal gasoline tax of 1½ cents a gallon. This would double the present Federal gasoline tax, making a total of 3 cents per gallon. I also note he proposes an increase in the Federal lubricating oil tax from 4½ cents a gallon to 10 cents a gallon, which is nearly a 150-percent increase in this tax.

As you know, I wrote a letter to Congressman Doughton, chairman of the House Ways and Means Committee, about a year ago in opposition to the proposal then to increase the Federal gasoline tax 1 cent per gallon in the revenue bill of last year. You will find a copy of this letter reproduced on page 700 of the hearings on Revenue Revision of 1941 before the Committee on Ways and Means of the House, Seventy-seventh Congress, first session. About that same time our State highway commission approved unanimously a resolution in opposition to such proposed increase, which is reproduced on page 1805 of the report of the hearings.

Since that time there has been no change in the reasons expressed in my letter to Mr. Doughton opposing the proposal, nor in the highway commission resolution of opposition. I fully recognize the necessity of revenue to finance the all-out effort to win this war. I likewise approach to the suggested program, namely, taxation to check inflation, reduction of Federal expenditures which compete with war production and add unnecessarily to the volume of purchasing power in the hands of the people, and that taxes should be fair and nondiscriminatory. Also I recognize the demands that are made upon our people in the agricultural sections of our country for an all-out production of food for our armed forces, our defense workers, our Allies, and our own people.

With these things in mind, I wish again to call your attention to the fact that the gasoline tax has long since departed from the class of a luxury tax insofar as South Dakota residents are concerned, and has been for many years, and in fact since its inception, a tax on one of the real necessities of the people of South Dakota. There are in excess of 40,000 tractors in use in South Dakota by farmers for production of agricultural products. More than one-third of the communities of this State are without any transportation facilities except motor vehicles. The great production demanded and required of our people must largely be transported from sources of production to markets and into distribution by motor vehicle. Our people are gladly cooperating in the war effort and are exerting their very best efforts in doing what we are able to do in prosecuting the war. We shall continue to do so. However, the increase of the Federal gasoline tax will be just one more extra burden on the efforts we are putting forth. At the present time the Federal gasoline tax amounts to a 10-percent retail sales tax on the commodity. The proposed increase will be an additional 10 percent retail sales tax, making a total of 20 percent retail sales tax on this necessity.

As you know, the entire Middle West agricultural section is not favored with any vast expenditure of money to carry out the war preparation except in a few isolated metropolitan areas. Inflation danger in gasoline prices in this area is very remote. The average farm family in South Dakota still has an annual earning of less than $30 per week. Congress has already inaugurated price controls affecting agricultural commodities.

The tire-rationing program has already materially affected motor vehicle use in South Dakota, and after another year of curtailment will be so effective that it is difficult to estimate the shrink in motor-vehicle use. Our distances are great, and our efficiency will be materially affected on account of rubber shortage. Our present highway construction program is now at a standstill. We do, however, have contracts which have been let and are in the process of completion. These contracts, I understand, will be permitted to proceed to final completion. If a further increase in the Federal gasoline tax takes place no doubt it will materially hamper the revenues received from the State gasoline tax. This could very easily reduce revenues below the bare necessity of maintenance of our State highway system. If our highway system deteriorates materially it will directly affect our efficiency in moving our agricultural products to the armed forces and the people engaged in defense and war production in the industrial areas. I cannot believe this is the intention of the Treasury's experts. Apparently they have not considered the matter very seriously in this regard, or they would never have made such a proposal.

Our Constitution provides that all taxation shall be equal and uniform. This same provision is carried into the constitutions of most of the States in this great agricultural section. A tax which selects one on the retail sales price certainly is discriminatory against the persons obliged to purchase th esame. If excise taxes on sales are to be imposed they are unfair and discriminatory unless imposed on all commodities equally. There may be some justification for the imposition of excise taxes at unfair and discriminatory rates on commodities designated as luxuries or nonessential, solely as a regulatory or political measure, but certainly not as a fair tax measure. I note the Treasury experts estimate a 5-percent retail sales tax on all commodities would raise over $3,200,000,000. If any sales tax is to be imposed on the theory of having all taxes fair and nondiscriminatory or equal and uniform, no single commodity or group of commodities should be selected as against all commodities.

All that I have heretofore said in this letter equally applies to the proposal to increase the Federal lubricating-oil tax. As you know, farm operations require lubricating oil. Further burden on this necessary commodity is again a direct burden upon necessary war production. At the rate suggested, namely, 10 cents per gallon, it amounts to a retail sales tax in excess of 15 percent.

I would appreciate your taking the matter up with Senator George, chairman of the Senate Finance Committee, and filing this letter with him in opposition to such proposed special tax increases. Also, any effort you can put forth in opposition to these proposals will be appreciated by me, and I am certain will be greatly appreciated by all of the people of this State and the entire agricultural territory of the Middle West. Likewise, I wish to specifically refer again to my letter of May 2, 1941, to Mr. Doughton, as reported in the hearings on the revenue bill of last year, which should be incorporated in this protest, together with the resolution of the South Dakota Highway Commission, also referred to above.

With kindest personal regards and best wishes, I am,

Sincerely yours,

HARLAN J. BUSHFIELD, *Governor.*

SOUTH DAKOTA STATE HIGHWAY COMMISSION,
Pierre, S. Dak., March 11, 1942.

Hon. CHAN GURNEY,
Senate Office Building, Washington, D. C.

DEAR CHAN: It has come to our attention that in a proposal made last week by Secretary Morgenthau, when presenting the Treasury's fiscal program for the coming fiscal year, he suggested an increase in the Federal gasoline tax of 1½ cents per gallon. This would double the present Federal gasoline tax, and make it total 3 cents per gallon. He also proposed an increase in the Federal lubricating oil tax of 5 cents a gallon, making a total of 10 cents per gallon. This amounts to 150 percent increase in such tax.

We are writing this letter to you individually and severally, in opposition to such proposals.

Approximately a year ago, you will recall, the Treasury then proposed an increase in the Federal gasoline tax to be included in the 1941 Federal Revenue Act of 1 cent per gallon. At that time we unanimously approved a resolution in opposition to such proposal. Copies of this resolution were sent to you, and a copy was filed with the Honorable Robert L. Doughton, as chairman of the House Ways and Means Committee, then considering the proposal. This resolution is reproduced on page 1805 of the reported hearings of the House Ways and Means Committee. There has been no change in the situation in South Dakota, or in the Nation, that would materially effect the reasons for opposition to such proposal contained in the resolution. We wish to incorporate all of such resolution in this letter as part of it by the reference above made.

We recognize the necessity of everyone exerting their best efforts in the successful prosecution of the war. In order to meet the requirements of production of agricultural products to feed the armed forces, defense workers, and the people of this country, as well as those of our Allies, we must maintain transportation facilities to get such production to those needing it. The State highway system of South Dakota is entirely dependent upon gasoline tax for maintenance and construction. Although construction is now at a standstill, due to priority requirements effecting materials, we do have some contracts, completion of which will be permitted. We are more concerned with being able to maintain our State highway system than anything else. The proposed increase in the Federal gasoline tax and the lubricating oil tax would definitely have a deterring effect on consumption of such commodities and a corresponding decrease in highway revenues would result. Serious harm to South Dakota's highway maintenance would be the inevitable ultimate fact.

As you know, distances in this State and in the northwestern States generally are very great from farms and ranches to markets. More than one-third of the communities of this State are entirely dependent upon motor vehicle transportation. The State highway system is approximately 6,000 miles. If any proposal materially retards highway revenue it could very easily cause a deterioration of the State highway system. This would directly effect the efficiency of our people moving our agricultural products to those of the country needing them.

We understand that the Treasury Department estimates a 5 percent retail sales tax on all commodities without exemptions would raise more than $3,200,000,000. We cannot understand why gasoline and lubricating oil, which are necessary commodities to carrying on our contribution to successfully prosecuting the war, should be separated from other commodities and taxed at 20 percent and 15 percent, respectively, of their retail price. We believe that if an excise tax on sales is expected to be fair and nondiscriminatory, it should apply equally to all commodities.

We would appreciate your filing this letter with Senator George, chairman of the Senate Finance Committee, in opposition to the proposed tax increases, and any effort you can put forth in opposition to such proposals will be appreciated by us.

With kindest personal regards, we are

Sincerely yours,

STATE HIGHWAY COMMISSION,
J. H. LAKE,
J. A. SWENSON,
D. H. MCCAY,
Commissioners.

UNITED STATES SENATE,
July 31, 1942.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C

DEAR SENATOR GEORGE: I have constituents in Tennessee who have taken up the proposed increase of Federal tax on gasoline at 3 cents per gallon. This is the way they put it up to me:

"Trucks, busses, and workers' cars must roll. As long as there are tires—there must be some means of transportation for essential workers, industrial and agricultural. These vehicles will consume gasoline and must be furnished lubricating oil to preserve parts. Is it now suitable or just that the Federal Government should further invade the State gasoline tax field upon which the State is so dependent, and increase the excise on the lubricating oil?

"Surely present State levies upon essential highway users are burdensome enough. In Memphis, Tenn., the present service-station price of gasoline is 11.4 cents per gallon without the tax and to this amount must be added 8.9 cents per gallon for existing and Federal taxes. The taxes now paid are equal to a 78-percent retail sales tax.

"If the Treasury Department proposal to increase the tax to 3 cents per gallon were enacted it would be the equivalent of 91.2-percent sales tax. If you increase the tax on lubricating oils it would be from about 4½ to 10 cents per gallon in Tennessee. In short, the Treasury is proposing that for every dollar spent at the gasoline station even the most essential user would be forced to pay 47.7 cents in taxes and additional taxes on lubricating oil. Gasoline purchased with this dollar would only propel the average vehicle 63 miles. This high tax is unprecedented and unjust even in war times."

It seems to me that there is a great deal of sound sense in the above proposal. I know you will give it every consideration.

With kindest personal regards, I am

Sincerely your friend,

KENNETH MCKELLAR.

PANHANDLE REFINING CO.,
Wichita Falls, Tex., June 24, 1942.

Hon. W. LEE O'DANIEL,
Senate Chamber, Washington, D. C.

DEAR SENATOR: In drawing the last tax bill, in some way the tax on lubricating oils was not applied to the reclaimers of crankcase drainings through an oversight, I am sure.

This reclaimed oil should be taxed the same as lubricating oil made from crude oil, just the same as tires made from reclaimed rubber bear the same tax as tires made from new rubber. Unless this is so the reclaimers of crankcase drainings have an enormous advantage over legitimate manufacturers of lubricating oils from a competitive standpoint, and the fact that they go free of tax is the means of helping breakdown the price structure for all manufacturers of lubricating oil. I call this to your attention, and hope that this point may be corrected in the new bill.

With best personal regards, I am

Very truly yours,

ROY B. JONES.

TAX LOOPHOLES SHOULD BE PLUGGED

Under present law and Treasury regulations, used crankcase oil may be reclaimed and resold legally in regular trade channels as lubricating oil, without payment of the 4½-cents-per-gallon Federal tax.

The cost of collecting used crankcase oil from garages and service stations amounts to little more than the labor cost involved. The cost of processing is nominal. In view of low costs of collecting and processing used crankcase oil, the reclaimer has a decided price advantage.

In all probability the new tax bill will provide for an increase in Federal tax on lubricating oil. Unless the present law is revised so as to make reclaimed oil subject to Federal tax, the reclaimer stands to further increase his present cost advantage. The reclaimer should pay the Federal tax and should be required to properly brand his product as "reclaimed oil," or "a blend of reclaimed oil," as the case may be. The tire manufacturer who makes a tire from reclaimed rubber pays the same Federal tax as though he used all new rubber.

Why then should the oil reclaimer have special privilege?

Why under present conditions, when tax is so vitally needed, continue to permit legal tax evasion now permitted under present Treasury regulations? Congress undoubtedly never intended to leave the loophole when writing the original bill. We urge our Senators and Congressmen to correct this unfair practice in writing the new tax bill.

"DEMOCRACY THRIVES WHEN COST OF GOVERNMENT IS JUSTLY DISTRIBUTED"

JUNE 15, 1942.

CHARLESTON, W. VA., *August 7, 1942.*

Senator WALTER F. GEORGE,
Senate Office Building, Washington, D. C.:

The West Virginia Farm Bureau has contacted you on several occasions this year in regard to various legislation we feel will affect agriculture in West Virginia. I am again taking the privilege of writing to you regarding another matter which we hope you will consider.

In 1940 the over-all automotive tax bill paid by West Virginia motorists reached the staggering amount of $23,173,000.

The significant thing about this tax bill is that the motorist pays these taxes in addition to all the other taxes levied generally to support the Government.

The farmer is under a distinct handicap in the State as far as transporting products by rail and must rely upon trucks to do the job.

It is now proposed to increase the Federal tax on gasoline by 100 percent to a total rate of 3 cents per gallon, which would make the over-all gasoline tax rate to be 8 cents per gallon.

We must not retard the progress of food supply. Let's keep our secondary roads and highways in the best possible condition through the revenue afforded us by our State government. Further increase in Federal tax will bring about further reduction in State income for roads.

We trust you will do everything in your power to have this legislation defeated.

WEST VIRGINIA FARM BUREAU,
F. L. MILES,
Executive Secretary.

HARRISON OIL CO.,
Milwaukee, Wis., July 31, 1942.

Hon. W. F. GEORGE,
Chairman, Senate Finance Committee,
Senate Building, Washington, D. C.

DEAR SENATOR GEORGE: In the new tax bill now before the Senate Finance Committee no provision has been made to place a tax on reclaimed motor oil. On the other hand it is our understanding the tax on new oil is to be increased from 4½ to 6 cents per gallon. Reclaimed oil is becoming an increasingly important factor in the petroleum industry, and if allowed to be sold tax free it (reclaimed oil) will grow in importance in view of the greater differential resulting from the increased tax on new oil.

People engaged in reclaiming waste oil invariably represent it to buyers as new oil or the equivalent thereto, and sales are made at a price, plus tax. Taxes so collected, however, are not returned to the Government. Obviously, therefore, there is a clear case of tax evasion, collecting taxes under false pretenses, while at the same time legitimate jobbers and marketers of petroleum products are confronted with unfair competition.

It is respectfully requested, therefore, that the Senate Finance Committee amend the new tax bill, as it relates to lubricating oil, whereby any waste oil that is cleaned, renovated, or refined for resale purposes will be taxed the same as new oil, and that those engaged in the business of reclaiming waste oil should be caused to register and file bond with the Internal Revenue Bureau, the same as refiners or marketers of new oil. Moreover as a safeguard to the consuming public we further suggest that it become obligatory for wholesale or retail sellers of reclaimed oil to properly identify all containers from which reclaimed oil is sold, in effect as follows "Oil in this container is reclaimed waste oil and sold as such."

A tax on reclaimed oil will correct an existing evil, and at the same time provide much-needed additional revenue. In view of the fact that reclaimed oil is offered as new oil it is doubtful if the question of double taxes enters into the matter. Favorable action by the committee in this matter will plug a tax loophole, and protect marketers of lubricating oil against competition, which today exists purely at the expense of the other fellow.

Cordially yours,

HARRISON OIL CO.,
JAMES S. HARRISON.

MEMORANDUM SUBMITTED BY JAMES K. POLK, OF WHITMAN, RANSOM, COULSON & GOETZ, NEW YORK CITY, AUGUST 15, 1942

SECTION 147, H. R. 7378, MUTUAL INSURANCE COMPANIES OTHER THAN LIFE

Section 147 of the House bill proposes to substitute for existing provisions of the Internal Revenue Code a new levy upon the net income of mutual insurance companies. In the proposed statutory provisions there is a complete departure from all accepted concepts of mutual insurance and there is attempted to be imposed by legislative definition a character to the transactions which constitute the mutual insurance enterprise which is directly contrary to fact.

Fundamentally, mutual marine, fire, and casualty insurance is a cooperative activity having as its sole objective the spreading of the losses of the unfortunate few who sustain them among all of the members at a minimum cost to each member. The dollars of premium deposit are received and held for the express purpose of paying the losses and expenses, and for the return to the policyholder of any remainder. There is no doubt that this excess collection of premium deposit belongs to the member under universally accepted mutual insurance concepts. In discussing this, the Supreme Court in the case of *Penn Mutual Co.* v. *Lederer* (252 U. S. 523, p. 533), stated:

"* * * The thing for which a fire or marine insurance premium is paid is protection which ceases at the end of the term. If after the end of the term a part of the premium is returned to the policyholder, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection; that is, the expense was less than estimated."

In fact, the courts and the Bureau of Internal Revenue have consistently held that the return of premium was not a part of gross income. As stated in the *Mutual Benefit Life Ins. Co.* v. *Herold* (198 Fed. 199, p. 205), the return is in no real sense a dividend.

"* * * The term as used is technical and well understood in insurance circles, and as so understood has a widely different signification from that ordinarily attached to the word 'dividend'. It operates, as already stated merely to abate or reduce the stipulated premium called for by the contract of insurance, to the extent and for the reason that it has been determined by experince that the policyholder paid for his insurance during the preceeding year more than it actually cost the company to carry the risk. This excess payment represents, not profits or receipts, but an overpayment—an overpayment because, being entitled to his insurance at cost and having paid more than it cost, he is equitably entitled to have such excess applied for his benefit."

Similar returns of patronage dividends in cooperative nonprofit organizations, other than insurance companies, have similarly been treated, not as a deduction in the computation of income, but as an exclusion from income in the first instance. Cf. S. M. 2592–C. B. III–2238; and G. C. M. 10798, XI–2 C. B., p. 58 a copy of which is attached.

No useful purpose would be served by expanding this memorandum by citations from the numerous authorities which are unanimous in their approval of the concepts of mutual insurance above indicated.

The previous revenue acts and the existing provisions of the Internal Revenue Code are drafted with full recognition of these concepts of mutual insurance. They recognize that the policyholders are the proprietors and make proper allowance upon the return of the excess premium collections. Except as to mutual marine insurance companies, they recognize that the amounts of premium deposits not used during the term of insurance for the payment of losses and expenses, or returns to policyholders, but which are set aside for the payment of future losses and expenses, are capital contributions by the proprietors and do not constitute taxable income. The proposals of H. R. 7378 are violative of these fundamental concepts of mutual insurance and are in direct disregard of the basis upon which the insurance business is conducted. It will be shown briefly below wherein the present act is violative of these mutual insurance principles, and corrective suggestions will be made with respect to taxing provisions, which, it is believed, would not be violative of basic principles and would produce the revenue needed in the present emergency.

Fundamental defects of H. R. 7378

In the proposed House bill, section 147 substitutes for section 207 of the code a new section 207 which computes a taxable net income consisting of the sum of (*a*) a net investment income (*b*) an underwriting income consisting of net premiums less (1) losses, (2) expenses, and (3) return of premiums and premiums contractually fixed to be returned within 5 years. The premiums so returned or to be returned, however, are to be reduced by the net investment income after a deduction for tentative taxes thereon.

It will be noted in the first place that this is completely at variance with the philosophy of mutual insurance. It arbitrarily tags the investment dollar as first returned to the policyholder, and retains in the corporation the premium dollar which is, in fact, returned to the policyholder. The policyholder does not have the same right to the investment income, as his fundamental right to a return of the excess deposit of premium. It is the premium dollar which is given back, and hence both in theory and fact the proposed bill is in error. The effect of this error is disastrous upon mutual companies. They are thereby taxed by the mechanics of the calculation at a higher rate of tax on receipts of dividends from domestic corporations, and on interest from State, municipal, and Government securities than are any other corporate owners of like securities in the United States.

It is submitted that the proposed bill is thus discriminatory and contrary to fact. It is wholly contrary to the fact in that it earmarks as first returned to the policyholder the investment income and as a consequence earmarks as being withheld premium dollars. These are then characterized is income and subjected to tax. Under universally accepted concepts of mutual insurance the returned dollar to the policyholder is, in specie, a return of his premium deposit and not a distribution of the investment income dollar. It is higply discriminatory in that the investment income is subjected to rates of taxation without regard to the credits and exemptions to which they are entitled. For examples of tax computations which establish this discrimination reference is invited to the illustrations and exhibits received by the Senate Finance Comittee in connection with the testimony on August 18. 1942, of Mr. A. B. Gruhn.

Suggestions for basis of taxation

1. *Investment income.*—A mutual insurance company derives gross income from its investment of unearned premium deposits and funds held for expenses and losses. From this income (usually interest, dividends, and rent) there are properly deducted the expenses of securing such income to produce a net investment income. This is not, however, a net income of the enterprise since the underwriting activities must also be considered before any final determination of the result of operation can be made. When the losses and expenses of underwriting exceed the premium deposits it would appear sound from a practical standpoint to deduct such losses from the investment income and to treat the remainder as the net investment income of the corporation. A mutual insurance company as to such remainder of investment income is a corporate recipient of income substantially as are all other domestic corporations deriving investment income.

It is recognized that the Bureau of Internal Revenue and the courts have in the past held that this investment income is (ahead of premium deposits) to be first applied against the expenses and losses of the insurance operation. (See, e. g., copy of L. O. 1050, C. B. 3–297, attached.) However, it would appear, at least during this period of national emergency, that the investment income of a mutual insurance company could be taxed in a manner comparable to the investment income derived by other domestic corporations. This may be accomplished if the current rule (that investment income be first applied against underwriting losses and expenses) enforced by the Bureau of Internal Revenue be reversed and the more important basic principles of mutual insurance stressed.

The fundamental theory in a mutual insurance undertaking is that the premium deposit is a trust fund out of which losses and expenses are first paid, and the remainder of this deposited fund is then returned to the policyholders or is held for the future payment of losses and expenses. Adhering to this primary concept, it appears sound for the purpose of this taxing statute, to earmark the underwriting losses and expenses as first paid out of these premium deposit dollars. If the premium deposit dollars are insufficient to pay the underwriting losses and expenses then as a secondary matter resort is had to the net investment income. This is in entire agreement with the fundamental principles of mutual insurance and under it the investment income may then be properly computed and subjected to tax in the same manner as in the case of any other corporation deriving investment income.

It is therefore proposed that the investment net income to the extent not necessary for the payment of losses and expenses of the insurance operation, should such losses and expenses exceed the premium deposits, be subjected to the same tax to which investment net income is subjected in the hands of all other types of domestic corporations. To that end, our first proposal is, therefore, that any remaining investment income, as above described, be taxed in the proposed Revenue Act of 1942.

2. *Underwriting income.*—With regard to the underwriting income, it would appear that the fundamental concepts of mutual insurance operations require that a full exclusion from premium income be recognized for premiums returned during the current year and for amounts set aside to be returned to policyholders after the expiration of their policy term. This latter adjustment is necessary to reflect within the current year proper allowance for premium deposits to be returned at the expiration of insurance contracts extending beyond the end of the taxable year.

It is further apparent that any amounts of premium not used to pay losses and expenses or appropriated for return to the policyholder and which unused premiums are retained and held to insure the adequate financial responsibility of the organization, are, in effect, contributed by proprietors. The policyholders are the proprietors.

Under the existing provisions of the Internal Revenue Code, these amounts are recognized as capital contributions. See *Duffy* v. *Mutual Benefit Life Insurance Co.* (272 U. S. 613). Since, however, the policyholders are customers as well as proprietors of the organization, the amounts held and not returned to the policyholders might be likened to the income which would have been derived in an identical insurance operation by a nonmutual company. Several factors favor the taxation of these amounts. There is a need of revenues by the Federal Government in this period of national emergency. As far as practicable it is always desirable that there be a uniform program of taxation of like activities, whether they be merchandising or insurance.

It is therefore proposed that the amounts of premium deposits so retained to insure the financial stability of the enterprise be treated as underwriting income and subjected to the same tax that like income is subjected to in the hands of other corporations.

Summary, basis of taxation

It is, therefore, suggested that in addition to the net investment income as above described here be added as income from underwriting sources the net annual addition to surplus (by whatever name called or however carried in the records of the company). The combined income should be taxed at the prevailing corporate rates, giving, of course, proper recognition to the character of the investment income, i. e., allowing the customary credit of 85 percent of domestic corporation dividend receipts and exclusions for nontaxable or partially taxable interest receipts. While there is justification for comparing investment characteristics of a mutual insurance company with banks, life insurance companies, etc., it appears that in view of the fact that the primary activity is insurance and the investment activity is incidental, the capital gains and loss provisions applicable to other domestic corporations having investment income should be made applicable to the mutual insurance companies, other than life.

A statutory provision is herewith submitted for your consideration which is believed would effectuate the basis of taxation herein outlined.

WHITMAN, RANSOM, COULSON & GOETZ.
JAMES K. POLK.

EXHIBIT A

SECTION 147, H. R. 7378, MUTUAL INSURANCE COMPANIES OTHER THAN LIFE

Article 51: What included in gross income. XI-33-5606
G. C. M. 10798

Revenue Act of 1928

Amounts returned to policyholders by a mutual marine insurance company are to be treated for income tax purposes as rebates on premiums, except to the extent they are paid out of earnings exclusive of premiums. In case the premiums have been charged off by the insured as a business expense, a rebate of any portion thereof is considered income.

An opinion is requested whether amounts paid to the policyholders of a mutual marine insurance company are to be treated by the policyholders as dividends (which in case the insured is a corporate taxpayer would not be reflected in its net income), or are to be treated as rebates on premiums and returned as such for income tax purposes.

In discussing the nature of the so-called dividend of a mutual life-insurance company the court, in the case of *Fuller* v. *Metropolitan Life Insurance Co. of New York* (70 Conn., 647, 41 Atl., 4), said:

"* * * It [the insurer] has a sum which is not needed for the purpose for which it was paid. This sum is called profits. It is in fact a surplus resulting from overpayments by policyholders. This surplus is derived from money paid by the insured and received by the company for a particular purpose, i. e., providing for cost of insurance and expense of management. If not needed for that purpose, it should, in equity, be returned to the policyholders. They do not, however, own it, or have any legal control over its distribution. Part of it, indeed, is derived from contributions of policyholders who are dead; but the equity is recognized, and it is the duty of the company, when a surplus is ascertained, to return such portion as it does not deem proper to keep as a guaranty fund to the existing policyholders in equitable (i. e., as nearly as practicable) proportion to their overpayments or contributions. Such return of overpayments, whether in cash or by application on future premiums, or by increase of the amount insured, is a dividend. This is the meaning of dividend, and the only meaning it has or can have in connection with mutual insurance."

The opinion of the court in the case of the *New York Life Insurance Co.* v. *Styles* (59 L. J. Q. B. 291, L. R. 14, App. Cas. 381) is to the same effect. The foregoing cases were cited, with approval, by the Federal District Court, New Jersey, in the case of *Mutual Benefit Life Insurance Co.* v. *Herold* (198 Fed. 199), in which the court said:

"The above cases furnish a clear exposition of the nature and character of the dividends considered in this case. Not only is their reasoning inherently persuasive, but their authority is enhanced by the fact that there are no conflicting decisions, or at least none have been brought to the court's attention. * * * [Affirmed, *Herold* v. *Mutual Benefit Life Insurance Co.*, 201 Fed. 918, cert. denied, 231 U. S. 755.]"

It is true that in these cases the court had under consideration the nature of the so-called dividend paid by life-insurance companies. However, in the case of the *Penn Mutual Life Insurance Co.* v. *Lederer* (252 U. S. 523, T. D. 3046, C. B. 3, 249), the Supreme Court said:

"* * * In a mutual company, whatever the field of its operation, the premium exacted is necessarily greater than the expected cost of the insurance, as the redundancy in the premium furnishes the guaranty fund out of which extraordinary losses may be met, while in a stock company they may be met from the capital stock subscribed. It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder. Some payment to the policyholder representing such excess is ordinarily made by every mutual company every year; but the so-called repayment or dividend is rarely made within the calendar year in which the premium (of which it is supposed to be the unused surplus) was paid. * * *"

The Bureau of Internal Revenue, following the decision of the court in the case of *Niles* v. *Central Manufacturers' Mutual Insurance Co.* (252 Fed., 564), has uniformly held with respect to mutual fire and mutual casualty insurance companies that it would be presumed that losses and expenses have been paid out of the earnings and profits, other than premiums, to the extent of such earnings and profits. In this connection see Law Opinion 1050 (C. B. 3, 279), article 1014, regulations 74, and the corresponding articles of prior regulations. It necessarily follows that if the earnings, other than premiums, of a mutual insurance company exceed the losses and expenses in a given year, the amount returned to its policyholders for that year would represent a true dividend to the extent that it was paid out of earnings in excess of losses and expenses. It is apparent, therefore, that the so-called dividend of a mutual property insurance company, except under the circumstances noted, does not represent a distribution of earnings as in the case of an ordinary corporation.

It is accordingly the opinion of this office that amounts returned to policyholders by a mutual marine insurance company are to be treated for income tax purposes as rebates on premiums, except to the extent they are paid out of earnings exclusive of premiums. In case the premiums have been charged off by the insured as a business expense, a rebate of any portion thereof is considered income.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

EXHIBIT B

SECTION 147, H. R. 7378, MUTUAL INSURANCE COMPANIES OTHER THAN LIFE

Section 234, article 572: Special deductions allowed mutual insurance companies. 40-20-1226 L. O. 1050

Income tax—Sections 233 (a), 213 (a), and 234 (a) 13 of the Revenue Act of 1918

In determining the amount of premium deposits retained by a mutual fire or mutual casualty company for the payment of losses, expenses, and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premiums, to the extent of such earnings and profits. O. D. 403 (Bulletin 7-20) overruled.

A question is raised as to the validity of office decision 403.

Section 233 (a) of the Revenue Act of 1918 provides—

"That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in section 213." with certain exceptions not here material.

Section 213 provides—

"That for the purposes of this title (except as otherwise provided in section 233), the term 'gross income'—

"(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *."

Section 234 (a) provides:

"That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * *

"(13) In the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive (unless otherwise allowed under such paragraphs), the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves."

In the Office Decision 403, it was ruled that—

"The following procedure will be followed in making final audit and assessment of returns of mutual fire and mutual casualty insurance companies, with reference to the deduction for premium deposits retained for the payment of losses, expenses, and reinsurance reserves authorized in section 234 (a) 13 of the Revenue Act of 1918.

"In determining the amount of deduction to be allowed for premium deposits retained, a company may begin with the premium deposits written during the tax year. From this amount will be subtracted any portion of such premium deposits written during the year which are not retained at the end of the year. The only portion of such premiums written during the year which may be considered as retained is *that portion in excess of the amounts paid or incurred for losses and expenses during the year* or returned to policyholders during the year. If there is no such excess, then it is to be presumed that any net income or increase in surplus shown by a company is derived, not from premiums retained but from other sources than premiums. *It is not to be presumed* that in determining the portion of premium income received during the year which is retained during the year *that payments made by the company during the year are made out of funds other than premiums.*

"The result of this procedure will be generally that companies, under section 234 (a) 13, will be permitted to deduct their entire premium income and will generally be taxed upon their remaining income which consists in this class of companies mainly of interest." [The italics are mine.]

The effect of this ruling is that premiums must be applied to the payment of losses, expenses, and reinsurance reserves to the extent of such premiums before recourse is had to income from other sources.

The principle upon which mutual insurance is based is that of furnishing to policyholders insurance at cost. As said in *Penn Mutual Life Insurance Co.* v. *Lederer*, decided by the Supreme Court of the United States, April 19, 1920 (T. D. 3046)—

"It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder."

See also *Mutual Benefit Life Insurance Co.* v. *Herold* (198 Fed. 199). The premium deposits are a guaranty fund. *Penn Mutual Life Insurance Co.* v. *Lederer, supra; Niles* v. *Central Manufacturers Insurance Co.* (252 Fed. 564). And as said by Judge Mack in the latter case:

"Purely incidental to the existence of such a fund is the interest earned thereon."

The language of section 213 (a) is clearly broad enough to include, and was intended to include, any dividends or interest earned by premium deposits. Such dividends and interest are, therefore, a part of the gross income of mutual fire and casualty insurance companies. Paragraph (13) of section 234 (a) of the act expressly provides for the deduction of the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves—

"In addition to the deductions allowed in paragraphs (1) to (10), inclusive."

The intent of this language, it is clear, is not to deprive mutual insurance companies of any deduction allowed to other corporations by reason of the deduction allowed under paragraph (13), but to allow them an additional deduction. Earnings and profits of every corporation are the natural resort for the payment of expenses on account of losses, and mutual fire and casualty companies afford no exception to the rule. As further said in *Niles* v. *Central Manufacturers Insurance Co., supra:*

"While * * * the earning of this interest is more clearly foreseen and contemplated, nevertheless * * * the business is not 'carried on' for this incidental profit, which merely operates to reduce the cost of protection, to diminish the amount to be taken from the premium deposits in order to meet losses; * * *."

If, then, the holder of a mutual insurance policy is to receive insurance at cost, it is evident that, before the actual cost can be determined, the losses and expenses to the company must be reduced by the amount of the earnings (dividends and interest) of the retained portions of premiums. If there were any doubt arising out of the language employed in the act that the above was the intent of Congress, it would be removed by the history of the provision in question.

Section 12 (a) of the Revenue Act of 1916 provides that—

"In the case of a corporation * * * organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

"First. All the ordinary and necessary expenses paid within the year, * * *.

"Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, * * *: *Provided further*, That mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: * * *."

Under this section all income of a mutual fire or casualty company other than premium deposits, without any deduction, constituted taxable income; that is to say, the tax was imposed on the gross-investment income plus the portion of the premiums retained for purposes other than the payment of losses, expenses, and reinsurance reserves. The effect of the changed language used in the Revenue Act of 1918, is to make these companies taxable like all other corporations upon their net income; and this net income is to be determined, as in the case of any other corporation, by first making the deductions allowed by the first 10 paragraphs of section 234 (a) and then in addition the deductions allowed by paragraph (13). Such is the express provision of the statute.

Office Decision 408 is accordingly overruled, and it is now held that in determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premiums, to the extent of such earnings and profits.

WAYNE JOHNSON,
Solicitor of Internal Revenue.

EXHIBIT C

SUGGESTED AMENDMENT TO SECTION 147, H. R. 7378, MUTUAL INSURANCE COMPANIES OTHER THAN LIFE

SEC. 147. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

(a) EXEMPT COMPANIES.—Section 101 (11) is amended to read as follows:

"(11) Mutual hail, cyclone, casualty, liability, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000."

(b) TAXABLE COMPANIES.—Section 207 (related to taxation of mutual insurance companies other than life) is amended to read as follows:

"SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

"(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every mutual insurance company (other than a life insurance company) a tax computed as follows:

"(1) Normal Tax.—A normal tax on the normal tax net income, computed at the rates provided in section 13, plus

"(2) Surtax.—A surtax on the corporation surtax net income, computed at the rate provided in section 15 (b).

"(3) Normal Tax and Corporation Surtax Net Income of Foreign Mutual Insurance Companies Other Than Life.—In the case of a foreign mutual insurance company (other than a life insurance company), the normal tax net income shall be the net income from sources within the United States minus the credit provided in section 26 (a), the credit provided in section 26 (b), and the credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e), and the corporation surtax net income shall be the net income from sources within the United States minus the credit provided in section 26 (b) (computed by limiting such credit to 85 percent of the net income reduced by the credit for income subject to the tax imposed by subchapter E of chapter 2 in lieu of 85 percent of the adjusted net income so reduced), and minus the credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e).

"(4) No United States Insurance Business.—Foreign mutual insurance companies (other than a life-insurance company) not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

"(b) DEFINITION OF INCOME, ETC.—In the case of an insurance company subject to the tax imposed by this section—

"(1) Gross Income.—'Gross income' means the sum of (A) investment income as defined in paragraph (2), (B) underwriting the income as defined in paragraph (4), and (C) all other items constituting gross income under section 22;

"(2) Investment Income.—'Investment income' means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in section 117, less (A) losses from sales or exchanges of capital assets to the extent provided in section 117, (B) investment expenses, (C) real-estate expenses, (D) depreciation, and (E) interest paid; (F) the amount of the excess of the deductions allowed under subparagraphs (A), (B), and (C) of paragraph (4) of this subsection, over the net premiums received;

"(3) Investment Expenses, Etc.—As used in this section the terms 'investment expenses,' 'real-estate expenses,' 'depreciation,' and 'interest paid' shall have the same meaning, and shall be subject to the same limitations, as in section 201 (c) (7) (B), (C), and (D), section 201 (c) (6) (A), and section 201 (d) (relating to life-insurance companies), but shall be computed as if the word 'paid' wherever it appears therein were 'paid or accrued';

"(4) Underwriting Income.—'Underwriting income' means net premiums received during the taxable year on insurance contracts plus any decrease during such year in any of the items specified in subparagraph (C) less:

"(A) Losses paid in excess of salvage and reinsurance recoverable;

"(B) Underwriting expenses and loss adjustment expenses paid or accrued;

"(C) The increase during the taxable year in any of the following items: (i) unearned premiums; (ii) unpaid losses;

"(D) Dividends and similar distributions paid or apportioned to policyholders out of premium income and surplus apportioned to policyholders. Dividends and similar distributions paid to policyholders shall be considered to be paid first out of premium income and surplus apportioned to policyholders;

"(5) Net Premiums Received.—'Net premiums received during the taxable year on insurance contracts' means gross premiums (including premium deposits and assessments) written or received on insurance contracts less return premiums and premiums paid for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (4) (D);

"(8) Net Income.—'Net income' means the gross income as defined in paragraph (1) of this subsection less the following deductions:

"(A) All deductions as provided in section 23 to the extent not otherwise allowed;

"(B) The amount of the net operating loss deduction provided in section 23 (s) except that in computing such deduction the terms 'third preceding taxable year', 'second preceding taxable year', and 'first preceding taxable year' as used in section 122 shall not include any taxable year beginning before January 1, 1942; and

"(C) The amount of interest which under section 22 (b) (4) is excluded for the taxable year from gross income.

"(c) Deductions of foreign corporations.—In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in supplement I in the case of a foreign corporation engaged in trade or business within the United States.

"(d) Double deductions.—Nothing in this section shall be construed to permit the same item to be twice deducted."

(c) Cross reference.—For stamp tax on policies written by foreign insurers, see section 502 of this act.

C. W. McNear & Co.,
Chicago, August 19, 1942.

Committee on Finance,
United States Senate, Washington, D. C.

Dear Sirs: We submit for your consideration the following as a proposed amendment to section 23 of the Internal Revenue Code, consisting of a new paragraph to be lettered (u), immediately following the present paragraph (t):

Sec. 23. Deductions from Gross Income.—In computing net income there shall be allowed as deductions:

* * * * * * *

(u) Payments on Principal Indebtedness.—In the case of a corporation or association furnishing utility service operated exclusively in the public interest, amounts paid on principal of indebtedness incurred to acquire, improve or extend its utility property, provided no part of its net earnings inures to the benefit of any private shareholder or member, as such, that all compensation payments are reasonable and are for services actually rendered, that all net income or surplus available to pay principal or indebtedness shall be so applied or set aside for that purpose each year and that as soon as its indebtedness shall have been paid in full or a sinking fund set aside sufficient for such payment all of its properties both real and personal shall without cost be transferred to and become the property of the State or States in which same is located or of such political subdivision, agency or instrumentality thereof as may be authorized by or pursuant to law to accept and operate same for the benefit of the public.

Such deductions from gross income shall not be disallowed any such corporation or association because it complies with any order, rule, or regulation of any State or Federal authority or commission having jurisdiction in the premises, or because it accumulates and maintains a reasonable reserve to pay the cost of renewals and replacements or for any other necessary purpose. No further deduction for recovery of capital cost or depreciation shall be allowed.

The term "indebtedness" as used in this paragraph shall be construed to include nonvoting limited dividend preferred stock (the owners of which are not entitled or permitted to participate directly or indirectly in the earnings or income thereof upon dissolution or otherwise beyond the fixed dividends thereon) issued and delivered at par to pay part of the cost of utility property, which stock may be amortized and retired in the same manner as other indebtedness and payments therefor allowed as deductions from gross income.

EXPLANATION AND PURPOSE

Application.—This amendment is intended to clarify the present provisions of the Internal Revenue Code together with the Commissioner's rulings relative to the payment of debt out of income by nonprofit organizations and to make them clearly applicable to corporations and associations furnishing utility service which are owned and operated exclusively for the benefit of the public.

Principal payments on debts deductible.—The authority to pay debt from operating income without losing tax exemption on such payments is contained in two rulings of the Commissioner of Internal Revenue. In the ruling *In re Dubuque Bridge Commission of Dubuque, Iowa,* it was held that the cost of the bridge or bridges represented by indebtedness could be recovered from the operating income of the Commission and that during the period of amortization of its indebtedness the Commission would have no taxable income as long as the net revenues were used for such purposes. The other ruling was *In re the Ak-Sar-Ben Bridge Association of Omaha,* which was organized under the laws of Nebraska to purchase a toll bridge across the Missouri River. The net income of the association is applied to amortize the indebtedness of the association representing cost of the bridge, under an agreement that the bridge will be toll-free when such indebtedness is paid in full. The Commissioner ruled that the Ak-Sar-Ben Bridge Association was exempt because it was not organized for profit and was operated exclusively for the promotion of civic welfare and for the benefit of the public. The principal of allowing payments out of income, on indebtedness incurred by nonprofit organizations only for the purchase of utility property is recognized in such rulings and, we believe, should be made clearly applicable by legislative enactment, to nonprofit organizations which operate utilities.

Necessity for amendment.—It may be argued that if present rulings of the Commissioner now cover principal payments by such nonprofit organizations as deductible, why then is such an amendment necessary. The answer was clearly expressed in a statement of an official who selects and approves the investments of one of the largest life insurance companies, with whom we discussed this matter in detail. He stated that although he was convinced such a security (revenue bonds issued by a nonprofit corporation and secured by the utility revenues therefrom) would be intrinsically good, both he and the general counsel of the company, who was in entire accord with the soundness of the reasoning upon which the present rulings of the Commissioner are based, were definitely of the opinion that life insurance or trust funds should not be invested in any such securities unless the tax exemption which assures their amortization was based upon statutory provisions rather than upon rulings or regulations of the Commissioner, which might later be modified or revoked. He further stated that although an existing law might in the future be repealed or changed, the fact that such was the law at the time the security was purchased would justify their action as trustees in making such investment, whereas they might be criticized justly if their action was based only upon administrative rulings which were later changed or revoked.

To make capital available.—Another purpose of the proposed amendment is to make available at reasonable rates the private capital or credit required to finance the acquisition by nonprofit organizations of utility properties to be owned and operated in the public interest. We are convinced, as dealers in public securities, that the enactment of such an amendment will make available the necessary private capital on advantageous terms, which othewise would not be obtainable.

Nonprofit.—As no pecuniary profit can accrue to any private shareholder or member as such, it is obvious that it is impossible for any taxable profit to result from the operation of such a corporation or association even under existing statutory provisions.

Reserves.—Paragraph 12 of section 101 now provides that exemption shall not be denied because of the accumulation of any reserve required by State laws or reasonable reserve for any necessary purpose. (Proposed amendment, second sentence).

Holding companies.—Incident to their integration as required by the Holding Company Act, a considerable number of operating utility companies must be sold by registered holding companies to provide funds to pay indebtedness and retire preferred stock. At the present time the only markets available to liquidate such holdings under compulsion are the States and their political subdivisions or agencies or instrumentalities created by the States for such purpose or the investing public by sale and general distribution either direct or through investment bankers. Recent experience has shown that the latter procedure is not feasible or advisable under existing adverse conditions.

Inadequate or complete lack of statutory authority in many States to issue revenue bonds or to purchase a utility system as a complete unit often present insurmountable obstacles to a holding company in a sale to a State, subdivision, or agency thereof. The nonprofit corporation affords to the holding company an additional market in which to liquidate the securities of an operating utility which it owns and is or may be required to sell.

It is obvious that nonprofit utility corporations, if enabled by the proposed amendment to secure the necessary capital on reasonable terms offer a direct and comparatively simple method of selling and transferring utility properties to public ownership, to be operated thereafter solely in the public interest, furnishing utility service at cost.

Indebtedness defined.—The concluding sentence of the proposed amendment defines "indebtedness" as including nonvoting limited dividend preferred stock, principal payments on which shall be deductible. This provision was included only to meet possible situations in which some form of equity financing as a margin of safety might be required in order to make marketable the balance of the cost represented by the revenue bonds. A precedent for the inclusion of this preferred-stock provision is found in the second sentence of the present paragraph 12 of section 101.

Loss of revenue negligible.—The income of now privately owned utilities is taxable. Many of these utilities, however, either must be sold pursuant to governmental decree or will be sold through voluntary negotiations to municipalities or other private corporations. If sold to another private corporation income would still be taxable, while if sold to a public authority, agency, or municipal authority, the income would be nontaxable. If sold to a nonprofit corporation as provided in this proposed amendment, there would be no profit or income to tax as all net profits would be applied to indebtedness, and payments from income to pay principal of indebtedness incurred as cost of property would be deductible. This is now the case under municipal ownership and under the two Commissioners' rulings as cited.

Income from bonds and dividends from preferred stock of such nonprofit corporation would, of course, be taxable.

SAFEGUARDS AGAINST ABUSES

In order to safeguard against possible abuses the proposed amendment contains the following provisions:

All compensation for services must be reasonable and not in excess of amounts usually paid for such services.

No profit may inure to any private shareholder or member as such.

The manner of distribution of net income is specified.

Securities and Exchange Commission.—Under present law security issues of a corporation as contemplated must be registered with the Securities and Exchange Commission, and any sale of a property by a holding company must have the approval of that regulatory body, thereby providing an additional safeguard.

Commissioner of Internal Revenue.—The Commissioner of Internal Revenue each year will be able to determine from the income-tax returns whether or not such corporation or association has complied with the terms of the amendment and if the Commissioner finds that it has not, such corporation or association will not be entitled to the deductions allowed and its income will be subject to taxation.

State utility commissions.—State utility commissions or regulatory authorities have jurisdiction over and must approve the issuance of all securities by utility corporations.

In the drafting of the proposed amendment, attorneys of national reputation, experienced in the practice of law incident to the issuance and sale of public securities, were consulted and the provisions therein contained were based upon their knowledge of the requirements and investment restrictions of the various insurance companies, and also the viewpoint and attitude of the general investing public.

The Committee on Banking and Currency reported favorably upon the proposed amendment to the Reconstruction Finance Corporation Act (H. R. 6182), now pending, which authorizes the Reconstruction Finance Corporation, with the approval of the Federal Loan Administrator, to make loans to any cooperative, corporation (including any nonprofit corporation), municipality, State, or political subdivision * * * to aid in financing the acquisition of utility properties provided private capital or credit is not obtainable at reasonable rates.

For the reasons herein mentioned, we are convinced that private capital will be available to such nonprofit corporations only if and when an amendment such as the one proposed is enacted.

Respectfully submitted.

C. W. McNear & Co.,
By C. O. Miles.

MEMORANDUM OF AMERICAN ASSOCIATION OF PERSONAL FINANCE COMPANIES, RE AMENDMENT TO SECTION 501 (B) OF THE INTERNAL REVENUE CODE

I. PRELIMINARY STATEMENT

Section 501 (b) of the Internal Revenue Code exempts from the definition of a personal holding company:

"* * * a licensed personal finance company, *under State supervision*, at least 80 percentum 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." [Italics supplied.]

Section 182 (a) of the revenue bill of 1942 amends this exemption to read as follows:

"A licensed personal finance company *subject to the supervision of State authority having supervision over financial institutions*, at least 80 percentum 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." [Italics supplied.]

The only change made by section 182 (a) of the bill with respect to the exemption of personal finance companies is the substitution of the phrase "subject to the supervision of State authority having supervision over financial institutions" for the phrase "under State supervision" in existing law.

The American Association of Personal Finance Companies respectfully submits that the proposed change should not be made and that the language of existing law should be retained.

II. DISCUSSION

The proposed change in language should not be made, for the following reasons:

(1) The limitation inserted in the bill is entirely inappropriate in the case of personal finance companies. The language of existing law limiting the exemption to licensed personal finance companies under State supervision accurately describes the licensed small loan company. However, the new language, limiting the exemption only to personal finance companies subject to the supervision of State authority having supervision over financial institutions, would arbitrarily exclude many bona fide personal finance companies which meet all the substantive tests and conform to the spirit of the exemption. This is because not all States place the supervision of small loan companies in the administrative official having authority to supervise "financial institutions" in general.

For example, in California the administration of the small-loan-company law is delegated to the Commissioner of Corporations. In Florida the administrative official is the comptroller of the State. In Illinois the administrative official is the head of the department of insurance. In Maryland he is the administrator of loan laws; and in Ohio he is the commissioner of securities. In still other States the official having administrative authority over the small-loan laws may be even further removed from the field of supervising financial institutions. Thus, in Alabama, the appropriate official is the probate judge or commissioner of licenses of the county. In Mississippi the administrative authority is conferred on the officer of the city or town where the business is sought to be conducted who is authorized to issue licenses.

The exemption should not depend on the way in which the State where such companies operate chooses to organize its administrative machinery. What is important is that these companies are subject to State supervision. If they are, it is immaterial for tax purposes whether such supervision is exercised by the State official having jurisdiction over financial institutions or by any other State officer.

(2) There is no reason for making so drastic a change in the law. The existing provision describing the exempt type of personal finance company has been in the law since the Revenue Act of 1938 and no evidence has been presented that it has been found defective by the Treasury Department.

(3) The change in language was apparently inadvertent on the part of the draftsmen. There is nothing in the House Ways and Means Committee report relating to this provision. (See H. Rept. No. 2333, 77th Cong., 2d sess., pp. 28 and 135.) Nor does the explanation of the bill by the draftsmen before the Senate Finance Committee contain any reference to this change (hearings before Committee on Finance, U. S. Senate, 77th Cong., 2d sess., on H. R. 7378, p. 102 (unrevised)). Certainly, if any change of substance had been intended in this respect, some reference to it would have been made on either occasion. It is more likely that the change represents a mistaken attempt to conform the language of the exemption in the case of personal finance companies to that of the entirely new exemption granted, for the first time in this bill, to industrial loan and investment companies.

Further evidence that no substantive change was contemplated is that the proposed amendments made by section 182 (a) of the bill are given retroactive effect to all years beginning after December 31, 1938. The effect of this provision would be to subject, retroactively, to the highly punitive personal holding company surtax some personal finance companies which had, under the law applicable to those years, been specifically exempted by the statute. There is no other instance in the history of the Federal revenue laws where there has been a retroactive imposition of a tax more than 3 years after the close of the taxable year. Certainly no such revolutionary principle would have been introduced without comment or explanation by the draftsmen.

III. CONCLUSION

In view of the foregoing it is submitted that the proposed change is unnecessary; arbitrarily discriminates among personal finance companies in essentially the same position; and will tend to defeat the purpose of the exemption. It should be eliminated from the bill and the language of existing law retained.

Respectfully submitted.

AMERICAN ASSOCIATION OF PERSONAL FINANCE COMPANIES,
EDGAR F. FOWLER, *Executive Vice President.*

AUGUST 14, 1942.

UNITED STATES DEPARTMENT OF AGRICULTURE,
AGRICULTURAL MARKETING ADMINISTRATION,
Washington, D. C., August 10, 1942.

Hon. WALTER F. GEORGE,
United States Senate.

DEAR SENATOR GEORGE: Revenue bill, H. R. 7378, at present before your committee for consideration, contains one provision to which we desire to direct your attention. We have reference to the proposal that there be imposed a 5 percent tax on transportation charges.

The Department of Agriculture ordinarily does not concern itself with revenue bills, but we feel impelled, in the present instance, to write you because this particular item in the pending bill, if enacted, unquestionably will have a discouraging effect upon the ready movement of farm products. This latter, we are certain you will agree, would prove highly detrimental to the present welfare of the country.

The imposition of a tax of this nature would mean that the aggregate transportation expense for the movement of farm products to market would be raised to a level of approximately 110 percent of the transportation expense of moving farm products during the year immediately preceding March 1942.

On March 2, 1942, the Interstate Commerce Commission issued its report and order in the proceeding known as Ex Parte 148, Increased Rail Rates, Fares, and Charges, 1942, in which the Commission declined to grant the petition of the carriers which sought a 10 percent increase in the existing freight rates. The Commission, however, did grant the carriers authority to increase, by 3 percent, the existing rates on basic or raw farm products, and authorized an increase of

6 percent in the rates on other farm products, and on all other commodities generally.

Predicated on the present volume of business, this represents an average increase of over 4 percent in the cost of transporting farm products. To superimpose a 5 percent tax upon freight rates, which already average 4 percent or more above last year's level of freight rates, would represent a freight bill increase of something well above 110 percent of last year's transportation expense.

In making this estimate, we have taken into account the fact that due to the curtailment of boat and barge-line services, as well as the curtailment of motor-truck services, our agricultural products today are generally moving over longer rail hauls than was previously the case, and the rail freight rates are higher, generally, than those ordinarily available via the boat, barge, and truck routes.

The sizeableness of such an increase, and the gravity of it from the standpoint of its possible effects upon the marketing and distribution of farm products is readily understood when it is observed that last year over $800,000,000 was paid for the movement of farm products, including livestock and their by-products, to market.

It is our belief that you will like to have this information before you in connection with your committee's consideration of the revenue bill, H. R. 7378.

Sincerely yours,

ROY F. HENDRICKSON,
Administrator.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D. C., August 18, 1942.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR GEORGE: I am enclosing herewith a letter received from Mr. J. J. Deuel, director of the law and utilities department of the California Farm Bureau Federation, Berkeley, Calif., wherein he has raised certain objections of the California fruit and vegetable growers regarding certain provisions of the 1942 Revenue Act (H. R. 7378), which is now before your committee for consideration.

You will note that the California Farm Bureau Federation does not complain about the amount of this proposed tax on transportation charges, but the method in which it is applied, which will be extremely detrimental to the California fruit and vegetable growers and shippers.

In view of the comments contained herein, I will be deeply grateful if you will arrange to have this particular expression of the California Farm Bureau Federation incorporated in the hearings pending on the 1942 Revenue Act.

Thanking you for your courtesy in this matter, I am,

Sincerely yours,

A. J. ELLIOTT.

Enclosure.

CALIFORNIA FARM BUREAU FEDERATION,
LAW AND UTILITIES DEPARTMENT,
Berkeley, Calif., August 12, 1942.

Hon. A. J. ELLIOTT,
House Office Building, Washington, D. C.

DEAR MR. ELLIOTT: As you know, when H. R. 7378, the 1942 Revenue Act, passed the House on July 20, it contained a provision placing a 5-percent tax on all freight and express charges except those for the transportation of coal, where the tax imposed was a flat 5-cent charge per ton. I am sure you realize how this particular tax will prejudice California agriculture and favor those areas with which we are in competition with our fresh fruits and vegetables, which you realize constitutes a very substantial portion of the sales and income of California producers.

We realize that with the war effort and ever-increasing cost of government it is necessary to pay new and increased taxes. For that reason we do not complain about the amount of this proposed tax on transportation charges, but the method in which it is applied. We think this proposal should be amended while it is pending in the Senate so as to change the tax from a percentage of the transportation charge to a fixed sum per 100 pounds or ton in order to make the burden equal on agricultural producers shipping to a given market from various parts of the country.

As this proposal now stands, a fruit or vegetable grower in California would pay more than double the amount of tax that would be paid by growers shipping a car of the same commodity and same weight from other districts with which we are in competition. We hope you will make an effort in the interest of agricultural producers in California and other Western States to have the form of this tax changed so that the burden would be equal on all producers and shippers of a given commodity.

Yours very truly,

CALIFORNIA FARM BUREAU FEDERATION,
LAW AND UTILITIES DEPARTMENT,
By J. J. DEUEL, *Director*.

WASHINGTON, D. C., *August 20, 1942*.

Hon. C. L. STAM,
Chief of Staff, Joint Committee on Internal Revenue,
New House Office Building, Washington, D. C.

MY DEAR SIR: The following statement is made in support of my request to enlarge section 501 of the revenue bill of 1942, now pending before the Senate Committee on Finance, to embrace an additional class of taxpayers who have been subjected to the surtax on "undistributed profits" imposed by section 14 of the Revenue Act of 1936. I appear in particular for Paris & Mount Pleasant Railroad Co., a short-line railroad organized under the laws of Texas. In general outline the facts of this company's case are these:

As the result of net operating loss sustained over a long period of years prior to 1937, the taxable year, this company's capital had been exhausted, which was neither replaced nor repaired at the beginning or at the close of the taxable year. As at the beginning of the year 1937 this company had a deficit in earned surplus and undivided profits of $418,516.69 and at the end of the year it had a similar deficit of $365,008.46. It has never paid a dividend since it was incorporated in January 1909.

At the beginning of the taxable year 600 of the company's outstanding bonds, evidencing an existing, valid liability in the aggregate principal amount of $600,000, were in default, with interest past due of approximately $592,500. As at the close of the taxable year there were outstanding and unpaid 592 bonds and interest coupons, evidencing an existing, valid liability in the aggregate principal amount of $592,000, all in default, with interest past due of approximately $603,600. The interest on the bonds was defaulted on January 1, 1925, and principal was defaulted when the bonds matured in 1932.

In his notice of deficiency, the Commissioner of Internal Revenue charged this company with an undistributed adjusted net income of $68,482.78, and determined a deficiency in income tax for the year 1937 in the amount of $13,540.88, which was reduced by the Board of Tax Appeals to approximately $9,760. See board's opinion, promulgated August 4, 1942, attached.

Before the Board of Tax Appeals it was insisted that the Commissioner had disregarded legal prohibitions, Federal and State, penal and civil, on payment of dividends by this company within the taxable year. It was stipulated that the Paris & Mount Pleasant Railroad, since construction was completed in July 1910, has been continuously operated in intrastate, interstate, and foreign commerce, except between the dates of February 26, 1920, and December 31, 1930, when the railroad was so operated by a receiver, and that it kept its records and reported its income for the taxable year 1937 and prior years according to the accounting classifications of the Interstate Commerce Commission. On brief it was insisted that, being an operating common carrier by railroad engaged in interstate and foreign commerce, and therefore subject to the Interstate Commerce Act, as amended by the Transportation Act, 1920, distribution of earnings of the taxable year in dividends before this company's exhausted capital was restored and its surplus deficit overcome would have been a further liquidation of its capital funds contrary to penal restrictions introduced in interstate commerce law by the Transportation Act, 1920, and since retained in the United States Code as section 20a (12), title 49, Transportation, pages 292–293. Thereby it was declared that—

"* * * It shall be unlawful for any officer or director * * * to participate in the making or paying of any dividends of an operating carrier from any funds properly included in capital account. Any violation of these provisions shall be a misdemeanor, and on conviction in any United States court having jurisdiction shall be punished by a fine of not less than $1,000 nor more than $10,000, or by imprisonment for not less than 1 year nor more than 3 years, or by both such fine and imprisonment in the discretion of the court." (Feb. 28, 1920, ch. 91, sec. 439, 41 Stat. 494; 49 U. S. C. A., section 20a (12).)

The Board of Tax Appeals cited in opposition to this contention the cases of *Crane Johnson Co.* (311 U. S. 54), and *Helvering* v. *Northwest Steel Rolling Mills, Inc.* (311 U. S. 46), with the comment that in both cases the corporations had existing deficits and they were prohibited by State statutes from paying dividends except out of surplus (p. 5), adding that it made no difference "that the statute which, presumably, prohibited the company from paying dividends, was a Federal statute."

An interpretation of the national railroad policy introduced by the Transportation Act, 1920, in Interstate Commerce Law, is contained in *T. & P. Ry. Co.* v. *G. C. & S. F. Ry. Co.*, 270 U. S. 266, 277, where the Supreme Court said:

"By that measure, Congress undertook to develop and maintain, for the people of the United States, an adequate railway system. It recognized that preservation of the earning capacity, and conservation of the financial resources, of individual carriers is a matter of national concern; * * *."

It was this taxpayer's position before the Board of Tax Appeals that the two laws under review by it—the Transportation Act of 1920 and the Revenue Act of 1936—though separately made in different moments of time and under distinct and separate exertions of power derived from the Constitution, must be permitted to stand consistently together and be treated as forming in the mind of the enacting body, parts of a connected whole in order to give unity and intelligence to the congressional system of laws. As aptly stated in Black on Interpretation of Laws, pp. 345–346:

"A legislative act is always to be considered with reference to the preexisting body of law, to which it is added and of which it is henceforth to form a part. No law can be viewed in a condition of isolation or as the beginning of a legal system. Further, it is always to be presumed that the legislature, in drafting and enacting any particular statute, had full knowledge and took full cognizance of all existing laws on the same subject or relating thereto. And it is a presumption of equal force and applicability that the legislative body did not intend to be inconsistent with itself, to keep contradictory enactments on the statute book, to make unnecessary changes in the existing laws, or to repeal statutes by mere implication."

This principle for construing congressional legislation is exemplified in *Appeal of New York, Ontario and Western Railway Co.*, 1 B. T. A. 1172. There the Board of Tax Appeals held that the Commissioner of Internal Revenue in assessing taxes is not confined to the provisions of the revenue acts alone, but must determine income-tax liability in the light of other acts of Congress, specifically, in that case, the Federal Control Act of March 21, 1918, under the provisions of which the Director General of Railroads was required to bear a portion of the tax on the income of common-carrier corporations subject to the Interstate Commerce Act. The two acts—relating to railroad control and to raising revenues—the Board observed, emanated from the same Congress, and the United States "was the same sovereign, acting through its legislative branch, which provided just compensation to the carriers for the use of their property in wartime and levied taxes for the collection of wartime revenues" (p. 1176). Further:

"The Government is an entity. To be sure, it has even in times of peace a multitude of various functions which in time of war are necessarily increased; but these functions, however separately carried on, do not render the United States divisible. What it does in one function cannot be presumed, except when unmistakably expressed, to be undone in another function. And this is the effect of what the Commissioner now contends. * * *" (p. 1180).

Again:

"The Commissioner looks only to the Revenue Act of 1918 and urges that to determine tax liability our attention must be confined to the revenue statutes. The Supreme Court, however, in *Evans* v. *Gore* (253 U. S. 245), looked beyond the revenue act into a separate section of the Constitution to apply an exemption of judges' salaries contrary to the provisions of the taxing statute. Consistently with this it is well known that the several Liberty Loan Acts relieved the interest from liberty loans wholly or partially from income tax without any reference thereto being found in the contemporaneous revenue acts" (p. 1182).

The Board has followed and applied in subsequent cases the principle of the *New York, Ontario and Western case.*

By the law of Texas, the issuance and execution of bonds and shares of stock by Texas railroad corporations are special privileges and franchises, the right of supervision, regulation, restriction, and control of which, it is declared, have always been and are now vested in the State government, to be exercised according to the provisions of article 6520, title 112 (formerly title 94), of the Civil Statutes of Texas, and other laws.

Other and related laws governing shares of stock of railroad corporations of the State of Texas penalize the payment of dividends out of any funds other than actual earnings, the payment of false or fictitious dividends, and the payment of any dividend when the corporation is insolvent or which would render it insolvent.

I shall undertake to supply any additional data that you may desire and will outline. And I entertain the hope that Congress will extend the benefits of section 501 of the pending revenue bill to taxpayers circumstanced as was the Paris and Mt. Pleasant Railroad Co. in 1937.

Respectfuly yours,

T. D. GRESHAM.

COMMITTEE ON TAXATION,
NEW YORK STATE BAR ASSOCIATION,
New York, N. Y., August 17, 1942.

Hon. WALTER F. GEORGE,
Chairman, Finance Committee, United States Senate,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR GEORGE: The committee on taxation of the New York State Bar Association made no appearance at the hearings of the Senate Finance Committee because of the great number of witnesses wishing to be heard. An appearance on behalf of the association was made before the Ways and Means Committee by the Honorable John G. Jackson, president of the association.

I am enclosing the resolutions recently adopted by the association relating to Federal taxation and respectfully request that such resolutions and this letter be made a part of the printed hearings.

In addition to these resolutions adopted by the association, the committee on taxation has voted to disapprove the recommendation of the Treasury, made to the Ways and Means Committee, that the recipient of property by bequest or inheritance be required to use the decedent's basis for determining gain or loss upon the sale or other disposition of such property.

Very truly yours,

WESTON VERNON, Jr.

Enclosure.

(The resolutions referred to by Mr. Vernon are on file with the clerk of the committee.)

MEMORANDUM SUBMITTED BY THE COMMITTEE ON TAXATION, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, WITH RESPECT TO H. R. 7378

The taxation committee of the Association of the Bar of the City of New York, after study of the Revenue Act of 1942 (H. R. 7378), as passed by the House of Representatives, respectfully recommends to the Finance Committee of the United States Senate the following changes in said bill:

INCOME TAX

(1) *Section 117—Alimony and separate maintenance payments (amending sec. 22 of the Internal Revenue Code).*—This section contains an obvious error in draftsmanship. The section purports in general to tax the wife on periodic payments of alimony or sums in lieu of alimony, and to allow the husband a corresponding deduction of such periodic payments. Lump-sum

settlements growing out of marital disputes, not being periodic payments, are not taxable to the wife or deductible by the husband. The penultimate sentence of the proposed new code subsection 22 (k) now reads: "An installment payment shall be considered a periodic payment for the purposes of this subsection if the amount thereof is 10 percent or more of such principal sum or if such principal sum is required, by the terms of the decree or instrument, to be paid within a period ending not more than 10 years from the date of such decree or instrument." To correct this sentence the "ifs" should be supplanted by the word "unless" or else the word "not" should be inserted after "shall."

Section 117 (d) of the bill adds a sentence to section 22 (b) (2) of the code which makes it doubtful whether the proceeds of life insurance taken out by the husband for the benefit of the divorced or separated wife continue to enjoy exemption from tax. This doubt should be eliminated by an appropriate amendment. At the same time it should be made clear that the premiums paid by the husband with respect to such insurance are taxable income to the wife and deductible by the husband.

(2) *Section 119—Deductions for bad debts, etc. (amending sec. 23 (k) of the code)*.—This section segregates, for the first time, business and nonbusiness bad debts and treats the latter as short-term capital losses. The report of the Ways and Means Committee (No. 2333), assigns as a reason for this distinction (at p. 45), the fact that the present law permits abuse by allowing unlimited deductions for loans to friends and relatives, repayment of which is not expected. However, the section as passed by the House goes considerably beyond the correction of this abuse. It makes the business character of the debt depend not upon the manner in which the taxpayer acquired it, but rather upon circumstances existing at the time the debt becomes worthless. Thus, the report cites as an example (at p. 77) the case of A, an individual engaged in the grocery business, who extended credit on open account to B in 1941:

"In 1942 A sells the business but retains the claim against B. The claim subsequently becomes worthless in A's hands. A's loss is controlled by the nonbusiness debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless."

Since A included the income from the sale in his 1941 income and paid the ordinary—not the capital gain—rates of tax thereon, it seems only fair to allow him an ordinary deduction when the debt became worthless. It is, therefore, suggested that the last sentence of the new subsection 23 (k) (4) of the code be amended to include in the category of business bad debts debts which arose in the operation of a trade or business by the taxpayer, as well as debts the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(3) *Section 129—Fiscal year taxpayers (adding secs. 16 and 108 to the code*.—This section of the bill restores a provision which was repealed in 1934 because experience had shown it to be administratively complicated and unworkable. Admittedly there is some equity to the point that fiscal-year taxpayers in a period of rising tax rates obtain an advantage in that the impact of the increased rates upon such taxpayers is delayed. However, the proposed provision will in some respects tip the scale the other way and put fiscal-year taxpayers at a disadvantage. For example, many fiscal-year taxpayers will not know the precise provisions of the law applicable to them until after their fiscal year is closed and may be prejudiced thereby, whereas calendar year taxpayers are ordinarily in a position to act in the light of a law which they know is applicable to them. This difficulty and others are illustrated in the Senate Finance Committee hearings, pages 78–81. If the House provision is retained, many taxpayers, in order to avoid the uncertainty that would result from not knowing, before the close of the year, the exact nature of the law applicable, and also in order to avoid the complicated calculations that must be made under the provision to ascertain tax liability, will abandon fiscal years which are for them natural accounting periods and adopt the calendar year. This will cause undue congestion for accountants and the Bureau of Internal Revenue. On balance, it seems to us that the considerations of expediency outweigh the immediate loss of revenue (which will certainly be made up to some extent later on), and that the provision should be deleted.

(4) *Section 144—Pension trusts (amending secs. 165 and 23 (p) of the code)*.—This section of the bill contains amendments to the code designed to eliminate

the abuse of the pension trust and profit-sharing plan as a tax-saving device. However, there is one amendment which will tend to discourage employers from creating pension trusts for the welfare of their employees and will thus defeat the very purpose of the pension trust provisions. The bill amends section 23 (p) (1) (A) of the code so that the deduction for the employer's contribution to the trust is limited during the taxable year to 5 percent of the compensation otherwise paid to the group of employees included therein; the excess over such 5 percent is to be spread over a period of 5 years commencing with the year of payment. It is believed that this limitation will deter many employers from establishing legitimate pension plans. Five percent of other compensation will be inadequate to finance an actuarially sound plan in many situations. For example, where the average age of the employees included in the group is fairly high, the proposed limitation would operate to deter the establishment of a plan or to influence the discontinuance of an existing plan, or to cause the employer to make the benefits of the plan smaller than they should be to accomplish its purpose. Assume that the amount required to be paid into a plan annually by the employer is $10,000, and that this represents 10 percent of the compensation otherwise paid to the employees covered by the plan. Under the proposed bill the employer's deduction in the taxable year will be limited to $6,000; the remaining $4,000, by reason of not being allowed as a deduction, will increase the company's tax by, let us say, 90 percent, or $3,600. The plan has, therefore, cost the employer during the taxable year, not merely $10,000, but $3,600 additional. It is true that in later years he may get the benefit of the $4,000 excess, provided he has profits for such later years. However, the immediate loss of cash would probably influence many employers to abandon legitimate pension plans. It is, therefore, recommended that the percentage limitation be increased to a point where it will not discourage the establishment of meritorious pension plans.

(5) *Section 185—Distributions by personal holding companies (amending sec. 115 (a) of the code).*—Section 185 (a) of the bill amends the definition of "dividend" in section 115 (a) of the code and of the Revenue Acts of 1936 and 1938, to provide that any distribution to shareholders by a personal holding company will be considered a dividend. This is a remedial provision designed to relieve certain personal holding companies which, under existing law, are perforce subject to the prohibitively high personal holding company surtax rates, even though they distribute their taxable income to shareholders. The House Ways and Means Committee report (at p. 136) specifically shows that the amendments are not intended to include distributions in complete or partial liquidation. However, it is doubtful whether the amendments in their present form clearly carry out this intent. Since the amendments relate to any distribution by a particular kind of corporation, section 115 might be interpreted to mean that complete or partial liquidating distributions by such corporations would not be governed by section 115 (c), relating generally to complete or partial liquidating distributions. In consequence, complete and partial liquidating distributions by personal holding companies might be taxable as ordinary dividends to shareholders. This unintended result can be avoided by adding after the word "distribution" in the first line of each of the amendments in section 185 (a) the phrase "(not in complete or partial liquidation)." This clarifying addition should prevent confusion and litigation.

EXCESS-PROFITS TAX

(6) *Section 205—Technical amendments made necessary by change in base for corporation tax (amending, among other sections, sec. 710 (c) of the code).*—Section 205 (c) of the bill amends section 710 (c) (1) of the code to provide that in computing the excess-profits credit carry-over, the excess-profits credit and excess-profits net income for taxable years beginning in 1940 and 1941 shall be computed under the law applicable to taxable years beginning in 1942. Unless amended, this provision will operate unfairly in certain cases where binding elections were made in the light of the then applicable law.

Various elections were required to be made in excess-profits-tax returns filed for taxable years beginning in 1940 and in 1941. For example, under section 742 of the code, in the case of a taxpayer which was an acquiring corporation, it was required to elect in the return whether its average base-period net income should be computed under section 713 or section 742. Under section 216 of the House bill the new code section 741 provides that an acquiring corporation is entitled to determine its average base-period net income under section 713 or under supplement A without the election being required to be made in the return.

It is apparent that the revisions of the Excess Profits Tax Act of 1940, applicable to returns for years beginning in 1941, and the further revisions proposed by the Revenue Act of 1942, applicable to returns for taxable years beginning in 1942 (and in part to corporations on a fiscal year basis), have made and will make substantial changes in the method of computing excess-profits-credit carry-over. Assume that a corporation made an election in its return for the calendar year 1940, which produced a substantial excess-profits carry-over. Assume further that the recomputation of the excess-profits carry-over required by section 710 (c)(1) for the excess-profits-tax return for 1941 and that recomputation under the same section for the calendar year 1942 result in a greatly diminished carry-over that would not have been encountered had election for a particular method not been made in the original return. It appears only equitable that a recomputation of the excess-profits carry-over under a later law carry with it the privilege to the taxpayer of applying any method available under the later law despite the elections made in a return under the prior law.

In order that changes in methods from those elected in the prior years' returns may not result in a greater carry over than that which would have been available had the carry-over been permitted to continue without recomputation, it is suggested that such recomputed carry-over be limited to the amount that would be available under the elected methods in the returns as originally filed and as determined by the then applicable law.

ESTATE AND GIFT TAXES

(7) *Section 403—Powers of appointment (amending sec. 811 (f) of the code); section 452—Powers of appointment (amending sec. 1000 of the code).*—Sections 403 (d) and 452 (b) of the bill provide that the amendments relating to powers of appointment in the estate and gift tax chapters of the code are not to apply to those types of powers of appointment which are not exercisable in favor of the donee of the power or his estate, creditors, or creditors of his estate, where such powers are released before 2 years after the date of the enactment of the Revenue Act of 1942. On the other hand, any powers which are so exercisable will be subject to the new provisions of both the estate and gift tax statutes unless released on or before the date of enactment of the act.

It is believed that in fairness, the holder of either type of power should have a reasonable time within which to consider the effect of releasing or not releasing his power. He should be given time to determine what powers of appointment he has, the properties involved, the situation of the parties who would receive the property if he did not exercise the power, and other factors entering into his decision as to whether he should exercise or release the power.

The House of Representatives Ways and Means Committee believed that 2 years should be allowed the holders of powers of appointment of the first type to consider and determine these matters. The holder of the second type of power will be confronted with the same problems. There is no reason why he should not be given an equal length of time in which to consider what action he should take.

The result can easily be accomplished in section 403 (d) by striking out the phrases "which is not exercisable in favor of decedent, his estate, his creditors, or creditors of his estate" and "and shall not apply with respect to a power to appoint released on or before the date of the enactment of this act." The corresponding phrases could be stricken from section 452 (b).

Respectfully submitted.

HARRY J. RUDICK, *Chairman,*
CARBERY O'SHEA, *Secretary.*

STATEMENT OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AIRCRAFT & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, CONGRESS OF INDUSTRIAL ORGANIZATIONS, AIRCRAFT LOCAL 365, ON THE PENDING REVENUE BILL

Aircraft Local 365 of the International Union, United Automobile, Aircraft & Agricultural Implement Workers of America, United Automobile Workers, Congress of Industrial Organizations, a labor organization of over 10,000 soldiers of production, engaged exclusively in the manufacture of airplanes for the United Nations, desires to state its position on the bill (H. R. 7378) now pending before the Senate Finance Committee after its disposition by the House Ways and Means Committee. We urge that our proposals and recommendations be given careful consideration.

In the light of our country's present crisis, the tax program is no longer merely a matter for the tax experts. If, in the words of Secretary of the Treasury Morgenthau, the tax program must be an instrument for victory, then it must be shaped by the people as a whole and especially by those who must bear the burden of the victory program. Although we do not claim to be tax experts in the accepted sense, we have given the matter of the tax program for the Nation careful consideration, and feel that the principles we wish adopted are valid.

The comments we make here will not consist of a detailed analysis of the tax bill as it left the House Ways and Means Committee. It will concern itself rather with a statement of needed measures which will remedy the inadequacies which now exist in the bill, and will make up the deficit of approximately $2,468,000 in the total revenue sought by the Treasury Department.

The United Automobile Workers-Congress of Industrial Organizations slogan of "Victory through equality of sacrifice" is not abstractly founded on principles of justice, but is a slogan directed toward a program dictated by the demands of the war and the needs of the people for a decent standard of living, in order that we may successfully produce in ever-increasing volume the weapons for victory. To effectuate such a program, we feel that the following measures should be adopted:

(1) Personal incomes should be limited to $25,000 after the payment of all taxes. This proposal, which was advocated by the President, has met with opposition only from those in the higher-income brackets. To limit personal income to such a figure during a time of such great crisis is very little sacrifice for the citizens of our country to make, when our boys are fighting and dying in order that our system of life can continue. This proposal is further validated by the facts of income distribution. The increase in the Nation's total income which is expected to take place this year will accrue to the benefit of the income groups in the upper 25 percent of the population. In other words, those who in the past have had adequate, and even fabulous incomes, are today absorbing in addition the main portion of the increase in the national revenue. This increase can and must be redirected into the Nation's Treasury in order to help pay for our war program. The limitation on personal incomes of $25,000 will accomplish that, and raise an estimated $660,000,000.

(2) Corporate profits must be limited to 3 percent of invested capital. The crying need of the hour is to stop the inflation which is threatened by the combination of ever-mounting prices and increased profits. Contrary to the belief of those who claim that increased wages are the primary cause of the present inflationary trend, we maintain that unchecked profits play that role, and that the stabilization of wages along with an effective control of prices and the effective rationing of all scarce commodities is preventing such inflation. Wages are being stabilized according to the policy laid down by the War Labor Board; prices are being fixed and rationing is continually being extended. The last factor—the limitation of profits—must be taken care of by the tax bill.

It is no argument against such a limitation of corporate profits to say that business will no longer be able to function. Profits today are not the motive which basically impels business to operate, and all patriotic executives have recognized that fact. It is the preservation of our Nation which is at stake, and the limitation of profits in the way we suggest will not hinder that main task.

(3) All special privileges provided by the present system must go.

(*a*) Thus, the institution this year of the provision for mandatory joint income-tax returns by husband and wife must be effected. The device of filing separate returns by a husband and wife has been used in the past by families enjoying a double source of income to evade their just portion of taxation. Its abolition would yield approximately $420,000,000 in revenue.

(*b*) The House committee rejected the Treasury's proposal to tax interest from all outstanding and future issues of State and local securities, resulting in a revenue loss of $275,000,000. We believe that the Treasury's proposal should be adopted, and further implemented by extending it to all outstanding Federal issues. The contention that the latter should remain tax-free because issued with a promise that they would not be subjected to taxation is untenable, when the very right to receive income from existing Government securities of all kinds is at stake in the struggle which our country is waging against the Axis Powers.

(4) As in the case of Government securities, the House committee rejected the Treasury's proposals covering the gift and estate tax, which would increase revenue by an estimated $309,000,000. The Treasury's proposals are valid as far as they go, but we believe that an integrated estate and gift-tax system with a single exemption of $20,000 and a single set of graduated rates drastically increased for all brackets, should be adopted. Hundreds of millions beyond the $309,000,000 proposed by the Treasury could thus be added to the financial arsenal.

(5) Finally, under no circumstances should a general sales tax be made a part of the revenue system of our Nation. A general sales tax is unfair, inequitable, regressive, and would undermine the standard of living of our Nation. A general sales tax would cut many meager incomes of wage earners below subsistence requirements and would bear disproportionately on low-income groups whose incomes are almost wholly spent on consumers' goods. It is completely at odds with the principle of taxation according to ability to pay.

If these principles are adopted, then the deficiency now existing in the tax bill can be remedied, the tax program can truly become a democratic one, and the morale of the working people who have already willingly made so many sacrifices, only to find no corresponding ones among the high-income groups, can truly be strengthened for victory.

AL NASH,
Legislative Representative.

AUGUST 17, 1942.

STATEMENT OF ROBERT BLOUNT RALLS, NEW YORK, N. Y., RE H. R. 7378, SECTION 218. PROPOSING AMENDMENTS TO CODE SECTIONS 760 AND 761, INVOLVING EFFECT UPON THE INVESTED CAPITAL OF DEFICIT CORPORATIONS AFTER REORGANIZATION

To the Chairman, Senate Committee on Finance:

With reference to the conference which you so kindly afforded me this morning on the above sections of the House revenue bill, I beg to submit the following for your consideration:

Pursuant to the definite intent of Congress as shown in Ways and Means Committee report on the Second Revenue Act of 1940, and also in the report of the Senate Finance Committee thereon, it is now an embedded principle of excess-profits tax law that a deficit in the accumulated earnings and profits shall not be deducted in determining the statutory invested capital. (Sec. 30.718-2 (a) of Treasury Regulations 109.)

This principle, however, has not been carried out with respect to corporations that are the result of nontaxable reorganizations and which carry on for tax purposes, under the established reorganization provisions of the Code, the same taxable corporate entity as the predecessor company or companies, as, for example, where a company merely changes its domicile from one State to another, the same business being carried on and the assets and liabilities being taken over from the old company. The present section 751 of the Code has been interpreted so as to violate these fundamental principles and so as to require in effect that such deficit be deducted in computing the invested capital of the reorganized company, although it appears that such interpretation was actually an afterthought and not the original intention of the Treasury Department.

This result is a glaring inequity and an unwarranted discrimination against the company that was forced to reorganize because it had incurred an accumulated operating deficit. Of all companies it is the least able to suffer such a reduction in its invested capital; and it would be a flagrant disregard of the long recognized purpose of the nontaxable reorganization provisions of Code section 112 to contend that the reorganized company should be considered as a new, separate, and distinct organization for tax purposes, unrelated to the predecessor company. To the contrary, ever since the reorganizations provisions were placed in the law a nontaxable reorganization has been considered by the Treasury and by the courts as having no effect for tax purposes; and the transaction has been treated as a mere matter of form without working any change in substance.

The well known *Sansome case* (60 Fed. (2d) 931; cert. den., 287 U. S. 667); held that in the case of a nontaxable reorganization the accumulated earnings and profits of the original company should carry through to the successor and not be frozen as a part of the capital of the successor. This principle will be insisted upon by the Treasury as applied to invested capital, with the result that such accumulated earnings and profits carry-over will be treated separately and always subject to be diminished by deficits incurred after the reorganization.

We have then three fundamental premises: (1) That by the express will of Congress and by Treasury regulation, accumulated deficits shall not reduce invested capital; (2) that nontaxable reorganizations do not result in a new entity for tax purposes; and (3) that accumulated earnings and profits survive as such after a nontaxable reorganization. So it is entirely inconsistent for the Treasury now to propose that the deficit existing before a nontaxable reorganization be not carried over separately but deducted from the invested capital. This inequity, now present in section 751 of the Code, is continued in the proposed section 760, and is also lurking in the background of section 761 which is so vague in its terms as to afford little hope that it will save the reorganized company from falling a victim to the discrimination described.

Section 761 should be retroactive to January 1, 1940, and should be clarified so as to assure the reorganized company against such discrimination, which it does not do in the proposed form. Instead, however, of affording such protection, it grants to the Commissioner a very wide discretionary power through special regulations to be made by him, and in effect gives him *carte blanche* to determine the invested capital after a reorganization as he might see fit.

Sections 760 and 761 have not been properly explained to your committee. At page 110 of the hearings before the committee they were referred to as purely technical amendments by the legislative draftsman for the House, with no discussion of their actual effect as applied to deficits and accumulated earnings and profits in cases of reorganization. But these amendments are not merely technical; they go right to the heart of the invested capital principle which Congress laid down in 1940. Nor do the sections present such difficulties but that your committee can readily understand them, and register in your report for the benefit of the Congress and the public the actual legislative intent of the provisions. You should insist that they be explained to you in relation to the reorganization provisions and to the proposed treatment of accumulated earnings and profits for purposes of invested capital.

It is respectfully submitted that the new sections 760 and 761 should be redrafted so as to insure that the congressional intent will be carried out by inserting provisos therein to the effect that in all cases of nontaxable reorganization the accumulated deficit of the predecessor company shall be carried over separately to the successor and not deducted so as to reduce the invested capital by an amount in excess of the successor's accumulated earnings and profits.

Reorganized corporations are not seeking any special privilege. All they ask is equality of treatment with unreorganized companies with respect to deficits and accumulated earnings and profits. In the matter of the equable and uniform application of tax laws, the criterion was well expressed for the Congress by Mr. Stam at page 107 of the hearings before your honorable committee in these words:

"So that everybody, every corporation is treated alike under this rule."

Respectfully submitted.

ROBERT BLOUNT RALLS.

STATEMENT OF W. H. DUFF, CHICAGO, ILL., IN CONNECTION WITH PUBLIC UTILITY TAXATION

I am appearing before this committee on behalf of the firm of Duff & Phelps as a representative of clients who are investors in public-utility securities. I am the senior partner of the firm of Duff & Phelps, public-utility security analysts, with offices at 208 South La Salle Street, Chicago, Ill. The firm of Duff & Phelps is engaged in the analysis and study of public-utility companies and their securities for a group of clients, most of whom are institutional investors such as insurance companies, investment trusts, educational institutions, and the trust departments of banks. At the present time our clients own a total par value of public-utility bonds of approximately $1,815,000,000, as well as a large amount of public utility preferred and common stocks which we would estimate at approximately $250,000,000. These figures cover only our institutional clients and do not cover other clients whose customers themselves own very substantial amounts of public-utility securities.

In our opinion, neither our clients nor investors in utility securities, nor utility companies themselves desire in any way to evade their responsibilities in connection with the successful culmination of the war effort. The utility industry, however, is owned by the American public, and its solvency is a matter of great concern to every investor in its securities, as well as to taxing bodies and regulating officials and to the large number of people employed in the industry. Utility companies, as well as their investors, are perfectly willing to pay their fair share of war costs in the form of taxation, but, in our opinion, the tax bill as passed by the House of Representatives imposes an undue and unfair burden upon utility companies and their security holders because of what appears to be a failure on the part of the proposed tax bill to take into consideration the fundamental characteristics of the utility industry. I think it is well recognized that it was necessary, in order to finance the utility industry, to sell senior securities in the form of debt and preferred stock and the percentage of senior securities in the utility field of necessity has far exceeded that in industry in general and is only exceeded in the railroad industry, much of which industry has had a notoriously bad financial structure. I mention especially the capitalization of the utility industry as compared with other industries, as this is directly tied up with the computation under the proposed tax bill of excess-profits taxes on the so-called invested-capital method, whereby only 50 percent of the debt of utility companies is included as part of invested capital. This, of course, means that only a portion of the capital actually invested in the industry is includible as invested capital in the computation of excess-profits taxes. Because of this fact the majority of electric power companies have been forced to use the average earnings option in calculating excess-profits taxes.

Again, a very considerable degree of unfairness exists in the use of the average earnings option because of the fact that a substantial portion of the increase in net income which has occurred over the base period 1936-39 has been due to a reduction in interest charges accompanying refunding operations rather than to any abnormal increase in operating revenues or net operating income due to war profits. Many utility companies, in carrying out refunding operations, issued serial debentures or notes to accomplish a reduction in mortgage debt and agreed to reduce debt through sinking-fund operations. Such serial debentures or bank loans and sinking-fund payments must be paid off in cash. The tax bill as passed by the House of Representatives, however, does not make any allowance for this fact, with the result that if many companies faced with heavy repayments of debt do not obtain some relief from income taxes either through being allowed to take credit for a percentage of the amount of debt which must be retired or at least a savings in interest on such debt, many companies are going to be seriously hampered in servicing their debts and making necessary additions to take care of expanding business or affording protection to customers requiring power for essential war production. The Federal Power Commission has issued a number of orders requiring utility companies to make emergency connections with other companies and, as a result of these orders, a number of utility companies have been required to spend substantial sums for additional plant investment which, in many cases, will not increase operating revenues or earnings.

The utility industry is a regulated inustry and this factor in my opinion, has been almost completely ignored in the provisions of the proposed tax bill with respect to excess-profits taxes. Fundamentally, a closely regulated industry cannot, in general, have true excess profits, but under the proposed tax bill very substantial amounts of excess-profits taxes will be levied. The first reaction of anyone in speaking of excess-profits taxes in connection with an operating utility is that earnings are too high and should be reduced, but this is not the case of the utility industry because of the fact that the base for computing excess-profits taxes and the base for determining a fair rate of return on sound property value are so widely different. This condition arises primarily, I think, because of the fact that in the 1941 tax law and in the tax bill recently passed by the House of Representatives, excess-profits taxes are computed before, rather than after, normal and surtaxes. Utility companies and their investors would not have any complaint if utility companies were allowed to earn a fair rate of return, say 6 percent after normal taxes, on sound property value, and then pay excess-profits taxes at whatever rate other corporations pay on the remaining amount. However, where a tax bill requires the computation of so-called excess-profits taxes before the deduction of normal and surtaxes, the result is that most utility companies will not earn a fair rate of return on sound property value, and therefore obviously cannot have excess profits. It has been estimated that on the basis of the tax bill recently passed by the House of Representatives, the rate of return on book value of property will be approximately 4⅛ percent in 1942. Testimony has already been introduced as to the impossibility, under the tax bill as passed by the House of Representatives, of offsetting either higher taxes or increased costs which might be incurred as a result of the war effort, through rate increases. When excess-profits taxes of the type embodied in the House bill take 90 percent of any increases which occur in earnings before taxes, which is the case where a company is subpect to excess-profits taxing, it is obvious that no relief in the tax burden can be obtained through increased rates and, of course, rate increases are definitely inflationary and therefore run counter to the administration's policy of holding down the cost of living.

There is one other very serious aspect to the excessively high tax burden which would be imposed on the utility industry by tax rates embodied in the House bill, which is tied up with the ultimate probable loss of a substantial portion of revenues by the Government through income taxes on utility companies. In 1941 electric utilities alone paid total Federal taxes of approximately $294,000,000 according to estimates made by the Edison Electric Institute. Of this figure, the largest portion consisted of normal and surtaxes in the amount of $180,000,000, with the total of normal and excess-profits taxes being around $225,000,000. Of the balance, about $49,000,000 is made up of the 3⅓-percent excise tax and $20,000,000 of other Federal taxes. Based on our study of the effect of the tax bill recently passed by the House of Representatives, we estimate that for the electric industry alone the total Federal tax bill in 1942 would be about $385,000,000. No figures are available on the gas industry, although it is known that very substantial Federal taxes were paid by that industry. In 1941 the telephone industry paid approximately $130,000,000 in the form of Federal income and excess-profits taxes and undoubtedly will pay a much larger figure in 1942. As far as the electric industry is concerned, the present large tax burden, tied up with the provisions of the Public Utility Holding Company Act of 1935, which calls for the divorcement from holding companies of a large number of operating companies, is very definitely leading to the acquisition by municipal or governmental bodies of many utility operating properties. Since such governmental bodies are exempt from the payment of Federal taxes, not only income and excess-profits taxes but taxes based on operating revenues and miscellaneous Federal taxes, the Federal Government, should this movement continue, will stand to lose a very substantial portion of present income being obtained from the utility industry. There has been a number of acquisitions of utility properties in recent months by governmental bodies, and there are under serious consideration at the present time a number of other acquisitions.

Irrespective of the merits of public ownership of utility properties, higher Federal income and excess-profits taxes unquestionably will stimulate the movement toward public ownership which, in turn, will substantially reduce revenues of the Federal Government which are now derived from operating companies. It seems to me that there has been created in this matter a sort of Frankenstein which will eventually take from the Government a considerable portion of the $294,000,000 of Federal taxes paid by the electric industry alone in 1941, in which event the loss of such revenue will have to be collected in some other manner, which will work great inequities. A solution of this phase of the problem might be to tax revenue bonds issued by various communities and to require municipal bodies owning utilities to make payments to the Federal Government in amounts equal to Federal taxes paid by private utilities. This, however, might be very difficult to accomplish and, likewise, would result in the impairment of the ability of municipalities and other governmental bodies in meeting debt-service charges, in view of the fact that debt service has been computed, in issues already sold, on the basis of an assumption that no Federal taxes would have to be paid by municipalities or other governmental bodies. Should municipalities be forced to pay taxes at a rate equivalent to tax rates being paid by private utilities either substantial increases in rates charged to consumers would have to be made by such municipal bodies or debt service could not be met in many cases.

An excessively high tax burden imposed on the utility industry would, in my opinion, have a number of other serious implications. For one thing, it would, I think, virtually prevent the carrying out of the integration provisions of the Public Utility Holding Company Act of 1935 without very substantial losses to investors because of the impossibility of selling utility properties at reasonable prices, due, of course, to the impossibility of selling common stocks of operating utilities to the public at reasonable prices. In this connection we know of no sale of utility company common stocks of any consequence to the public since the proposal was made some time ago by the Treasury Department for a tax bill embodying a 55 percent normal and a 75 percent top excess-profits tax, and, as is well known, utility common stocks have declined drastically during recent months, due to proposed tax legislation. Another serious objection to an excessively high tax burden for utility companies is tied up with the fact that if the public utility industry is to remain sound a good market must exist for preferred and common stock equities as, if the industry is to have any growth, it must be able to market preferred and common stocks at relatively good prices, which it cannot do even under existing taxes, to say nothing of much higher Federal income and excess-profits taxes. In connection with equity financing, the Securities and Exchange Commission since the enactment of the Public Utility Holding Company Act of 1935 has done an excellent job in promoting sound financing of public utilities through a program which included periodic reduction of debt and, in many cases, additional equity financing. Higher Federal income taxes would seriously interfere with the continuation of this program and would probably result in pressure being put on the Commission by utilities to finance additions and betterments solely through the sale of debt securities. This program, of course, would defeat the sound financing of public utilities which has occurred during recent years.

The utility industry, generally speaking, is not obtaining boom earnings due to war conditions. There has been a considerable increase in the amount of electricity sold by utility companies and there has been a moderate increase in operating revenues. Due to the fact that most of the increase in the sale of electricity has been occasioned by increased demands of industrial customers where the profit margin is relatively low, the increase in operating revenues has been much less than the increase in sales of electricity, and a large portion of the increased operating expenses, maintenance, and increased depreciation appropriations. As a matter of fact, the utility industry is now beginning to receive the impact of a change in the character of the load, to wit, a loss of domestic and commercial business at attractive rates to industrial sales at very low rates. Also in certain parts of the country utility companies have been adversely affected by dim-outs and other restrictions which have curtailed sales of electricity to residential and commercial customers, and as the war continues it is probable that further restrictions of this type will occur.

In view of the fact that the utility industry is not in any sense a war industry, it probably stands to lose more in the form of profitable business as a result of war conditions than it will obtain through the sale of additional amounts of electricity to industrial customers, and being a regulated industry, it has not and will not have excess profits as that term is usually defined. Is it, therefore, fair or wise to impose on the industry an excessively high tax burden which will reduce earnings to considerably less than a fair return, which will probably make equity financing virtually impossible, and which may very well lead to the acquisition of utility properties by municipal and other Government bodies with a resultant loss of taxes to the Government?

As Secretary of the Treasury Morgenthau so aptly said when he testified before the House Ways and Means Committee:

"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."

Respectfully submitted.

WM. H. DUFF.

AUGUST 13, 1942.

BRIEF BY EARLY LYMAN GILBERT FOR STANDARD PRESSED STEEL CO., JENKINTOWN, PA.

To the Finance Committee, United States Senate, Washington, D. C.:

I wish to present to you the effect that the 1942 House revenue bill and Public Law No. 528 (renegotiation of contracts) will have upon Standard Pressed Steel Co.

The application of these two laws to the Standard Pressed Steel Co., even though they increased their production 600 percent in 1941, all of which entered into the production of actual engines of combat and machine tools that produced actual engines of combat, for the year of 1941, would have created an actual loss of capital.

It was in the spring of 1940 that the executives of my company visualized the United States entering the war and took immediate action to prepare their own factory and organization for an "all out" in the production of articles entering into the actual engines of combat. I was told personally by a major in the War Department that Standard Pressed Steel Co. was the first in the United States to go on record.

The Standard Pressed Steel Co. is one of many companies with a small capital. Its entire capital and surplus amounted to $1,365,651 as at January 1, 1941. By the end of 1941 their activities, in increasing production, had created a debt of $2,600,000 with commitments for further expansion of its plants aggregating $600,000 to $800,000.

The application of the 1942 House revenue bill and Public Law No. 528 to my company's 1941 activities would have actually reduced its capital and surplus and at the same time increased their liabilities to at least $3,300,000 with additional commitments aggregating $600,000 to $800,000.

This is a condition no company can withstand.

The Standard Pressed Steel Co. cannot be placed in the same category with a large company, for the very simple reason that it has an exceedingly small capital in proportion to its productive capacity and indebtedness. Increased capacity and indebtedness were created solely for the war effort. Standard Pressed Steel Co., with its net worth of $1,365,651, is producing war goods in 1942 at the rate of $18,000,000 to $20,000,000. Comparing this with 12 steel companies (Survey of American Listed Corporations, volume I, of registrants with Securities Exchange Commission, pp. 69 and 87), the Standard Pressed Steel Co. should have a capital of approximately $18,000,000.

Standard's capital produces an exemption so small that, after eliminating items of expense as disallowed by other sections of the 1942 House revenue bill, there will be left no exemption whatever.

The articles produced by the Standard Pressed Steel Co. enter into the production of tanks, airplanes, airplane engines, machine tools, gun mounts, precision instruments (used by the Navy as well as the Army), and, in addition thereto, they are major producers of armor-piercing bullet cores and primer heads for 75 mm. shells.

The proposed excess-profits tax and Public Law No. 528 are, without question, hampering the war effort. This fact is clearly proven by the position in which Standard Pressed Steel Co. finds itself.

It was this year that a bottleneck developed in the production of an article produced by the Standard Pressed Steel Co., which bottleneck slowed up production of certain engines of war for actual combat. The Standard Pressed Steel Co. was called upon for an increased production. It was then producing some 50,000,000 units per month compared to a normal capacity of some 3,000,000 per month. It was impossible to increase the output without further expansion of the plant. The proposed excess-profits tax law, afterward enacted by the House and known as H. R. 7378, made it impossible for my company to further increase its capacity.

All of the increased production for the war effort was accomplished without asking the Government for any financial assistance whatever.

If the excess-profits tax law, as proposed in the House bill, becomes a law and Public Law No. 528 is not repealed, the Standard Pressed Steel Co. will be unable to pay its obligations and will eventually wind up in the bankruptcy courts.

Yes, it can be said that section 213 of the 1942 revenue bill as passed by the House amends section 722 of the Internal Revenue Code, giving general relief in the construction of average base period net income for excess-profits tax purposes. The provisions of this section explore the entire field of economics. The field of economics is so broad and all embracing that no group of economists will agree on major points. Who agrees on "a profit cycle," "sporadic and intermittent periods of high production and protfis"? These subjects are unknown quantities and cannot be determined. Some answer can be reached by an arbitrary application by individuals sitting in judgment, and yet this section of the House bill says, that in arriving at a constructive average base period net income, there shall be taken into consideration:

"(A) A profit cycle differing materially in length and amplitude from the general business cycle,

"(B) Sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period."

Those are only two of several such unknown and indeterminable factors included in this section. Such provisions in a tax law only open up many subjects for litigation, filling the courts, consuming time and effort of people who should spend that time and effort toward winning the war instead of bickering to settle accounts.

It appears to me that Public Law No. 528 affects only companies who cannot afford to maintain expensive offices in Washington to look after their business affairs in the war effort. The larger company maintains an office in the city of Washington and is permitted to deduct such expense. The smaller company, with insufficient finances to maintain a Washington office, uses the services of representatives on a fee basis. This cost is not an allowable deduction to the smaller company. Such provisions in a law undoubtedly hamper the war effort for the reason that the majority of the production comes from the smaller companies when taken in the aggregate. The smaller companies are forced to curtail their efforts or face inevitable ruin.

The excess profits portion of the Revenue bill as passed by the House is definitely written for companies with large capital in proportion to their production. No consideration whatever is given to companies such as the Standard Pressed Steel Co. who, in the production of articles for the war effort in the year of 1942, are turning over their capital and surplus every thirty working days of a 6-day week as compared to steel companies, hereinbefore cited, turning over their net worth approximately one time per year. Standard Pressed Steel Co. is not the only company of its size that is accomplishing such results; therefore, a provision in the revenue bill recognizing such companies will not only act to save the Standard Pressed Steel Co. from the bankruptcy courts but other small manufacturers where their invested capital is small compared to their production and indebtedness.

In the case of Standard Pressed Steel Co., they have in their plant machinery leased to them by the Government, which machinery, having a cost value of some $7,000 to $8,000 per machine, is being operated alongside of machines that cost my company $1,500, and yet the production of both machines is comparable.

Had the Standard Pressed Steel Co. made its investment on the same basis as the Government, their production of war goods would have been approximately 75 percent less than actually produced by them.

The entire production claimed by the Standard Pressed Steel Co. comes from its own factory. None of it has been sublet to others.

To permit the smaller company to continue in the war effort, meet its obligations, and stay out of bankruptcy, the excess-profits-tax section of the 1942 Revenue Act must contain provisions recognizing such conditions. It is the opinion of the Standard Pressed Steel Co. that: A graduated basis of an exemption such as contained in the 1941 Revenue Act should be in the 1942 Revenue Act.

Public Law No. 528 should be repealed.

There is attached to this brief a schedule showing the application of the 1942 House revenue bill and Public Law No. 528 to my company's activities for 1941.

Respectfully submitted.

EARLY LYMAN GILBERT.

SCHEDULE OF STANDARD PRESSED STEEL CO.

Nineteen forty-two House revenue bill and Public Law No. 528 superimposed on 1941 activities

Total sales	$8,378,000

PUBLIC LAW NO. 528

Limitation 10 percent of sales (the Vinson Act as amended places an 8 percent limitation)		$837,800
Less allowable items of expense (authority—the two laws, Treasury Decision 5000 and opinion of Comptroller General):		
Amortization of war facilities	$70,894	
Selling expenses (estimated one-half)	97,433	
Advertising expenses	94,091	
Federal capital stock tax	34,868	
Interest on borrowed money	19,131	
Other disallowable items, including compensation, cost of collecting accounts, and certain accounting cost to the taxpayer proving his income tax position	225,000	
		541,417
Net income recognized as being available to the contractor (all income above this to be paid to the Government)		296,383

INCOME SUBJECT TO TAXES

Income as limited		296,383
Less items of expense disallowed under Public Law No. 528 but allowable for taxes:		
Amortization of war facilities	$70,894	
Selling expenses (one-half, estimated)	97,433	
Advertising expenses	94,091	
Federal capital stock tax	34,868	
Interest on borrowed money	19,131	
Other disallowed items, including compensation, estimated, allowable for taxes	100,000	
		416,417
Income subject to tax		None

PROFIT AND LOSS

	Debit	*Credit*
Income as limited		$296,383
Expense items that must be paid:		
Amortization of war facilities	$70,894	
Selling expenses	97,433	
Advertising expenses	94,091	
Federal capital stock tax	34,868	
Interest on borrowed money	19,131	
Other disallowed items (hereinbefore described) that must be paid	225,000	
		541,417
Net loss		245,034

BRIEF OF EARLY LYMAN GILBERT FOR PENNSYLVANIA MANUFACTURING CO., JENKINTOWN, PA.

To the Finance Committee, United States Senate, Washington, D. C.

I wish to present to you the effect that the 1942 House revenue bill and Public Law No. 528 (renegotiation of contracts), will have upon the Pennsylvania Manufacturing Co.

A young man, by name, H. Thomas Hallowell, Jr., invented a machine for assembling primer heads for 75-mm. shells. The War Department learned of this machine and insisted that they be made for the United States Government, resulting in original contracts for some forty-odd machines at a cost of more than $500,000.

Each one of these machines, operated by three men, assembles and inspects approximately 4,000 primer heads per hour, rejecting all imperfect units.

The production (assembly) of primer heads, through the use of these machines, has been increased beyond the possibility of reasonable estimation, when compared to the hand method of assembly used before the installation of these machines.

To meet the Government's request for the production of these machines, Mr. Hallowell, together with friends, organized the Pennsylvania Manufacturing Co. with $120,000 paid in cash capital and his application for patents. In addition thereto, they borrowed large sums, as of course, it is impossible to complete an $800,000 contract with only $120,000 paid in cash capital.

This machine is truly an art of science, devoted to the war effort, and it gives my company great pleasure in having made such a large contribution toward the production of articles entering into actual combat service.

Under the 1942 House revenue bill and Public Law No. 528, the Pennsylvania Manufacturing Co. cannot make the contribution to the war effort that it otherwise could and should make.

The paid-in cash capital of the Pennsylvania Manufacturing Co. is so small, compared to its accomplishments, that the exemption for excess profits tax purposes, as provided for in the 1942 House revenue bill, is so low that, when taking into consideration development cost and other items that must be capitalized or eliminated from cost of operations under the same bill, the result would be a deficit in its operations, thereby hampering one of the finest contributions in the production of articles of war.

This company was organized in October 1941 and made its plans, both operational and financial, on a fiscal year basis under the 1941 Revenue Act. In that act, a fiscal year was governed by the revenue law in effect for the calendar year in which the fiscal year began. The proposal in the 1942 House revenue bill, to divide fiscal year income tax returns on the basis of the number of months in each of the 2 calendar years, upsets the entire financial arrangement of the Pennsylvania Manufacturing Co. for meeting the emergency and making its contribution to the war effort. This feature of the proposed revenue law will upset and definitely hamper the company's war effort—a company with $120,000 cash paid-in capital, to complete contracts of more than $800,000, cannot possibly have financial plans permitting a change, particularly a change so drastic as proposed in the 1942 House revenue bill.

For the Pennsylvania Manufacturing Co. to continue its contribution to the war effort

The 1942 Revenue Act should contain: A graduated basis of taxation such as is in the 1941 Revenue Act, provisions for fiscal year returns to be filed as in past years, and Public Law No. 528 (renegotiation of contracts) should be repealed.

Respectfully submitted.

EARLY LYMAN GILBERT.

STATEMENT BY RICHARD H. TYRRELL, REPRESENTING CHAIN BELT CO. AND GREDE FOUNDRIES, INC., RE 1942 REVENUE BILL

This statement is presented by Richard H. Tyrrell, of the law firm of Wood, Warner & Tyrrell of Milwaukee, Wis., general counsel for Chain Belt Co., of Milwaukee, a Wisconsin corporation, having plants in Wisconsin and Massachusetts, and for Grede Foundries, Inc., of Milwaukee, a Wisconsin corporation, having plants in Wisconsin. Because I was unable to appear in person before the committee on the date set, I have heretofore asked permission to submit this written statement on behalf of the above-named corporations.

I

I wish to present first a technical amendment to the revenue act that is required to remedy an inequitable situation in the taxation of the proceeds of corporate life insurance.

Corporations frequently carry insurance upon the lives of their important executives to protect the corporation against loss through their death. Proceeds of such insurance are not taxable to the corporation.

Section 22 (b)(2) of the Internal Revenue Code provides that in the event of a transfer of a life-insurance policy for a valuable consideration, the proceeds thereof received by the transferee (less purchase price plus premiums subsequently paid) are subject to income taxation. Without doubt it was the intent of Congress to tax the profits from purchases of policies when the transaction is entered into for purposes of gain. The courts (for instance, in the case of *King Plow Co.* v. *Commissioner*, 110 F. (2d) 649), have applied this provision to include a transfer of such a policy in connection with a corporate reorganization where the officer thus insured continued as an officer of the acquiring corporation, the latter of which maintains an insurable interest in him. I believe that this is a harsh result, not intended by Congress, and should be corrected by legislation.

As concrete examples, each of Chain Belt Co. and Grede Foundries, Inc., is confronted with the foregoing situation in cases in which they desire to continue to carry insurance upon the lives of officers. Each company acquired the business and assets of another corporation pursuant to a reorganization which was tax free under the reorganization provisions of the Revenue Code (sec. 112). Among the assets so acquired were life-insurance policies upon the lives of certain officers of the corporations whose assets were so acquired and which officers continued and now continue as officers of Chain Belt Co., and Grede Foundries, Inc., respectively. Under such circumstances it is just as vital to the interests of the surviving corporation and its stockholders that the corporation be protected against the loss of the life of an important executive.

Congress and the Treasury Department have recognized and do now recognize that the proceeds of insurance upon the life of an employee, which insurance is taken out and carried by a corporation, are exempt from income taxation. Such proceeds merely restore in part the loss suffered through the death of the employee. The Government also recognizes the tax-free character of such a reorganization. This sound policy should not be impaired by a judicial construction of the law which goes beyond the real purpose of that law.

Under such construction, the beneficent purpose of life insurance in the cases at hand will be wholly lost and there will be no reason for the assignee corporations to continue such policies of insurance upon their important officers. New insurance may not be feasible because the officers concerned may no longer be insurable and in any event the premium cost would be much increased.

There must be many other existing situations of this kind. Such cases and the cases at hand are entirely different from the case of an assignee who has speculated in the purchase of an insurance policy where the purchaser has no insurable interest in the assured. It must be to such a case that the statutory provision, denying income taxation, was intended to apply.

Inasmuch as governmental policy recognizes that proceeds of real life insurance, protecting a corporation against the loss of the service of an officer, should be, and are, exempt from income taxation and Government policy also recognizes that certain corporate reorganizations which involve a continuance of financial interest in substantially the same persons are tax-free transactions, then it seems to follow naturally that where a life-insurance policy is one of the assets involved in the tax-free reorganization, its tax-free status should extend to and vest in the surviving corporation.

While this technical point may seem minor in comparison with the many larger problems presented by the 1942 revenue bill, the high rates of that bill emphasize the importance of the matter to all corporations concerned.

I believe that the inequality that results from the situation above described can easily be remedied by an amendment to section 22 (b) (2) of the Internal Revenue Code in form substantially as that annexed hereto which we submit for the consideration of the committee.

II

THE CHAOS OF RENEGOTIATION

The renegotiation statute of April 28 last is producing such confusion on the part of industry that the war effort, in which industry is wholeheartedly engaged, is being hampered and obstructed by the appalling uncertainty that confronts it. No reliable financial statement can be made for Security and Exchange Commission or for credit purposes. Earnings cannot be distributed because of the impending fear of recapture 3 years after the war ends, when funds may not be available. Stockholders will have little if any income from dividends for the payment of taxes or for other necessary purposes. Provision cannot be made for post-war reserves. The futility of this legislation from the Government fiscal viewpoint should be apparent. Price ceilings apply that influence reasonable profits. Excess profits can be recaptured by taxation without wrecking the economic machinery of industry. The law should be repealed without delay now that its deplorable effect is realized.

We invite the attention of the committee to these problems.

Respectfully submitted.

RICHARD H. TYRRELL.

AUGUST 13, 1942.

PROPOSED AMENDMENT

[To clarify the exemption of proceeds of life insurance in a tax-free exchange]

Insert the italicized phrase in the last sentence of section 22 (b) (2) of the Internal Revenue Code as follows:

"In the case of a transfer for a valuable consideration, by assignment or otherwise (*except in a tax-free exchange under section 112*), of a life-insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph;".

TESTIMONY ON REVENUE ACT OF 1942 BY DAVID ROBERTS, JR., PRESIDENT, BRILLIANT COAL CO., BIRMINGHAM, ALA.

My name is David Roberts, Jr. I am president of the Brilliant Coal Co. of Birmingham, Ala. I have been engaged in the business of mining coal in Alabama for 36 years. Your committee has heard much testimony on the Revenue Act of 1942. I do not propose to discuss theory or measure of taxation other than to say that when proposed corporation normal and surtax reaches the high figure of 45 percent, and excess-profits taxes the figure of 90 percent, there is imminent danger of crippling industry, and much caution should be exercised in the determination of what is normal income and what is excess profits.

I do wish to relate to you how disastrously such measures of taxation will affect the small company I head. Of course, I realize that our country's revenue measure in this time of crisis cannot be shaped to meet the need of one small mining company, but I am quite positive that our position is not unique, but is the position of thousands of other small companies. Discriminatory taxation and injustice will arise through entirely accidental differences in capital structure or previous earning records. Possibly, ruin to such companies can be avoided by relief provisions entailing an insignificant loss of revenue to the Federal Treasury.

The Brilliant Coal Co has operated coal mines in Alabama for 36 years with modest success. Organized in 1906 with $300,000 capital stock, the capital structure is today unchanged except for the retirement of debt and accumulation of $180,000 of surplus. No stock has ever changed hands except by inheritance or family distribution. The majority of the stock is held by people past middle age. The company has paid dividends regularly for over 25 years, and the income from this source is the major income of the older stockholders.

The company's most valuable assets are coal lands and leases on coal lands mostly acquired many years ago at prices in no way commensurate with today's values. The book value of the property in no way reflects today's value; hence, an exemption from excess-profits taxes based on a fixed percentage of the book value results in an exceedingly low measure of return on the actual value. We, therefore, take the average earnings for the years 1936 to 1939 as our exemption. In this period we had 2 bad years. Our average earnings for the base period were approximately $44,000 as against an average of $66,000 for the 25 years ending December 31, 1941, and an average of $59,000 for the 20 years ending December 31, 1939, this period including the depression years of the early thirties.

Just what tax problems does this small company face for 1942?

For reasons other than the present demand for coal, our earnings for the year 1942 will be quite large when compared to the subnormal average for the base period. With advancing wages in the coal industry, the cost of loading coal by hand, our former method, gradually increased to such a point that by the end of 1939 we could see that continued operations under this method would be impossible. Therefore, in 1940 and 1941 we spent large amounts of money mechanizing our mines. The results from the mechanization have been good. 1941 earnings increased sharply and 1942 will exceed 1941.

We also have today sources of income not enjoyed in the base period. We are large landowners and have leased some of our hitherto idle lands to other corporations or individuals. Royalties from these leased lands add to our income. We also have today an appreciable sale for old equipment and scrap.

With the increased earnings we face this tax picture: Comparatively early in the year we had earned our subnormal excess-profits-tax exemption of approximately $54,000. This amount subject to the 45 percent normal and surtax creates a tax liability of $24,300, leaving us $29,700. Having reached this point we will operate our mines for the balance of the year at top speed with our earnings subject to a 90 percent tax. The 10 percent we can keep will not replace the equipment we are wearing out. Nothing can replace the coal we are removing from our properties. We depleted our working capital in 1940 and 1941 to purchase labor-saving equipment. We are earning handsome profits on this investment, but can retain too small percentage of the same to replenish the exhausted working capital. When our equipment is worn out as the result of present high speed production we will have no funds to purchase new equipment. It is entirely to our selfish interest to slow up production, or discontinue production for the rest of the year, but we must continue high-speed production to provide our little proportion of the country's coal.

If we maintain production at the present rate we will mine approximately 300,000 tons of coal in the year 1942 as opposed to an average of 211,000 in the base period 1936 to 1939, a 40 to 50 percent increased tonnage. This increased production not only entails the unusual wear and tear on our equipment, but of greater seriousness to us means an accelerated rate of exhaustion of our coal supply which, especially in the case of our present most profitable mine, is limited.

Our estimate is that our taxable profits for the year will be $120,000.

Divided for tax purposes:

$54,000 at 45 percent	$24,300
66,000 at 90 percent	59,400
Total taxes	83,700

Practically 70 percent of income, leaving us $36,300 or 30 percent.

Of the first $54,000 we can retain $29,700, so since we passed that mark some months ago, we have been wearing out our equipment without retaining earnings sufficient to replenish the working capital put into this equipment, and with no possible source of funds to replace this equipment when it is worn out. At the same time, we have been, and are, shortening our future life and the possibility of earnings in years to come by exhausting our supply of coal.

The royalties from the lands we have leased to others will fall into the 90 percent class. We are, therefore, selling our lands at 10 percent of their royalty value.

We are urged to collect our scrap, old equipment and get it into the proper channels for war materials manufacture. We are doing this, but we are selling it for 10 cents on the dollar.

Summing up, we are in this unhappy position: We must, in good faith, produce coal, and allow others to produce coal from our property, but in so doing we are destroying our future.

The picture presented above applying to our company applies to thousands of other small mining companies. To prevent such injustices I respectfully suggest the following modifications of the bill:

1. That to prevent penalizing the production of coal (i. e., the operator exhausting his coal and shortening the life of his property without compensation) percentage depletion on both owned and leased lands be retained in the bill, and that those who in the past did not elect this method be now permitted to do so.

2. That to prevent today's reasonable profits being computed as excess, because of comparison with a subnormal base, the base period 1936–39 be not made inflexible. That where any 1 year in the base period shows earnings substantially lower than the average of the other three, the average of the other three be used, or the year 1940 substituted for the subnormal year.

3. That to prevent discouraging the leasing of coal lands to those who wish to produce coal from the same the royalties received from leased land be deducted from total income when computing excess-profits income. Otherwise the corporation lessor is selling his coal at 10 cents on the dollar.

4. That to prevent discouraging and penalizing the sale of scrap or second-hand equipment to proceeds of such sales of completely depreciated assets be not subject to excess-profits taxes.

5. That as a final safeguard against confiscatory taxation the bill provide an outside percentage figure which all Federal income taxes shall not exceed.

BRILLIANT COAL CO.
DAVID ROBERTS, *Jr.*,
President.

INDEX

	Page
Alcohol, tax on medicinal: Jones, Rowland, Jr	1675
Analysis of 1942 revenue bill: O'Brien, John	34
Amortization allowances:	
Jouett, John H	1829
Shorb, Paul E	1736
Amortization of bond premiums: Osgood, Roy C	1723
Amortization period: Chapman, A. B	2089
Apartments, tenant-owned:	
Eagle, J. Frederick	164
Forster, Henry	173
Appointment, powers of: Osgood, Roy C	1720
Automotive parts and accessories, tax on:	
Daubin, Meredith M	1143
Goldman, Albert D	1148
Rosenberg, Aaron	1149
Bad debts, deductions for: Munson, G. Kibby	2145
Bad debts, recovery of:	
Alvord, Ellsworth C	1784
Brach, Henry	1496
Shorb, Paul E	1732
Sutherland, William A	1422
Banking and taxation: Safley, Maurice	253
Base period:	
Capehart, Homer E	2224
Carroll, Mitchell B	209
Connolly, John L	2172
Tower, Carleton M	157
Bitters, tax on imported: Hull, Hon. Cordell	1811
Board of Tax Appeals:	
Biddle, Hon. Francis	2297
Klepinger, Robert F	2300
Law Notes	2301
Murdock, Hon. J. E	2304
Sutherland, William A	1419
Bonds, deductions for: Little, Royal	337
Bonds, incentive buying of: Baar, Arnold R	1949
Bonds, liberty annuity: Squires, J. Duane	2212
Broadcasting, tax on:	
Alvord, Ellsworth C	729
Haggerty, John B	716
National Association of Broadcasters	729
Paul, Randolph E	721
Treasury Department, Division of Tax Research	722
Canadian pension, tax on payments to United States citizens	387
Rice, Duncan	403
Capital gains and losses:	
Alvord, Ellsworth C	1782
Chapman, A. B	2088
Cowdin, J. Cheever	2064
Dresser, Robert B	2280
Ehrman, Sidney M	2270
Forstall, James J	2229
Hopkins, Albert L	1755
McNeny, Frank L	961
Seidman, M. L	151
Shorb, Paul E	1734
Strong, Homer	1918

Page

Capital gains tax:
- Friedman, Elisha M. 1214, 1222, 1227
- Schieffelin, W. J., Jr. 1003
- Schram, Emil 1186

Capital losses, limitation on: McFarland, Elden 2235
Capital reduction: Hopkins, Albert L. 1754
Capital stock tax:
- Baar, Arnold R. 1949
- Ehrman, Sidney M. 2269
- Jouett, John H. 1829
- Schieffelin, W. J., Jr. 1003
- Seghers, Paul D. 689

Certificates of necessity: Shorb, Paul E. 1741
Charitable contributions: Osgood, Roy C. 1719
Charitable, etc., exemptions: Ready, Michael J. 1806
Cigar tax:
- Brown, Ray C. 1460
- Bunerman, Harry B. 1440
- Calamia, Eric 1441
- Cigar Makers International Union of America 1461
- Cigar Manufacturers Association of America 1428
- Dickinson, William H. 1437
- Fisher, Harry 1438
- Garcia, Alvero M. 1427
- Gershel, George F. 1437
- Hull, Hon. Cordell 1462
- Kolodny, Joseph 1442
- Pepper, Hon. Claude 1451
- Thrall, Oliver J. 1437
- Lancaster County, Pa., tobacco farmers 1439
- Van Horn, R. E. 1461
- Wissler, A. R. 1439
- Witt, Eli 1455

Cigarette papers, tax on: Straus, Harry H. 2188
Cigarettes, tax on:
- Alexander, William C. 1917
- May, William H. 1901
- Robertson, H. M. 1907

Coin-operated machines:
- Bruntjen, Herman A. 1141
- Glassgold, George M. 1132
- Lansing, Harold S. 1135
- Mohr, Arthur 2256
- National Vending Machine Association 1139
- Robinson, Samuel 2256

Claims against United States involving acquisition of property: Sullivan, Benjamin H. 2105
Collection of tax at source:
- American Institute of Accountants 1606
- Bodfish, Morton 964
- Chapman, A. B. 2092
- Cowdin, J. Cheever 2066
- Cranch, Raymond G. 1715
- Ehrman, Sidney M. 2271
- Foreman, H. E. 2128
- Gretz, Harry C. 1685
- Helman, N. C. 1694
- Morrison, H. W. 538
- Mylander, Charles M. 1995
- O'Donnell, Al F. 139
- Ohio Chamber of Commerce 1663
- Paul, Randolph E. 137
- Rice, Stephen E. 135
- Smith, J. Emil 1805
- Spence, A. D. 1131
- Tarleau, Thomas 140

Page

Community property:
Cobb, Zach Lamar 2260
Donworth, George 2260
Dunbar, Charles E., Jr 2260
Ingebretsen, James C 2260
Jackson, J. P 2263
Montague, Joseph G 2260
Osgood, Roy C 1724
Paul, Randolph E 33
Compensation for services rendered: Spitzer, A. Lewis 1678
Compulsory savings:
Cowdin, J. Cheever 2067
Goldman, Julian 244
O'Neal, John R 261
Peyton, Robert E 515
Consolidated returns: Ehrman, Sidney M 2269
Consolidated returns, extension of: Hopkins, Albert L 1752
Constructive Income Taxation: Fisher, Irving 2169
Consumer income: Nixon, Russ 330
Consumer's tax: Colborn, I. L 1557
Contracts, renegotiation of:
Alvord, Ellsworth C 1782
Chapman, A. B 2090
Connolly, John L 2174
Forrest, C. H 404
Lovett, John L 387, 404
Maguire, Walter N 2193
Paul, Randolph E 405
Conversion, involuntary: Locke, Herbert E 1564
Corporation dividends paid credit: Brach, Henry 1496
Corporation income tax: Seidman, M. L 148
Corporation taxes:
Appelbe, Clark 326
Colerick, Guy 776
Friedman, Elisha M 1244, 1254
Little, Royal 343
Murray, Philip 319
Strong, Homer 1918
Corporate normal and surtax: Brooks, John W 425
Cosmetics, tax on:
Broudy, David M 219
Freiberg, L. A 2143
Schlesinger, Walter C. B 222
Credits, foreign tax: Hopkins, Albert L 1752
Credit for Pan-American trade corporations:
Hatch, James P 1978
Page, Frank C 2273

Debt, deductions for:
Alvord, Ellsworth C 1771
American Institute of Accountants 1612
Anderson, C. Vivian 1972
Baar, Arnold R 1949
Brown, Hon. Prentiss M 1080
Cooper, Walter A. M 1596
Cowdin, J. Cheever 2061
Ehrman, Sidney M 2270
Hodes, James 1621
Illinois Chamber of Commerce 1950
Kern, Paul J 2204
Lachman, Charles 1304
McClure, John E 1585
New York City Bar Association 2346
Robineau, M. H 444
Shorb, Paul E 1732
Wisconsin Power & Light Co 2293
Witherspoon, John A 781

Page
Debt relief: Porter, J. W ---- 883
Decedent's basis for determining gain or loss: Vernon, Weston ---- 2345
Decedent's income on inherited property: Osgood, Roy C ---- 1719
Declared value excess profits tax: Seghers, Paul D ---- 689
Declared value tax: Cowdin, J. Cheever ---- 2064
Deductible, items not: Witherspoon, John A ---- 781
Defense bonds: Morgenthau, Hon. Henry, Jr ---- 14
Deficit corporations after reorganization: Ralls, Robert Blount ---- 2350
Depletion allowance:
Ash, Robert ---- 526
Battle, J. D ---- 802
Broadgate, W. C ---- 1381
Brown, Russell B ---- 1309
Caldwell, W. L ---- 1417
Callahan, Donald ---- 1389
Campbell, Rolla D ---- 1399
Compton, Wilson ---- 1696
Cranch, Raymond G ---- 1711
Davis, Ralph E ---- 1371
Dow, Hiram M ---- 1355
Eberstadt, F ---- 2279
Fell, Harold B ---- 1323
Fernald, Henry B ---- 969
Gibbons, George C ---- 1376
Goodner, E. H ---- 1409
Gore, Hon. Thomas P ---- 1311
Gurney, Hon. Chan ---- 1819
Harbaugh, M. D ---- 982
Holbrook, George ---- 1362
Hunter, J. C ---- 1309
Interstate Oil Compact Commission ---- 1355
Johnson, Hon. Hiram W ---- 2152
Kansas Independent Oil Producers ---- 1361
Kellar, Kenneth ---- 1819
Kilgore, Hon. Harley M ---- 1358
Lee, Hon. Josh ---- 1356
McCarran, Hon. Pat ---- 1923
Michigan Oil and Gas Association ---- 1379
Montana State Oil Conservation Board ---- 1378
Morgenthau, Hon. Henry, Jr ---- 6, 25
Murray, Philip ---- 319
Neely, Hon. Matthew M ---- 1359
Nelson, Dr. Wilbur A ---- 1928
Paul, A. Harding ---- 2237
Pennsylvania persons and organizations favoring, list ---- 1943
Petroleum Industry War Council report ---- 1334
Robertson, Jeff A ---- 1973
Swann, A. K ---- 1368
Thomas, Hon. Elmer ---- 1358, 1405
Willis, C. G ---- 2152
Depreciation deduction: Shorb, Paul E ---- 1742
Distilled spirits:
Botwinick, Benjamin ---- 1562
Cilento, Sol ---- 1554
Cox, Millard ---- 1547
Flore, Edward T ---- 1555
Law, John ---- 1559
Lourie, Harry L ---- 1560
Regan, Joseph ---- 1553
Distilled spirits, nonbeverage: Burnett, George H ---- 2124
Dividends, distribution of: Kellogg, Howard ---- 347
Dividends, treatment of: Hyde, William Truslow, Jr ---- 159
Distributions by corporations: McFarland, Elden ---- 2232
Documents, payment of stamp taxes on:
Bliss, D. S ---- 1809
Massachusetts Cooperative Banks ---- 1808
Double taxation: Friedman, Elisha M ---- 1299

Estate and gift taxes: Page
Kern, Paul J — 2204
Kilpatrick, H. Cecil — 361
Murray, Philip — 320
New York City Bar Association — 2348
Osgood, Roy C — 1717
Estate tax: Harris, Samuel K — 1581
Estates of nonresident, exemptions of: Osgood, Roy C — 1724
Estates of United States residents, double taxation of: Friedman, Elisha M — 1299
Excess-profits tax:
Alvord, Ellsworth C — 1777
Arkwright, Preston — 1839
Baar, Arnold R — 1948
Berry, Richard F — 989
Bird, Frank W — 1859
Bowman, H. E — 1963
Bozell, Harold V — 1652
Brooks, John W — 425
Capehart, Homer E — 2225
Carroll, Mitchell B — 209
Chapman, A. B — 2077
Christensen, C. M — 797
Connolly, John L — 2172
Controllers Institute of America — 2083
Cranch, Raymond G — 1710
Dawson, A. F — 1887
Dorety, F. G — 881
Driesen, Daniel — 2254
Duff, W. H — 2352
Ehrman, Sidney M — 2269
Ferguson, Samuel — 528
Fernald, Henry B — 973
Forstall, James J — 2228
Friedman, Elisha M — 1279
Frost, Jack — 525
Gadsby, G. M — 1192
Gilbert, Early Lyman — 2355
Hardgrave, Arthur — 949
Harrington, John — 1919
Hawley, John B., Jr — 677
Hopkins, Albert L — 1755
Hotchkiss, C. F — 428
Ingebretsen, James C — 2252
Jouett, John H — 1829
Kellogg, C. W — 1873
Kelly, William J — 914
Kern, Paul J — 2204
Kline, Clayton E — 1862
Langley, William C — 1629
Laylin, Clarence D — 1659
Lewis, Charles W — 2206
Manufacturers Association of Connecticut, Inc — 993
McCarran, Hon. Pat — 1927
McCarter, Thomas M — 1851
McWain, L. J — 1982
Miller, Robert N — 351
Morgenthau, Hon. Henry, Jr — 7
Moylan, Frank J — 1895
Nelson, Dr. Wilbur A — 1929
Nemzek, Theodore C — 2137
New York City Bar Association — 2347
Nixon, Russ — 333
Norris, K. T — 1010
Ogg, J. S — 1827
Pach, G. V — 367
Patton, Thomas F — 908

Excess-profits tax—Continued. Page
Paul, A. Harding 2237
Paul, Randolph E 26
Priest, Benjamin B 405
Ralls, Robert Blount 2350
Ringer, Walter M 1569
Roberts, David, Jr 2360
Robins, James 1576
Robinson, Reid 322
Satterlee, Hugh 388
Schneider, William W 811
Seghers, Paul D 690
Seidman, M. S 147
Snyder, Daniel W 1616
Spence, Paulsen 446
Stiles, James P., Jr 1423
Straus, Harry H 2178
Sutton, Louis V 2307
Tower, Carleton M 158
Weaver, H. R 2119
Whiting, Justin R 1813
Wisconsin Power & Light Co 2293
Excess-profits tax, individual: Seidman, M. L 147
Excess-profits tax on wages: Cranch, Raymond G 1712
Exchanges, computation of highest bracket amount: White, John C 383
Excise taxes: Schieffelin, W. J., Jr 998
Exemptions, individual income: Cranch, Raymond G 1715
Exemptions, servicemen: Osgood, Roy C 1724
Expenditures, reduction in nonessential:
Baar, Arnold R 1946
Ehrman, Sidney M 2271

Financing, plan of: Walters, August 734
Fiscal planning: Alvord, Ellsworth C 1762
Fiscal year:
Chapman, A. B 2091
Comer, Donald 1992
Conboy, Martin 517
Cowdin, J. Cheever 2062
Dana, Charles 1990
Ehrman, Sidney M 2270
Farrar, W. W 921
Forstall, James J 2230
Glass, I. R 1573
Group of individuals opposing 1804
Hayes, T. C 1017
Hopkins, Albert L 1752
Hoyt, Fred 1026
Hughes, John E 1020
Kellogg, Howard 347
Kolb, Clifton 1031
Laylin, Clarence D 1656
Little, Royal 336
McFarland, Elden 2234
Nemzek, Theodore C 2141
New York City Bar Association 2346
Oehler, I. C 1988
Quinlan, J. J 1803
Skoner, Lee J 1007
Stokely, William B., Jr 1024
Tripp, L. E 1190
Weil, James M 1493
Wiseman, John 2147
Forfeiture of contract: Schultz, Raymond H 2213
Foreign corporations, treatment of: Savoy, Prew 924
Foreign countries and possessions, tax of: Carroll, Mitchell B 206

Foreign income of United States citizens, tax on: Page
McClintock, E. I 761
McGovern, Maurice T 743
McGrath, James E 750
Nave, Cyril W 747
Richardson, George F 763
Royce, Alexander Burgess 1204
Sollenberger, W. S 756
Swingle, William S 774
Wright, Harry 760
Foreign tax credit: Chapman, A. B 2091
Foreign war losses: Kent, Arthur H 2093
Foreign wartime taxation: Friedman, Elisha M 1283
Freight and express tax:
Arata, Frank B 536
Baar, Arnold R 1951
Batchelder, K. C 1074
Bean, Ormand R 1086
Billings, C. L 537
Boise Chamber of Commerce 536
Brenckman, Fred 1691
Bruce, J. G 535
Craig Mountain Lumber Co 537
Crapo, P. M 1077
Cordon, Alfred C 534
De Long, C. L 534
Deuel, J. J 2342
Donaldson, C. V 1086
Ehrman, Sidney M 2270
Elliott, Hon. A. J 2342
Flaherty, R. D 1081
Fletcher, R. V 851
Geddes, W. C 537
Hamley, Frederick G 1080
Harlan, E. G 536
Hendrickson, Hon. Roy F 2341
Hogue, F. H 536
Idaho Farm Bureau Federation 534
Idaho State Chamber of Commerce 536
Lytle, R. D 1082
McCarran, Hon. Pat 1927
McCune, Jay W 1084
Morgenthau, Hon. Henry, Jr 7, 30
Nelson, Dr. Wilbur A 1929
Norman, J. V 988
North Pacific Millers' Association 1082
Palumbo, J. C 536
Plette, Ivan L 1085
Potlatch Forests, Inc 537
Rahn, A. A. D 895
Seattle Traffic Association 1083
Shafer, George, Jr 1078
Shepherd, Ralph L 1083
Shevlin, Carpenter & Clarke Co 895
Sutton, A. E 1085
Tacoma Chamber of Commerce 1084
Thomas, Hon. John 533

Gain or loss, recognition of: McCobb, Edward C 2111
Gasoline, price of: Paul, Randolph E 31
Gasoline tax:
American Association of State Highway Officials 2289
Arkansas users opposed to tax, list 2317
Bailey, Hon. Bob 2316
Bushfield, Hon. Harlan J 2324
Caraway, Hon. Hattie 2286

Gasoline tax—Continued. Page
Cavanaugh, Leo R 2323
Everett, F. E 2323
Fontenot, Rufus W 2319
Ford, Hon. Sam 2320
Girling, W. R 2319
Hurley, Frank C 2316
James, Richard T 2319
Jones, Roy B 2327
Lawrence, John V 816
McKellar, Hon. Kenneth 2327
Miles, F. L 2328
Montana State officials opposed to tax, list 2320
Provis, B. M 2318
Rhode Island users opposed to tax, list 2324
Sours, Hal G 2023
South Dakota State Highway Commission 2326
Summers, Turner A 2317
Tobey, Hon. Charles W 2321
Ullrich, Lew 2318
Walker, L. M 2156
General statement:
Alvord, Ellsworth C 1762
Associated Industries of Massachusetts 709
Baar, Arnold R 1944
Bowen, E. R 1586
Colborn, I. L 1556
Controllers Institute of America 2081
Cowdin, J. Cheever 2057
Drefs, Arthur G 2285
Ferguson, Samuel 528
Fernald, Henry B 969
Gilman, Mrs. S. H 712
Harnischfeger Corporation 2241
Harper, Ford C 1830
Hooper, John W 1163
Iglauer, Jay 823
Illinois Manufacturers' Association 1920
Javits, Benjamin 2117
Kern, Paul J 2200
Klein, Joseph J 1507
Laylin, Clarence D 1656
Luhrsen, J. G 1579
Marsh, Benjamin C 226
Miller, Martin H 2153
Nash, Al 2348
New York Social Democratic Federation 1810
Ohio Chamber of Commerce 1663
Parker, Lovell H 1463
Powers, Leland 707
Reece, Millard 730
Schieffelin, W. J., Jr 997
Seghers, Paul D 691
Sutherland, William A 1419
Tanzer, Lawrence A 699
United Automobile, Aircraft and Agricultural Implement Workers of America, C. I. O 2348
Vernon, Weston 2345
Wisconsin Shipbuilding Co 2191
Young, Benjamin E 887
Gifts reduced, specific exemptions of: Osgood, Roy C 1724
Gross income: Porter, J. W 883
Gross income, deductions from: Miles, C. O 2337
Gross income, exclusions from: Fletcher, R. V 832
Gross income tax: Townsend, Dr. Francis E 1543

Page
Gross profits tax: Johnson, Arthur L. 2247
Gross sales tax, graduated: Priestley, T. J. 943
Growth company: Fraser, A. D. R. 1176

Head tax, Federal: Sandblast, L. B. 2197

Incentive saving: Cooper, Walter A. M. 1596
Incentive taxation: Hazelett, C. William 937
Income and profits limitation: Comer, Donald 1994
Income, earned, from sources without United States:
Easley, George A. 2123
McClintock, E. I. 761
McGovern, Maurice T. 743
McGrath, James E. 750
Nave, Cyril W. 747
Pichardson, George F. 763
Shorb, Paul E. 1744
Sollenberger, W. S. 756
Swingle, William S. 774
Wright, Harry 760
Income, nontaxable: Alvord, Ellsworth C. 1767
Income, special tax on part spent: Fisher, Irving 2163
Income tax: New York City Bar Association 2345
Income tax, individual:
Cowdin, J. Cheever 2065
Driesen, Daniel 2255
Income-tax liability, adjustments in:
Blodgett, George R. 412
Clapp, A. W. 419
Income tax plan, pay-as-you-go: Ruml, Beardsley 175
Income tax rates, corporation: Ehrman, Sidney M. 2269
Income, taxable net:
Alvord, Ellsworth C. 1776
Harnischfeger Corporation 2246
Individual income tax:
Greenfield, Samuel C. 1531
Haddock, Hoyt S. 330
Little, Royal 339
Murray, Philip 315
Nixon, Russ 332
Robinson, Reid 322
Seidman, M. L. 145
Shorb, Paul E. 1731
Wells, Marguerite M. 1303
Individual normal tax: Schieffelin, W. J., Jr. 997
Individual tax liabilities: Blough, Roy 18
Individual tax returns: Blough, Roy 18
Installment sales, taxation of: Schultz, Raymond H. 2213
Insurance, other than life:
Barton, Walter E. 794
Chapelle, C. C. 2047
Cooper, Harry W. 1974
Ekern, Herman L. 2025
Freeman, Hovey T. 2041
Gross, Harry F. 2018
Gruhn, A. V. 2001
Hurst, O. E. 2018
Jacobs, Floyd E. 1485
Murphy, Ray 2050
Polk, James K. 2329
Smart, J. D. 2046
Wood, George A. 2106
Insurance, stock companies:
Joyce, William B. 2016
Pink, Louis H. 2049
Insurance, taxation on surplus: Pink, Louis H. 2049

Intangible drilling and development costs: Page
Internal Revenue Bureau, Regulation 103 1353
Gibbons, George C 1376
Interest, deduction of, denied: Hodes, James 1621
Inventory reserve:
Chapman, A. B 2088
Cowdin, J. Cheever 2063
Harnischfeger Corporation 2244
Illinois Chamber of Commerce 1951
Paul, Randolph E 1094
Puckett, B. Earl 1089
Inventory valuation:
Adair, Herbert 2111
Arisman, George M 2108
Invested capital base: Robineau, M. H 443
Invested capital, exchanges and liquidation: Satterlee, Hugh 389
Investment companies, regulated:
Higgins, Allan H. W 907
Jaretzki, Alfred, Jr 906
Morton, William F 899
Sholley, S. L 904
Wood, George A 2106
Life insurance:
Anderson, C. Vivian 1972
Association of Life Insurance Presidents 1303
Baar, Arnold R 1950
Baker, Lawrence E 787
Barton, Walter E 794
Colerick, Guy 776
Hess, Beecher 1971
Hodes, James 1621
Illinois Chamber of Commerce 1950
Osgood, Roy C 1719
Tyrrell, Richard H 2358
Witherspoon, John A 781
Limitations, statute of:
Hopkins, Albert L 1753
McClure, John E 1585
Mandatory joint returns:
Haddock, Hoyt L 330
Katz, Mrs. Julia 334
Morgenthau, Hon. Henry, Jr 6
Murray, Philip 318
Paul, Randolph E 31
Medical expenses, deduction for:
Kern, Paul J 2204
National Association of Retail Druggists 1676
Mortgage foreclosures, income tax consequences of: Shorb, Paul E 1745
Musical instruments, tax on: McFarland, Elden 2234
National income:
Morgenthau, Hon. Henry, Jr 17
O'Donnell, Al F 23
National lottery: Seghers, Paul D 696
Net gifts reduced, exemptions from: Osgood, Roy C 1724
Nonresident alien individuals, tax on income: Banser, John C 1196
Nontrade or nonbusiness deductions:
McFarland, Elden 2233
Shorb, Paul E 1733
Normal and surtaxes:
Alvord, Ellsworth C 1776
Baar, Arnold R 1948
Chapman, A. B 2077
Connolly, John L 2172
Harrington, John 1919
Langley, William C 1471
Seghers, Paul D 689
Weaver, H. R 2119

	Page
Normal tax:	
Citron, William	155
Tower, Carleton M	157
Normal tax rate, individual: Baar, Arnold R	1950
Oil, tax on lubricating: Keller, Joseph E	2308
Oil, tax on reclaimed lubricating:	
Harrison, James S	2329
Palin, Willard P	2296
Sonneborn, Rudolph G	2323
Pari-mutuel wagering, tax on:	
Chindgren, H. H	2198
Florida State Legislature	1123
Florida State Racing Commission	1126
Holland, Hon. Spessard	1114
Swope, Herbert W	1098
Underwood, Thomas R	1105
Partnerships, tax on: Cranch, Raymond G	1712
Pay-as-you-go tax plan:	
Alvord, Ellsworth C	1771
Ruml, Beardsley	175
Pension trusts:	
Beers, Henry S	483
Bright, Joseph E	469
Bucher, G. H	1821
Chapman, A. B	2089
Christian, A. M	467
Despain, Donald	1951
Duhig, Standley W	512
Erickson, Edwin R	2134
Forster, H. Walter	494
Goldstein, Meyer M	505
Hansen, Arthur S	498
Jones, E. Leigh	514
Klein, Eugene M	472
Maduro, Denis B	508
New York City Bar Association	2346
Sturtevant, Richard D	455
Wear, Wilbert	1835
Personal exemptions: Paul, Randolph E	27
Personal finance companies: Fowler, Edgar F	2340
Personal holding companies:	
Brach, Henry	1496
Frost, Norman B	1305
Levine, Leonard	673
McFarland, Elden	2232
New York City Bar Association	2347
Sawyer, Charles	1302
Petroleum requirements: Office of Petroleum Coordinator	1345
Photographic apparatus, tax on: Webster, Monroe	1818
Postponement of tax collection:	
Blake, Octave	2142
Garrison, J. D	2141
Post-war credits:	
Baar, Arnold R	1948
Chatters, Carl H	643
Cowdin, J. Cheever	2061
Cranch, Raymond G	1714
Dewey, Hon. Charles S	1152
Ehrman, Sidney M	2270
Hobby, Hon. W. P	739
Jouett, John H	1829
Kelly, William J	914
Kelly, Ralph	1985
Kingsbury, F. B	1594
Laylin, Clarence D	1660

Post-war credits—Continued. Page
Matthisen, A. F 1682
Ringer, Walter M 1566
Robins, James 1576
Post-war losses, allowances for: Chapman, A. B 2087
Post-war recovery reserve:
Davidson, Clinton 268
Sullivan, F. M 277
Woll, Matthew 276
Post-war refund:
Morgenthau, Hon. Henry, Jr 23
Vallier, L. C 1492
Prepayment of anticipated deficiencies: Chapman, A. B 2092
Profit sharing:
Bright, Joseph E 469
Christian, A. M 467
Despain, Donald 1951
Forster, H. Walter 494
Hansen, Arthur S 498
Sturtevant, Richard D 457
Profits and income limitation: Comer, Donald 1994
Property paid in, basis of: Hopkins, Albert L 1755
Public utility taxation:
Duff, W. H 2351
Friedman, Elisha M 1244, 1254

Radio broadcasting tax:
Alvord, Ellsworth C 729
Haggerty, John B 716
Hushing, W. C 2154
McCurry, John J 2277
National Association of Broadcasters 729
Paul, Randolph E 721
Treasury Department, Division of Tax Research 722
Railroads, tax problems of:
Association of American Railroads 854
Bell, Marcus L 861
Fletcher, R. V 854
Whitlock, A. N 876
Refrigerators, tax on: Henderson, William B 682
Renegotiation of contracts:
Cowdin, J. Cheever 2065
Fernald, Henry B 980
Gilbert, Early Lyman 2354, 2357
Paul, Randolph E 1007
Ringer, Walter M 1566
Tyrrell, Richard H 2359
Reorganization, railroad company: Atkinson, Arthur K 376
Reorganized companies, determination of tax liability of: McCobb, Edward C 2111
Revenue revision of 1942, specific suggestions: Brooklyn Chamber of Commerce 1172
Revenue revision recommendations: Federal Tax Forum 697
Ruml pay-as-you-go tax plan 175

Safe deposit boxes, tax on: Parton, George F 370
Salaries, increases in: Morgenthau, Hon. Henry, Jr 24
Salary limitation:
Comer, Donald 1994
Cowan, Nathan E 313
Cranch, Raymond G 1711
Haddock, Hoyt S 329
Katz, Mrs. Julia 335
Kern, Paul J 2203
Little, Royal 340
Murray, Philip 317
Nixon, Russ 329
Robinson, Reid 322
Seidman, M. L 152

Sales tax: Page
Anderson, C. Vivian 1972
Appelbe, Clark 326
Baar, Arnold R 1947
Cowan, Nathan E 313
Cowdin, J. Cheever 2066
Cranch, Raymond G 1709
Gilman, Mrs. S. H 713
Haddock, Hoyt S 331
Hazelett, C. William 929
Ingebretsen, James C 2252
Katz, Mrs. Julia 335
Kern, Paul J 2205
Laylin, Clarence D 1662
Lee, Algernon 1810
Little, Royal 342
Murray, Philip 320
Nixon, Russ 331
Paul, Randolph E 21
Priestley, T. J 943
Robinson, Reid 323
Rothschild, Meyer D 1210
Seghers, Paul D 689
Strong, Homer 1918
Townsend, Dr. Francis E 1541
Tripp, L. E 1191
Sales tax, graduated: Schieffelin, W. J., Jr 998
Sales tax receipts in Canada and Great Britain: Paul, Randolph E 22
Seven-point tax program:
Appelbe, Clark 325
Cowan, Nathan E 312
Cranch, Raymond G 1715
Haddock, Hoyt S 327
Murray, Philip 314
Nixon, Russ 328
Robinson, Reid 321
Small-business relief: Colborn, I. L 1557
Social-security taxes:
Cranch, Raymond G 1714
Laylin, Clarence D 1661
Ohio Chamber of Commerce 1663
Special privileges:
Driesen, Daniel 2255
Kern, Paul J 2203
Morgenthau, Hon. Henry, Jr 3
Nixon, Russ 330
Spendings tax: Fisher, Irving 2163
Stamp tax, payment of, on stocks and bonds of domestic building and loan associations:
Massachusetts Cooperative Banks 1808
Bliss, D. S 1809
State and municipal bonds:
American Bar Association 641
Chatters, Carl H 643
Cranch, Raymond G 1714
Epstein, Henry 665
Ely, Northcutt 638
Fairchild, Prof. Fred R 631
Fox, Charles J 658
Green, Hon. W. Cooper 662
Jeffries, Hon. Edward J 570
La Guardia, Hon. Fiorello 565
Long, Henry F 548
Lutz, Prof. Harley L 549
Morgenthau, Hon. Henry, Jr 3
Municipal Finance Officers Association 645
Murray, Philip 318
National Education Association 640

State and municipal bonds—Continued. Page
Resolutions and letters from various State and municipal groups and from individuals 579
Seasongood, Murray 641
Stokes, Edward L 1978
Tobin, Austin J 539
Surtax rates: Little, Royal 341

Tax Appeals, Board of:
Biddle, Hon. Francis 2297
Klepinger, Robert F 2300
Law Notes 2301
Murdock, Hon. J. E 2304
Sutherland, William A 1419
Tax, four-point plan: Keyser, C. R 1822
Tax plan, net income: Lapp, Grover W 196
Tax relief: Thatcher, George B 1928
Taxable income, computing: Fletcher, R. V 843
Taxation and cost of living: Morgenthau, Hon. Henry, Jr 2
Taxes, monthly payment of: Seidman, M. L 147
Technical amendments:
Controllers Institute of America 2083
McFarland, Elden 2236
New York City Bar Association 2347
Tyrrell, Richard H 2358
Technical provisions of H. R. 7378, amendments urged: Alvord, Ellsworth C 1795
Technical suggestions: American Institute of Accountants 1605
Telephone, telegraph tax: Bozell, Harold V 1644
Time for filing returns, extension of: Byerly, F. B 2136
Tobacco prices to farmers: Barkley, Hon. Alben W 1942
Tobacco tax:
Byrd, Hon. Harry F 1969
Caldwell, Harry B 1938
Lanier, J. C 1930
Larus & Bros. Co 1971
May, William H 1001
Toilet preparations, tax on:
Broudy, David M 219
Freiberg, L. A 2143
Schlesinger, Walter C. B 222
Transportation tax:
Anthracite Institute 809
Madeira, Louis C., III 809
Norman, J. V 988
Treasury program: Morgenthau, Hon. Henry, Jr 3

Undistributed profits tax:
Gresham, T. D 2343
Sutherland, William A 1422
Viser, Harry L 1306
Zens, Paul 1160
Unemployment taxes, credit against: Brewster & Steiwer 1706

War consumption taxes: Cowdin, J. Cheever 2066
War, expenditures of: Morgenthau, Hon. Henry, Jr 1
War financing:
Denson, W. A 2157
National Association of Manufacturers 2068
Young, Benjamin E 894
War losses in foreign countries: Chapman, A. B 2088
War spending, efficiency in: Alvord, Ellsworth C 1770
Wartime taxation: Friedman, Elisha M 1283
Watches, tax on: Kendig, C. M 2291
Wines, tax on: Wine industry representatives 2271
Withholding of tax at the source:
Seidman, M. L 147
Schieffelin, W. J., Jr 1004
Working wife credit: Paul, Randolph E 27