RENEGOTIATION OF CONTRACTS

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

SEVENTY-SEVENTH CONGRESS

SECOND SESSION

ON

Sec. 403 of Public Law Numbered 528

AN ACT MAKING ADDITIONAL APPROPRIATIONS FOR THE NATIONAL DEFENSE FOR THE FISCAL YEAR ENDING JUNE 30, 1942, AND FOR OTHER PURPOSES

SEPTEMBER 29 AND 30, 1942

Printed for the use of the Committee on Finance

UNITED STATES
GOVERNMENT PRINTING OFFICE
77629 WASHINGTON : 1942

COMMITTEE ON FINANCE

WALTER F. GEORGE, Georgia, *Chairman*

DAVID I. WALSH, Massachusetts
ALBEN W. BARKLEY, Kentucky
TOM CONNALLY, Texas
JOSIAH W. BAILEY, North Carolina
BENNETT CHAMP CLARK, Missouri
HARRY FLOOD BYRD, Virginia
PETER G. GERRY, Rhode Island
JOSEPH F. GUFFEY, Pennsylvania
PRENTISS M. BROWN, Michigan
CLYDE L. HERRING, Iowa
EDWIN C. JOHNSON, Colorado
GEORGE L. RADCLIFFE, Maryland
WILLIAM H. SMATHERS, New Jersey

ROBERT M. LA FOLLETTE, JR., Wisconsin
ARTHUR CAPPER, Kansas
ARTHUR H. VANDENBERG, Michigan
JAMES J. DAVIS, Pennsylvania
HENRY CABOT LODGE, JR., Massachusetts
JOHN A. DANAHER, Connecticut
ROBERT A. TAFT, Ohio

CHRISTIE B. KENNEDY, *Clerk*

SUBCOMMITTEE ON FINANCE

DAVID I. WALSH, Massachusetts, *Chairman*

ALBEN W. BARKLEY, Kentucky
TOM CONNALLY, Texas
BENNETT CHAMP CLARK, Missouri

ROBERT M. LA FOLLETTE, JR., Wisconsin
ARTHUR CAPPER, Kansas
ARTHUR H. VANDENBERG, Michigan

CONTENTS

RENEGOTIATION OF CONTRACTS

TUESDAY, SEPTEMBER 29, 1942

UNITED STATES SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON FINANCE,
Washington, D. C.

EXECUTIVE SESSION

The subcommittee met at 10:30 a. m., pursuant to notice, in room 310, Senate Office Building, Senator David I. Walsh (chairman) presiding.

Senator WALSH. I ask to have copied into the record at this point, before we proceed with any testimony, section 403 of Public 528.

(Sec. 403, Public Law 528, 77th Cong., ch. 247, 2d sess., is as follows:)

SECTION 403. (a) For the purposes of this section, the term "Department" means the War Department, the Navy Department, and the Maritime Commission, respectively; in the case of the Maritime Commission, the term "Secretary" means the Chairman of such commission; and the terms "renegotiate" and "renegotiation" include the refixing by the Secretary of the Department of the contract price. For the purposes of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) The Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department (1) a provision for the renegotiation of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty; (2) a provision for the retention by the United States or the repayment to the United States of (A) any amount of the contract price which is found as a result of such renegotiation to represent excessive profits and (B) an amount of the contract price equal to the amount of the reduction in the contract price of any subcontract under such contract pursuant to the renegotiation of such subcontract as provided in clause (3) of this subsection; and (3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (A) a provision for the renegotiation by such Secretary and the subcontractor of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty, (B) a provision for the retention by the United States or the repayment to the United States of any amount of the contract price of the subcontract which is found as a result of such renegotiation, to represent excessive profits, and (C) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by or repaid to the United States.

(c) 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 from the contractor or subcontractor any amount of the contract price which is found as a result of renegotiation to represent excessive profits, and (3) in case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor; to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United

States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States. All amounts recovered under this subsection shall be covered into the Treasury as miscellaneous receipts. This subsection shall 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.

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable. For the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred, each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each Department shall have the right to demand of any contractor who holds contracts, with respect to which the provisions of this section are applicable, in an aggregate amount in excess of $100,000 statements of actual costs of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who willfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any such statement containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the Department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

(f) The authority and discretion herein conferred upon the Secretary of each Department, in accordance with regulations prescribed by the President for the protection of the interests of the Government, may be delegated in whole or in part by him to such individuals or agencies in such Department as he may designate, and he may authorize such individuals or agencies to make further delegations of such authority and discretion.

(g) If any provision of this section or the application thereof to any person or circumstance is held invalid, the remainder of the section and the application of such provision to other persons or circumstances shall not be affected thereby.

(h) This section shall remain in force during the continuance of the present war and for three years after the termination of the war, but no court proceedings brought under this section shall abate by reason of the termination of the provisions of this section.

Senator WALSH. Secretary Patterson.

Mr. PATTERSON. Yes, sir.

Senator WALSH. Come forward.

I understand, Mr. Secretary, that you think it might be in the public interest to have the press hear your statement. At least, you have no objection?

Mr. PATTERSON. No objection to that.

Senator WALSH. Therefore, the press may be present while Secretary Patterson is testifying before the committee.

Mr. Secretary, we will be glad to hear your views on this problem which confronts this subcommittee of the Finance Committee.

Mr. PATTERSON. I have a statement, Mr. Chairman. It covers in general the War Department's views as to the general policy to be served by section 403, and then discusses some suggested amendments of a clarifying nature which we believe will make section 403 and the price adjustment more workable and will answer certain objections that have arisen in our experience under that act.

Senator WALSH. Proceed.

STATEMENT OF HON. ROBERT C. PATTERSON, UNDER SECRETARY OF WAR

Mr. PATTERSON. Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, providing for the renegotiation of contracts and subcontracts became effective on April 28, 1942.

Section 403 originated in the adoption on the floor of the House of Representatives of the Case amendment to H. R. 6868 (Sixth Supplemental National Defense Appropriation Act, 1942) the purpose of which was to limit the profits on any war contract to 6 percent. For reasons which were fully stated to the Senate Subcommittee on Appropriations, the War Department suggested the elimination of this provision. At the request of the chairman of that subcommittee, Mr. Donald Nelson and representatives of the War and Navy Departments agreed to suggest a substitute method of preventing excessive profits on war contracts.

The suggested substitute which was presented by General Somervell was based on the theory that if every contract price could be reexamined by the parties in the light of actual experience under the contract, it should be possible to eliminate the bulk of excessive profits. No other compulsion upon the contractor was contemplated than:

(1) To furnish adequate data as to actual and legitimate costs; and

(2) In the light of such data to bargain in good faith, for the purpose of readjusting the contract price. It was thought that existing contracts could properly be subjected to such reexamination and the proposal submitted to the subcommittee accordingly so provided. This proposal in effect would have given statutory sanction and implementation to voluntary readjustment of contract prices which was being widely practiced by the armed services prior to the adoption of the Case amendment.

Senator WALSH. The Case amendment was adopted by the House and when the bill came to the Senate, the Case amendment was in it and this section that you are discussing was substituted for the Case amendment in the Senate.

Mr. PATTERSON. That is exactly right; yes.

Senator WALSH. Senate Appropriations Committee.

Mr. PATTERSON. Yes.

The statute as finally enacted differed radically from the proposal submitted by General Somervell. In substance, it imposed upon each of the services the duty of eliminating excessive profits by a process of renegotiation. Every contract and every subcontract made by every prime contractor is required to contain a provision for such renegotia-

tion without regard to whether in the judgment of the Secretary such a provision was necessary or appropriate.

In other words, it was sweeping.

The term "renegotiation" was so defined as, in the opinion of many lawyers, to authorize the Secretary to refix a contract price regardless of agreement with the contractor or subcontractor. In the light of the legislative history of the act, there may be serious doubt as to whether it was the actual intention of Congress to confer any such power of unilateral redetermination of the contract price, but the words clearly permit of such construction and it has been widely adopted by the business community.

Finally, the statute seems clearly to contemplate something more than the reduction of contract prices found to be excessive; in cases where excessive profits have already been paid to contractors, a clear duty seems to be imposed upon the Secretary to recapture such profits by various devices suggested in the statute. Thus the statute seems to impose upon the Secretary the duty of recovering excessive profits as well as the duty of reducing unreasonable prices.

The Sixth Supplemental National Defense Appropriation Act, 1942, became effective on April 28, 1942. Three days prior thereto the War Department organized a Price Adjustment Board to assist the Secretary in carrying out the mandate of the statute. There followed a period of study and organization as a result of which the Board was finally reorganized and designated as the War Department Price Adjustment Board. That Board, of which Mr. Maurice H. Karker is now chairman, is at present charged with the duty of supervising on behalf of the War Department the performance of the duties imposed upon it by the statute. I should like to file with the committee a copy of a memorandum signed on June 30, 1942, defining the functions of the Board, and memoranda of July 3, 1942, and July 8, 1942, supplemental thereto. I also ask leave to file a statement of policy issued by my special representative, Col. Albert J. Browning, with my approval and addressed to the Chairman of the War Department Price Adjustment Board under date of August 8, 1942. Finally, I should like to file with the committee a copy of a statement of principles, policies, and procedure to be followed in renegotiation, published by the War Department Price Adjustment Board with my approval on August 10, 1942.

Senator WALSH. It may be filed.

Mr. PATTERSON. The statute in its present form presents various difficulties of administration. Before undertaking to discuss them, however, I think that I should deal with certain objections to the statute which have been advanced from time to time. Some of these are based on misinformation or a misunderstanding of the practice of the boards. Thus, some have said that renegotiation consumes a large amount of the time of executives who should be devoting their time to production. This charge is not well founded. The Board has striven to reduce the time required for renegotiation by dealing with all contracts and subcontracts as a group for a specified period such as the fiscal year of the contractor and by not requiring any further renegotiations during the agreed period. Furthermore, the boards have limited their requests for information, reports, and their auditing to the minimum amount consistent with fairness and sound ad-

ministration. In the absence of unusual circumstances the actual renegotiation with a contractor should not consume more than a few days during an entire fiscal year. The claim that executives must be constantly in Washington for this purpose is therefore ill-founded.

Certain other objections which have been made are based on the fact that the statute is phrased in general terms and does not specifically cover some of the questions which have arisen in practice. Of necessity these questions which have arisen have been resolved in the light of the purposes of the statute and the practical requirements of administration. As I will point out later, it is probably desirable to amend the statute to eliminate these uncertainties.

There are objections to the statute, however, which raise more fundamental questions. It is contended that the statute is unfair to the contractor in that it permits the Government to obtain relief from a bad bargain while denying the same right to the other party to the contract. It is also contended that the statute leaves contractors uncertain with respect to their profits and thereby impairs their ability to obtain bank credit and to establish policies with respect to dividends and reserves. Furthermore, the failure of the statute to fix standards for determining what are excessive profits makes it difficult to obtain uniformity of treatment between contractors similarly situated. Finally, it is contended that the statute removes all incentives for efficient operation by giving the contractor his cost plus a percentage over costs and by treating the efficient and inefficient alike.

In evaluating these criticisms it is necessary to consider the problem which the statute was intended to meet and the alternative methods available for that purpose. The problem arose out of a situation which was without precedent. Contractors had been asked to produce in the shortest possible time war materials of a kind or kinds with which they had had no prior experience or in quantities beyond anything they had ever attempted. Costs could not be estimated with accuracy and when tested by actual production the estimates frequently proved to be far too high. In many cases there resulted very large profits which the contractors themselves neither anticipated nor wished to retain. Under these circumstances some method had to be provided by which the prices in the contracts let under such circumstances could be adjusted to a reasonable and fair basis. As I have already pointed out, varius expedients were considered for this purpose and section 403 was chosen from the methods proposed.

In the meantime the close control of prices and profits in war materials has become a vital part of the campaign to prevent inflation, and to promote the most efficient use of manpower, materials, and productive capacity. Extensive controls have already been imposed on a large part of the national economy and wider restrictions are in prospect. Under these conditions prices of military equipment and material must likewise be carefully controlled. Because of the wide diversity of conditions in war industry, regulation by ordinary price ceilings is not feasible and would involve a division of authority between the Office of Price Administration and the services in procurement of war materials. For these reasons we have requested the Office of Price Administration to refrain from regulating prices in

this special field. In doing so we have undertaken a responsibility to make certain that such prices do not rise improperly.

That agreement with the Office of Price Administration is now in the course of consummation, whereby they will not move into the field of aircraft, tanks, machine guns, but will leave the regulation of those prices to the War Department and to the Navy Department, and we believe, as part of our obligation under that, that the renegotiation of contracts and the price adjustment procedure plays a very important part in discharging our responsibility.

Senator BARKLEY. Mr. Chairman, I have got to go to the floor. I am sorry I cannot hear the rest of Judge Patterson's statement. I don't know if there will be a vote today, but I wish to be recorded as in favor of the amendment to the act, and against its repeal.

Senator WALSH. Very well, Senator. I don't think there will be any vote today. You can read the record.

Senator BARKLEY. Yes.

Senator WALSH. Judge Patterson, does the Government expect to be able to save money by that agreement?

Mr. PATTERSON. We think so. But the main purpose is to prevent divided authority in the procurement of aircraft and leave the authority where it has always been, with the War Department or the Navy Department, and not have two governmental agencies moving in on the contracting procedure with aircraft producers.

Senator WALSH. You may proceed.

Mr. PATTERSON. Three alternatives are now available. Section 403 can be repealed and nothing substituted. Again section 403 can be repealed and a fixed percentage profit limitation enacted in its place—as was the purpose of the original Case amendment.

Senator WALSH. That was the purpose of the proposal of Senator George.

Mr. PATTERSON. Another form of that same control.

Senator WALSH. Which, as I understand, was only presented to the committee for study, and not with his full approval or endorsement.

Mr. PATTERSON. Yes, sir.

Finally section 403 could be amended to eliminate its defects without impairing its benefits. Obviously, the repeal of the statute without enacting a substitute would leave the problem of profit and price control completely unsolved.

Senator VANDENBERG. May I ask, at that point, Judge Patterson: I assume that comment means that you think it is impossible to reach excessive profits through an excess-profits tax alone; is that correct?

Mr. PATTERSON. Yes, sir; effectively, without controlling prices and profits that we believe to be essential.

I don't believe that an excess-profits tax alone would control those elements. That is developed in a few minutes, Senator.

Senator VANDENBERG. All right.

Senator WALSH. Do you mean by that, a general excess-profits tax or a special excess-profits tax relating only to war contracts?

Mr. PATTERSON. Well, both. In general, we are against any special tax levied on war contractors alone and not on the general business community.

Senator WALSH. Have you any suggestion upon the limitation of profits—outright limitation of profits?

Mr. PATTERSON. I am coming to that in just a moment, Senator.

Senator WALSH. All right.

Mr. PATTERSON. Furthermore, the War Department believes that a flat profit limitation does not meet the needs of the situation. We are convinced that section 403, if amended as hereafter suggested, affords the best solution of the problem so far proposed. Our reasons for this preference for renegotiation instead of a flat profit limitation are as follows:

(1) Effect on costs: In our view, the control of profits is an integral part of the problem of controlling costs and prices, and any method must be evaluated by its effects on all three aspects. From this point of view, we feel that renegotiation is far superior to a fixed percentage limitation.

Undoubtedly, renegotiation can either help or hinder the control of costs, depending on the policies followed. Reduction of current contract prices through renegotiation and consequent prevention of excessive profits before they accrue have the tendency to keep costs at a minimum. In this respect renegotiation is distinguishable from a fixed profit limitation which reaches profits only after they accrue and affords no incentive to reduction of costs. In the administration of the statute greater emphasis is therefore being placed on reductions in contract prices for future performance to reasonably close margins to promote such cost control.

On the other hand, renegotiation for the purpose of recapturing past profits has a tendency to impair incentives for contractors to reduce costs, unless the policy is to distinguish between contractors on the basis of efficiency in keeping costs down. If a uniform flat percentage is applied, all contracts are virtually on a cost-plus basis, and there is little incentive for performance above average. Because of this danger and for other reasons, the War Department has not favored flat limitations on profits. It is administering the renegotiation statute with a view to the relationship between profits and the control of costs, on the theory that it is sound policy to reward the more efficient. From this point of view comparison of the rate of profit of particular contractors is unwise and misleading unless the factors affecting costs have been considered. In other words, we feel that profits should be a reward for performance and that they should be judged and compared in terms of relative performance and not on the basis of flat percentages. Only by constant attention to costs as well as profits will the public interest be well served. For this reason it is the announced policy of the Price Adjustment Board to reward low-cost producers by the allowance of a greater margin of manufacturing profit. This is a second purpose which a fixed profit limitation does not accomplish.

Senator VANDENBERG. Would it interrupt you if I asked at that point, Judge Patterson, this question: You are constantly emphasizing the control of costs. As a matter of fact, does your renegotiation process go into the question of costs?

Mr. PATTERSON. Yes, sir.

Senator VANDENBERG. To the degree which attempts to eliminate excessive costs?

Mr. PATTERSON. Yes, sir.

Senator VANDENBERG. And excessive profits?

Mr. PATTERSON. Yes, sir; that is true.

Senator VANDENBERG. Isn't the control of costs even—well, isn't it equally important with the control of profits?

Mr. PATTERSON. Yes, sir.

Senator VANDENBERG. How does it happen that all over the country, in connection with war contracts, stories are constantly heard about these enormously outrageous rates of pay for industrial activity on war contracts which would indicate that there is no adequate control over costs?

Mr. PATTERSON. I believe that most of those—most of them that have come to my attention have had to do with construction contracts, or with projects of a new nature, perhaps shipbuilding, where the necessity is to attract labor from what they have been doing to something new, like a construction project in a new place, and they have to assemble rapidly a large force of labor.

In those jobs, and especially construction jobs where wages of skilled labor have been high anyway, under the pressure of time and with the requirement that they get a large force assembled quickly, there have undoubtedly been high wages paid.

Most of the cases that have come to my notice have been of that character. It is regrettable, of course.

Senator VANDENBERG. Yes. It seems to me that whether it is true or not, the belief that war contracts present bonanzas opportunities for labor is one of the things which is seriously impairing public morale.

Mr. PATTERSON. Well, there is a good deal of truth in that.

Senator VANDENBERG. I assume, in your renegotiations, however, your renegotiation processes are unable to do anything with the labor wage-scale factor because you are bound by other governmental authorities, upon that score?

Mr. PATTERSON. That is true. When I said we tried to control costs, we take a good many elements of cost into consideration.

Senator VANDENBERG. But you are rather helpless in controlling the chief element?

Mr. PATTERSON. That is one of the chief elements.

Senator VANDENBERG. You are rather helpless to deal with it?

Mr. PATTERSON. Yes. We can't do very much on it. We can do it in the way of excessive salaries. That is different.

Senator WALSH. Excessive employees?

Mr. PATTERSON. Our control is not perfect over that, Senator. That will, undoubtedly have to be settled. Of course, there are instances where there are far too many employees on the job.

Senator WALSH. In the ordinary industry. I don't think you have difficulty about that. In the building of cantonments the padding of the pay roll by putting on a surplusage of employees, of course, you can control that.

Mr. PATTERSON. Yes. That is followed up pretty vigorously. But the costs that Senator Vandenberg mentioned are true. I have explained some of the things that cause them.

Senator WALSH. Yes.

Mr. PATTERSON. Nevertheless, they ought to be better controlled than they are.

Senator VANDENBERG. They cannot be reached through a renegotiation process. They have to be reached in some other way.

Mr. PATTERSON. That is right.

Senator WALSH. Senator Capper.

Senator CAPPER. I want to say that the bulk of the complaints, in the correspondence I am getting, is that farm help is being steadily drawn away from the farms because of the fact that they are offered two or three times as much pay on these war projects, in the war plants, and they are seriously alarmed about that situation.

Mr. PATTERSON. I can't predict that anything we do on adjustment of prices could cure that. That is a problem, too.

Senator WALSH. Senator McKellar.

Senator McKELLAR. Mr. Secretary, you spoke of being opposed to the fixed percentage. You will recall that before the Committee on Appropriations of the Senate, a substitute was offered for the House provision, a sliding scale percentage, but as I understand it, your Department is also opposed to a sliding scale percentage of profits as well as the fixed percentage.

Mr. PATTERSON. Yes, sir.

Senator McKELLAR. Yes. I am sorry I interrupted you.

Mr. PATTERSON. That is all right.

Senator WALSH. What kind of contracts is the Army making? I assume you are still making some competitive-bidding contracts?

Mr. PATTERSON. Very few.

Senator WALSH. What are the different types?

Mr. PATTERSON. We have been instructed by the War Production Board to resort to negotiated contracts rather than to the advertised bidding contract.

Senator WALSH. How about contracts of the cost-plus-a-fixed-fee?

Mr. PATTERSON. We have those. We do not care for those and our policy is against it.

Senator WALSH. The Navy is using that contract in the construction of bases other than on the continent of the United States and it has worked out, apparently, pretty well. I think the post-plus-fee averages about only 4 percent; but it is only applicable to construction outside of the continent of the United States.

Mr. PATTERSON. We don't like the cost-plus-fixed fee contract. Our policy is against it. We have discouraged it with all of the supply services.

Senator WALSH. Practically all your contracts are negotiated-price contracts?

Mr. PATTERSON. As far as we can make them. The air force have many cost-plus-fee contracts.

Senator VANDENBERG. What is your comment, Judge, on the often-repeated charge that the result of renegotiation is virtually to reduce al contracts to a basis of cost-plus-fixed-fee?

Mr. PATTERSON. There is some merit in that. We have an amendment which we suggest and which we think will overcome that objection.

Senator VANDENBERG. All right.

Mr. PATTERSON. And which will give the Secretary power to agree upon a fixed price without renegotiation for a limited period of time, say 4 months or something like that, which will furnish incentive, we believe, for the reduction of costs.

Senator WALSH. You may proceed.

Mr. PATTERSON. On the other hand, a fixed-limitation on the rate of profit based on the volume of sales will tend to discourage reductions in costs and prices. Thus a low-cost, low-price producer will have a smaller dollar volume of sales than a comparable but less efficient high-cost producer and under a profit-limitation based on sales will therefore be entitled to a smaller maximum profit. Since increases in costs and prices will raise the permissible profit, the proposal suffers from the same vice as cost-plus-a-percentage-of-cost contracts which Congress has forbidden. Of course, the relation is less direct and immediate, but it is nevertheless present and would seriously hamper the efforts by the services to keep costs down in order to reduce public expenditures and to foster efficient use of manpower and materials.

(2) Uniformity: In the second place, a flat percentage limitation does not really achieve its prime objective of uniformity of treatment. Although it allows a fixed uniform percent of profit on gross sales, this will be most unfair as applied to the diverse types of business engaged in war work. It takes no account of the fact that in different lines of business the same volume of sales may require widely different amounts of capital, skill, and work, depending on the rate of turn-over or production, the nature of the article or service, and similar factors. Moreover, some will be using Government facilities and others their own; some will be Government financed either through advance payments, direct or guaranteed loans, or cost-plus-a-fixed-fee contracts. The same maximum rate of profit for all will necessarily be unfair to many, and the diversities in war production are so great that classification even according to industries would not be feasible.

I think that it is evident that the people who make uniforms or shoes or caps have not at all the same problems as people who are making, perhaps, some new device, some new fire-control equipment or apparatus, and trying to classify them all together and make them all entitled to the same percentage of ultimate profit would not be fair.

Renegotiation, however, is sufficiently flexible to cope with this diversity. In negotiating to eliminate excessive profits and to adjust prices, the various relevant facts can be taken into account in each case. It is true that the very flexibility of renegotiation makes complete uniformity and certainty almost impossible and the necessity of dealing with cases individually creates a serious administrative burden. While recognizing this we feel that the benefits and advantages of renegotiation outweigh these disadvantages and make it preferable to other methods proposed.

I am still speaking on the flat limitation of profits.

(3) Maximum becomes minimum: Thirdly, by specifying a percentage the fixed-percentage limitation implies that contractors are entitled to receive that rate of profit.

If the rate is fixed high enough to be fair for certain contractors, it will allow others a much larger actual profit than they have heretofore been permitted. Inevitably they will seek to increase their rate of profit to the statutory maximum. This is especially objectionable where the maximum rate is based on profits after all other taxes including the excess-profits tax. Thus, in order to have the maximum rate of profit after such taxes, a contractor would often have to obtain many times that rate of profit before taxes.

I believe, that if you arrived at a figure, say of 5 percent after taxes, that might be 50 or 60 percent before taxes, which would be, we believe, a very exorbitant profit, and also would get the War Department all mixed up with taxation questions, and we think that taxation is a common burden imposed by Congress on all alike, and should not be taken into account by the War Department when it makes its contracts for war material.

Any suggestions that are made by contractors of what will be left after taxes we always avoid discussing and tell them we won't go into that at all. That is like a man demanding a salary which will leave him so much after income taxes, which we do not believe can possibly be done.

Senator WASH. It is your judgment, that if any provision of law is adopted, limiting profits to a percentage, a particular percentage, it would have to be adopted by the Treasury?

Mr. PATTERSON. Yes, sir.

Senator WALSH. So as to apply the tax principles and the deduction principles that the Treasury works out in determining income?

Mr. PATTERSON. Yes, sir.

This would tend to force up original prices. This is another disadvantage flowing from the attempt to apply a uniform standard to widely varying conditions. On the other hand, when prices are adjusted in the light of all the facts of the particular case, this problem does not arise.

(4) Discriminatory: Another objection particularly applicable to some of the suggestions made is that they discriminate against war contractors.

If, for example, a profits-limit tax is applied only to war business, it may tend to discourage producers from entering that field if civilian production remains more profitable, for it will obviously be impossible by the tax statute to insure a proper adjustment between profits in war industry and civilian business. Since renegotiation applies only to war contractors, it may also seem discriminatory to the same extent; but the emphasis is different. Civilian business is subject to price control by the Office of Price Administration, and renegotiation is an equivalent in the military field.

As I have said, we are seeking as far as possible to renegotiate to adjust prices for future performance and prevent excessive profits from accruing, and our proposed amendments are designed to extend this policy. Moreover, it is essential to have some method for revision of prices for military equipment from time to time. Indeed, even before the statute was adopted the uncertainties in pricing and costs made such provisions necessary in many of our contracts.

Senator MCKELLAR. Mr. Chairman.

Mr. WALSH. Senator McKellar.

Senator MCKELLAR. Mr. Patterson, could I ask you there, to explain the last statement you made? You may be doing it right now, but if you are not, I would like for you to explain how the renegotiation affects the future contracts. For instance, if you make a contract for some new product that the Army needs and neither the Army nor the contractor knows what a fair and equitable price would be, but after it is tried out for a short time, both the Army and the contractor knows what a reasonable profit would be, then such a renegotiation operates to fix a reasonable price for the larger

manufacture, or the greater manufacture, for such guns or other implements of war, does it not?

Mr. PATTERSON. Yes, sir. I think the typical case would be one where we were buying a lot of machine guns, buying them from a producer who had never made machine guns before.

The contract will have, say, a year and half a run. The quantity of machine guns under it may be enormous. The contractor figures in all kinds of contingencies that may affect his costs and figures them in over a period of time, not only as of that moment but what he thinks they may be a year and a half hence.

The result of that is generally a high price. It seems to me that if, after 6 months' experience under that contract—by that time the producer will have gone into volume production, which always brings down costs—if at the end of the 6 months the price can be adjusted—adjusted downward to the advantage of the Government—based on the experience the contractor has had over the first 6 months of performance, and adjust it down to what his costs have actually proven to be rather than as to what might be estimated to be before he got into the business, it seems to me that we would be in the best possible situation.

I don't see that the contractor has any complaint on that. I don't think the War Department has any complaint on it.

Senator VANDENBERG. May I ask a question regarding the particular example that you have just cited?

Suppose this manufacturer is forced to put in special equipment and make a special expansion of his plant in order to accept this contract which you want him to take. When you figure his costs, do you allow him to include any reserves?

Mr. PATTERSON. Yes, sir; so far as that apparatus cannot be converted to ordinary civilian business, we do; yes, sir.

Senator VANDENBERG. Do you recognize as elements of cost the ordinary normal reserves, which are recognized as essential in the operation of conservative business?

Mr. PATTERSON. Yes, sir. We have had trouble with several contractors—and they had a fair point; it has not been worked out entirely yet—as to what would happen on the termination of the contract, if the war should come to an abrupt end and that contract should still be in existence. The contractor is bothered by the costs he has incurred in installing special apparatus for the performance of that contract—apparatus which is not of a nature that he would ordinarily use in conducting his ordinary civilian business. Several have expressed apprehension of where they would be left if that would happen. We are trying to work that out with them now. Our normal clause on termination, as you doubtless know, reimburses them for cost of materials and labor already incurred, and gives them a percentage of profit, depending upon the stage of the contract at the time of termination.

If it was half done, half of what he presumably would have made if the contract had been completed. There is some fear by some contractors that they are not being taken care of for some of that building construction or special machinery costs. That is, in the contingency of an abrupt termination of the contract.

We were told by the War Production Board some months ago not to allow the element of reconversion. With respect to conversion, yes; but not reconversion, but to cast that upon the business that was

expected to be continued by him with civilians later on. That is now being rexamined.

Senator VANDENBERG. Have you encountered any reluctance on the part of war contractors to take your contracts because of what they deem to be an uncertainty inherent in the Renegotiations Act?

Mr. PATTERSON. I don't know about that. Have you, Colonel Browning?

Col. ALBERT J. BROWNING (Director, Purchases Division, War Department). We have had one or two, but in those cases by explaining what we planned to do on this revision of the bill, they have gone ahead and taken the contracts.

Mr. PATTERSON. We have encountered resistance toward renegotiation itself.

Senator VANDENBERG. Yes.

Mr. PATTERSON. But that is not connected with the placing of new business.

Mr. BROWNING. I don't know of a single contract that has not been signed as a result of that Renegotiations Act.

Senator VANDENBERG. I have heard many contractors fomenting in their beards on the subject.

Mr. PATTERSON. You mean renegotiation?

Senator VANDENBERG. Yes.

Mr. PATTERSON. Yes; I have, too.

Senator CONNALLY. Mr. Chairman, may I ask one question?

Senator WALSH. Yes.

Senator CONNALLY. When this matter was up in the committee, there was considerable said about eliminating from renegotiation purchases of raw materials. Have you any views to submit on that on the theory they were basic and it would relieve you of a lot of work?

Mr. PATTERSON. The War Department believes that, in defining "subcontract" material men should be eliminated. It will more or less help us on our administrative burden, and also because of their being subject to O. P. A. prices—O. P. A. price ceilings anyway. But there isn't complete uniformity between the different services on that point.

Senator MCKELLAR. Have you an amendment on that point?

Mr. PATTERSON. Yes, sir. I will come to that.

Senator VANDENBERG. May I ask one thing further, Judge?

The complaint was made in the full committee the other day that "renegotiation" is a misnomer in connection with this process because renegotiation infers freedom of action on the part of both parties to the undertaking. What show does a contractor have when he enters renegotiations and when you announce what you think ought to be the renegotiation base?

What would happen if he said "No"?

Mr. PATTERSON. That is a matter on which the original statute is in some ambiguity.

"Renegotiation" in and of itself implies an agreement, mutual agreement.

Now, the provision about recapture that is in 403 may have another significance. You can argue that it means "move in." I myself believe that renegotiation is mutual. Of course, we have various weapons we can use. We can, I suppose, cancel the contract and place

a compulsory order with the producer at what we call a reasonable price. We can, I suppose, report the case to the people up here as a case to be taken up. We can do that, but I don't think that that is desirable. Or we could withhold future business, on renewal of a contract, from a contractor who had not been what we thought was reasonable on renegotiation.

Senator VANDENBERG. I think you have ample weapons to proceed, as I have indicated. I am just wondering, just in cold reality, whether the contractor isn't totally at the mercy of your negotiator's judgment.

Mr. PATTERSON. Well, we have recoveries now already consummated, or far under way, of $600,000,000 in War Department alone on price adjustment, and I do not think in any of those cases there has been any real controversy with the contractor. It has not been an important element in actual practice under the act.

Senator VANDENBERG. If there was a controversy, you would win, wouldn't you?

Mr. PATTERSON. I hope so.

Senator VANDENBERG. Yes.

Senator CONNALLY. Isn't it a fact that you are just as much interested, and probably more so, to get this stuff and have these contracts executed, as the contractor?

Mr. PATTERSON. Yes.

Senator CONNALLY. And therefore there is no motive on your part to squeeze them to the point where they can't go on and produce and live under the contract?

Mr. PATTERSON. That is true. We have raised prices for some contractors, where it was evident that the price fixed in the beginning was too low and the man was going to be forced out of business. It is not to our interest to see him forced out of business.

Senator CONNALLY. Yes. Your natural approach would be to fix a price at which he could deliver the goods.

Mr. PATTERSON. We have to do that. We are more interested in getting the goods than anything else.

Senator VANDENBERG. If you will allow me, that is not quite the point of the inquiry which I was making.

Senator CONNALLY. No; I see your point, Senator.

Senator VANDENBERG. The impasse I am talking about does not involve any suggestion of intentional unfairness or duress on the part of the War Department. It involves this age-old argument over what appropriate reserves should go into costs and, as I stated a moment ago, to what extent reimbursement at the end of the contract shall be included as part of the costs. There can be such a legitimate difference of opinion on that subject, and it is at that point where, it seems to me, the contractor's judgment is pretty important to maintaining himself in business and at that point, he really has to take your judgment.

Mr. PATTERSON. We have not gone into renegotiation on the basis of getting down to the last cent. We have tried to stick to very broad lines. We don't do a great deal of auditing. I don't know that we do any, in fact. If a contractor comes in with his financial statements and his cost analyses certified by thoroughly reputable people, we have no reason to doubt it and we accept it as it is and take those to be the facts.

Senator McKellar. May I ask the Secretary another question?

Senator Walsh. Yes; certainly.

Senator McKellar. With regard to these differences, in regard to renegotiations, have any of these differences, in your judgment, slowed down war production in any way?

Mr. Patterson. No; they have not.

Senator Walsh. You may proceed.

Senator Connally. May I ask a question, Mr. Chairman?

Senator Walsh. Certainly.

Senator Connally. I assume that the basis for this legislation we passed was that Congress has the power—there is no constitutional inhibition against the Congress passing an act that would, in effect, abrogate a contract—I mean, impinge on the contractor—since the constitutional inhibition is only against the States. They shall pass no law to interfere with obligations under a contract. Is that right?

Mr. Patterson. You will have to excuse me from answering a question of law, Senator.

Senator Connally. I understand you are not on the bench now. When you left the bench, you left your law with it, sir?

Mr. Patterson. I have to confess I did.

Senator Connally. Well, I don't think you did, but I will accept it. I have a very high regard for your legal ability as well as your administrative and executive ability.

Senator Walsh. You may proceed, Mr. Secretary.

Mr. Patterson. Contractors making unfamiliar articles or using new processes lack the data for fixing fair prices, and renegotiation on the basis of experience often provides the only feasible method of dealing with the situation. Even if the statute were repealed, the duty of supervising prices of contractors and subcontractors will still remain and would have to be performed by the services as part of their procurement function.

In pointing out our reasons for believing that renegotiation with the suggested amendments is preferable to a fixed statutory profit limitation, we do not wish to be misunderstood. The problem of controlling profits, costs, and prices is an extremely difficult one, and no method of handling it is ideal or free from objections.

Thus the very flexibility of renegotiation in dealing with the wide diversity of conditions makes complete uniformity and certainty almost impossible, and the necessity of dealing with cases individually creates a serious administrative burden. We can only say that we feel that the benefits and advantages of renegotiation outweigh these disadvantages and make it preferable to other methods proposed.

So far as possible, we are seeking to meet the objections to the method by amendments which we are proposing and by impartial and fair-minded administration. If, hereafter, we become convinced that the task is too great to be done with reasonable equality of treatment, we will ask for further corrective measures or for substitution of other means.

As I have already said, we feel that certain amendments to the statute are desirable at this time, and will improve it and remove many of the objections now made to it. These amendments are intended in large measure merely to eliminate existing doubts and uncertainties concerning the present procedures of the Board. At the

same time they are designed to make the statute more flexible and workable as a means of reducing excessive profits, prices, and costs and of promoting greater efficiency in war production.

Broadly speaking, the amendments fall into four groups:

(1) Those dealing with the procedure of renegotiation;
(2) Those dealing with the restrictions on negotiation;
(3) Those dealing with contract provisions, and
(4) The definition of "subcontract."

Senator VANDENBERG. When you say "to make the statute more flexible," you don't mean you are inserting any more new uncertainties, do you?

Mr. PATTERSON. I hope not.

I. RENEGOTIATION PROCEDURE

In their work thus far the Price Adjustment Boards have developed certain procedures and practices in carrying out renegotiation. It is believed that these are consistent with the terms and provisions of the statute, but some of them are not expressly authorized. In the interest of certainty it seems desirable, therefore, to amend the statute to cover these procedures and practices expressly, by authorizing over-all renegotiation, by clarifying the methods of eliminating excessive profits, by directing credits for excess-profits taxes and by authorizing final agreements. The reasons are briefly as follows:

(1) Over-all renegotiation: At present when a contractor or subcontractor holds a number of war contracts or subcontracts it has been found desirable to renegotiate with him to eliminate excessive profits on these contracts or subcontracts as a group on an over-all basis instead of individually. Excessive profits can be determined more quickly and accurately by an over-all study of a company's financial position and the profits, past and prospective, from its contracts taken as a whole than by analyzing each individual contract on a unit-cost basis. In addition, this greatly simplifies the work of the board and of contractors by reducing the number of renegotiations and by avoiding the necessity of allocating costs among the various contracts to determine the profit on particular contracts. It is believed that this method carries out the purpose of the statute, but it might well be expressly authorized—and so an amendment so provides.

Senator VANDENBERG. Are you proposing simply to authorize it as an option, or are you proposing to set it down as a standard practice?

Mr. PATTERSON. Standard practice, except in special cases. It is more convenient. We believe the contractors prefer it.

Senator WALSH. In other words, your policy is to deal with the contractor rather than contract by contract?

Mr. PATTERSON. For a fiscal period rather than contract by contract.

Senator VANDENBERG. Would any contractor have contracts with the Navy Department, the Maritime Commission, and the War Department?

Mr. PATTERSON. Yes.

Senator VANDENBERG. Do you renegotiate for all three?

Mr. PATTERSON. It is according to who has the predominant interest. The contract is allocated to a particular service—the Navy or the Army or the Maritime Commission—and that agency deals for all.

Senator VANDENBERG. And do all of these various agencies operate on a common standard of practice?

Mr. PATTERSON. By and large they do.

Second--methods of elimination: I am still speaking now on the renegotiation-procedure amendments.

The statute now provides for eliminating excessive profits by withholding or recovery.

Senator VANDENBERG. Before you go to that, let me ask you about one complaint I have heard. I have heard the complaint that, in some instances, your renegotiator would take into account the entire unit operation of a factory, even though 25 percent of it was still doing commercial work. Would that be true?

Mr. PATTERSON. No, sir. We try to confine it entirely to contracts with the military services, and the profits from such contracts, unless the contractor consents to a broader base.

Senator VANDENBERG. In other words, your policy is: If a manufacturer still has civilian work, you eliminate that factor in your calculation of costs as a basis for renegotiation?

Mr. PATTERSON. Yes, sir.

Senator WALSH. I suppose it is a factor in determining the overhead cost?

Mr. PATTERSON. Yes; we would have to split those between the two classes of business, but it is preferable by far than taking contract by contract and trying to allocate everything to that.

Senator VANDENBERG. Under no circumstances do you try to control the civilian end of the operation?

Mr. PATTERSON. No; we have no right to do that.

With respect to prospective profits it is often practical and desirable from the point of view of the Government and the contractor to eliminate such profits by reductions in the contract price or by revision in the contract terms instead of by recapture or refund. In the case of subcontracts, the fear has been expressed that even though the price reduction is made as agreed, the subcontractor might still be liable for the excessive profit if for any reason the Government failed to receive the benefit. While this construction seems improbable, the possibility should be removed.

(3) Offset: At present the statute makes no express provision for offsetting excess profits taxes paid by a contractor against any amount of excessive profits found to exist by renegotiation under the statute. In the absence of such offset the contractor would be forced to pay twice, once in the form of taxes and the second time by refund of excessive profits. While it seems plain that Congress did not intend such double liability, it would be better if the statute directed the credit for excess profits taxes paid.

And that is the construction we have been operating on.

Senator VANDENBERG. You think that should be written into the law?

Mr. PATTERSON. Yes; I think it would be better.

Senator VANDENBERG. The Treasury Department's attitude was that it would be preferable to have it handled by interdepartmental agreement, with which I heartily disagreed, and concur with your point of view. I think it should be in the statute itself.

Senator MCKELLAR. Mr. Chairman——

Senator WALSH. Senator McKellar.

Senator McKellar. I know it was intended that that should be the construction placed on the act, but I think—by all means—it ought to be put in the act so that it will be clarified.

Mr. Patterson. I come now to quite an important amendment, which relates to final agreements.

(4) Final agreements: When a contractor or subcontractor has renegotiated in good faith and agreed to eliminate any excessive profits found as a result of such renegotiation, he is clearly entitled to assurance that the matter will not be reopened at a later date. The statute does not provide expressly for any final clearance for liability for excessive profits. The War Department, however, gives clearance for the period covered by the renegotiation, either at the time of renegotiation or after the end of the period, and it is believed that this is the proper construction of the act.

This is obviously of the utmost importance to contractors and subcontractors, and the power to give clearance aids in reaching agreements with contractors. The amendments specifically authorize such final or other agreements for a past or future period. Thus by such an agreement, the secretary may fix firm prices for a reasonable time in the future when he thinks it poper. This matter is so fundamental that it should not be left to interpretation.

We find an attitude on the part of producers fearful of being called back again a year hence to renegotiate for the very period, and the very subjects that have already once been settled by renegotiation. We believe that we ought to give them the assurance that, when we once renegotiate, the matter is closed for that particular subject matter and that particular period.

Senator Vandenberg. I think you are right at the heart of most of the uncertainty and the criticism. Are you proposing merely that you should be given authority to make closed agreements, or are you suggesting that you should say that there will be one renegotiation period?

Mr. Patterson. How is that phrased in the act?

Mr. William L. Marbury. (Purchases Division, Legal Branch, War Department). We are simply providing that we may give final agreement.

Senator Vandenberg. Would it be possible to go further than that?

Mr. Patterson. We think it should be made discretionary with the Secretary. There may be cases where you can't do it enough. You can do it in a tentative way and it might be absolutely prudent to have a reexamination later; but in a proper case, where all elements are known, and where we do intend to make it final, I think it should be clear that the Secretary has the power to make it final.

Senator Vandenberg. Are you talking about clearance for the entire life of the contract, or clearance for just 1 year and then another renegotiation.

Mr. Patterson. The latter.

Senator Vandenberg. You are talking about clearance for 1 year?

Mr. Patterson. It takes two forms, and there is another amendment which I will discuss in a minute. For the past, say, for the first 6 months of 1942, that period is past. We can renegotiate on that and fix what profits actually are determined to be. There is another phase of it and that is when you make a contract initially we believe that the Secretary ought to have the power to provide that,

for the first 6 months, or the first 4 months or 3 months, any period of performance under that contract, the price shall be firm, and that after that period, at the close of that period, the price should be subject to adjustment or renegotiation.

We think that in proper cases, the contractor has a good point of wanting a fair amount of assurance for the beginning of his operation, and then at the close of the first 6 months, when you came to adjust that price, you could adjust it firm for the next 6 months, and leave the balance for further revision. That becomes an incentive for effective performance, efficient performance, and economical performance on the part of the contractor; and, if it is not for too long a period, you probably can figure out the profits with fair certainty during that short period of time.

Senator VANDENBERG. As a matter of practice, is it necessary to renegotiate as often as every 6 months?

Mr. PATTERSON. No; I do not believe so.

Senator VANDENBERG. As a matter of practice, what would be the average life of a contract?

Mr. PATTERSON. I think, when we get together on renegotiation now, the period is usually a year. Isn't that right?

Colonel BROWNING. That is right.

Mr. PATTERSON. But it might be on one of these prospective things you would want to do it that way.

Senator WALSH. Senator McKellar.

Senator MCKELLAR. Mr. Secretary, your recommendations with reference to this matter of renegotiation are based on your actual experience under the act?

Mr. PATTERSON. Yes, sir. Mr. Karker, the Chairman of the Price Adjustment Board of the War Department can, I think, go into considerable detail, and very interesting detail, which I do not have at my finger tips.

Senator WALSH. Of course, this final agreement would not give immunity to the contractor against fraud?

Mr. PATTERSON. No, sir.

Senator WALSH. Senator Clark.

Senator CLARK. You may have covered this before I came in, Mr. Secretary, but one of the things that the contractors complained of most bitterly was the situation of a contractor who, under the statute, is theoretically liable 3 years after the end of the war.

Mr. PATTERSON. We are suggesting a statute of limitations in these amendments.

Senator CLARK. Those firms claimed that they might go ahead and pay their taxes, dispose of their dividends, and then be liable later on.

Mr. PATTERSON. We propose a statute of limitations which will give relief against any far-fetched renegotiations in the distant future.

II. RESTRICTIONS AND LIMITATIONS

1. Exemptions: As I have already stated, the War Department feels that it is essential to preserve and strengthen the incentives of contractors to reduce costs and maintain efficiency. The threat of renegotiation to recapture the profits for past periods frequently tends to undermine this incentive to a serious degree. The experience else-

where indicates however, that it is possible to make contracts which provide such incentives and still prevent serious danger of excessive profits.

Thus, in England various forms of incentive or target price contracts with periodic revision of the contract price for the next period, in the light of actual experience with production have been successfully used for this purpose. By means of such agreements the contractor has the usual incentives to keep his costs constantly at the lowest possible level and at the same time the Government receives the benefits of the increased efficiency through lower prices at periodic intervals.

Under the statute in its present form, it is not possible to make such contracts at firm prices not subject to renegotiation or recapture.

This is the point we discussed a moment ago, Senator.

The War Department is therefore proposing an amendment to authorize such contracts by allowing the Secretary to exempt a contract or subcontract from renegotiation with respect to a portion thereof or for a specified period or periods, if in his opinion, the porvisions of the contract or subcontract are otherwise adequate to prevent excessive profits. We believe that this limited discretion is essential in order to foster the greatest possible efficiency in production.

Several other amendments relate to the exemption from renegotiation of certain prime contracts and subcontracts where it is inappropriate. The provision should not be required in contracts with other Federal or local governmental agencies or a foreign government. Likewise, the Secretary should be permitted to exempt contracts from renegotiation when the profit can be determined with reasonable certainty when the original price is agreed on. Contracts of this type include those for personal services, for the purchase of real estate or perishable goods or for commodities at a minimum price fixed by a regulatory body, and contracts to be performed in a short period.

We have instances of contracts to be performed in 30 days, contracts for stable commodities. We buy a lot of fresh vegetables at Army posts. Some of them do run into substantial sums of money but they are at the current figures and we do not believe that Congress ever contemplated that contracts of that kind would actually be renegotiated.

Contracts to be performed outside the United States also often present special difficulties for renegotiation.

We had to make a contract with respect to some railroad construction work in Persia, and I understood that the contractors, or subcontractors, I guess they were, out in Persia, did not relish the idea of renegotiation. It is a pretty far-fetched business. But I am not sure we do not have to put a renegotiation clause in that contract. Some think we do and some think we do not, but we would rather have the power to leave those out.

Senator VANDENBERG. Does your suggestion go to the extent of eliminating the lend-lease contracts from renegotiation?

Mr. PATTERSON. No, sir; only those made with foreign countries. Our lend-lease contracts are made with our producers here. We treat those exactly like our own supply contracts.

In the opinion of the War Department, the Secretary should have authority to exempt contracts of these types from renegotiation when-

ever he thinks it justified. Finally, for administrative reasons, we propose that contractors and subcontractors whose aggregate sales for war purposes are less than $250,000 in a fiscal year should also be exempt.

That is also for practical purposes, to try to keep down the administrative load.

2. Time limitations: And these are the ones that you mentioned a moment ago, Senator Clark.

One of the objections most frequently made to the statute by businessmen is based on the fact that contracts remain subject to renegotiation until 3 years after the war. In part, this objection will be met by the proposed amendment specifically authorizing final agreements discharging any liability under the statute. But to meet the point completely other provisions are required.

Two of the proposed amendments are intended to do this. One prohibits renegotiation after 1 year from the close of the fiscal year in which the contract or subcontract was completed or terminated.

Senator VANDENBERG. Will you read that again, please?

Mr. PATTERSON. One prohibits renegotiation after 1 year from the close of the fiscal year in which the contract or subcontract was completed or terminated. The other authorizes a contractor to file financial and cost statements for a fiscal period and obtain clearance under the statute unless the Secretary begins renegotiations within 1 year thereafter. Together these limit to a considerable extent the period during which a contract remains subject to renegotiation.

III. CONTRACT PROVISIONS

Certain changes are suggested in the provisions required to be inserted in contracts and subcontracts primarily to set at rest certain fears and doubts of contractors and subcontractors from some of the present language, and to conform to the changes already discussed.

These clarifying changes include amendments to make clear that excessive profits may be eliminated through a reduction in the contract price or otherwise as the Secretary may direct, and need not be recovered if so eliminated; that a contractor or subcontractor may be required to refund excessive profits only if they have actually been paid to him; that the Secretary may fix a period or periods for renegotiation in the contract and in this way prescribe a shorter statute of limitations on renegotiation; that a contractor is liable for reductions in the subcontract price only if he receives the benefit of the reduction; and that a surety under a contract is not liable for excessive profits upon renegotiation. In addition, there are a few other changes of a purely verbal nature involving no questions of policy.

In connection with the amendment already discussed, the proposed revision authorizes the Secretary by the contract provision to exempt the contract price from renegotiation during a specified period, if in his opinion the other provisions of the contract are adequate to prevent excessive profits. The reasons and policy behind this have already been explained.

IV. SUBCONTRACTS

A final problem concerns the subcontracts within the statute. Since the act applies to all "subcontracts" but does not define that term, considerable uncertainty has arisen as to its correct meaning.

This is particularly important to contractors who are under a duty to insert the renegotiation provisions in their subcontracts and must determine which of their contracts and purchases require these provisions. For this reason, and because disagreements between the contractor and his suppliers over the necessity of including the clause would delay procurement, the Army has included in its contracts a definition of the term. This definition was adopted after study of the administrative construction of the word "subcontract" under the Vinson-Trammell Act, and was made broad in order to give full effect to the statute in view of its uncertainty.

Within the last month, however, the Board of Tax Appeals has decided in a case under the Vinson-Trammell Act (*Aluminum Company of America* v. *Commissioner of Internal Revenue*), that the term "subcontract" as used in that act does not include materialmen or suppliers of raw materials or standard commercial articles. As a result, some contractors have objected that the present definition in use by the Army extends the renegotiation statute beyond its intended scope. Under the circumstances a definition of the term by Congress would be helpful in clearing up this difficulty.

The War Department, Navy Department, and Maritime Commission are all agreed that Congress should define this term in order to clear up the present uncertainty, but are not in complete agreement on the proper scope of a definition. The War Department feels that it might properly exclude agreements for raw materials or standard commercial fabricated or semifabricated articles. The prices of articles of this character are subject to regulation by the Office of Price Administration and are reasonably susceptible of such generalized treatment. Any excessive profits resulting from increased volumes of such business can probably be satisfactorily handled by the excess-profits tax. If the contracts and purchases of these supplies and materials are excluded, renegotiation will be limited to prime contracts and to subcontracts with those doing specialized war work. In this field price control by the Office of Price Administration is not feasible without seriously dividing authority, and impeding war production. Renegotiation, however, provides a method of price and profit control retaining sufficient flexibility to allow for the wide variations in conditions. Moreover with the field thus limited, a more effective job can be done with respect to the contracts and subcontracts covered.

On the other hand, if purchases of standard products and raw materials are included as subcontracts, the problem of administering the statute becomes much more difficult. The number of contracts and contractors might be so large as to make it impossible to renegotiate with all of them. For these reasons the War Department feels that it is probably wiser to define the term "subcontracts" to exclude purchases of raw materials and standard commercial products. Nevertheless, we believe that a uniform definition should be adopted, and are of the opinion that we can operate under a broader definition as favored by the Navy and the Maritime Commission.

I might just say that we favor the narrower definition of "subcontract" but we aren't stubborn about it.

Senator VANDENBERG. Would it be appropriate for you to indicate the nature of your disagreement with the Navy Department and the Maritime Commission with respect to this definition?

Mr. PATTERSON. I think they want to include everything, the Maritime Commission does.

Do you want the raw materials?

Mr. F. M. BRADLEY (counsel, Price Adjustment Board, Maritime Commission). No.

Mr. PATTERSON. I had better not speak for them.

Senator WALSH. First of all, may I ask, Mr. Secretary, whether or not the amendments proposed on September 22 are the same as you are now proposing?

Mr. MARBURY. Not entirely.

Senator WALSH. The verbiage has been changed and therefore, for the purpose of the record, we ought to take your present verbiage of these amendments.

Mr. MARBURY. Yes, sir.

Senator WALSH. Now, Mr. Secretary, Mr. Forrestal says in his letter about this, the following:

> This is a new paragraph defining the term "subcontract" and differs from the definition submitted by the War Department. The definition of the War Department excluded orders or agreements to furnish (1) raw materials; (2) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use, and (3) articles for the general operation or maintenance of the contractor's plant. It is the opinion of the Navy Department that it was the intention of Congress that excessive profits should be removed from all war contracts irrespective of whether such contracts were of the character referred to in (1) and (2) above. For this reason, the Navy Department has proposed a definition of subcontract which includes virtually all contracts made with prime contractors of the Government. It is our opinion that this definition is in accord with the suggestion of the chairman of the Maritime Commission as contained in his letter of September 22, 1942, to Senator George.

That defines the distinction between your views and those of the Navy Department and the Maritime Commission.

Mr. PATTERSON. That seems to show the difference in view between us and the Navy and the Maritime Commission.

Senator WALSH. Any other questions?

Senator VANDENBERG. I understood the Maritime Commission to say they did not object to excluding raw materials. Is that correct?

Mr. BRADLEY. That is correct.

Mr. PATTERSON. Well, standard commercial articles, that would include a motor of exactly the same kind as used in an automobile, or something like that. I don't believe that a contractor who subcontracted for the purchase of one of those engines or motors, if it is a standard, ordinary standard article, should insert a renegotiation clause in his contract with a subcontractor, but we will abide by your decision on it.

Senator CLARK. What about personal services, are they exempt?

Mr. PATTERSON. We recommend that the Secretary be authorized to exempt contracts for personal services. Of course, most of them will come below the minimum.

Senator CLARK. I understand.

Senator WALSH. Judge, have the contractors with whom the Army has been dealing had an opportunity to see these amendments and to express an opinion upon them?

Mr. PATTERSON. No, sir.

Senator WALSH. So they were not consulted and their opinion was not available when these amendments were made?

Mr. PATTERSON. That is true. We didn't discuss them with the contractors.

Senator WALSH. Have you found a distinction between the contractors with whom you have made contracts since the passage of section 403 and the contracts entered into prior to that time?

Of course, now, and from the time of the passage of section 403, the contractor has known that his contract is subject to renegotiation. He had no such knowledge before. Have those contractors who had contracts before the passage of 403 resisted the attempt to renegotiate their contracts?

Mr. PATTERSON. Largely not. At first, not at all. I believe that within the last month or two there has been some resistance built up. I think, as I said earlier, largely due to misinformation and misunderstanding about the policies and practices of the War Department under the act and, in some measure, due to uncertainties in the act itself, which we think these amendments will clear up.

Senator WALSH. You think section 403 is retroactive?

Mr. PATTERSON. I believe it is worded that way; yes, sir.

Senator WALSH. Of course, it begins with a declaration, "In all future contracts, this provision"——

Mr. PATTERSON. That is right, but then it has some other language later on.

Senator WALSH. Yes.

Mr. PATTERSON. In conclusion, I will just say this, gentlemen, and then I will be glad to answer any questions

As I have said, most of these proposed amendments merely give explicit sanction to the procedure and practices being followed in negotiation under the statute. These do not change existing policy or purpose, Such clarifying amendments are desirable, however, in a statute of such wide application and importance, in order to remove any doubts as to the power and procedure of the renegotiating boards in carrying on operations, and to reassure contractors in their dealings with the boards. The more important of these amendments are the amendment covering express authority for over-all renegotiation, and the amendment providing for final and other agreements.

The amendment to allow exemption of contracts for specified periods where the Secretary considers the other provisions adequate to prevent excessive profits does involve a matter of policy. For the reasons already stated that is considered to be vitally important in promoting the highest efficiency in production. Likewise the definition of "subcontract" involves questions of policy which Congress should settle by statute.

These amendments do not, of course, solve all the problems under the statute or answer certain basic objections made to it. They will, however, greatly improve it. If so amended, we feel that the act provides a better method of dealing with the problems involved than any other now proposed.

Senator VANDENBERG. Are there any major complaints, pretty universally held by contractors, which you have ignored in your recommendations?

Mr. PATTERSON. Well, I do not think so. I think I discussed that here. Some of the objections rest purely upon misinformation and misunderstanding, and unwarranted fears. Other objections—such as the one that Senator Clark adverted to, that it left them open too long—I believe are remedied by the amendment suggested here, giving them a shorter statute of limitations, wherein the matter can be put at rest.

The objection sometimes made that even after your renegotiation you still can be subject to further renegotiation covering the very same matters, is handled by an amendment giving the Secretary power to fix a final agreement.

Senator WALSH. The telegrams which have come to me suggesting repeal of this section, have come largely, it seems to me, from what I may describe as contractors supplying general supplies, general manufacturers, supplying general supplies to the Army and Navy, and not from what I might describe as manufacturers of munitions, for example. Have you observed a distinction between those two groups of contractors as to their attitude?

Mr. PATTERSON. Well, I have not, Senator, but perhaps some of my people have.

One amendment here would allow the Secretary to exempt from renegotiation, such contracts as those for staple commodities, things where the profits are known or reasonable for them at the time the contract is made. Take, for example, the purchase of a piece of land that we buy for a camp, or for a munitions plant. It becomes an executed transaction right away. There is no extended time of performance. I see no point in sticking into a contract like that a provision for renegotiation—although, in some instances, we would have saved money by it, as you know, Senator.

Senator CLARK. Yes.

Mr. PATTERSON. But, don't hold those cases against us. Those were in the early stages 2 years ago, when the thing was not under proper control. We haven't got any of those cases now.

Senator WALSH. I haven't received many communications from those who are manufacturing ordnance of one kind or another, which I assume is a very heavy part of the contract work of the Army. I haven't seen any protest against this section from that group.

Mr. PATTERSON. I cannot say. That is a heavy part, of course, of our work.

How much of our work is in aircraft and tanks alone? Or just tanks?

Mr. BROWNING. I would say a third.

Mr. PATTERSON. I should think more than that.

Mr. BROWNING. Ordnance is $40,000,000 alone.

Mr. PATTERSON. Tanks and combat vehicles are now the greatest single category in ordnance, are they not?

Mr. BROWNING. Yes, sir.

Senator WALSH. Senator McKellar.

Senator MCKELLAR. Mr. Secretary, would you be good enough to furnish the stenographer with the amendments that your department and the other departments think are wise and important, the one or ones that there may be any difference of view about?

Mr. MARBURY. The amendments have been printed; committee print No. 3.

Senator WALSH. I was going to ask, for the purpose of the record, that that committee print 3 be revised so as to have the language you now desire to use in your amendments incorporated and put in the record of today's proceedings.

Mr. MARBURY. That has been done, sir.

Senator WALSH. Very well.

Senator MCKELLAR. Mr. Secretary, I would like to ask as to one other thing: I think I saw in some paper something about an army of examiners and administrators. Is your set-up for this work large or small?

Mr. PATTERSON. Quite small. Our set-up, I should explain——

Senator WALSH. That was explained in the general proceedings.

Mr. PATTERSON. We have a price-adjustment board, War Department Price Adjustment Board, which takes the larger cases and which also supervises the work down the line. Now, in the supply services, each one of them has a price adjustment section, like the ordnance in the Air Force.

The ordnance has price-adjustment sections out in the district offices, like Detroit, Chicago, and Pittsburgh, and so forth. Their work is supervised by the Price Adjustment Board, which also handles initially, and of its own accord, exclusively certain contracts of a—well, notable cases either from size or from some striking feature about them. We have no army of accountants or auditors. And I submit that, if we get into a flat profit-limitation act, then we will have a swarm of locusts, accountants, bookkeepers, and auditors—and we will then have a real bookkeepers' war, which it is the policy of the War Department to avoid.

Senator MCKELLAR. Mr. Secretary, will you be good enough to put into the record about the number that you have, and I wish the other departments would do the same thing.

Mr. PATTERSON. Can you give that, Mr. Karker?

Mr. KARKER. Mr. Secretary, we have audited only three companies out of the total number that have been brought before us on renegotiation. At this time the number of employees probably totals between 350 and 400 for all the services.

Mr. PATTERSON. How many have you in Washington?

Mr. KARKER. We have 53 or 54—59.

Senator WALSH. These regional boards are composed of a banker and a lawyer and so forth, is that not true?

Mr. PATTERSON. No; I do not think so.

Mr. KARKER. No limitation.

Senator WALSH. I got the impression that the Department designated the type of the men.

Mr. PATTERSON. We have never done that. It may be that the district officer out there will think that that is a wise thing to do, but there is no uniformity on that, Senator.

Senator VANDENBERG. Are these renegotiators, by and large, men of business experience?

Mr. PATTERSON. Yes, sir. I have known some of them—although my acquaintance had nothing to do with them getting on the board out in the districts—but I can speak for their high caliber, and they are men of industrial experience.

Senator WALSH. Now, do you desire to bring any facts to the attention of the committee, not yet brought out, in executive session?

Mr. PATTERSON. No, sir. I will be glad, however, to answer any questions.

Senator WALSH. I got the impression that there were some facts that you might want to present to the committee in executive session.

Now, Senator McKellar, you desire to leave. Would you like to be heard tomorrow morning?

Senator MCKELLAR. That would suit me.

Senator WALSH. Do you want it in executive session or public session?

Senator MCKELLAR. Just as the committee desires. I do not see any necessity of my being heard. I think the Secretary's statement here has been so full and fair and frank that I do not think there is anything I need add.

Senator WALSH. So we may assume then, that the Secretary has covered material that you would want to present?

Senator MCKELLAR. He has covered the material things and I have examined the amendments and agree with those amendments generally. There may be some small differences, but they do not amount to anything. I think they will all be satisfactory to me. They will all help the act and make it fairer, juster, and easier of administration.

Mr. PATTERSON. I submit, gentlemen, the act, with proper amendments and with fair administration, serves the interests of the contractors as well as the Government. If you don't have it and do not try to follow instructions, you will have some scandalous cases. They won't be representative, but they will exist. And it is not in the interests of American business to have those cases displayed and let the impression be gotten that they are common and representative of the whole thing.

And, I do not think their own interests are served, some of these people who object to the act, who will have to perform under the act, I don't believe their own interests would be served by a repeal of it and by no close control at all over prices.

Senator CONNALLY. And those few cases would reflect on all.

Mr. PATTERSON. Yes. The series of cases discussed last spring, I believe in the Naval Affairs Committee of the House, the facts in them were shocking. I do not think it does the country or business itself, of the war contractors, any good to have people get the impression that that kind of stuff goes on. It is better to have a fair and reasonable control, than to have that kind of stuff.

Senator WALSH. The commitee had a letter from Mr. Forrestal, Acting Secretary of the Navy, giving the Navy's views. Is there someone here representing the Martime Commission?

Mr. A. G. RYDSTROM (Price Adjustment Board, Maritime Commission). I do, sir.

Senator WALSH. Do you want to be heard or do you want to submit your views in writing?

Mr. RYDSTROM. Very briefly, I would like to make a statement.

Senator CLARK. May I ask a question, Mr. Chairman?

Senator WALSH. Yes.

Senator CLARK. In renegotiation contracts, do you give any consideration to reserves for reconversion? Take the case of an auto-

mobile concern. They have quit the automobile business for the duration of the war. They have their machinery out in the weather. They are making tanks. Now, they know that at the end of the war this machinery they put in there for making tanks or airplanes will not be of any use to them except for scrap. I was wondering if you give any consideration to reserves for reconversion.

Mr. KARKER. We do give consideration—but we have instructions from the War Production Board not to make specific allowances for them, and in the particular case of one of the largest manufacturers in that category, they themselves made public statements several months ago which included no provision and no request for one on their own part.

Mr. PATTERSON. That is not a matter peculiar to renegotiation, Senator.

Senator CLARK. No; but when you consider whether a fellow is making an excessive profit, the question of reasonable reserves, it seems to me, is inextricably connected with what are excessive profits.

Mr. PATTERSON. The same question was there when the contract was originally made, and we have the ruling of the War Production Board that reserve for reconversion back to civilian industry at the conclusion of the war shall not be allowed. Isn't that right?

Colonel BROWNING. Yes.

Mr. PATTERSON. As I said in the discussion with Senator Vandenberg, that is now under reexamination.

Colonel BROWNING. That is really an academic question, because if the Treasury does not allow it as reserve for tax purposes, whatever we did not allow they would take a large part of.

Senator VANDENBERG. Is the War Department subordinate to the War Production Board?

Mr. PATTERSON. On a matter like that it is; on price policy.

Of course, we make all contracts, and we have very little direction from them on things; but on that point we happen to have a rule by Mr. Nelson, which I think applies to the Army and the Navy and the Maritime Commission—all of them.

Senator WALSH. Do you desire to present any other evidence on behalf of the War Department?

Mr. PATTERSON. No, sir. I have here Colonel Browning; Mr. Karker, the Chairman of the Price Adjustment Board; Mr. Marbury, counsel for the Price Adjustment Board; and Mr. Pengira, counsel for the Price Adjustment Board, and they know the details far better than I do.

(The memoranda and amendments submitted by Mr. Patterson are as follows:)

WAR DEPARTMENT PRICE ADJUSTMENT BOARD

JUNE 30, 1942.

MEMORANDUM FOR COMMANDING GENERAL, SERVICES OF SUPPLY, COMMANDING GENERAL, MATÉRIEL COMMAND, ARMY AIR FORCES

Subject: War Department Price Adjustment Board.

1. The Price Adjustment Board created by memorandum of April 25, 1942, is hereby redesignated as the War Department Price Adjustment Board. It will serve as the coordinating agency of the War Department to determine and eliminate by renegotiation excessive profits from War Department contracts, and subcontracts thereunder, subject to approval by the Under Secretary of War or his designated representative.

2. The functions of the Board will be:

(*a*) To establish policies, principles, and procedures to be followed in renegotiation.

(*b*) To assist the Services of Supply and the Matériel Command, Army Air Forces, in the selection and training of personnel.

(*c*) To assign companies to the Services of Supply and the Matériel Command, Army Air Forces, for renegotiation and to coordinate all renegotiation functions and activities.

(*d*) To review renegotiations and settlements recommended by the Services of Supply and the Matériel Command, Army Air Forces.

(*e*) To conduct renegotiation with any company, whenever, because of the size of the company, the dollar volume of the contracts involved, the number of contracting services interested, new questions presented, or for any other reason, it appears that renegotiation by the Services of Supply or the Matériel Command is impracticable.

(*f*) To develop and recommend for approval such other policies and procedures as it may deem advisable in performing its functions and accomplishing its purposes.

3. The members of the Board will be appointed by the Under Secretary of War on the recommendation of the commanding general, Services of Supply, and the commanding general, Matériel Command, Army Air Forces. One member will be selected with the approval of the Chairman of the War Production Board as his representative. The present membership of the Board shall continue during the pleasure of the Under Secretary of War.

4. The Board is instructed wherever appropriate to function jointly with representatives or agencies of the Navy Department, Maritime Commission, and other departments or agencies of the Government.

5. The Board will receive from the Cost Analysis Section of the War Production Board, the Cost Analysis Section of the Fiscal Division of the Services of Supply, the Supply Services, the Army Air Forces, and from any other source, information with respect to contractors and subcontractors who are thought to have excessive costs, to be making excessive profits, or to be paying excessive salaries or bonuses.

6. (*a*) The Cost Analysis Section of the Fiscal Division of the Services of Supply shall upon request of the Board make such audits and analyses as may be designated by the Board and shall secure for the Board from the Treasury Department, the Securities and Exchange Commission, the Federal Trade Commission, and from any other department or agency of the Government, or from the contractor involved, such additional information as the Board may request in order to expedite and assist it in the performance of its functions.

(*b*) All divisions and personnel of the Services of Supply and the Matériel Command, Army Air Forces, shall furnish such information and assistance to the Board as it may request or as may appear desirable to aid it in the performance of its functions.

7. The Board is authorized to delegate to any one or more of its members the power to initiate investigations and request information and assistance on behalf of the Board and to represent the Board in renegotiations with contractors and subcontractors.

8. In conducting renegotiations the Board shall take into consideration the financial position and over-all profits, past and prospective, of a contractor or subcontractor with a view to determining or agreeing upon the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole, subject to such instructions as the Under Secretary of War may issue from time to time.

9. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as he may prescribe from time to time.

10. The manner in which agreements shall be carried out, whether by a reduction of contract prices, refunds, or otherwise, shall be determined by the Under Secretary of War, or his designated representative. Agreement shall be reached with the Navy Department and the Maritime Commission as to any part of the agreement affecting contracts with them.

11. The Commanding General, Services of Supply, and the Commanding General, Matériel Command, Army Air Forces, are authorized and directed to create, with the advice of the War Department Price Adjustment Board, Price Adjustment Sections to conduct renegotiations with such companies as may be assigned to them by the War Department Price Adjustment Board, subject to review by the Board and approval by the Under Secretary of War or his designated representative, except in cases where by general instructions or in the particular instance, the Under Secretary or such representative may authorize them to make final agreements.

12. The Commanding General, Services of Supply, and the Commanding General, Matériel Command, Army Air Forces, are authorized and directed to establish within their command such Cost Analysis Sections as shall be necessary to act as fact-finding units with respect to cost and profits on War Department contracts, and subcontracts thereunder, for the foregoing Price Adjustment Sections.

13. The Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, is hereby designated as the duly authorized representative of the Under Secretary of War for the purposes specified herein.

14. The Board will be assigned to the Services of Supply for administrative purposes.

15. The provisions of memorandum of April 25, 1942, are modified accordingly.

(Signed) ROBERT P. PATTERSON,
Under Secretary of War.

WAR DEPARTMENT,
HEADQUARTERS, SERVICES OF SUPPLY,
Washington, D. C., July 3, 1942.

SPPDP 020 (7-3-42).

MEMORANDUM FOR DIRECTORS AND CHIEFS OF STAFF DIVISIONS, THIS HEADQUARTERS; CHIEFS OF SUPPLY AND ADMINISTRATIVE SERVICES, SERVICES OF SUPPLY; AND COMMANDING GENERALS, ALL CORPS AREAS

Subject: Price Adjustment Sections.

1. The chief of each Supply Service is authorized and directed to create, with the advice of the War Department Price Adjustment Board, such Price Adjustment Sections as may be necessary, to renegotiate contracts with such contractors and subcontractors as may be assigned to his Service by the War Department Price Adjustment Board.

2. The chief of each Supply Service is authorized and directed to establish in the Fiscal Division of such Service a Cost Analysis Section, the function of which shall be to act as a fact-finding unit with respect to costs and profits on War Department contracts and subcontracts thereunder. Pursuant to Paragraph 9 *g* (5) of the initial directive for the organization of the Services of Supply, dated March 9, 1942, the Fiscal Division, Headquarters, Services of Supply, shall prescribe, supervise and coordinate all cost analysis methods and procedures within the Supply Services.

3. All renegotiation by any Price Adjustment Section shall take into consideration the financial position and over-all profits, past and prospective, of the contractor or subcontractor with a view to determining by agreement the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole, subject to such instructions as the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, may issue from time to time.

4. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as may be prescribed.

5. Agreements reached by the Price Adjustment Sections shall be transmitted to the chief of the appropriate Supply Service and, when approved by such chief, shall be transmitted to the War Department Price Adjustment Board for review by the Board and final approval by proper authority, except in cases where, by general instructions or in the particular instance, the chiefs of the Supply Services are authorized to make final agreements.

6. The manner in which agreements shall be carried out, whether by a reduction of contract prices, refunds or otherwise, shall be determined by the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply.

7. Nothing herein contained shall preclude contracting officers from—

a. Continuing to make adjustments of prices or fees in individual contracts containing an express provision for redetermination of the price or fee on the basis of a specified formula or containing an express provision that the price or fee shall be subject to renegotiation, whether or not under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942.

b. Continuing to reconsider individual contracts of any type with a view to adjustment of the contract prices by voluntary renegotiation or to accept voluntary reductions in such contract prices without auditing the accounts of the contractor or subcontractor if the amount is deemed reasonable.

Each adjustment shall be reported promptly to the Chief of the appropriate Supply Service for transmittal to the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, for the information of the War Department Price Adjustment Board and shall be expressly made without prejudice to the determination of any excessive profits of the company upon subsequent renegotiation.

8. These instructions are issued in conformity with memorandum from the Under Secretary of War dated June 30, 1942, copy attached, and supplement the memorandum dated April 25, 1942, subject: Price Adjustment Board, Services of Supply.

For the Commanding General:

(Signed) H. A. MAIN,
Colonel, General Staff Corps,
Executive, Administrative Branch.

JULY 8, 1942.

TI-1171.

CONTRACT PRICE RENEGOTIATION

COMMANDING GENERAL,
Matériel Center, Wright Field, Dayton, Ohio.

1. *Problem Presented.*

a. To establish within the Contract Section, Matériel Center, Wright Field, Dayton, Ohio, a Price Adjustment Branch and a Cost Analysis Branch.

2. *Factual Data.*

a. By memorandum directive from the Under Secretary of War to the Commanding General, Services of Supply, and Commanding General, Matériel Command, Army Air Forces, dated June 30, 1942, a copy of which is attached, a War Department Price Adjustment Board was established and provision was made for the establishment of Price Adjustment and Cost Analysis Sections within the Matériel Command of the Army Air Forces.

3. *Authority.*

a. The Under Secretary of War.

4. *Action Desired.*

a. The creation within the Contract Section at the Matériel Center, Wright Field, Dayton, Ohio, of a Price Adjustment Branch and a Cost Analysis Branch.

b. All renegotiation shall take into consideration the financial position and over-all profits, past and prospective, of the contractor or subcontractor with a view to determining by agreement the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole.

c. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as may be prescribed.

d. The functions and duties of the Price Adjustment Branch, Matériel Center, shall be as follows:

(1) It shall conduct reviews and renegotiate contract prices of companies in accordance with the policy and procedure established and maintained by the Commanding General, Matériel Command.

(2) It shall submit all proposed contract modifications resulting from such renegotiation to the Commanding General for review and approval by proper authority.

(3) It shall procure from the Cost Analysis Branch such additional factual information or data as may be pertinent to or useful in connection with any review or renegotiation conducted by it.

(4) It may request the Contract Audit Section, Fiscal Division, Dayton, Ohio, to conduct special audits or reviews of the records of contractors or subcontractors holding contracts or subcontracts subject to renegotiation.

e. The function of the Cost Analysis Branch of the Contract Section of the Matériel Center shall be to act as a fact-finding unit with respect to costs and profits on War Department contracts.

f. Nothing herein contained shall preclude contracting officers from—

(1) Continuing to make adjustments of prices or fees in individual contracts containing an express provision for redetermination of the price or fee on the basis of a specified formula or containing an express provision that the price or fee shall be subject to renegotiation, whether or not under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942.

(2) Continuing to reconsider individual contracts of any type with a view to adjustment of the contract price by voluntary renegotiation or to accept voluntary reductions in such contract prices without auditing the accounts of the contractor or subcontractor if the amount is deemed reasonable.

g. Each adjustment shall be reported promptly to the Commanding General, Matériel Command, for transmittal to proper authority and shall be expressly made without prejudice to the determination of any excessive profits of the company upon subsequent renegotiation.

B. E. MEYERS,
Brigadier General,
Army Air Forces.

WAR DEPARTMENT,
OFFICE OF THE UNDER SECRETARY,
Washington, D. C., August 8, 1942.

MEMORANDUM FOR MR. MAURICE KARKER, CHAIRMAN, WAR DEPARTMENT PRICE ADJUSTMENT BOARD

Subject: Policy.

1. The following policies will be followed in the operation of the War Department Price Adjustment Board:

a. Since it would be administratively and practically impossible to analyze unit costs and profits on individual contracts, the Board will base its recommendations primarily on a study of the over-all profits of companies from their war contracts taken as a whole.

b. The Board will endeavor to reach agreements with as many companies as possible, as quickly as the size of its organization permits.

c. Detailed audits should not be attempted except in those cases where the Board feels that the companies' records, statements or estimates are incorrect, insufficient or misleading.

d. Due to the uncertainty of the supply of materials, wage rates, and other possible contingencies, the Board should allow a profit margin sufficient reasonably to protect the contractor. The Board shall not attempt to get the last increment of possible excess profit, but shall take a practical and realistic view in arriving at an agreement. Bear in mind always that uninterrupted, efficient, and maximum production (at minimum cost) is essential to the war effort and greatly desired by the War Department.

e. The attitude of the Board should be firm but friendly and renegotiations should be conducted in a spirit of cooperation and to require a minimum of time and inconvenience on the part of executives. Requests for information or detail not absolutely essential to the negotiation must be avoided.

f. The Board should consider the effect of the activities of other governmental agencies, such as the War Production Board, the Office of Price Administration and the Treasury Department, on the business of the company.

g. The uncertainty of estimates requires that the right be reserved to review findings when final figures of the year are available. But it will be the policy of the Board to allow its original agreements to stand, unless the actual figures with respect to such factors as costs, volume of production, or nature of products prove to be materially at variance with the estimates upon which the settlements were based. In the final review, if it is shown that increased profits have resulted from extra effort on the part of the contractor to reduce costs, the contractor will be given the benefit of this factor.

h. In case a company appears to be uncooperative or is unable or refuses to accept a settlement which the Board considers reasonable, the matter should be referred to the undersigned, Special Representative of the Under Secretary of War, for proper action.

2. Recognizing that it is not the intent or desire of business to make excessive profits out of war, it should be the effort of the Board to make its activities and operations of constructive benefit to contracting companies in the following respects:

a. Helping them to avoid the criticism, distrust and retaliation of the people, which would be sure to follow unreasonable and excessive profits by business.

b. Removing temptation to increase expenditures which would result in unsound and unnecessary increases in costs.

c. Helping to insure competitive advantage for industries on war work, after the war by emphasizing the maintenance of low unit costs.

d. Increasing incentive to maximum quantity production at minimum cost by relating allowed profits to production volume in proportion to facilities and efficiency shown in their use.

e. Ameliorating the tax burden, since reduction in expenditure reduces the size of necessary appropriations.

f. Helping to avoid disastrous inflation by using only the minimum number of dollars necessary to the winning of the war.

3. It should be made clear to executives and representatives of contracting companies engaged in renegotiation that it is the intention of the Board—

a. To encourage the application of sound business principles to war production by War Department contractors.

b. To maintain the present economy of private business enterprise as part of the freedom for which we are fighting the war.

c. To recognize that solvency and financial prudence in business management are essential to efficient operation.

d. To enable business, as far as possible, to emerge from the war in condition to resume peace-time operations as quickly and vigorously as possible, thus reducing the strains of the post-war adjustment to a minimum.

It is believed that when businessmen clearly realize the policies and purposes of the Board in these respects, they will readily cooperate with it in seeking the rapid advancement of its program.

(Signed) ALBERT J. BROWNING,
Colonel, A. U. S.,
Special Representative of the Under Secretary of War.

Approved:

(Signed) ROBERT P. PATTERSON,
Under Secretary of War.

WAR DEPARTMENT

PRICE ADJUSTMENT BOARD

PRINCIPLES, POLICY, AND PROCEDURE TO BE FOLLOWED IN RENEGOTIATION

Pursuant to a directive issued by the Under Secretary of War on June 30, 1942, designating the War Department Price Adjustment Board as the coordinating agency of the War Department to determine and eliminate by renegotiation excessive profits from War Department contracts, and subcontracts thereunder, subject to approval by the Under Secretary of War or his designated representative, the Board has established the principles, policy, and procedure to be followed in renegotiation.

I. STATUTE AND DIRECTIVES

The Sixth Supplemental National Defense Appropriation Act, 1942, approved April 28, 1942, contained a specific congressional enactment relating to excessive profits, constituting section 403 thereof, and authorizing and directing the Secretary of War, the Secretary of the Navy, and the Chairman of the Maritime Commission to require contractors and subcontractors to renegotiate contract prices, a copy of section 403 being attached hereto as exhibit A.

Subsection (b) of section 403 provides for the insertion in contracts made after April 28, 1942, of a provision requiring renegotiation of the contract price "at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty" as well as a provision requiring the contractor to insert a similar provision in each subcontract for an amount in excess of $100,000 made by him under such contract. For the form and discussion of these provisions reference is made to Circular No. 23 issued by headquarters, Services of Supply, on July 7, 1942.

Subsection (c) of section 403 provides as follows:

"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 from the contractor or subcontractor any amount of the contract price which is found as a result of such renegotiation to represent excessive profits, and (3) in case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor, to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States. All amounts recovered under this subsection shall be covered into the Treasury as miscellaneous receipts. This subsection shall 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."

This subsection authorizes and directs the Secretary of War, as well the Secretary of the Navy and the Chairman of the Maritime Commission, whenever in his opinion excessive profits have been realized, or are likely to be realized, from any contract with his department or from any subcontract thereunder, to require the contractor or subcontractor to renegotiate the contract price of any existing contract or subcontract, even though made prior to April 28, 1942 (provided final payment had not been made prior to that date) and of any contract or subcontract made thereafter, whether or not it contains a renegotiation or recapture clause.

On June 30, 1942, the Secretary of War delegated to the Under Secretary of War all the authority and discretion conferred upon him by subsections (a) to (e), inclusive, of section 403 and on the same day the Under Secretary of War in a memorandum directed to the Commanding General, Services of Supply and the Commanding General, Matériel Command, Army Air Forces, designated the War Department Price Adjustment Board as "the coordinating agency of the War Department to determine and eliminate by renegotiation excessive

profits from War Department contracts, and subcontracts thereunder, subject to approval by the Under Secretary of War or his designated representative," a copy of this directive being attached hereto as exhibit B.

This directive described the functions of the Board as follows:

(a) To establish policies, principles, and procedures to be followed in renegotiation.

(b) To assist the Services of Supply and the Matériel Command, Army Air Forces, in the selection and training of personnel.

(c) To assign companies to the Services of Supply and the Matériel Command, Army Air Forces, for renegotiation and to coordinate all renegotiation functions and activities.

(d) To review renegotiations and settlements recommended by the Services of Supply and the Matériel Command, Army Air Forces.

(e) To conduct renegotiation with any company, whenever, because of the size of the company, the dollar volume of the contracts involved, the number of contracting services interested, new questions presented, or for any other reason, it appears that renegotiation by the Services of Supply or the Matériel Command is impracticable.

(f) To develop and recommend for approval such other policies and procedures as it may deem advisable in performing its functions and accomplishing its purposes.

and authorized and directed the commanding general, Services of Supply, and the commanding general, Matériel Command, Army Air Forces, (1) to create Price Adjustment Sections to conduct renegotiations with such companies as may be assigned to them by the Board, subject to review by the Board and approval by the Under Secretary of War or his designated representative, except in cases where by general instructions or in the particular instance the Under Secretary or his representative may authorize them to make final agreements, and (2) to establish Cost Analysis Sections to act as fact-finding units with respect to costs and profits on contracts and subcontracts for the Price Adjustment Sections. Pursuant thereto, the commanding general, Services of Supply, on July 3, 1942, and the commanding general, Matériel Command, Army Air Forces, on July 8, 1942, issued directives providing for the creation of such Price Adjustment Sections and Cost Analysis Sections within the Supply Services and the Matériel Command, the latter being designated a Price Adjustment Branch, copies of these directives being attached hereto as exhibit C and exhibit D.

II. DUTIES OF PRICE ADJUSTMENT BOARD, PRICE ADJUSTMENT SECTIONS, AND CONTRACTING OFFICERS

The ultimate purpose of renegotiation under the statute is to determine excessive profits realized, or likely to be realized, from contracts with the departments and the Commission, or from subcontracts thereunder, and to provide for the withholding or recovery thereof by the United States. In renegotiation with companies which have contracts with the Navy Department or the Maritime Commission, as well as with the War Department, the renegotiations will be in charge of the department or Commission which they mutually agree has the predominant interest, the other departments or the Commission being represented if they so desire.

The directive from the Under Secretary of War provides that in conducting renegotiations the Board "shall take into consideration the financial position and over-all profits, past and prospective, of a contractor or subcontractor with a view to determining or agreeing upon the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole," and each of the directives providing for the creation of the Price Adjustment Sections provides that all renegotiation by them "shall take into consideration the financial position and over-all profits, past and prospective, of the contractor or subcontractor with a view to determining by agreement the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole." Under these directives the sections will confine their activities to reaching agreements subject to review by the Board and approval by the Under Secretary of War, or his designated representative. When an agreement cannot be reached the Board will be advised promptly.

The Board itself will conduct renegotiation with any company whenever because of the size of the company, the dollar volume of the contracts involved, the number of contracting services interested, new questions presented, or for any other

reason it appears that renegotiation by the Supply Services or the Matériel Command is impracticable.

Companies will be assigned by the Board to the Supply Services or the Matériel Command to determine whether they have realized, or are likely to realize, excessive profits from their contracts and subcontracts, and if so to conduct renegotiations through the Price Adjustment Sections. The service or command to which the company is assigned will be in charge of the renegotiation, but will notify the other services interested and, when interested, the Navy Department and the Maritime Commission, who may be represented if they so desire, it being the intention that only one agency shall negotiate with any one company on an over-all profit basis. Upon reaching an agreement, the service or command in charge of the renegotiation will obtain from the company a recommendation as to the allocation of any price reduction among the interested services, the departments, and the Commission for adjustment of prices and fees in individual contracts.

Under the directives, and as provided in circular No. 23, headquarters, Services of Supply, referred to above, the contracting officer is still authorized (a) to renegotiate the contract price or fixed fee pursuant to any renegotiation article in any contract whether inserted pursuant to section 403 or otherwise; (b) to redetermine the contract price under any article in the contract providing therefor; (c) to enter into supplemental agreements effecting voluntary reductions in the contract price or fixed fee of any contract; and (d) to demand cost and financial statements pursuant to statutory or contract provisions to the extent necessary to carry out these functions. The contracting officer periodically will review costs and profits under contracts subject to his supervision in order to obtain reductions in the contract price whenever justified. The provisions of (d) above relate to the review of individual contracts and contracting officers should not demand financial statements for the purpose of renegotiation on the over-all profit basis.

The contract price as renegotiated or redetermined by the contracting officer or as voluntarily reduced will still be subject to renegotiation under section 403, and any contract article pursuant thereto, to eliminate excessive profits of the contractor. The supplemental agreement or other instrument effecting the adjustment in price or fixed fee will therefore include a proviso substantially as follows:

"The adjustment hereby made in the contract price is without prejudice to the determination of any excessive profits of the of the contractor upon subsequent renegotiation under section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, or any contract article inserted pursuant to that act."

The contracting officer will promptly report each such adjustment to the chief of the appropriate Supply Service or the commanding general, Matériel Command, Army Air Forces, as the case may be, for transmittal to the Director, Purchases Division, Services of Supply, as representative of the Under Secretary of War.

III. Contractors and Subcontractors Who May Be Required to Renegotiate

The form of the renegotiation clause to be inserted in each contract for an amount in excess of $100,000 made after April 28, 1942, in accordance with subsection (b) of the statute requires contractors to include a similar renegotiation clause in only those subcontracts which are made with prime contractors, or with manufacturers producing for the prime contractor the same completed unit covered by the prime contract (who for purposes hereof will be included in the term "prime contractor"), in other words, the so-called first tier of subcontracts, and defines the term "subcontract" as follows:

"The term 'subcontract' includes any purchase order from, or any agreement with, the contractor (i) to perform all or any part of the work to be done under this contract, or to make or furnish all or any part of any articles or structures covered by this contract, (ii) to supply any services required directly for the production of any articles or structures covered by this contract, or any component part thereof, not including services for the general operation of the contractor's plant or business, (iii) to make or furnish any articles destined to become a component part of any article covered by this contract, or (iv) to make or furnish any article acquired by the contractor primarily for the performance of this contract, or this contract and any other contract with the

United States. The term 'articles' includes any supplies, materials, machinery, equipment, or other personal property."

Pending further instructions this definition of subcontracts will be adopted in determining what subcontractors may be required to renegotiate under subsection (c) of the statute. Accordingly any company which has one or more prime contracts with the War Department or which has one or more subcontracts (as so defined) with a prime contractor may be required to renegotiate. Nevertheless when it appears that a company has made excessive profits on subcontracts or orders from others than prime contractors for products or materials flowing into war production and the company refuses to renegotiate them, a statement of the circumstances will be forwarded to the Board promptly.

IV. CONTRACTS AND SUBCONTRACTS SUBJECT TO ADJUSTMENT AS A RESULT OF RENEGOTIATION

Subsection (c) of the statute, providing for renegotiation of the contract price where excessive profits have been realized or are likely to be realized, is applicable to all contracts and subcontrasts (as defined above), whether made before or after April 28, 1942 (provided that final payment had not been made prior to that date), and whether or not they contain a renegotiation or recapture clause, and the terms "renegotiate" and "renegotiation" are defined in subsection (a) to include "the refixing by the Secretary of the Department of the contract price."

Subsection (c) of the statute does not impose a minimum dollar limitation on contracts or subcontracts under which the contract price may be refixed, corresponding to the $100,000 limitation in subsection (b), and therefore the contract price in any contract or subcontract may be so refixed irrespective of the amount of the contract or subcontract.

Under subsection (c) of the statute, contractors and subcontractors may be required to renegotiate the fees in cost-plus-a-fixed-fee contracts in force on April 28, 1942, and as a result of such renegotiation the fees may be refixed. They will also be required to renegotiate the fees in cost-plus-a-fixed-fee contracts made after that date in those cases where the contract contains a provision for renegotiation of the fee. For instructions relating to the insertion of renegotiation clauses in cost-plus-a-fixed-fee contracts pursuant to subsection (b) of the statute, reference is made to circular No. 23, Headquarters, Services of Supply, referred to above.

V. RENEGOTIATION PROCEDURE

The procedure in renegotiation will conform with that prescribed in the directives supplemented by such instructions as may be issued by the Under Secretary of War from time to time.

Renegotiation should proceed first to a determination of the total excessive profits from war production during a specified period, which ordinarily will be the current fiscal year of the company. It is necessary to distinguish between a period already past, for which definite figures are available, and a current or future period for which only estimates are available. For a past period, such as a prior fiscal year or the expired part of the current fiscal year, a definite amount of excessive profits can be determined. For a current or future period, such as the current fiscal year or the unexpired part thereof, the estimated amount of excessive profits is related to the estimated volume of business. The full dollar amount of excessive profits determined for a past period may be withheld or recovered by the Government, but the dollar amount determined for a current or future period is only an estimate, unless otherwise agreed, and the actual dollar amount withheld or recovered may turn out to be more or less than that stated.

The total war production for the period should be segregated, when practicable, between (a) the prime contracts, (b) the subcontracts with other prime contractors and (c) the rest of the war production. When this is not practicable, for accounting or other reasons, the total excessive profits agreed upon may be allocated between (a), (b), and (c) above. This allocation need not be by individual contract or on a unit cost basis and can readily be worked out with the company by groups of contracts. Provision must be made for withholding or recovery by the Government of excessive profits from the prime contracts and the subcontracts with prime contractors, but voluntary arrangements for additional price reductions on products or materials flowing into war production are to be encouraged and obtained wherever possible.

The primary purpose of the renegotiation is to arrive at the prices which would have been agreed upon when the contracts were made if the facts and factors now known had been known at that time. Accordingly, after an agree-

ment has been reached with a contractor or subcontractor as to the aggregate amount of any excessive profits realized, or likely to be realized, from its prime contracts and subcontracts with other prime contractors, these excessive profits may be withheld or recovered by the Secretary of War, the Secretary of the Navy, or the Chairman of the Maritime Commission in various ways, among which are the following: (1) A direct cash refund by the prime contractor to the Government, in which event his contract prices would not be adjusted; (2) a reduction in the contract prices on future deliveries under prime contracts, which automatically would accrue to the benefit of the Government; (3) a direct cash refund by the subcontractor to the Government; and (4) a reduction in the contract prices on future deliveries under subcontracts, with a provision that the prime contractors, as a condition to its acceptance, should pass on an equivalent benefit to the Government in the form of a corresponding reduction in the contract prices of the prime contracts or a direct cash refund to the Government. These methods may also be used in combination and are not exclusive of other appropriate and effective methods applicable to particular situations. When the procedure under (4) above places an undue burden of adjustment on the prime contractor, the latter can arrange with the Government for a periodic method of accounting.

Notwithstanding the foregoing, when substantially all the war work of a company, such as those engaged in construction, is covered by a few individual contracts, renegotiation may be conducted on the individual contract basis, subject to check on the overall profit basis, with the approval of the chief of the appropriate supply service or the commanding general, matériel command.

Agreements reached by the Board will be transmitted directly to the Under Secretary of War, or his designated representative, for final approval. Agreements reached by the price adjustment sections of the Services of Supply will be transmitted in the first instance to the chief of the appropriate Supply Service. Agreements reached by the Price Adjustment Branch of the Matériel Command, Army Air Forces, will be transmitted in the first instance to the Commanding General, Matériel Command. When approved by the chief of the Supply Service or the Commanding General, Matériel Command, they will be transmitted to the Board for review, except in cases where by general instructions or in the particular instance, the Supply Services or the Matériel Command may be authorized to make final agreements.

The Director, Purchases Division, Services of Supply (Col. A. J. Browning), has been designated by the Under Secretary of War as his duly authorized representative for the foregoing purposes.

I. Elimination of Excessive Profits

In the present emergency the existence of excessive profits is no indication that a company has taken undue advantage of the Government or that the contracting officers have failed to exercise their best judgment under all the circumstances where companies have been asked to produce war equipment with which neither they nor others have had any previous experience, and in quantities far beyond anything ever before contemplated. Estimates of costs have necessarily been unreliable and when subjected to the test of actual production have often proved to be substantially higher than the actual costs. Companies have been left with profits which they neither anticipated nor wish to retain. The true purpose of renegotiation is to determine, preferably by agreement, the amount of these profits which exceed a fair margin under all the circumstances, and these circumstances are bound to vary in individual cases.

The purpose of renegotiation is to eliminate excessive profits at the source and in this respect it is distinguishable from taxation which can only reach excessive profits long after they have accrued. When these profits have to be eliminated or returned as they accrue instead of a year or more later costs will be substantially reduced for lower prices invariably stimulate efficiency in production and any reduction in contract prices will leave the War and Navy Departments and the Maritime Commission that much more money available to meet the expenses of the war without asking Congress for additional appropriations.

The ultimate test is what would have been a fair profit before Federal and other income and excess-profits taxes. It is for Congress, through the Treasury, to determine how much of that profit should be taxed. Increases or proposed increases in tax rates, while a factor to be considered, should not affect the principles of renegotiation or change the basic consideration from what would

be a fair profit before taxes to what would be a fair profit after taxes. To renegotiate on the basis of allowing a company a fair profit after taxes would be tantamount to returning to the company part of what Congress has decided should be its contribution to the war effort. The effect of the excess-profits tax on companies which are financially extended and have little or no tax base is frequently so severe, however, that strict adherence to the principle of considering only profits before taxes would leave practically nothing for the company, or even result in financial embarrassment, and under these circumstances the profit after taxes is a factor which may be taken into consideration in order not to impair its incentive to production.

VII. Determination of Excessive Profits

Renegotiation in most instances will be confined to the determination of excessive profits, past and prospective, for the fiscal year of the company in which the renegotiation takes place. Companies will not be required to renegotiate for any fiscal year ending on or before December 31, 1941, except with the approval of the Board on each occasion.

The Cost Analysis sections will obtain, from other Government agencies and by use of statistical services or personal inquiry or investigation, the basic data for its fact-finding report on the profits, past and prospective, as shown by the records and estimates of the company. If questionnaires are used, they should be of a uniform type to be developed under the supervision of the Board.

The Price Adjustment Sections will analyze the costs allocable to war production of the company, with a view to excluding improper or excessive charges including excessive salaries, bonuses, and commissions; unreasonable maintenance and depreciation charges; improper amortization of war facilities or write-ups of property; unreasonable charges for research, development, and experimental work; and unallowable advertising expenses. They will consider the propriety and amount of the reserves and extraordinary charges to income. They will review the estimates of prospective sales and costs in the light of information obtained from the War Department and based on experience with other companies.

The Price Adjustment Sections will be guided in general by the following principles of renegotiation established by the War Department Price Adjustment Board:

A company is entitled to no more than a reasonable war-time margin of profit. Ordinarily this is taken as the ratio of profits before taxes to sales or to costs or to net worth at the beginning of the year. Under existing war conditions more reliance should be placed on the ratio of profit to sales or to adjusted costs, and the ratio of profit to net worth should be used only as a check. In determining what percentage would be fair, consideration should be given to the corresponding profits in pre-war years for the particular company and for the industry especially in cases where the war products are substantially like the pre-war products, but it cannot be assumed that under war conditions a company requires as great a margin of profit as under competitive conditions in normal times; to the corresponding percentage allowed to other companies manufacturing similar war products or operating under similar conditions; and to the volume of sales, the allowable percentage being reduced on a graduated scale as the volume increases. Consideration should also be given to the ratio of labor and burden (overhead) to materials included in the adjusted costs since a company performing its own contracts requires a greater margin of protection than one which subcontracts most of the work, and a company engaged in a complex manufacturing operation is entitled to more consideration than one engaged in a comparatively simple manufacturing operation. Consideration may also be given to the fact that a company has voluntarily made available to the Government its patent rights affecting war production.

The margin of profit so determined should be adjusted, upward or downward, to reflect consideration of so-called factors of performance in respect of which the operations of the company compare favorably or unfavorably with those of other companies engaged in war production. Among these factors of performance are the following: (1) Quality of production; (2) rate of delivery and turnover; (3) inventive contribution; (4) cooperation with other manufacturers; (5) economy in use of raw materials; and (6) efficiency in reducing costs.

The margin of profit so determined should also be adjusted upward to reflect consideration of risks attributable to war production which a company with fixed-price contracts must assume. Among these risks are the following: (1)

Increases in cost of materials; (2) imminent wage increases; (3) inexperience in new types of production; (4) complexity of manufacturing technique; and (5) delays from inability to obtain materials.

In the case of a company with substantial capital devoted to war production, the ratio of the profit so determined to net worth at the beginning of the year should then be used as a check to determine whether the company is making a fair return on its investment. Net worth should be analyzed to determine to what extent it includes accumulated profits from war business. Furthermore, it cannot be assumed that under war conditions a company is entitled to as great a return as under competitive conditions in normal times.

No attempt will be made to prescribe or even recommend actual percentages or ranges of percentages, for use in determining excessive profits. These percentages necessarily vary under all the circumstances and should be arrived at by the Price Adjustment Sections in discussions with representatives of companies engaged in the particular business under consideration.

VIII. Agreements

All agreements resulting from renegotiation should be in writing signed in behalf of the company by the owner, a partner, or an authorized officer and, in the case of a corporation, accompanied by an attested copy of the authorizing resolution of the board of directors. They will be executed in behalf of the Government by the Under Secretary of War, or his duly authorized representative, or by the chief of the appropriate Supply Service or the commanding general, Matériel Command, when so authorized by general instructions or in the particular instance.

If further negotiations are contemplated before the company receives a clearance under the statute for the period under consideration, the agreement will not be final but in that event must contain a provision substantially as follows:

"This agreement is not final and is made without prejudice to the determination of any exeecssive profits realized, or likely to be realized, by the undersigned for the fiscal year under consideration upon for the period from to subsequent final renegotiation under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, or any contract article inserted pursuant to that Act, but no amount previously paid or credited to or withheld by the Government as a result of any renegotiation shall be refunded as a result of any subsequent renegotiation."

On the other hand, if the company is to have a clearance for the period under consideration, it must execute a final agreement, a skeleton form of which is attached hereto as exhibit E.

(1) Prohibited provisions

For administrative reasons agreements should not contain any provision which would have the effect of requiring the Government to repay all or any part of any payment previously made to it thereunder.

Complicated questions of taxation arise in connection with renegotiation, particularly where the agreement provides for a cash refund. It is expected that as a result of recent conferences the Internal Revenue Bureau will presently issue a statement of its policy from which companies and their counsel will be able to satisfy themselves as to the general principles involved, but the company should take up detailed questions relating to any particular return or to any unusual situation directly with the Bureau. Conferences with representatives of the Bureau can be arranged through the Board upon request. The Bureau will be prepared to rule promptly on questions presented and accordingly no agreement should be made conditional upon the determination of any related tax question.

(2) Interim agreements

Agreements which are not final need not be in any particular form, a covering letter signed by an authorized officer of the company being sufficient. They may contain provisions of more latitude than would be appropriate from an administrative standpoint in a final agreement, but care should be taken not to impose an unusual or unnecessary burden on contracting and accounting officers. An effort should be made to see that the Government obtains directly or indirectly the benefit of any price reductions provided for, and general price reductions

on products and materials which ultimately flow into war production should be encouraged and obtained when possible even though the benefit to the Government may be too indirect to be made the subject of specific provision.

(3) FINAL AGREEMENTS

Final agreements must be related to the statute and must follow the general structure of exhibit E. For that purpose schedules should be attached to the agreement containing either an enumeration or a general description of the prime contracts and the subcontracts with other prime contractors. In many cases an enumeration of the subcontracts will be impracticable, but by arrangement with the company the known subcontracts can be generally described.

A dollar amount should be agreed upon, and inserted in the agreement, as representing the aggregate excessive profits realized, or likely to be realized, by the company from the prime contracts and subcontracts described in the schedules for the fiscal year or other period under consideration. The expression "or likely to be realized" is taken from the statute and indicates that the aggregate dollar amount is based on estimates for such fiscal year or other period. The excessive profits ultimately realized, being based on estimates, may turn out to be more or less than the dollar amount stated and, accordingly, unless otherwise agreed, the actual dollar amount stated may not be withheld or recovered.

Although such agreements are final in the sense that no further or subsequent renegotiation for the fiscal year or other period in question is contemplated, the estimates on which they are based should be set forth in an exhibit attached thereto and will be subject to review after the close of such fiscal year or other period and accordingly the provision to that effect set forth in exhibit E is a uniform provision and may not be changed in any respect. The uncertainty of estimates requires that the right be reserved to review findings when final figures of the fiscal year or other period become available, but it will be the policy of the Secretary of War to allow original agreements to stand unless the actual figures with respect to such factors as costs, volume of production, or nature of products prove to be materially at variance with the estimates upon which the settlements were based. In the final review, if it is shown that increased profits have resulted from extra effort on the part of the company to reduce costs, the company will be given the benefit of this factor.

The last paragraph of exhibit E must be included and may not be changed in any respect.

(4) ILLUSTRATIVE PROVISIONS

The provisions of exhibit E relating to refunds and price reductions may be varied to give effect to the particular refunds and price reductions negotiated, but so far as possible the framework of these provisions as they appear should be followed. The terms and conditions upon which such refunds or price reductions may be negotiated cannot be prescribed because of the impossibility of anticipating particular situations which may have to be provided for, but simplicity is essential and so far as possible conditions which are dependent upon future circumstances involving complicated accounting, administrative difficulties or controversial questions should be avoided. Whatever these terms and conditions may be, they should be set forth specifically in an exhibit attached to the agreement.

Without intending to restrict or encourage the use of any particular type of provision, and merely as an illustration, the following description of certain types of provisions which have already been used by the Board in renegotiation is submitted:

In renegotiation for a prior fiscal year, such as 1941, the return of excessive profits will ordinarily take the form of a refund. Since the agreement and refund will be made after the close of such fiscal year, the Internal Revenue Bureau will not adjust the tax liability to reflect the result of the renegotiation, and therefore that part of the tax liability, settled or admitted, which represents a tax on the excessive profits agreed upon must be taken into consideration in the renegotiation. It is expected upon request the Internal Revenue Bureau will furnish a statement of this amount and enter into an appropriate closing agreement. The agreement should contain a provision whereby the company waives any claim for redetermination, abatement, or refund of the tax by reason of the renegotiation.

In renegotiation for a current fiscal year, such as 1942, the return of excessive profits may be accomplished by a price reduction as well as by a refund. The agreement will determine the excessive profits realized, or likely to be realized, by the company during such fiscal year from prime contracts and subcontracts with prime contractors in force at the time of the renegotiation or completed prior thereto, based on the estimates attached thereto. The withholding or recovery of these estimated excessive profits may be accomplished by various forms of price reduction or refund. Among these, for example, are the following: (*a*) The company will make an actual reduction effective as of a particular date in the actual price to be charged for certain products or materials; or (*b*) instead of making an actual price reduction, the company will make a cash refund to the Government monthly, quarterly, or semiannually in an amount equal to a specified percentage of its actual net sales of certain products or materials, or perhaps of all products or materials during the period, with a credit for any price reductions ordered by the Office of Price Administration or other Government agencies; or (*c*) the company will set aside on its books a reserve in the amount agreed upon, against which it may make certain charges for prescribed items such as reduction in volume of net sales below the estimated amount, uncompensated costs from shut-downs due to shortages of materials or imminent labor difficulties, price reductions ordered by the Office of Price Administration or other Government agencies, increases in the price of raw materials and other anticipated situations, and at the end of the year it will pay or credit to the Government the balance of the reserve; or (*d*) the company will make reductions in the price of various products or materials for the balance of the current fiscal year in amounts which may vary from time to time in its discretion, and at the end of the year it will pay or credit to the Government an amount equal to the excess of its profit before taxes over a certain percentage of its actual net sales during that period, which percentage should be limited to a specified dollar amount. Provisions of the type in (*c*) and (*d*) above should be resorted to only when special circumstances make the use of the type in (*a*) or (*b*) impracticable. Tax questions arising out of these provisions, when not covered by the statement of policy to be issued by the Internal Revenue Bureau, should be taken up with the Bureau by representatives of the company, and conferences to this end can be arranged through the Board upon request.

IX. Review

Four original counterparts of each agreement, interim or final, each final agreement being executed in behalf of the company in the manner prescribed above, will be transmitted by the Price Adjustment Sections of the Supply Services to the chief of the appropriate service or by the Price Adjustment Branch of the Matériel Command, Army Air Forces, to the Special Assistant to the Chief of Staff and will be accompanied by the following documents:

A signed original and three copies of a summary analysis along the lines indicated in PAB Form No. 10–E.

A memorandum showing the allocation of the refunds and price reductions provided for in the agreement between the War Department, the Navy Department and the Maritime Commission, and their subordinate services, proposed by the company and recommended by the section or branch.

If the chief of the appropriate Supply Service or the Commanding General, Matériel Command, approves the settlement covered by the agreement, it will be transmitted to the War Department Price Adjustment Board for review unless the Under Secretary of War, by general instructions or in the particular instance, has directed that such approval shall be final.

X. Audits and Financial Information

Subsections (d) and (e) of section 403 provide as follows:

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable. For

the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred, each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each department shall have the right to demand of any contractor who holds contracts with respect to which the provisions of this section are applicable in an aggregate amount in excess of $100,000, statements of actual costs of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who willfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any such statement containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

Subsection (a) provides that for the purposes of subsections (d) and (e) the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

Pursuant to Executive Order 9127, issued on April 10, 1942, the President designated certain governmental agencies, including the War Department, as the governmental agencies authorized to inspect the plant and audit the books and records, as provided in Title XIII of the Second War Powers Act, 1942, and authorized the War Production Board to issue rules and regulations and establish policies to coordinate and govern these agencies in exercise of the functions vested in them by that order. Accordingly no inspection or audit under subsection (d) should be made or authorized except through the Cost Analysis Section of the Supply Service or of the Matériel Command in charge of the renegotiation, which will first advise the Cost Analysis Section of the War Production Board in the manner prescribed by the Fiscal Division. All formal demands for inspection or audit under subsection (d) or for financial statements under subsection (e) must first be authorized by the chief of the Supply Service or the commanding general, matériel command, in charge of the renegotiation who will obtain any necessary approval by the Under Secretary of War, or his designated representative.

MAURICE H. KARKER,
Chairman, War Department Price Adjustment Board.

Recommended for approval:
ALBERT J. BROWNING,
Colonel, A. U. S.

Approved:
ROBERT P. PATTERSON,
Under Secretary of War.

EXHIBIT "A." SEC. 403 OF TITLE IV OF THE SIXTH SUPPLEMENTAL NATIONAL DEFENSE APPROPRIATION ACT, 1942, APPROVED APRIL 28, 1942

SEC. 403. (a) For the purposes of this section, the term "Department" means the War Department, the Navy Department, and the Maritime Commission, respectively, in the case of the Maritime Commission, the term "Secretary" means the Chairman of such Commission; and the terms "renegotiate" and "renegotiation" include the refixing by the Secretary of the Department of the contract price. For the purposes of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) The Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department (1) a provision for the renegotiation of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty; (2) a provision for the retention by the United States or the repayment to the United States of (A) any amount of the contract price which is found as a result of such renegotiation to represent excessive profits and (B) an amount of the contract price equal to the amount of the reduction in the contract price of any subcontract under such contract pursuant to the renegotiation of such subcontract as provided in clause (3) of this subsection; and (3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (A) a provision for the renegotiation by such Secretary and the subcontractor of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty, (B) a provision for the retention by the United States or the repayment to the United States of any amount of the contract price of the subcontract which is found as a result of such renegotiation, to represent excessive profits, and (C) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by or repaid to the United States.

(c) 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 from the contractor or subcontractor any amount of the contract price which is found as a result of such renegotiation to represent excessive profits, and (3) in case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor, to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States. All amounts recovered under this subsection shall be covered into the Treasury as miscellaneous receipts. This subsection shall 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.

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable. For the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred, each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each Department shall have the right to demand of any contractor who holds contracts with respect to which the provisions of this section are applicable in an aggregate amount in excess of $100,000, statements of actual costs of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who willfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any

such statement containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the Department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

(f) The authority and discretion herein conferred upon the Secretary of each Department, in accordance with regulations prescribed by the President for the protection of the interests of the Government, may be delegated, in whole or in part, by him to such individuals or agencies in such Department as he may designate, and he may authorize such individuals or agencies to make further delegations of such authority and discretion.

(g) If any provision of this section or the application thereof to any person or circumstance is held invalid, the remainder of the section and the application of such provision to other persons or circumstances shall not be affected thereby.

(h) This section shall remain in force during the continuance of the present war and for three years after the termination of the war, but no court proceedings brought under this section shall abate by reason of the termination of the provisions of this section.

EXHIBIT B

JUNE 30, 1942.

MEMORANDUM FOR COMMANDING GENERAL, SERVICES OF SUPPLY, COMMANDING GENERAL, MATÉRIEL COMMAND, ARMY AIR FORCES

Subject: War Department Price Adjustment Board.

1. The Price Adjustment Board created by memorandum of April 25, 1942, is hereby redesignated as the War Department Price Adjustment Board. It will serve as the coordinating agency of the War Department to determine and eliminate by renegotiation excessive profits from War Department contracts, and subcontracts thereunder, subject to approval by the Under Secretary of War or his designated representative.

2. The functions of the Board will be:

(a) To establish policies, principles, and procedures to be followed in renegotiation.

(b) To assist the Services of Supply and the Matériel Command, Army Air Forces, in the selection and training of personnel.

(c) To assign companies to the Services of Supply and the Matériel Command, Army Air Forces, for renegotiation and to coordinate all renegotiation functions and activities.

(d) To review renegotiations and settlements recommended by the Services of Supply and the Matériel Command, Army Air Forces.

(e) To conduct renegotiation with any company, whenever, because of the size of the company, the dollar volume of the contracts involved, the number of contracting services interested, new questions presented, or for any other reason, it appears that renegotiation by the Services of Supply or the Matériel Command is impracticable.

(f) To develop and recommend for approval such other policies and procedures as it may deem advisable in performing its functions and accomplishing its purposes.

3. The members of the Board will be appointed by the Under Secretary of War on the recommendation of the Commanding General, Services of Supply and the Commanding General, Matériel Command, Army Air Forces. One member will be selected with the approval of the Chairman of the War Production Board as his representative. The present membership of the Board shall continue during the pleasure of the Under Secretary of War.

4. The Board is instructed wherever appropriate to function jointly with representatives or agencies of the Navy Department, Maritime Commission, and other Departments or agencies of the Government.

5. The Board will receive from the Cost Anaylsis Section of the War Production Board, the Cost Analysis Section of the Fiscal Division of the Services of

Supply, the Supply Services, the Army Air Forces, and from any other source, information with respect to contractors and subcontractors who are thought to have excessive costs, to be making excessive profits, or to be paying excessive salaries or bonuses.

6. (a) The Cost Analysis Section of the Fiscal Division of the Services of Supply shall upon request of the Board make such audits and analyses as may be designated by the Board and shall secure for the Board from the Treasury Department, the Securities and Exchange Commission, the Federal Trade Commission, and from any other Department or agency of the Government, or from the contractor involved, such additional information as the Board may request in order to expedite and assist it in the performance of its functions.

(b) All Divisions and personnel of the Services of Supply and the Matériel Command, Army Air Forces, shall furnish such information and assistance to the Board as it may request or as may appear desirable to aid it in the performance of its functions.

7. The Board is authorized to delegate to any one or more of its members the power to initiate investigations and request information and assistance on behalf of the Board and to represent the Board in renegotiations with contractors and subcontractors.

8. In conducting renegotiations the Board shall take into consideration the financial position and overall profits, past and prospective, of a contractor or subcontractor with a view to determining or agreeing upon the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole, subject to such instructions as the Under Secretary of War may issue from time to time.

9. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as he may prescribe from time to time.

10. The manner in which agreements shall be carried out, whether by a reduction of contract prices, refunds or otherwise, shall be determined by the Under Secretary of War, or his designated representative. Agreement shall be reached with the Navy Department and the Maritime Commission as to any part of the agreement affecting contracts with them.

11. The Commanding General, Services of Supply, and the Commanding General, Matériel Command, Army Air Forces, are authorized and directed to create, with the advice of the War Department Price Adjustment Board, Price Adjustment Sections to conduct renegotiations with such companies as may be assigned to them by the War Department Price Adjustment Board, subject to review by the Board and approval by the Under Secretary of War or his designated representative, except in cases where by general instructions or in the particular instance, the Under Secretary or such representative may authorize them to make final agreements.

12. The Commanding General, Services of Supply, and the Commanding General, Matériel Command, Army Air Forces, are authorized and directed to establish within their command such Cost Analysis Sections as shall be necessary to act as fact-finding units with respect to cost and profits on War Department contracts, and subcontracts thereunder, for the foregoing Price Adjustment Sections.

13. The Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, is hereby designated as the duly authorized representative of the Under Secretary of War for the purposes specified herein.

14. The Board will be assigned to the Services of Supply for administrative purposes.

15. The provisions of memorandum of April 25, 1942, are modified accordingly.

(Signed) ROBERT P. PATTERSON.
Under Secretary of War.

EXHIBIT C

WAR DEPARTMENT,
HEADQUARTERS, SERVICES OF SUPPLY,
SPPDP 020 (7-3-42) *Washington, D. C., July 3, 1942.*

MEMORANDUM FOR DIRECTORS AND CHIEFS OF STAFF DIVISIONS, THIS HEADQUARTERS, CHIEFS OF SUPPLY AND ADMINISTRATIVE SERVICES, SERVICES OF SUPPLY, AND COMMANDING GENERALS, ALL CORPS AREAS

Subject: Price Adjustment Sections.

1. The chief of each Supply Service is authorized and directed to create, with the advice of the War Department Price Adjustment Board, such Price Adjustment Sections as may be necessary, to renegotiate contracts with such contractors and subcontractors as may be assigned to his Service by the War Department Price Adjustment Board.

2. The chief of each Supply Service is authorized and directed to establish in the Fiscal Division of such Service a Cost Analysis Section, the function of which shall be to act as a fact-finding unit with respect to costs and profits on War Department contracts and subcontracts thereunder. Pursuant to Paragraph 9 *g* (5) of the initial directive for the organization of the Services of Supply, dated March 9, 1942, the Fiscal Division, Headquarters, Services of Supply, shall prescribe, supervise and coordinate all cost analysis methods and procedures within the Supply Services.

3. All renegotiation by any Price Adjustment Section shall take into consideration the financial position and overall profits, past and prospective, of the contractor or subcontractor with a view to determining by agreement the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole, subject to such instructions as the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, may issue from time to time.

4. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as may be prescribed.

5. Agreements reached by the Price Adjustment Sections shall be transmitted to the chief of the appropriate Supply Service and, when approved by such chief, shall be transmitted to the War Department Price Adjustment Board for review by the Board and final approval by proper authority, except in cases where, by general instructions or in the particular instance, the chiefs of the Supply Services are authorized to make final agreements.

6. The manner in which agreements shall be carried out, whether by a reduction of contract prices, refunds or otherwise, shall be determined by the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply.

7. Nothing herein contained shall preclude contracting officers from—

a. Continuing to make adjustments of prices or fees in individual contracts containing an express provision for redetermination of the price or fee on the basis of a specified formula or containing an express provision that the price or fee shall be subject to renegotiation, whether or not under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942.

b. Continuing to reconsider individual contracts of any type with a view to adjustment of the contract prices by voluntary renegotiation or to accept voluntary reductions in such contract prices without auditing the accounts of the contractor or subcontractor if the amount is deemed reasonable.

Each adjustment shall be reported promptly to the Chief of the appropriate Supply Service for transmittal to the Chief, Purchases Branch, Procurement and Distribution Division, Services of Supply, for the information of the War Department Price Adjustment Board and shall be expressly made without prejudice to the determination of any excessive profits of the company upon subsequent renegotiation.

8. These instructions are issued in conformity with memorandum from the Under Secretary of War dated June 30, 1942, copy attached, and supplement the memorandum dated April 25, 1942, subject: Price Adjustment Board, Services of Supply.

For the Commanding General: (Signed) H. A. MALIN,
Colonel, General Staff Corps, Executive, Administrative Branch.

1 Incl.
c/Memorandum dated
6-30-42

EXHIBIT "D"

TI-1171 JULY 8, 1942.

CONTRACT PRICE RENEGOTIATION

COMMANDING GENERAL, MATÉRIEL CENTER,
Wright Field, Dayton, Ohio

1. Problem Presented.

a. To establish within the Contract Section, Matériel Center, Wright Field, Dayton, Ohio, a Price Adjustment Branch and a Cost Analysis Branch.

2. Factual Data.

a. By memorandum directive from the Under Secretary of War to the Commanding General, Services of Supply, and Commanding General, Matériel Command, Army Air Forces dated June 30, 1942, a copy of which is attached, a War Department Price Adjustment Board was established and provision was made for the establishment of Price Adjustment and Cost Analysis Sections within the Matériel Command of the Army Air Forces.

3. Authority.

a. The Under Secretary of War.

4. Action Desired.

a. The creation within the Contract Section at the Matériel Center, Wright Field, Dayton, Ohio, of a Price Adjustment Branch and a Cost Analysis Branch.

b. All renegotiation shall take into consideration the financial position and overall profits, past and prospective, of the contractor or subcontractor with a view to determining by agreement the amount of any excessive profits realized, or likely to be realized, from its war contracts taken as a whole.

c. All agreements reached as a result of such renegotiation shall be made expressly subject to approval by the Under Secretary of War, or his duly authorized representative, and shall be in such form and accompanied by such supporting reports and documents as may be prescribed.

d. The functions and duties of the Price Adjustment Branch, Matériel Center, shall be as follows:

(1) It shall conduct reviews and renegotiate contract prices of companies in accordance with the policy and procedure established and maintained by the Commanding General, Matériel Command.

(2) It shall submit all proposed contract modifications resulting from such renegotiation to the Commanding General for review and approval by proper authority.

(3) It shall procure from the Cost Analysis Branch such additional factual information or data as may be pertinent to or useful in connection with any review or renegotiation conducted by it.

(4) It may request the Contract Audit Section, Fiscal Division, Dayton, Ohio, to conduct special audits or reviews of the records of contractors or subcontractors holding contracts or subcontracts subject to renegotiation.

e. The function of the Cost Analysis Branch of the Contract Section of the Matériel Center shall be to act as a fact finding unit with respect to costs and profits on War Department contracts.

f. Nothing herein contained shall preclude contracting officers from—

(1) Continuing to make adjustments of prices or fees in individual contracts containing an express provision for redetermination of the price or fee on the basis of a specified formula or containing an express provision that the price or fee shall be subject to renegotiation, whether or not under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942.

(2) Continuing to reconsider individual contracts of any type with a view to adjustment of the contract prices by voluntary renegotiation or to accept voluntary reductions in such contract prices without auditing the accounts of the contractor or subcontractor if the amount is deemed reasonable.

g. Each adjustment shall be reported promptly to the Commanding General, Matériel Command, for transmittal to proper authority and shall be expressly made without prejudice to the determination of any excessive profits of the company upon subsequent renegotiation.

B E. MEYERS,
Brigadier General,
Army Air Forces.

Attach. Cy memo fr USW 6-30-42

EXHIBIT E

WAR DEPARTMENT

(SUPPLY SERVICE OF MATÉRIEL COMMAND)

Price Adjustment Section

AGREEMENT

Date: _____, 194__.

I. As a result of renegotiation between the undersigned _____ { a sole owner / a partnership / a _____ corporation } with its principal office at _____, in the City of _____, State of _____, and the Under Secretary of War, it has been found that _____ Dollars ($_____) of the aggregate prices and fees of the undersigned in effect under the contracts of the undersigned with the War Department (and in contracts, if any, with the Navy Department and the Maritime Commission) enumerated or generally described in Exhibit A attached hereto, and in its subcontracts enumerated and generally described in "Exhibit B" attached hereto, represent the amount of excessive profits realized, or likely to be realized, by the undersigned during its fiscal year ending _____, 194__. The finding herein is based upon the financial and other data including the comparative statement of projected operating results before and after this adjustment for said fiscal year, and is subject to the terms and conditions, all as set forth in "Exhibit C" attached hereto. "Exhibit D" attached hereto contains a complete list of the subsidiaries of the undersigned, all of which are consolidated with the undersigned for the purposes hereof except such, if any, as may be expressly excluded by proper notation on said exhibit.

II. The undersigned agrees that the Secretary of War (and, if applicable, also the Secretary of the Navy and the Chairman of the Maritime Commission) shall have the right to withhold or recover from the undersigned, and the undersigned will pay or credit to the United States, the sum of _____ Dollars ($_____), in accordance with the provisions of "Exhibit E" attached hereto.

III. The undersigned likewise agrees that it will make reductions in the prices and fees provided for in said contracts and subcontracts in accordance with a schedule of new prices and fees which the undersigned has submitted concurrently herewith, or will submit within _____ days hereafter, and represents that in its opinion such reductions are calculated to eliminate from said contracts and subcontracts, taking into consideration the provisions of II hereof, the excessive profits found herein to have been realized, or likely to be realized, by the undersigned during said fiscal year. If any such reductions are submitted after the date hereof, they shall be subject to approval by the Secretary of War, (and if and to the extent applicable, also the Secretary of the Navy and the Chairman of the Maritime Commission) who shall have the right to require the undersigned to revise said prices and fees in such manner as he deems appropriate to effectuate the purposes of this agreement.

IV. To assure to the United States the benefit of reductions in the prices and fees under subcontracts as herein provided, the undersigned agrees to give notice of such reductions to its contractors forthwith and to insert therein a provision substantially in the following form:

"This reduction is the result of renegotiation between the undersigned and the Under Secretary of War, in behalf of the United States Government, and therefore, in respect of your prime contracts with the Government under which costs will be affected by this reduction, you agree with the Government, as a condition to the acceptance of this reduction, that the full benefit thereof shall be passed on to the Government through equivalent aggregate price reductions or refunds under these prime contracts. Contracting officers of the War Department, the Navy Department and the Maritime Commission are being advised accordingly."

V. The undersigned will not utilize this renegotiation or adjustment in any attempt to recover for its own benefit from any person, firm or corporation all or any part of any such price reduction or of any amount so withheld or recovered from, or paid or credited to the United States by, the undersigned pursuant to this agreement. It is expected, however, that the undersigned will make

every effort to reduce its costs whenever possible, to enable it in turn to reduce its prices to the Government.

VI. Within _____ days after the end of said fiscal year the undersigned will furnish to the Under Secretary of War, properly signed by or on behalf of the undersigned, (1) a written statement, substantially in the form of "Exhibit C," showing the actual results of operations for said fiscal year, with necessary supporting data, and (2) a balance sheet, profit and loss statement and analysis of surplus for said fiscal year, in form satisfactory to the Under Secretary of War, certified by independent public accountants who may be those regularly employed by the undersigned.

VII. The finding herein shall be deemed a final determination of the excessive profits of the undersigned for said fiscal year under said contracts and subcontracts, subject to the right of the Under Secretary of War, or his duly authorized representative, (a) to reopen the renegotiation in his discretion, but not later than sixty (60) days after the undersigned shall have filed with the Under Secretary of War the statement and financial statements provided for in VI hereof, if the actual figures with respect to such factors as costs, volume of production or nature of products prove to be materially at variance with the estimates on which the finding herein was based, and (b) to reopen the renegotiation in his discretion at any time hereafter if the undersigned in the course hereof knowingly furnishes any false or misleading information or fails to disclose any material information. In deciding whether to reopen the renegotiation and for the purpose of any subsequent renegotiation for said fiscal year, if it is shown that increased profits have resulted from extra effort on the part of the undersigned to reduce costs, the undersigned will be given the benefit of this factor.

VIII. This agreement is executed by or on behalf of the undersigned pursuant to proper authority and shall be binding upon the undersigned and upon the War Department if and when approved by the Under Secretary of War or his duly authorized representative (and also upon the Navy Department if and when approved by the Under Secretary of the Navy or his duly authorized representative, and upon the Maritime Commission if and when approved by its Chairman or his duly authorized representative) and shall remain in full force and effect notwithstanding any interpretation, amendment or disposition of Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942.

_____

By _____

President.

(Attached hereto is an attested copy of an authorizing resolution of the Board of Directors.)

Approved:

For the Under Secretary of War

By _____

Authorized Representative.

Approved:

For the Under Secretary of the Navy

By _____

Authorized Representative.

Approved:

For the Chairman of the Maritime Commission

By _____

Authorized Representative.

WAR DEPARTMENT'S REVISED REDRAFT OF SECTION 403, PUBLIC LAW 528, COMMITTEE PRINT NO. 3

[Committee Print No. 3, September 29, 1942]

AMENDMENT

Renegotiation of war contracts (section 403 of Public, 528)

SEC. 403. (a) For the purposes of this section—

(1) The term "Department" means the War Department, the Navy Department, and the Maritime Commission, respectively.

(2) In the case of the Maritime Commission, the term "Secretary" means the Chairman of such Commission.

(3) The terms "renegotiate" and "renegotiation" include the refixing by the Secretary of the Department of the contract price.

(4) *The term "excessive profits" means any amount of a contract or subcontract price which is found as a result of renegotiation to represent excessive profits.*

(5) *The term "subcontract" means any purchase order or agreement to perform all or any part of the work, or to make or furnish any article, required for the performance of another contract, except orders or agreements to furnish (i) raw materials, (ii) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use, or (iii) articles for the general operation or maintenance of the contractor's plant. The term "article" includes any material, part, assembly, machinery, equipment, or other personal property.*

For the purposes of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) *Subject to subsection (i)*, the Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department—

(1) a provision for the renegotiation of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty;

(2) a provision for the retention by the United States *from amounts otherwise due the contractor*, or *for* the repayment *by him* to the United States, *if paid to him*, of[(A) any amount of the contract price which is found as a result of such renegotiation to represent] *any* excessive profits *not eliminated through reductions in the contract price, or otherwise, as the Secretary may direct* [and (B) an amount of the contract price equal to the amount of the reduction in the contract price of any subcontract under such contract pursuant to the renegotiation of such subcontract as provided in clause (3) of this subsection; and];

(3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (i) a provision for the renegotiation by such Secretary and the subcontractor of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty, (ii) a provision for the retention by *the contractor for* the United States *of the amount of any reduction in the contract price of any subcontract pursuant to its renegotiation hereunder*, or *for* the repayment *by the subcontractor* to the United States of any [amount of the contract price of the subcontract which is found as a result of such renegotiation, to represent] excessive profits *from such subcontract paid to him and not eliminated through reductions in the contract price or otherwise, as the Secretary may direct*, and (iii) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by *the contractor* or repaid *by the subcontractor* to the United States, *and (iv) in the discretion of the Secretary, a provision requiring any subcontractor to insert in any subcontract made by him under such subcontract,*

provisions corresponding to those of subparagraphs (3) and (4) of this subsection (b); and

(4) a provision for the retention by the United States from amounts otherwise due the contractor, or for repayment by him to the United States, as the Secretary may direct, of the amount of any reduction in the contract price of any subcontract under such contract, which the contractor is directed, pursuant to clause (3) of this subsection, to withhold from payments otherwise due the subcontractor and actually unpaid at the time the contractor receives such direction.

The provision for the renegotiation of the contract price, in the discretion of the Secretary, (i) may fix the period or periods when or within which renegotiation shall be had; and (ii) if in the opinion of the Secretary the provisions of the contract or subcontract are otherwise adequate to prevent excessive profits, may provide that renegotiation shall apply only to a portion of the contract or subcontract or shall not apply to performance during a specified period or periods and may also provide that the contract price in effect during any such period or periods shall not be subject to renegotiation.

(c) [The Secretary of each Department is authorized and directed, whenever in his opinion excessive profits have been relized, 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 from the contractor or subcontractor any amount of the contract price which is found as a result of such renegotiation to represent excessive profits, and (3) in case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor, to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States.]

(1) Whenever, in the opinion of the Secretary of a Department, the profits realized or likely to be realized from any contract with such Department, or from any subcontract thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or subcontractor to renegotiate the contract price. When the contractor or subcontractor holds two or more such contracts or subcontracts the Secretary in his discretion, may renegotiate to eliminate excessive profits on some or all of such contracts or subcontracts as a group without separately renegotiating the contract price of each contract or subcontract.

(2) Upon renegotiation, the Secretary is authorized and directed to eliminate any excessive profits under such contract or subcontract (i) by reductions in the contract price of the contract or subcontract, or by other revision in its terms; or (ii) by withholding, from amounts otherwise due to the contractor or subcontractor, any amount of such excessive profits; or (iii) by directing a contractor to withhold for the account of the United States, from amounts otherwise due to the subcontractor, any amount of such excessive profits under the subcontract; or (iv) by recovery from the contractor or subcontractor, through repayment, credit or suit, of any amount of such excessive profits actually paid to him; or (v) by any combination of these methods, as the Secretary deems desirable. In determining the amount of any excessive profits to be eliminated hereunder, the Secretary shall allow the contractor or subcontractor appropriate credit for any Federal taxes (including income, normal and excess profits taxes) paid or payable with respect to such excessive profits and not subject to adjustment, but may require such evidence thereof, including a closing agreement with the Internal Revenue Bureau, as he deems necessary. Such Secretary may bring actions on behalf of the United States in the appropriate courts of the United States to recover from such contractor or subcontractor, any amount of such excessive profits actually paid to him and not withheld or eliminated by some other method under this subsection. The surety under a contract or subcontract shall not be liable for the repayment of any excessive profits thereon. All [amounts] *money* recovered *by way of repayment or suit* under this subsection shall be covered into the Treasury as miscellaneous receipts.

(3) Upon renegotiation pursuant to this section, the Secretary may make such final or other agreements with a contractor or subcontractor for the elimination of excessive profits and for the discharge of any liability for excessive profits under

this section, as the Secretary deems desirable. Such agreements may cover such past and future period or periods, may apply to such contract or contracts of the contractor or subcontractor, and may contain such terms and conditions, as the Secretary deems advisable.

(4) Any contractor or subcontractor who holds contracts or subcontracts, to which the provisions of this subsection (c) applicable, may file with the Secretaries of all the Departments concerned statements of actual costs of production and such other financial statements for any prior fiscal year or years of such contractor or subcontractor, in such form and detail, as the Secretaries shall prescribe by joint regulation. Within one year after the filing of such statements, or within such shorter period as may be prescribed by such joint regulation, the Secretary of a Department may give the contractor or subcontractor written notice, in form and manner to be prescribed in such joint regulation, that the Secretary is of the opinion that the profits realized from some or all of such contracts or subcontracts may be excessive, and fixing a date and place for an initial conference to be held within sixty days thereafter. If such notice is not given and renegotiation commenced within such sixty days the contractor or subcontractor shall not thereafter be required to renegotiate to eliminate excessive profits realized from any such contract or subcontract during such fiscal year or years and any liabilities of the contractor or subcontractor for excessive profits realized during such period shall be thereby discharged.

(5) This subsection (c) shall 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] *unless (i)* final payment pursuant to such contract or subcontract [has not been made prior to the date of enactment of this Act] *was made prior to April 28, 1942, or (ii) the contract or subcontract provides otherwise pursuant to subsections (b) or (i), or is exempted under subsection (i), of this section 403, or (iii) the aggregate sales by the contractor or subcontractor, and by all persons under the control of or controlling or under common control with the contractor or subcontractor, under contracts with the Departments and subcontracts thereunder do not exceed, or in the opinion of the Secretary concerned will not exceed, $250,000 for the fiscal year of such contractor or subcontractor.*

No renegotiation of the contract price pursuant to any provision therefor, or otherwise, shall be commenced more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary, occurs.

Subsections (d) through (h) of the present section 403 would remain unchanged. New subsections (i) and (j) would be added after the present subsection (h) to read as follows:

"(i) The provisions of this section shall not apply to any contract by a Department with any other department, bureau, agency, or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or agency thereof. The Secretary of a Department is authorized, in his discretion, to exempt from some or all of the provisions of this section 403, (1) any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska; (2) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of thirty days; (3) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary the provisions of the contract or subcontract are otherwise adequate to prevent excessive profits.

"(j) Nothing in sections 109 and 113 of the Criminal Code (U. S. C., title 18, secs. 198 and 203) or in section 190 of the Revised Statutes (U. S. C., title 5, sec. 99) shall be deemed to prevent any person appointed by the Secretary of a Department for intermittent and temporary employment in such Department, from acting as counsel, agent, or attorney for prosecuting any claim against the United States: Provided, That such person shall not prosecute any claim against the United States (1) which arises from any matter directly connected with which such person is employed, or (2) during the period such person is engaged in intermittent and temporary employment in a Department."

MEMORANDUM—SUGGESTED AMENDMENTS TO SECTION 403 OF THE SIXTH SUPPLEMENTAL NATIONAL DEFENSE APPROPRIATION ACT, 1942 (RENEGOTIATION OF CONTRACTS)

Attached hereto is a draft of amendments suggested by the War Department and the Navy Department incorporating changes which would (1) eliminate certain existing ambiguities and (2) make the statute more flexible and more effective as a means of reducing prices and costs. This draft supersedes the previous draft submitted to Mr. Randolph Paul, General Counsel for the Treasury Department, and to the Senate Finance Committee at an executive session on Tuesday, September 22, 1942, because certain additional amendments incorporated in this new draft have been agreed upon by the War Department and the Navy Department since that date. The definition of "subcontract", however, is proposed by the War Department alone and it is understood that the Navy Department desires a broader definition. The interlineations of this new draft indicate changes in the present statute. The changes of substance are as follows:

1. DEFINITIONS

(*a*) "*Excessive profits.*"—Throughout the present statute the phrase "any amount of a contract price which is found as a result of renegotiation to represent excessive profits" is constantly used. For convenience and brevity in revised form the term "excessive profits" has been substituted for this phrase, but subsection (a) (4) defines the term as having the same meaning as the phrase for which it is substituted.

(*b*) "*Subcontracts.*"—The present statute does not define the term "subcontract." The definition in the draft, proposed by the War Department, would exclude what are commonly known as materialmen and is generally in line with the decision of the Board of Tax Appeals in *Aluminum Company of America, petitioner* v. *Commissioner of Internal Revenue, respondent*, decided August 13, 1942, interpreting the term "subcontract" as used in the Vinson Act. The exclusion of raw materials and standard articles ordinarily sold for civilian use would leave that field for regulation by the Office of Price Administration.

2. CONTRACT PROVISIONS

Subsection (b) prescribes the contract provisions required to be inserted in contracts over $100,000. The changes proposed in this subsection are designed to eliminate ambiguities or uncertainties in the present statute and also confer on the Secretary discretion to limit or restrict the contract provision in certain respects.

(*a*) Subparagraphs (2) and (3) are revised to make it clear that a contractor or subcontractor can be forced to repay excessive profits only after they have actually been paid to him. The revision of these subparagraphs also makes it clear that excessive profits may be eliminated through reductions in the contract price or otherwise as the Secretary may direct and need not be recovered if so eliminated.

(*b*) While subparagraph (3) of the present statute appears to require the United States to withhold excessive profits from a subcontractor, this will normally be impossible since the Government will not owe anything directly to the subcontractor. The revision of this subparagraph makes it clear that such amounts are to be withheld by the prime contractor for the benefit of the Government. The addition of subdivision (iv) to subparagraph (3) will permit the Secretary in his discretion to require any subcontractor to insert similar contract provisions in his own subcontracts whereas subparagraph (3) of the present statute provides for the insertion of the contract provision only in subcontracts made by the prime contractor.

(*c*) The first section of subparagraph (4) has been added to allay the fear of contractors that under subparagraph (2) (B) of the present statute they may be liable for reductions in the contract prices of their subcontracts even though they do not receive the benefit of it.

(*d*) The second section of subparagraph (4) has been added to confer on the Secretary certain discretion as to the form of contract provision to be used. He may fix the period or periods for renegotiation and in this way prescribe a statute of limitations. In his opinion the provisions of the contract are otherwise adequate to prevent excessive profits, he may restrict renegotiation to a portion of the contract or he may make the contract price firm during a specified period or periods and provide that the contract price in effect during such period

or periods shall not be subject to renegotiation. The mandatory and inflexible provisions of the present statute make it difficult, if not impossible, to make firm prices for limited periods, a power which is essential in negotiating target prices affording the contractor an incentive to reduce costs below a specified amount, and this would permit him to exempt the prices so fixed from renegotiation.

3. RENEGOTIATION PROCEDURE

In the revised draft subsection (c) prescribes the procedure for renegotiation and the elimination of excessive profits. For clarity it has been divided into five subsections in the revised form:

(*a*) *Over-all renegotiation.*—At the end of subsection (c) (1) a new sentence has been added which expressly allows renegotiation of contracts or subcontracts of a contractor or subcontractor as a group. This authorizes the procedure which has been found to be more practical where a contractor or subcontractor holds a large number of such contracts.

(*b*) *Methods of eliminating excessive profits.*—Subsection (c) (2) specifies the methods by which excessive profits may be eliminated. It expands the present methods of eliminating excessive profits. It expressly authorizes elimination through reductions in the contract price by revision in its terms and clarifies several minor uncertainties in the present statute. It also relieves the surety under a contract from liability or excessive profits thereon, as was done under the Vinson Act.

(*c*) *Excess-profits taxes.*—Under the present statute no provision is made to offset excess-profits taxes paid against the excessive profits under the statute. Subsection (c) (2) of the revised form provides for such offset.

(*d*) *Payments to Treasury.*—The present statute makes it doubtful just what amounts are to be covered into the Treasury as miscellaneous receipts. The revised sentence in subsection (3) (2) expressly limits it, as originally intended, to money repaid to the Government or recovered by suit.

(*e*) *Agreements.*—The present statute contains no express authorization for the making of agreements which shall be binding as a result of renegotiation which will preclude reopening of the question at a later date. Subsection (c) (3) has been added to expressly authorize final agreements with a contractor or subcontractor for the discharge of any liability for excessive profits under this section. It also permits the agreement to contain any terms and conditions which the Secretary deems advisable.

(*f*) *Clearances for prior fiscal years.*—Even with the amendment referred to in (*e*) above, there would still be no statutory method by which a contractor or subcontractor could initiate renegotiation in order to obtain a clearance from liability for excessive profits under the statute. Subsection (c) (4) has been added to enable them to file financial statements for any prior fiscal year or years, in such form and detail as the Secretaries shall prescribe by joint regulation, and unless within 1 year thereafter, or within such shorter period as may be prescribed, one of the Secretaries has initiated renegotiation the contractor or subcontractor will automatically have a clearance for such fiscal year or years.

(*g*) *Statute of limitations.*—In line with the amendments referred to in (e) and (f) above, the second paragraph of subsection (c) (5) has been added to limit the time within which renegotiation of any particular contract or subcontract may be commenced to 1 year after the close of the fiscal year within which it is completed or terminated.

4. EXEMPTIONS

A new subsection (i) has been added at the end of the present statute permitting certain exemptions from its terms.

(*a*) *Government contracts.*—The contracts with any Federal or local agency or any foreign government are completely exempted.

(*b*) *Permissive exemptions.*—The Secretary is authorized to exempt:

(1) Contracts to be performed outside the United States, and

(2) Contracts where the profits can be determined with reasonable certainty when the price is established, such as certain classes of agreements, specified as agreements for personal services, for the purchase of real property, perishable goods or commodities, the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of 30 days.

(3) Any contract or subcontract for a specified period or periods during the performance thereof, if in the opinion of the Secretary its provisions are otherwise adequate to prevent excessive profits. This last provision has been added in order to extend the discretion of the Secretary in making firm prices for limited periods to those contracts and subcontracts which are subject to renegotiation although they contain no contract provision for renegotiation.

(c) *Contracts and subcontracts subject to the statute.*—Under subsection (c) (5), just as under the present statute, all contracts and subcontracts heretofore or hereafter made are subject to renegotiation, whether or not they contain a renegotiation or recapture clause unless (i) final payment was made prior to April 28, 1942, or (ii) the contract or subcontract provides otherwise pursuant to subsection (b) or is exempt or provides otherwise under this subsection (i).

5. LIMITATION OF OPERATION OF SECTIONS 109 AND 113 OF THE CRIMINAL CODE AND SECTION 190 OF THE REVISED STATUTES

A new subsection (j) has been added to the statute to make clear that the above-mentioned statutes do not prevent any person employed on an intermittent or temporary basis by a secretary, from acting as counsel, agent, or attorney for prosecuting a claim (such as a claim arising under the tax statutes) against the United States, under certain conditions. This subsection has been added in order to make it possible for the Department to retain the services of lawyers, accountants, and other professional men who might otherwise feel constrained to refuse to continue their present intermittent or temporary work for the Department because of these statutes. While this new subsection (j) has been added to section 403 primarily to clear up any doubts as to the application of these statutes to persons employed to aid the Secretary in renegotiating prices under contracts, it is not limited to such persons.

Senator WALSH. We have had presented to us the proposed amendments offered by the Lumber and Timber Products War Committee. I will request that one of your officials examine these and give us an analysis or your view of them.

Mr. PATTERSON. Yes, sir.

Senator WALSH. May I ask, is the Treasury represented here?

Mr. ROBERT B. EICHHOLZ. Yes.

Senator WALSH. May I suggest, for the purpose of the record, you have the Treasury submit to the committee a statement of their operations and administration under the Vinson-Trammel Act to date?

Mr. EICHHOLZ. You mean the amount collected, and so forth?

Senator WALSH. The number of cases, the amount collected, and their views as to that method of reaching profits.

Mr. EICHHOLZ. Yes; I have a short statement to make on behalf of the Treasury in connection with this.

Senator WALSH. Now, the Maritime Commission is here?

Mr. BRADLEY. Yes, sir.

Mr. JOHN KENNEY (Special Assistant to the Undersecretary, Navy Department). I would like for the record, to state that committee print No. 3 is the War Department's draft of the bill and committee print No. 4 is the Navy Department's proposed amendments. Now, those two drafts are identical with the exception of the definition of "subcontract.

Senator WALSH. Now, does the Maritime Commission desire to make a brief statement?

Mr. BRADLEY. Yes.

Senator WALSH. Will you be able to come tomorrow morning?

Mr. BRADLEY. I will, sir.

Senator WALSH. And the representative of the Treasury also?

Mr. EICHHOLZ. Yes.

Senator WALSH. And you will have this information that we asked for?

Mr. EICHHOLZ. Yes.

Senator WALSH. Does anyone else want to be heard?

(No response.)

Senator WALSH. What is the desire of the committee in reference to those contractors who have asked to be heard?

Senator VANDENBERG. I would like to hear one or two contractors. Judge Patterson has been so fair and reasonable about everything, I don't know what it is that scares these fellows to death.

Senator WALSH. Well, we will decide that tomorrow morning. We need not consider that until tomorrow morning.

In order to have the record clear, in addition to the statement made by Secretary Patterson, we will put into the record, first, a letter of transmittal of proposed Navy Department recommendations, and also other material as follows:

NAVY DEPARTMENT'S REVISED REDRAFT OF SECTION 403, PUBLIC, 528, COMMITTEE PRINT 4

DEPARTMENT OF THE NAVY,
OFFICE OF THE SECRETARY,
Washington.

Senator DAVID I. WALSH,
Committee on Finance, Washington, D. C.

MY DEAR SENATOR WALSH: There is submitted for the consideration of the subcommittee appointed by Senator George, certain proposed amendments to section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942. The submitted amendments differ in the following respect from the amendments submitted to the Committee on Finance at its hearing on September 22, 1942.

(*a*) (1) The term "department" has been amplified to include the Treasury Department in accordance with the request of Mr. Paul at the hearing of September 22, 1942.

(*a*) (5) This is a new paragraph defining the term "subcontract" and differs from the definition submitted by the War Department. The definition of the War Department excluded orders or agreements to furnish (1) raw materials, (2) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use, and (3) articles for the general operation or maintenance of the contractor's plant. It is the opinion of the Navy Department that it was the intention of Congress that excessive profits should be removed from all war contracts, irrespective of whether such contracts were of the character referred to in (1) and (2) above. For this reason, the Navy Department has proposed a definition of subcontract which includes virtually all contracts made with prime contractors of the Government. It is our opinion that this definition is in accord with the suggestion of the Chairman of the Maritime Commission as contained in his letter of September 22, 1942, to Senator George.

(*b*) (3) (4) This is a new provision permitting the Secretary to require any subcontractor to insert in any subcontract made by him, provisions corresponding to those required of the initial subcontractor.

(*b*) (5) This is a new provision to permit the Secretary (1) to fix the period or periods when renegotiation may be had and (2) to provide in certain classes of contracts that renegotiation shall only apply to a portion of the contract or to performance during a specified period. Clause (1) was included in the earlier draft as a part of paragraph (*b*) (1) and (*b*) (3) (i). Clause (2) is included to permit the use of so-called "target" price contracts.

(*c*) (4) This is a new paragraph to permit the contractor to file with the department, statements of his actual cost of production upon the conclusion of the contract, and unless the Secretary acts within 1 year after the filing of such statements, the contracts for which such statements have been filed shall not be subject to renegotiation.

(*c*) (5) This is substantially similar to paragraph (*c*) (4) of the earlier draft except that subparagraph (iii) has been added. The additional subparagraph exempts from renegotiations a contractor or subcontractor whose total volume of war contracts for a fiscal year does not exceed $250,000. Such a provision will aid materially in the administration of the statute and will relieve small contractors from renegotiation.

Also, there has been added to this paragraph, a provision requiring renegotiation to be commenced within 1 year after the close of the fiscal year within which the contract or subcontract which is subject to renegotiation has been terminated. This will answer one of the principal objections to the renegotiation statute and will relieve the contractor from the fear of having renegotiation hanging over his head for a number of years after his contracts have been terminated.

(*i*) A new paragraph (3) has been added to this section to permit the exclusion from the purview of the statute of so-called "target" price contracts.

With the exception of the definition of the term "subcontract", I believe the proposed amendments are identical with those suggested by the War Department.

In conclusion, I would like to point out that these proposed amendments have not been submitted to the Bureau of the Budget but are merely submitted to the Committeee on Finance for such action as it may deem desirable.

Very truly yours,

JAMES FORRESTAL,
Acting Secretary of the Navy.

[Committee Print No. 4, September 29, 1942]

AMENDMENT

Renegotiation of war contracts (section 403 of Public, 528)

SEC. 403. (a) For the purposes of this section—

(1) The term "Department" means the War Department, the Navy Department, the Treasury Department, and the Maritime Commission, respectively.

(2) In the case of the Maritime Commission, the term "Secretary" means the Chairman of such Commission.

(3) The terms "renegotiate" and "renegotiations" include the refixing by the Secretary of the Department of the contract price.

(4) The term "excessive profits" means any amount of a contract or subcontract price which is found as a result of renegotiation to represent excessive profits.

(5) The term "subcontract" means (a) any purchase order or agreement (i) to perform all or any part of the work to be done or to supply all or any part of the articles to be furnished, under a contract with the Government, (ii) to supply any services required directly for the production of any article or equipment covered by such contract or any portion thereof, (iii) to make or furnish any supplies, materials, articles, or equipment specifically destined to become a component part of any article or equipment covered by such contract, or (iv) to make or furnish any material, part, assembly, machinery, equipment, or other personal property acquired by the contractor exclusively for the performance of such contract, but shall not include any agreement to supply services or any such articles for the general operation or maintenance of the contractor's plant or business in those cases where the Government is not obligated to reimburse the contractor for the cost of such articles; (b) any purchase order from, or any agreement with, a subcontractor who is obligated to furnish completed articles called for under the contract of the contractor with the Government if such purchase order or agreement would be construed under paragraph (a) above as a subcontract if entered into with the contractor; and (c) any agreement of a subcontractor providing for the delivery to such subcontractor of completed articles called for under his subcontract.

For the purpose of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) Subject to subsection (i), the Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department—

(1) a provision for the renegotiation of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty;

(2) a provision for the retention by the United States from amounts otherwise due the contractor, or for the repayment by him to the United States, if paid to him, of any excessive profits not eliminated through reductions in in the contract price, or otherwise, as the Secretary may direct;

(3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (i) a provision for the renegotiation by such Secretary and the subcontractor of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty, (ii) a provision for the retention by the contractor for the United States of the amount of any reduction in the contract price of any subcontract pursuant to its renegotiation hereunder, or for the repayment by the subcontractor to the United States of any excessive profits from such subcontract paid to him and not eliminated through reductions in the contract price or otherwise, as the

Secretary may direct, and (iii) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by the contractor or repaid by the subcontractor to the United States, and (iv), in the discretion of the Secretary, a provision requiring any subcontractor to insert in any subcontract made by him under such subcontract, provisions corresponding to those of this subparagraph and subparagraphs (4) and (5) of this subsection (b); and

(4) a provision for the retention by the United States from amounts otherwise due the contractor, or for repayment by him to the United States, as the Secretary may direct, of the amount of any reduction in the contract price of any subcontract under such contract, which the contractor is directed, pursuant to clause (3) of this subsection, to withhold from payments otherwise due the subcontractor and actually unpa'd at the time the contractor receives such direction.

(5) the provision for the renegotiation of the contract price, in the discretion of the Secretary, (i) may fix the period or periods when or within which renegotiation shall be had; and (ii) if in the opinion of the Secretary the provisions of the contract are otherwise adequate to prevent excessive profits, may provide that renegotiation shall apply only to a portion of the contract or shall not apply to performance during a specified period or periods and may also provide that the contract price in effect during any such period or periods shall not be subject to renegotiation.

(c) (1) Whenever, in the opinion of the Secretary of a Department, the profits realized or likely to be realized from any contract with such Department, or from any subcontract thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or subcontactor to renegotiate the contact price. When the contractor or subcontractor holds two or more such contracts or subcontracts the Secretary, in his discretion, may renegotiate to eliminate excessive profits on some or all of such contracts or subcontracts as a group without separately renegotiating the contract price of each contract or subcontract.

(2) Upon renegotiation, the Secretary is authorized and directed to eliminate any excessive profits under such contract or subcontract (i) by reductions in the contract price of the contract or subcontract, or by other revision in its terms; or (ii) by withholding, from amounts otherwise due to the contractor or subcontractor, any amount of such excessive profits; or (iii) by directing a contractor to withhold for the account of the United States, from amounts otherwise due to the subcontractor, any amount of such excessive profits under the subcontract; or (iv) by recovery from the contractor or subcontractor, through repayment, credit, or suit, of any amount of such excessive profits actually paid to him; or (v) by any combination of these methods, as the Secretary deems desirable. In determining the amount of any excessive profits to be eliminated hereunder, the Secretary shall allow the contractor or subcontractor appropriate credit for any Federal taxes (including income, normal, and excess-profits taxes) paid or payable with respect to such excessive profits and not subject to adjustment, but may require such evidence thereof, including a closing agreement with the Internal Revenue Bureau, as he deems necessary. Such Secretary may bring actions on behalf of the United States in the appropriate courts of the United States to recover from such contractor or subcontractor any amount of such excessive profits actually paid to him and not withheld or eliminated by some other method under this subsection. The surety under a contract or subcontract shall not be liable for the repayment of any excessive profits thereon. All money recovered by way of repayment or suit under this subsection shall be covered into the Treasury as miscellaneous receipts.

(3) Upon renegotiation pursuant to this section, the Secretary may make such final or other agreements with a contractor or subcontractor for the elimination of excessive profits and for the discharge of any liability for excessive profits under this section, as the Secretary deems desirable. Such agreement may cover such past and future period or periods, may apply to such contract or contracts of the contractor or subcontractor, and may contain such terms and conditions as the Secretary deems advisable.

(4) Any contractor or subcontractor who holds contracts or subcontracts, to which the provisions of this subsection (c) are applicable, may file with the Secretaries of all the Departments concerned statements of actual costs of production and such other financial statements for any prior fiscal year or years of such contractor or subcontractor, in such form and detail as the Secretaries shall

prescribe by joint regulation. Within one year after the filing of such statements, or within such shorter period as may be prescribed by such joint regulation, the Secretary of a Department may give the contractor or subcontractor written notice, in form and manner to be prescribed in such joint regulation, that the Secretary is of the opinion that the profits realized from some or all of such contracts or subcontracts may be excessive, and fixing a date and place for an initial conference to be held within sixty days thereafter. If such notice is not given and renegotiation commenced within such sixty days the contractor or subcontractor shall not thereafter be required to renegotiate to eliminate excessive profits realized from any such contract or subcontract during such fiscal year or years and any liabilities of the contractor or subcontractor for excessive profits realized during such period shall be thereby discharged.

(5) This subsection (c) shall 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, unless (i) final payment pursuant to such contract or subcontract was made prior to April 28, 1942; (ii) the contract or subcontract provides otherwise pursuant to subsection (b) (5) or (i), or is exempted under subsection (i) of this section 403; or (iii) the aggregate sales under all war contracts by the contractor or subcontractor and by all persons under the control of, or controlling, or under common control with, the contractor or subcontractor, under contracts with the Departments and subcontracts thereunder do not exceed, or in the opinion of the Secretary concerned will not exceed, $250,000 during the fiscal year of the contractor or subcontractor under consideration.

No renegotiation of the contract price pursuant to any provision therefor, or otherwise, shall be commenced more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary occurs.

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable. For the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred, each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each Department shall have the right to demand of any contractor who holds contracts with respect to which the provisions of this section are applicable in an aggregate amount in excess of $100,000, statements of actual costs of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who willfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any such statement containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the Department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

(f) The authority and discretion herein conferred upon the Secretary of each Department, in accordance with regulations prescribed by the President for the protection of the interests of the Government, may be delegated, in whole or in part, by him to such individuals or agencies in such Department as he may designate, and he may authorize such individuals or agencies to make further delegations of such authority and discretion.

(g) If any provision of this section or the application thereof to any person or circumstance is held invalid, the remainder of the section and the application of such provision to other persons or circumstances shall not be affected thereby.

(h) This section shall remain in force during the continuance of the present war and for three years after the termination of the war, but no court proceedings brought under this section shall abate by reason of the termination of the provisions of this section.

(i) The provisions of this section shall not apply to any contract by a Department with any other department, bureau, agency, or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or any agency thereof. The Secretary of a Department is authorized, in his discretion, to exempt from some or all of the provisions of this section 403, (1) any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska, (2) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of thirty days, (3) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract are otherwise adequate to prevent excessive profits.

(j) Nothing in sections 109 and 113 of the Criminal Code (U. S. C., title 18, secs. 198 and 203) or in section 190 of the Revised Statutes (U. S. C., title 5, sec. 99) shall be deemed to prevent any person appointed by the Secretary of a Department for intermittent and temporary employment in such Department, from acting as counsel, agent, or attorney for prosecuting any claim against the United States: *Provided*, That such person shall not prosecute any claim against the United States (1) which arises from any matter directly connected with which such person is employed, or (2) during the period such person is engaged in intermittent and temporary employment in a Department.

NAVY DEPARTMENT'S DEFINITION OF "SUBCONTRACT" UNDER REDRAFTED SECTION 403 OF PUBLIC 528

(5) The term "subcontract" means (a) any purchase order or agreement (i) to perform all or any part of the work to be done or to supply all or any part of the articles to be furnished, under a contract with the Government, (ii) to supply any services required directly for the production of any article or equipment covered by such contract or any portion thereof, (iii) to make or furnish any supplies, materials, articles, or equipment specifically destined to become a component part of any article or equipment covered by such contract, or (iv) to make or furnish any material, part, assembly, machinery, equipment, or other personal property acquired by the contractor exclusively for the performance of such contract, but shall not include any agreement to supply services or any such articles for the general operation or maintenance of the contractor's plant or business in those cases where the Government is not obligated to reimburse the contractor for the cost of such articles; (b) any purchase order from, or any agreement with, a subcontractor who is obligated to furnish completed articles called for under the contract of the contractor with the Government if such purchase order or agreement would be construed under paragraph (a) above as a subcontract if entered into with the contractor; and (c) any agreement of a subcontractor providing for the delivery to such subcontractor of completed articles called for under his subcontract.

For the purpose of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

PROPOSED SUBSTITUTE SUBMITTED BY HON. WALTER F. GEORGE TO SECTION 403, PUBLIC, 528, PRINT NO. 5

[Committee Print No. 5, September 30, 1942, showing proposed amendments to existing law]

AMENDMENTS

Renegotiation of war contracts (section 403 of Public, 528)

Section 403 (a) For the purposes of this section—

(1) The term "Department" means the War Department, the Navy Department, and the Maritime Commission, respectively;

(2) In the case of the Maritime Commission, the term "Secretary" means the Chairman of such Commission; and

(3) The terms "renegotiate" and renegotiation" include the refixing by the Secretary of the Department of the contract price; *and*

(4) The term "volume" means net sales and the gross amount received for services, including the amounts billed by the contractor or subcontractor under any cost-plus-a-fixed fee contract and allowed for reimbursement, under any contract subject to renegotiation.

For the purposes of subsections (d) and (e) of this section, the term "contract" includes a subcontract and the term "contractor" includes a subcontractor.

(b) The Secretary of each Department is authorized and directed to insert in any contract for an amount in excess of $100,000 hereafter made by such Department—

(1) a provision for ~~the~~ renegotiation *in connection with any determination of excessive profits under this section* ~~of the contract price at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty~~;

(2) a provision for the retention by the United States *from amounts otherwise due the contractor,* or *for* the repayment *by him* to the United States, *if paid to him, of any excessive profits not eliminated through reductions in contract price, or otherwise, as the Secretary may direct;* ~~(A) any amount of the contract price which is found as a result of such renegotiation to represent excessive profits and (B) an amount of the contract price equal to the amount of the reduction in the contract price of any subcontract under such contract pursuant to the renegotiation of such subcontract as provided in clause (3) of this subsection; and~~

(3) a provision requiring the contractor to insert in each subcontract for an amount in excess of $100,000 made by him under such contract (i) a provision for ~~the~~ renegotiation by such Secretary and the subcontractor *in connection with any determination of excessive profits under this section,* ~~of the contract price of the subcontract at a period or periods when, in the judgment of the Secretary, the profits can be determined with reasonable certainty~~ (ii) a provision for the retention by the *contractor for the* United States *from amounts otherwise due to the subcontractor,* or *for* the repayment *by the subcontractor* to the United States, *if paid to him,* of any *excessive profits not eliminated through reductions in contract price, or otherwise, as the Secretary may direct,* ~~amount of the contract price of the subcontract which is found as a result of such renegotiation, to represent excessive profits,~~ and (iii) a provision for relieving the contractor from any liability to the subcontractor on account of any amount so retained by *the contractor* or repaid *by the subcontractor* to the United States;

(4) a provision for the retention by the United States from amounts otherwise due the contractor, or for repayment by him to the United States as the Secretary may direct, of the amount of any excessive profits of any subcontractor which the contractor is directed pursuant to clause (3) of this subsection to withhold from payments otherwise due the subcontractor and actually unpaid at the time the contractor receives such direction.

~~(c) 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 from the contractor or subcontractor any amount of the contract price which is found as a result of such renegotiation to represent excessive profits, and (3) in any case any amount of the contract price found as a result of such renegotiation to represent excessive profits shall have been paid to the contractor or subcontractor, to recover such amount from such contractor or subcontractor. Such contractor or subcontractor shall be deemed to be indebted to the United States for any amount which such Secretary is authorized to recover from such contractor or subcontractor under this subsection, and such Secretary may bring actions in the appropriate courts of the United States to recover such amount on behalf of the United States.~~

(c) (1) At the end of each taxable year (as used for Federal income tax purposes) ending after April 30, 1942, of a contractor or subcontractor, if the Secretary believes that such contractor or subcontractor derived excessive profits, in the aggregate, from all contracts being performed during said year, the Secretary is authorized and directed to require the contractor or subcontractor to renegotiate the contract price of such contracts.

(2) Upon renegotiation, the Secretary is authorized and directed to eliminate any excessive profits under such contracts or subcontracts (i) by withholding, from amounts otherwise due to the contractor or subcontractor, any amount of such excessive profits; or (ii) by directing a contractor to withhold for the account of the United States, from amounts otherwise due to the subcontractor, any amount of such excessive profits under the subcontract; or (iii) by recovery from the contractor or subcontractor, through repayment, credit, or suit, of any amount of such excessive profits actually paid to him; or (iv) by any combination of these methods, as the Secretary deems desirable. In determining the amount of any excessive profits to be eliminated hereunder, only profits for the taxable year which remain after subtraction of all Federal income and excess-profits taxes shall be considered, and in no event shall such profits be deemed to be excessive if less than five percent of volume. Such Secretary may bring actions on behalf of the United States in the appropriate courts of the United States to recover from such contractor or subcontractor, any amount of such excessive profits actually paid to him and not withheld or eliminated by some other method under this subsection. The surety under a contract or subcontract shall not be liable for the repayment of any excessive profits thereon. All ~~amounts~~ *money* recovered *by way of repayment or suit* under this subsection shall be covered into the Treasury as miscellaneous receipts.

(3) In the determination of excessive profits, consideration shall be given to the following factors, among others: Quality of production; rate of delivery and turn-over; inventive contribution and use of patents; cooperation with other manufacturers; economy in use of raw materials; efficiency in reducing costs; use of private financing (including loans to the contractor or subcontractor); in case of fixed price contracts, the risks resulting therefrom, including increases in cost of materials, wage increases, additional costs resulting in case of inexperience in new types of production, complexity of manufacturing technique, and delays from inability to obtain materials; extent of conversion to war production and the resultant loss of nonwar business and opportunities; probable costs and risks of conversion to peacetime operations; and curtailment of research, use of patents, development of patents and processes, and losses of personnel, customers and goodwill, as a result of war work.

(4) Any contractor or subcontractor who holds contracts or subcontracts, to which the provisions of this subsection (c) are applicable, may file with the Secretaries of all of the Departments concerned statements of actual costs of production and such other financial statements for any prior taxable year (as used for Federal income tax purposes) ending after April 30, 1942, of such contractor or subcontractor, in such form or detail, as the Secretaries shall prescribe by joint regulation. Within six months after the filing of such statements, or within such shorter period as may be prescribed by joint regulation, the Secretary of a Department may give the contractor or subcontractor written notice, in form and manner to be prescribed in such joint regulation, that upon a review of the statements filed the Secretary is of the opinion that the aggregate profits realized during such taxable year from all contracts or subcontracts being performed during said year may be excessive, and fixing a date

and place for an initial conference to be held within sixty days thereafter. If such notice is not given and renegotiation commenced within such sixty days the contractor or subcontractor shall not thereafter be required to renegotiate to eliminate excessive profits realized from any such contract or subcontract during such taxable year and any liabilities of the contractor or subcontractor for excessive profits realized during such year shall be thereby discharged.

(5) In case of agreement between the Secretary and a contractor or subcontractor as to the amount of excessive profits for any taxable year, a written agreement shall be made with respect thereto between the Secretary and such contractor or subcontractor. Such agreement shall be final and conclusive and shall not be reopened except in case of fraud, malfeasance, or mutual mistake of fact (including a mistake as to the total Federal income and excess-profits tax liability of such contractor or subcontractor). If the agreement is reopened by reason of any such mistake, the only factor to be considered shall be the effect of such mistake.

~~This subsection shall 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.~~

(d) In renegotiating a contract price or determining excessive profits for the purposes of this section, the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any costs incurred by the contractor which are excessive and unreasonable, *but any cost allowed for Federal income tax purposes shall not be disallowed.* For the purpose of ascertaining whether such unreasonable compensation has been or is being paid, or whether such excessive reserves have been or are being set up, or whether any excessive and unreasonable costs have been or are being incurred each such Secretary shall have the same powers with respect to any such contractor that an agency designated by the President to exercise the powers conferred by title XIII of the Second War Powers Act, 1942, has with respect to any contractor to whom such title is applicable. In the interest of economy and the avoidance of duplication of inspection and audit, the services of the Bureau of Internal Revenue shall, upon request of each such Secretary and the approval of the Secretary of the Treasury, be made available to the extent determined by the Secretary of the Treasury for the purposes of making examinations and determinations with respect to profits under this section.

(e) In addition to the powers conferred by existing law, the Secretary of each Department shall have the right to demand of any contractor who holds contracts with respect to which the provisions of this section are applicable in an aggregate amount in excess of $100,000, statements of actual cost of production and such other financial statements, at such times and in such form and detail, as such Secretary may require. Any person who willfully fails or refuses to furnish any statement required of him under this subsection, or who knowingly furnishes any such statement containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than two years, or both. The powers conferred by this subsection shall be exercised in the case of any contractor by the Secretary of the Department holding the largest amount of such contracts with such contractor, or by such Secretary as may be mutually agreed to by the Secretaries concerned.

(f) The authority and discretion herein conferred upon the Secretary of each Department, in accordance with regulations prescribed by the President for the protection of the interests of the Government, may be delegated, in whole or in part, by him to such individuals or agencies in such Department as he may designate, and he may authorize such individuals or agencies to make further delegations of such authority and discretion.

(g) If any provision of this section or the application thereof to any person or circumstances is held invalid, the remainder of the section and the application of such provision to other persons or circumstances shall not be affected thereby.

(h) This section shall remain in force during the continuance of *hostilities in* the present war [and for three years after the termination of the war], but *shall terminate at the cessation of hostilities in said war except that (i) it shall remain in effect for the renegotiation of contracts made prior thereto, and (ii)* no court

proceedings brought under this section shall abate by reason of the termination of the provisions of this section.

(i) *This section shall not apply to—*

(1) *Any contract or subcontract to furnish raw materials when unalloyed, or unprocessed beyond final refining and casting, or otherwise converting such materials, into commercial shapes or beyond treatment process of a natural element;*

(2) *Any contract or subcontract to provide standard commercial fabricated or semifabricated articles ordinarily sold for civilian use and with respect to which at the time of making the contract or subcontract there was a general market price or a differential therefrom or there was a ceiling price fixed by a Federal governmental agency;*

(3) *A subcontract for articles or services for the general operation or maintenance of a contractor's plant;*

(4) *Any contract or subcontract to render personal services;*

(5) *Any contract or subcontract to be performed within 90 days from the date specified therein;*

(6) *Any contract or subcontract made prior to April 28, 1942;*

(7) *Any contract by a department with any other department, bureau, agency, or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or any agency thereof; and*

(8) *Any contractor or subcontractor in respect of any taxable year whose total volume for such year from contracts and subcontracts which would otherwise be subject to renegotiation under this section does not exceed $100,000.*

(j) *In addition to the contracts and subcontracts excluded from the operation of this section by subsection (i), the Secretary of a department is authorized in his discretion to exempt from some or all of the provisions of this section—*

(1) *Any contract or subcontract to be performed outside the territorial limits of the continental United States or in Alaska;*

(2) *Any contract or subcontract under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for the purchase of real property, perishable goods or commodities, the minimum price for the sale of which has been fixed by a public regulatory body, and certain classes of leases and license agreements;*

(3) *Any contract or subcontract which by its terms provides for a refund or reduction in price based upon a reduction in actual costs below the estimates thereof; and*

(4) *A portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract or subcontract are otherwise adequate to prevent excessive profits.*

(k) *The amendments made hereby to section 403 of title IV of the Sixth Annual Supplemental National Defense Appropriation Act, 1942, approved April 28, 1942, shall be effective as of April 29, 1942, and any provision in any contract contrary to said amendments shall be invalid.*

(l) *No person shall be held liable for damages or penalties in any Federal, State, or Territorial court, on any grounds for or in respect of anything done or omitted to be done in good faith pursuant to any provision of this section, or because of any price fixed in any contract or subcontract pursuant to any negotiation by the Secretary of a Department, or any renegotiation hereunder notwithstanding that such price may be modified, rescinded, or superseded.*

SUGGESTED AMENDMENTS BY LUMBER AND TIMBER PRODUCTS WAR COMMITTEE TO SECTION 403, PUBLIC 528

[Committee print—Printed for the use of the Committee on Finance]

AMENDMENTS TO SECTION 403 OF PUBLIC LAW NO. 528, APPROVED APRIL 28, 1942, SEVENTY-SEVENTH CONGRESS, SECOND SESSION, SUGGESTED BY LUMBER AND TIMBER PRODUCTS WAR COMMITTEE (REPRESENTING MANUFACTURERS AND DISTRIBUTORS OF TIMBER PRODUCTS—33 ORGANIZATIONS); NATIONAL COAL ASSOCIATION; NATIONAL LUMBER MANUFACTURERS ASSOCIATION

PROPOSAL

Accept, without further change, section 403 (a), (b), and (c), as proposed by the price adjustment boards, except as set out in subsections (l) and (m). Accept, without change, subsections (d) through (h) of the present section 403.

Accept, without change, the new subsections (i) and (j), as proposed by the price adjustment boards.

EXPLANATION

These two paragraphs are merely concurrences with the position of the price adjustment boards except as set out in subsections (l) and (m). Explanation of the subsections will be found under each, respectively.

PROPOSED AMENDMENT

Add the following:

"(k) Contracts and subcontracts for the purchase of raw materials, natural resource products, or of any general commercial commodity, for which the purchase price does not exceed a then existing maximum price fixed by statute, or by the Office of Price Administration, or by other governmental agency, are exempted from the provisions of this section. The phrase 'general commercial commodity' includes standard commercial fabricated or semifabricated articles ordinarily sold for civilian use and the term 'articles' includes any material, part, assembly, machinery, equipment or other personal property."

EXPLANATION

The first sentence meets the astounding suggestion that the Price Adjustment Boards shall ignore prices of raw materials or general commercial commodities fixed by statute or by the Office of Price Administration or by other governmental agencies. It is difficult to believe that the Congress will endorse any such course. Maximum prices fixed by statute are those fixed by the Congress itself as proper; maximum prices fixed by governmental agencies other than the Office of Price Administration are few and probably negligible. The maximum prices which it is proposed the price adjustment board shall ignore are principally those fixed by the Office of Price Administration. These prices are not carelessly or casually fixed. The Office of Price Administration has been established for months. It employs in Washington alone 5,500 persons, many of whom are experts. To and including September 18 it had issued 223 maximum price regulations. Each of these regulations contains in substance the following certificate:

"In the judgment of the Price Administrator, it is necessary and proper to establish maximum prices for sales of _____ by a specific maximum price regulation. The Price Administrator has ascertained and given due consideration to the prices of _____ prevailing between October 1 and October 15, 1941, and has made adjustments for such relevant factors as he has determined and deemed to be of general applicability. So far as practicable, the Price Administrator has advised and consulted with representative members of the industry which will be affected by this regulation.

"In the judgment of the Price Administrator, the maximum prices established by this regulation are and will be generally fair and equitable and will effectuate the purposes of the Emergency Price Control Act of 1942. A statement of the considerations involved in the issuance of this regulation has been issued simultaneously herewith and has been filed with the Division of the Federal Register.*

"Therefore, under the authority vested in the Price Administrator by the Emergency Price Control Act of 1942, and in accordance with Procedural Regulation No. 1,[1] issued by the Office of Price Administration, Maximum Price Regulation No. —— is hereby issued."

Footnotes indicate where Procedural Regulations No. 1 may be found; that the statement of the considerations involved in the issuance of the regulation may be obtained from the Office of Price Administration; and that the Maximum Price Regulation is issued under Public Law 421, Seventy-seventh Congress. This certificate indicates that the prices and conditions which usually follow for a considerable number of pages are based on the work and the study of an organization which the Congress deemed proper to do such work and study. If maximum prices so established are to be ignored by another governmental organization it must be that the Office of Price Administration is untrustworthy. If the Congress allows another organization set up by itself to ignore the maximum prices established by the Office of Price Administration, also established by itself, how can it expect the general public to have any confidence in the work of the Office of Price Administration? To thinking men of experience there is but one answer to this question.

The only ground that we have heard for attempting to go behind prices fixed by the statute, the Office of Price Administration and other Government agencies, is that sometimes these prices result in profits. As such prices are established on the assertion that they are generally fair and equitable, they ought generally to result in a profit. If they do not, they are not fair and equitable. Such profits are the basis for taxes. When applied to corporations they pay a combined normal and surtax of 40 percent (Senate action) and when they are high enough to reach the excess-profits bracket, that portion of the net income pays 90 percent. An excess-profits tax has been tried in the past and found successful to meet conditions such as we are now in. A result of the excess-profits tax in the Revenue Act of 1918 in its three divisions was that there is no known large fortune in the United States today, the foundation of which was laid in the war period of 1917–18. The Congress very recently applied its knowledge of the efficacy of the excess-profits tax. Section 3 of the Vinson Act (act of March 27, 1934) as amended by the act of April 3, 1939, and the Second Supplemental National Defense Appropriation Act of June 28, 1940, dealt with the excess profits derived from contracts for naval vessels and aircraft. When the second Revenue Act of 1940, containing the excess-profits tax (act of October 8, 1940, section 401) was passed it suspended the operation of section 3 of the Vinson Act. At the present time there is no limitation on profits derived from the manufacture of naval vessels or Army and Navy aircraft under the Vinson Act. This was a recognition of the known efficacy of the excess profits tax method.

The second sentence of (k) is based on material put in the record by Mr. Marbury (hearings, p. 41). The only difference between the positions of the Army and Navy boards, as stated by Mr. Marbury, and (k) is that their language applies only to subcontracts while (k) applies to both prime and subcontracts. Obviously, if these exceptions are right as to subcontracts (and they are), they are right as to prime contracts. On page 39 the following is found:

"Senator CONNALLY. You advocate excluding all raw materials?

"Mr. MARBURY. Yes, sir; we do."

Possibly, Mr. Marbury meant his answer to apply only to subcontracts, but there is no reason why it should not apply to prime contracts as well. It is not overlooked that the Maritime Commission does not agree with the Army and Navy. As the Army and Navy together have a much greater aggregate of contracts, both as to number and amount, the Maritime Commission should be asked to draw and submit language covering their positions, rather than that what the Army and Navy agree is right should be struck out.

---

*Copies may be obtained from the Office of Price Administration.

[1] 7 F. R. 971, 3063, 6907.

PROPOSED AMENDMENT

Add the following:

"(1) To the full extent necessary to prevent a taxpayer from being taxed on moneys not received and finally retained by such taxpayer, deductions from gross income shall be allowed for any year for the amount of any excessive profits excluded from gross income and repaid to the Government. The taxpayer shall be given, in order to carry out this provision, whatever deductions, credits, or refunds are necessary or required and the Treasury Department is specifically authorized to enter into closing agreements to fix the amounts of such deductions, credits, or refunds made or to be made. Such closing agreements shall have the force and effect of closing agreements entered into under section 3760 of the Internal Revenue Code."

EXPLANATION

No one contends that any taxpayer ought to be taxed on the income derived from the moneys which such taxpayer receives but is required to return to the Government; yet unless some action is taken that precise result will be reached.

Internal Revenue Bulletin No. 37, dated September 14, 1942, embraces I. T. 3577 which on page 7 contains the following sentence:

"No deduction from gross income will be allowed for any year for the amount of the excessive profits excluded from gross income and repaid to the Government."

This sentence is a correct statement of the law. Nothing is deducted from gross income except items deductible by statute. The purpose of subsection (1) is to make such payments to the Government deductible items.

Section 403 as it stands is the greatest existing danger threatening the collection of any tax on profits on war contracts. It requires every qualified tax adviser, whether an attorney or an accountant, to tell his client frankly that it is impossible to report definite figures as to any war contract subject to the section. If a taxpayer cannot report definite figures, all that he can do is to report the facts, including the effects of the statute, in his return. There is no penalty for this except interest. Apparently this was the course pursued by the Aluminum Co. of America in relation to transactions which it alleged did not come within the Vinson Act. The Commissioner determined deficiencies and the case was decided by the Board of Tax Appeals August 13, 1942. Both the petitioner and the Commissioner were sustained in part, but apparently the petitioner was the more successful. The years involved were 1936, 1937, and 1938—4, 5, and 6 years back, respectively. Our country cannot afford to have the taxes on the profits of war contracts which are earned in 1942 postponed as to their payment for 4 years, to say nothing of 5 and 6. Incidentally, the finding of the Board that the materialman, as described in its opinion, is not a subcontractor states the law as understood by most lawyers familiar with the subject.

Apparently the tax advisers of the Westinghouse & Electric Manufacturing Co. take the view as to the impossibility of reporting definite figures stated above. On August 3, 1942, Chairman A. W. Robertson of the company, in connection with the company adjustment compensation plan which it was found necessary to cancel because of the section 403, made the following public statement:

"This action is necessary on account of recently enacted laws providing for the renegotiation of contracts with the Government and subcontracts relating thereto, and the refund of profits, which will prevent the company from reporting definite figures monthly or even yearly."

It is not overlooked that the proposed new (c) (2) contains the following:

"In determining the amount of any excessive profits to be eliminated hereunder, the Secretary shall allow the contractor or subcontractor appropriate credit for any Federal taxes (including income, normal, and excess-profits taxes) paid or payable with respect to such excessive profits and not subject to adjustment." This, however, applies only to a case where the renegotiation results only in a deduction in the contract price. Despite the use of the words "paid or payable" it does not apply to a case where money is repaid to the Government (I. T. 3577 of September 14, 1942, p. 7). In any event, the language of (c) (2) is not definite enough. Where a taxpayer claims a deduction or a refund the burden is usually on him, and the language asserted to give him a right should do so definitely.

To illustrate: In the hearing attention is called to a Treasury announcement or ruling which was promulgated on September 17 known as I. T. 3577. The purpose of that Treasury announcement was to announce a plan by which

business might be assured that if the contract price were reduced they would not have to pay taxes on the amount of the reduction. In effect, the plan is that if renegotiation for a particular fiscal period is concluded during that period or before March 15 when the income- and excess-profits tax returns are due, the amount of the reduction of the profits for the fiscal year which are to be recaptured in any way from the contractor or subcontractor may be excluded from the return for that year. Secondly, because there will be instances where renegotiation is not concluded in a current fiscal year and the taxpayer has included what are afterward determined to be excessive profits in his income- and excess-profits-tax returns and paid a tax, in these circumstances the plan provides that the adjustment boards shall credit the amount of the excessive profits which they find for a particular fiscal period with the amount of taxes which have been paid upon those excessive profits which are subsequently recaptured. The Treasury Department treats the taxes which it has already collected as a partial recapture of the excessive profits and will recapture under section 403 only the balance of the excessive profits. The tax law should be amended so that, despite any lapse of time which might affect the statute of limitations, when, in a subsequent year, excessive profits are determined, the taxpayer may amend his previous return and be allowed a refund of the excess of the tax which he has paid over what he would have paid if he had in the previous year excluded from his profits the excessive profits subsequently determined. As is pointed out in the hearing, there is no provision in the law which either directs or authorizes the price adjustment boards to give the credit which is provided for in the Treasury plan, and unless the law is to be amended so as to require a refund of taxes from the Treasury it is vitally important that the law direct that the credit provided for in the Treasury plan be given. In the amendments which are found on pages 42–45, inclusive, in subsection (c) (2) on page 43 is the following language:

"In determining the amount of any excessive profits to be eliminated hereunder the Secretary shall allow the contractor or subcontractor appropriate credit for any Federal taxes (including income normal and excess-profits taxes) paid or payable with respect to such excess profits and not subject to adjustment (note: the word 'adjustment' refers to adjustment in taxes) but may require such evidence thereof, including a closing agreement with the Internal Revenue Bureau, as he deems necessary."

This amendment authorizes the carrying out of the plan announced by the Secretary of the Treasury in I. T. 3577. This clause should be made more definite. What are the taxes paid "with respect to such excessive profits"? It would be the Internal Revenue Bureau which would report to the Adjustment Boards the amount of these taxes, and what would they report? Let us take the case of a corporation which pays large excess profits taxes at the 80-percent rate and also, of course, pays normal and surtaxes on the part of its income not subject to excess-profits tax. Now, while it does pay 90 percent on the top part of its net income its effective rate payable on its entire income may be, say 70 percent. It is possible that the Internal Revenue Bureau might report that instead of paying 90-percent tax upon the excessive profits the taxpayer has paid only 70 percent because that is the average or effective rate upon the whole income. Nevertheless, of course, if the taxpayer had been able to deduct the excessive profits in his income-tax return he would have paid a lesser tax by the amount of 90 percent of the excessive profits. In other words, he has actually paid 90 percent on the excessive profits. There is one other angle which the Internal Revenue Bureau might take. The bill as it stands at present provides for 90 percent excess-profits tax but provides for what amounts to a refund to the taxpayer at the end of the war of 10 percent. The Treasury Department in all of its computations have been treating the revenue collected from corporations not as being based upon the full tax but upon the full tax less what will be refunded at the end of the war. When the Internal Revenue Department reports what tax has been paid by the contractor or subcontractor will it report the full amount of the tax or will it report what it considers revenue collected; in other words, the full amount of the tax less 10 percent? If the Internal Revenue Department did that, it would entirely defeat the purpose of the 10-percent refund. Therefore, the language quoted above should be changed so as to provide that there shall be credited the amount of taxes which the contractor or subcontractor may have paid in excess of the amount he would have paid if there had been excluded from his return the amount of excessive profits found in the subsequent year. That will mean that the amount of the credit will be the same as the amount he would be refunded if the taxpayer had the right to go back, amend his return, and exclude the excessive profits. Certainly nothing less than that

should be credited and the law should make it absolutely plain that that certain amount is to be used as a credit. The language "taxes * * * with respect to such excessive profits" is entirely too indefinite. So long as business is to be assured that they are not going to have to pay taxes on the amount recaptured, the language of this provision must be made absolutely clear so that the taxpayer will get the credit for the excess taxes which he has paid over and above what he would have paid if he had deducted the amount of the excessive profits in the fiscal year for which he has paid taxes.

PROPOSED AMENDMENT

Add the following:

"(m) No contract or subcontract shall be renegotiated more than once. Such renegotiated contract shall be final and not subject to further renegotiation. It may, however, be set aside for fraud or willful misrepresentation."

EXPLANATION

This is the application of ordinary common sense. No contractor can proceed efficiently if he has to devote a substantial portion of his time to renegotiating his contract. The present practice of the price adjustment boards is to renegotiate every 12 months (hearings, pp. 4 and 5). Further, no Secretary without statutory authority can make a decision which is binding on any successor; therefore, after any of these renegotiations has been made any Secretary can upset any or all of them at any time up to 3 years expiration after the war. Consequently, no contractor can finance his contract because he cannot tell any banker what his contract price is and unless something like (m) is adopted, financing of war contracts will have to be quite generally assumed by the Government. A price-adjustment board should be able after a contract has been in operation for a year to renegotiate it correctly. This will be particularly true if the new (c) (5) is adopted. Courts of equity reach such results every day in every State.

An alternative would be to substitute for (c) (3) of Committee Print No. 2 and (m) the following:

"Any renegotiation pursuant to this section with respect to elimination of excessive profits for any specific period or periods shall be final and not subject to renegotiation except for fraud or willful misrepresentation of a material fact; and upon renegotiation for the elimination of excessive profits from any contract or contracts without reference to any specific period or periods the secretary may make an agreement with the contractor or subcontractors making such renegotiation final upon such terms and conditions as the secretary deems advisable."

PROPOSED AMENDMENT

Add the following: "(n) The provisions of this section shall not apply to any contract involving less than $100,000."

EXPLANATION

The reasons for this are these: First, there are 3,500,000 outstanding contracts covered by section 403. Obviously there is no intention of renegotiating them all. At the time that the section was under discussion in the Senate on April 7, 1942, the statement was made that not more than 200 contracts in all were involved; $100,000 is adopted as the dividing line because that is the dividing line used in the section. Second, after a contractor has paid a combined 40 percent normal and surtax and a 90-percent-excess-profits tax on any possible earnings under a $100,000 contract, there couldn't possibly be sufficient additional money recovered by a price adjustment board to pay for the equity. The price adjustment boards recognize this situation. Their new (b) (1), (2), (3), and (4) deal only with contracts and subcontracts in excess of $100,000 and Mr. Marbury in his testimony (p. 39) states that it is a matter that should be considered.

CONCLUSION

The chief reasons why the renegotiation law is a serious detriment to production are (1) that it makes every contract price uncertain. It is difficult to persuade owners of sawmills and coal mines to put on additional shifts and run more hours

per week when they know that their contract prices are not certain. In addition, because of this uncertainty banks hesitate to make loans to carry out contracts which come under section 403 (2). What the price-adjustment boards started out to do is set out on page 62 of the revised hearings. This procedure is startling. It is also unsound. Who is to say that the average profits of a corporation for the years 1936 to 1940, inclusive, were an adequate return on capital? The system is a renegotiation of profits, not contracts, with the resulting collections paid, not to the Treasury but to a department. It is also a collection of taxes based on general business as well as war contracts. It sets up the price-adjustment boards as additional taxing bodies, levying taxes without any standards whatever except those that they themselves set up. Surely this was not the intent of the Congress in enacting section 403.

The income-tax uncertainty is equally grave, but the boards show a willingness to meet this and it can probably be done. Almost everyone wants to pay the taxes which will be fixed by the pending bill for 1942 and subsequent years and to pay them when and as due. Taxpayers will go a long way to do this. If they can be assured by law that they will be protected in their right to proper refunds and credits, they probably will not stand on their technical rights. Most lumber and coal operators who have Government contracts feel that the prices in such contracts are not excessive. Largely they are at, or below, those fixed by the Office of Price Administration. They are confident that, in the end, they will not be renegotiated because there is no reason why they should be.

HISTORY OF PROFIT LIMITATIONS ON WAR CONTRACTS

By David I. Walsh

I have had prepared for the information of the members of the Senate and the Finance Committee a brief history of profit-limiting legislation.

(1) The first attempt providing, in recent years, for limitation of profits on Government contracts was in connection with the manufacture and construction of naval vessels and naval aircraft in 1934 (Vincent-Trammell Act). This law required the contractor, or subcontractor, to pay into the Treasury any excess profit realized on a particular contract by limiting the allowable profit to 10 percent of the total contract price.

(2) In June 1936 this act was amended forbidding contractors, or subcontractors, to combine all contracts or subcontracts completed in any taxable year to determine whether a profit in excess of 10 percent had been made. This law also permitted any contractor, or subcontractor, to carry forward a net loss on any contract completed in an income taxable year and take it as a credit in determining the excess profit on contracts completed in the next succeeding income taxable year.

(3) The next action taken was on April 3, 1939. One of the sections of this act provided that contracts for Army aircraft (heretofore the law only applied to naval contracts) should be subject to the limitation of profits contained in the Vincent-Trammell Act of 1934. It also increased the allowable profit from 10 to 12 percent in the case of Army and Navy aircraft, retaining the allowable profit to 10 percent in the case of naval vessels. A more liberal net loss carry-over was also provided, extending the time for carrying forward such losses in determining the excess profits to 4 succeeding income taxable years.

It should be noted that these provisions, increasing the allowable profit and providing for a more liberal net loss carry-over, were applicable only to contracts in the manufacture of Army and Navy aircraft and not applicable to the contracts for construction of naval vessels.

(4) In the following year, on June 28, 1940, in an effort to limit profits because of the large building expansion, an act was passed changing the allowable profits on naval vessels and Army and Navy aircraft to 8 percent of the contract price, or 8.7 percent of the cost of performing the contract on other than prime contracts made on a cost-plus-a-fixed-fee basis, in lieu of the 10 percent previously applicable to naval vessels and the 12 percent applicable to the Army and Navy aircraft.

(5) Shortly after this act was adopted, because of contractors' complaints of uncertainty of costs and delays in obtaining supplies and parts, Congress in the Second Supplemental National Defense Appropriation Act, September 9, 1940, amended the profit-limiting provisions of the act of June 28, 1940, by removing from the operations of such section contracts entered into after September 9, 1941, for the manufacture of Army and Navy aircraft. The effect of this amendment was to increase the allowable profit under the Vincent-Trammell Act on contracts for Army and Navy aircraft from 8 to 12 percent and to retain the allowable profit at 8 percent on naval vessels, as fixed by the act of June 28, 1940.

(6) A few weeks later another change in policy was made. In section 401 of the Second Revenue Act of 1940, October 8, 1940, the profit limiting provisions of the Vincent-Trammell Act and those of the act of June 28, 1940, were suspended in cases of all contracts and subcontracts which were entered into during taxable years and to which the excess profits tax is applicable (taxable years beginning after December 31, 1939). This suspension was applicable also to contracts and subcontracts which were entered into prior to the date when the contractor, or subcontractor, became subject to the excess profits tax and which were not completed before such date. The effect of this section was to remove profit limiting provisions affecting particular Army and Navy contracts (naval vessels and Army and Navy aircraft), and, thereby, made contractors

who since 1934 had been subject to profit limitations subject only in the future to the excess profits tax the same as other corporations.

NEGOTIATION OF CONTRACTS

In Public Law No. 43, approved April 23, 1939, Congress for the first time since World War I, authorized the Secretary of the Navy to negotiate, without competitive bidding, contracts for certain public works projects outside the continental limits of the United States on a cost-plus-a-fixed-fee basis. This act provided that the fixed-fee should not exceed 10 percent of the estimated cost of the contract, exclusive of the fee. This method of negotiating contracts has been extended from time to time to include practically all public works contracts, but the fixed fee is now limited to 6 percent of the estimated cost of the contract and in actual practice averages about 4 or 5 percent.

A few months later the Navy Department requested authorization to negotiate without competitive bidding contracts for construction of naval vessels and aircraft, the Army already having such authority in contracting for Army aircraft. Section 2A of Public Law 671 of June 28, 1940, authorized the Secretary of the Navy to negotiate contracts for the acquisition, construction, repair, or alteration of naval vessels or aircraft and of machine tools and their equipment without advertising or competitive bidding. This section however provided that if the fixed-fee contract was used the amount to be paid by the War Department or Navy Department (so as to put them both on an equal basis) should not exceed 7 percent of the estimated cost of the contract, exclusive of the fee.

Section 2 b (2) of this same law, Public Law 671 of June 28, 1940, however, provided that any profit in excess of 8.7 percent of the cost of performing such contracts, except prime contracts, made on a cost-plus-a-fixed-fee basis, shall be considered to be profits in excess of 8 percent of the total contract prices of such contracts.

It is to be noted that this law of June 28, 1940, places a distinct limitation on the profits on contracts negotiated on a fixed-price basis as well as contracts made on a cost-plus-a-fixedfee basis.

Very shortly after this law was adopted Congress, in the appropriation bill of September 9, 1940, increased the allowable profit to 12 percent on both Army and Navy aircraft and left it at 8 percent on naval vessels. Within a few weeks thereafter, namely in the Second Revenue Act of 1940, October 8, 1940, Congress removed all profit limitation provisions on competitive bid contracts or negotiated contracts at a fixed price leaving the contractors with war contracts in the same position as all other taxpayers subject to the excess profits tax.

TYPES OF CONTRACTS

There are now four methods of making contracts with the Government, to wit:

1. By competitive bidding at a fixed price.
2. By negotiation at a fixed price.
3. By negotiation on a cost-plus-a-fixed-fee basis for certain articles and equipment where the fixed fee is not to be more than 7 percent of the than 7 percent of the estmated cost.
4. By negotiation on a cost-plus-a-fixed-fee basis for naval public works projects where the fixed fee shall not exceed 6 percent of the estimated cost.

It is a fact that during the past 8 years attempts have been made to limit excessive profits on the manufacture of war materials and that neither the Congress, the Treasury Department, the War Department, the Navy Department, the Maritime Commission, nor any other department of the Government has as yet been able to formulate a satisfactory plan of eliminating excessive profits or recapturing excess profits on the production of war materials.

It is also a fact that during the past 8 years, without consultation or unity of action, the Naval Affairs Committee, the Military Affairs Committee, the Appropriations Committee, and the Finance Committee have at various times dealt with this subject with the result that one law after the other has been repealed and constant changes have been made in the attempts to control war-contract profits.

RENEGOTIATION OF WAR CONTRACTS

It became apparent to the Senate Appropriations Committee that many negotiated contracts were awarded before either of the contracting parties had any accurate idea as to the actual cost of producing the article on a mass production

basis. Firms and corporations naturally bid very high or negotiated at a very high price in order to play safe. When the actual cost of manufacturing the article became known it was apparent that some firms were making an excessive profit, and both the Government and the manufacturer desired to renegotiate the contract in order to reduce the cost to the Government.

This led to the enactment of section 403 of Public Law No. 528, (April 8, 1942) authorizing the "Renegotiation of Contracts" but did not set any standards for determining "excess profits," and left this matter entirely in the hands of officials of the Government.

This law authorized and directed the Secretaries of the War and Navy Departments and the Maritime Commission to insert in any contract where the amount is in excess of $100,000, provisions for the renegotiating of the contract prices at a period or periods when in the judgment of the Secretaries, profits can be determined with reasonable certainty.

It also contained a provision for the retention by the United States or the repayment to the United States any amount of the contract prices which were found to be excessive profits. It permits the renegotiation of subcontracts as well as prime contracts where excessive profits could be determined.

This law is to remain in force during the continuation of the present war and for 3 years after the termination of the war.

PROPOSED CHANGE IN RENEGOTIATION OF WAR-CONTRACTS LAW

The Finance Committee of the Senate is now studying the operation of this law and considering changes and amendments that have been proposed by the Departments and representatives of contractors having Government war contracts.

HANDLING OF WAR CONTRACTS IN CANADA AND GREAT BRITAIN

CONGRESS OF THE UNITED STATES

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Washington, September 29, 1942.

Honorable DAVID I. WALSH,
United States Senate, Washington, D. C.

MY DEAR SENATOR: In accordance with your request, we submit herewith a statement on the handling of war contracts in Canada and in Great Britain.

Very truly yours,

COLIN F. STAM,
Chief of Staff.

WAR CONTRACTS

CANADA

In the time available we have made a study of the handling of war contracts in Canada and in Great Britain. We have been in consultation with officials who have visited Canada and studied the British practice, and of the Library of Congress who have made some study of war contracts.

In Canada, there is no statutory limitation on the profits from war contracts. The Canadian Defence Purchases Profit Control and Finance Act of 1939 provided for control of profits in respect of certain defense contracts by means of a tax of 100 percent of all such profits in excess of 5 percent of the capital employed. In the House of Commons Debates of May 23, 1940, Mr. Douglas said:

"The 5 percent is gone, and the reason why it is gone is that on September 12 the Minister of Transport said that he and his Department could not get the manufacturers of this country to accept contracts if the profits were limited to 5 percent."

At the present time, the Ministry of Supply has general jurisdiction of war contracts. This is separate and distinct from the board fixing prices and wages. The Ministry of Supply handles the matter administratively and fixes all prices for the purpose of war contracts. The larger contracts must be approved by the Minister. The smaller contracts must be approved by the contracts branch of the Ministry of Supply, and intermediate contracts by the Ministers Committee. However, it is aided considerably by the fact that wages, an important part of the contract cost, are already fixed in Canada.

In Canada the ascertainment of costs is a comparatively easy matter because the Government is very familiar with the operations and capabilities of the important businesses in the country. Therefore, it is not as difficult to ascertain costs as it is in this country. In many of the larger concerns, the Treasury has a Government auditor to check the cost as the contract is being performed. Most of the work is done through a spot checking system. Physical inventories are not required, as they will seriously interfere with the war effort.

In the past, some contracts were negotiated on a cost-plus-fixed-fee basis, with an added percentage being allowed for reduction in costs. This proved somewhat cumbersome, and has been abandoned in favor of the fixed-price or target-price contracts.

In cases where a concern is making an article for the first time, it may be necessary to fix a target price for a fixed period. For example, a company manufacturing fuses for the first time, may be given a contract for a period of 2 months fixing a price at $3 per fuse. At the end of this period, the target price may be reduced to $2, and later on to a still lower price. However, there

77020—42——6

is no effort in Canada to apply these changes retroactively except in cases of fraud or collusion. Thus the contractor knows definitely in the example given that the $3 price will be paid for the fuses manufactured in the 2-month period, and any effort which is made to cut his costs will result in a benefit to him.

Most of the large contracts are handled by Government plants, of which there are about 20, with businessmen employed to manage them. Some contracts, with large corporations, are handled on a fixed-price basis. They may be for as long as 1 year in duration. In this type of contract, adjustments may be made, but such adjustments will not affect the price with respect to articles already delivered.

Under the fixed-price contract, the awards are made by tenders, award being made to the lowest tender believed capable of performing the contract.

In the case of contracts involving the building of ships, etc., extending over a long period of time, it is usually necessary to negotiate the contract on a cost-plus-fixed-fee basis. Many manufacturers would not accept a fixed-price contract for such undertakings, due to the difficulty in predicting the ultimate costs.

To some extent, the high excess-profits tax of 100 percent interferes with the effort through this type of contract to hold costs down to a reasonable basis. There has been some recent agitation, both in England and in Canada, to lower the rate from 100 percent.

GREAT BRITAIN

Types of contracts.—Four types of contract are in use, the principal type at this time being the fixed-price contract. The Chancelor of the Exchequer stated to the House of Commons in October 1941 that an increasing proportion of contracts are being entered into on the fixed-price basis, and that the Government recognizes that other types of contracts were open to objections and were diminishing. He stated that fears that there has been large avoidable extravagance were not justified by the facts. The four types in use are:

(1) *Cost-plus-percentage contracts.*—This type is used for work such as for repairs, where the extent of the work to be done cannot be accurately estimated; also, where companies are making new weapons for the first time. A maximum price is fixed in such contracts for the purpose of preventing profiteering.

(2) *Cost-plus-a-fixed-profit contract.*—This is used where a company is producing items for the first time, but which other companies are producing. In this case the Government on the basis of experience can ascertain what the cost should be, but makes allowance for the lack of experience of the new company. A maximum price is fixed also in this type of contract.

(3) *Fixed-price contracts.*—This is the prevailing type. A company may be allowed in the beginning of production to operate under the cost-plus-percentage contract, or the cost-plus-a-fixed-profit contract, but as soon as the company has gained the experience necessary it must operate under the fixed-price contract.

(4) *Target-price contract.*—This is chiefly used by the Air Ministry, and is used where companies produce items subject to frequent changes in design. In the beginning of war production it was in more general use, but has gradually been abandoned generally in favor of the fixed-price contract. In such a contract the Government sets a target price to cover anticipated costs and a reasonable profit; also, a maximum price is set to prevent profiteering. Savings effected below the target price are shared with the contractor. In other words, if the contractor can reduce the cost below the target figure, he may add to the profit which the contract allows a percentage of such reduction. For example, if the cost is reduced 10 percent below the target cost, the contractor may be allowed 5 percent of such reduction; if the reduction is 20 percent, he may be allowed to increase his profit by 10 percent of such reduction, and so on.

This type of contract was formerly used more widely, but has been generally abandoned by reason of the fact that through experience in production it is now practicable to fix costs and determine a reasonable profit. Its principal purpose was to offer incentive to the contractor to reduce costs.

Cost control or post-costing.—A system of post-costing or post-auditing, is followed by which costs may be allowed or disallowed, according to whether they are fair and reasonable. The purpose is to prevent padding with fraudulent cost and to ascertain how reductions can be brought about in future contracts. It is not for the purpose of recapturing profits, which is effected through the excess-profits tax. The emphasis has been upon speed of production and post-costing has not been allowed to hamper production.

Under this system, at first the Government assigned an auditor or cost accountant to each plant. He kept a running account of costs and where they appeared to be too high this was reported. Later, when production expanded, it was not possible to maintain this procedure and it is followed now only with respect to the larger plants.

In the case of new plants, Government experts are assigned to them and they are able on the basis of experience to ascertain what the cost of operations ought to be and to help in eliminating wasteful operations. They speed up the transition from operating under the cost-plus contracts, allowed firms who have not had experience in production, to fixed-price contracts, already described.

Spot costing, or spot checking, in various plants is practiced, which has a good effect in bringing about more efficient operation.

The contractors' own auditors and cost accountants cooperate with the Government to the same general purpose.

Achievement of profit control.—It has been estimated on the basis of the period 1935–36, that profits of the main industries rose ot 131.7 in 1938 but were only 105.1 in 1941. Net profits in 1941 were 10 percent lower than in 1940. This would seem to indicate that profit control has been pretty well achieved under the system outlined.

Senator WALSH. I am also offering for the record a letter addressed to the Honorable Walter F. George, chairman of the Senate Committee on Finance, under date of September 22, 1942, from the Honorable Carl Vinson, chairman of the Naval Affairs Committee of the House of Representatives, dealing with profit limitations on war contracts.

(The letter above referred to is as follows:)

PROFIT LIMITATIONS ON WAR CONTRACTS AS PROPOSED BY HON. CARL VINSON, MEMBER OF CONGRESS

HOUSE OF REPRESENTATIVES,
COMMITTEE ON NAVAL AFFAIRS,
Washington D. C., September 22, 1942.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C.

DEAR SENATOR: I have noted with considerable interest recent publicity concerning your proposal to repeal the contract renegotiation authority contained in Public, 528, Seventy-seventh Congress, and to substitute therefor a direct statutory limitation on profits.

It has long been my firm conviction that the only equitable and effective method of limiting profits on war contracts is by means of a direct statutory limitation. The House Naval Affairs Committee has devoted considerable thought to a bill containing such a provision which I introduced but which the committee, after extended hearings, failed to report because of other controversial matters contained in the same measure. I am sure that a bill dealing solely with the matter of a limitation on war profits would have been enthusiastically received by the House.

At the time Public, 528, was before the House I pointed out the injustice of conferring on the various department heads the arbitrary and unlimited authority to limit profits on war contracts by renegotiation, and the uncertainty which would result from such a provision, and expressed the hope that such renegotiation authority would soon be superseded by legislation setting out statutory standards defining reasonable profits on war contracts.

It is my feeling that the renegotiation provisions of Public, 528, makes any contract with the War or Navy Department ineffectual and illusionary.

I am enclosing for your study a copy of H. R. 6790 (Committee Print No. 2), which embodies the result of the time and thought devoted to the problem by myself and by the House Naval Affairs Committee. I hope that it may be of some help to you in connection with your present proposal.

With kindest regards, I am

Yours very truly,

CARL VINSON, *M. C.*

[Confidential Committee Print No. 2, April 27, 1942]

PROPOSED COMMITTEE SUBSTITUTE FOR H. R. 6790

Strike out all after the enacting clause and insert in lieu thereof the following:

FINDINGS AND DECLARATION OF POLICY

SECTION 1. (a) Congress hereby finds that it is inconsistent with the expeditious and successful prosecution of the present war and prejudicial to those serving in the armed forces of the United States—

(1) for war contractors to derive excessive profits from the performance of war contracts;

(2) for labor organizations to demand and war contractors to accede to contract provisions not heretofore in effect which require such contractors to refuse to employ or retain individuals whose labor may be indispensable to the expeditious and successful prosecution of the war, if such individuals are not members of such labor organizations;

(3) for the United States to maintain in effect provisions of law which penalize the performance of labor indispensable to the expeditious and successful prosecution of the war by requiring the payment of overtime compensation before a full six days of labor is performed in each workweek; and

(4) for war contractors to enter into or maintain in effect contracts which penalize the performance of labor indispensable to the expeditious and successful prosecution of the war by requirements that premium compensation be paid for labor on Saturdays, Sundays, holidays, or during the night.

(b) It is hereby declared to be the policy of this Act to effectuate the expeditious and successful prosecution of the war by removing the obstructions thereto described in subsection (a), and by providing for the payment of production bonuses to employees whose volume and efficiency of production justify such payments.

SEC. 2. As used in this Act—

(a) "Person" means an individual, partnership, joint venture, association, corporation, business trust, or any organized group of persons.

(b) "War contract" means—

(1) a contract with the United States entered into on behalf of the United States by an officer or employee of the Department of War, the Department of the Navy, or the United States Maritime Commission; or

(2) a contract with the United States entered into by the United States pursuant to an "Act to promote the defense of the United States"; or

(3) a contract, whether or not with the United States, for the production, manufacture, processing, assembly, construction, reconstruction, installation, maintenance, storage, repair, alteration, conversion, distribution, or supply of—

(A) any weapon, munition, aircraft, vessel, or boat;

(B) any building, structure, or facility;

(C) any machinery, instrument, tool material, supply, article, or commodity; or

(D) any component material or part of or equipment for any article described in subparagraph (A), (B) or (C);

the production, manufacture, processing, assembling, construction, reconstruction, installation, maintenance, storage, repair, alteration, conversion, distribution, or supply of which is certified by the President as being necessary to the prosecution of the war.

(c) "War contractor" means the person producing, manufacturing, processing, assembling, constructing, reconstructing, installing, maintaining, storing, repairing, altering, converting, distributing, or supplying, under a war contract.

(d) "Net profit derived from war contracts" completed within a profit period means the excess of the aggregate of the contract prices under such contracts over the aggregate cost of performing such contracts, minus, in case in the preceding profit period there was a net profit deficit from the performance of war contracts completed within such preceding period, the amount of such deficit. "Net profit deficit" from war contracts completed within any profit period means the excess of the aggregate cost of performing such contracts over the aggregate of the contract prices under such contracts.

(e) "Profit period" of a war contractor means the annual accounting period on the basis of which such contractor keeps his books.

(f) "Performance period" as applied to any war contract means the period beginning with the day such contract is entered into and ending with the day the performance thereof is completed, except that it shall not in any event exceed the period estimated by the Secretary of War, the Secretary of the Navy, or the Chairman of the United States Maritime Commission, as the case may be, as necessary to complete such performance.

(g) "Restrictive employment contract" means any contract, arrangement, plan, or practice of a war contractor which has the effect of making it a condition of employment with such contractor that any individual become, be, or remain a member or adherent of any labor organization, or which requires such contractor to influence or encourage any individual in his employ or seeking employment with such contractor, to become, be, or remain a member or adherent of any labor organization.

(h) "Paid or incurred" shall be construed according to the method of accounting employed by the war contractor in keeping his books.

LIMITATION OF PROFITS ON WAR CONTRACTS

SEC. 3. (a) Every war contractor shall pay to the Secretary of the Treasury, at such times and in such manner as the Secretary shall by regulations prescribe,

all net profits derived from war contracts, completed within each profit period, in excess of—

(1) an amount with respect to each such contract equal to 8 per centum per annum of the daily cost for each day of the performance period, computed, as applied to the daily cost for any such day, on the basis of the number of days (including the day for which such cost is determined) remaining in such period; plus

(2) an amount ascertained by dividing $6,000 by three hundred and sixty-five and multiplying the result by the number of days in the performance period of the contract the total costs incurred in the performance of which is the greatest; plus

(3) an amount equal to 10 per centum per annum (determined on a daily basis) of the first $1,000,000 of the undepreciated and unamortized cost of the fixed capital of the contractor used in the performance of the contract, and an amount equal to 6 per centum per annum (determined on a daily basis) of the undepreciated and unamortized cost in excess of $1,000,000 of the fixed capital of the contractor used in the performance of the contract. For the purposes of this paragraph "fixed capital" means depreciable tangible property of the contractor and nondepreciable real property of the contractor, no part of the cost of which (except through the allowance for depreciation or amortization) is otherwise used, directly or indirectly, in determining the cost of performing such contract, and which is not represented by borrowed capital.

This subsection shall not apply with respect to any profit period in which the contract prices of contracts completed within such profit period do not exceed in the aggregate $100,000. All payments made to the Secretary of the Treasury pursuant to this subsection shall be covered into the Treasury as miscellaneous receipts. For the purposes of other provisions of law the amount of such payment shall not be deemed to have been received by or accrued to such contractor.

(b) Every war contractor shall, at such times and in such manner as the Secretary of the Treasury shall by regulations prescribe, state under oath the aggregate of the contract prices under war contracts completed within the profit period in respect of which such statement is made. The daily cost for any day of performing any war contract shall be determined by adding to the direct costs of such performance actually paid or incurred on such day the indirect costs of such performance attributable to such day and, in case prior to such day any part of the contract price has been paid, by subtracting from the sum so ascertained such portion of such payment as is attributable to such day, determined by dividing the amount of such payment by the number of days remaining in the performance period after the day of such payment. The indirect costs of performing any such contract attributable to any day shall be an amount ascertained by dividing the total of such indirect costs by the number of days in the performance period; and in case the contractor does not employ a method of cost accounting under which the direct costs actually paid or incurred on each day may be determined, the direct costs paid or incurred on each day may, with the approval of the Secretary of the Treasury, be determined in a similar manner. The direct and indirect costs of performing war contracts shall be determined in accordance with the method of cost accounting regularly employed in keeping the books of the war contractor in question, but if no such method of cost accounting has been employed, or if the method so employed does not in the opinion of the Secretary of the Treasury clearly reflect such costs, such costs shall be determined in accordance with such method as in the opinion of the Secretary does clearly reflect such costs. In the case of a war contractor which does not regularly employ a method of cost accounting in keeping its books, such war contractor may, with the approval of the Secretary, determine the allocation of indirect costs to be made to war contracts according to the ratio of direct costs of performing war contracts to total direct costs. Irrespective of the method employed by any war contractor for determining costs of performing war contracts completed within any profit period, and except as provided in subsection (c), (1) no item of cost shall be charged to the performance of any such contract or used in any manner for the purpose of determining such cost if the Secretary of the Treasury determines that such item is unreasonable or not properly chargeable to such contract, and (2) unless the Secretary of the Treasury shall by regulations otherwise provide, no item of cost shall be charged to the performance of any such contract or used in any manner for the purpose of determining the cost of such performance unless such item would have been chargeable against such contract if such con-

tract had been subject to the provisions of section 3 of the Act of March 27, 1934, and the regulations thereunder, as in effect prior to the enactment of the Second Revenue Act of 1940, and (3) in case the salary, bonus, and other compensation applicable to any executive position in the employ of the contractor exceeds in the aggregate an amount greater than 110 per centum of the aggregate of the salary, bonus, and other compensation applicable to such position, or a position involving comparable duties, on July 1, 1940, no part of such excess shall be charged to the cost of performing any such contract or used in any manner for the purpose of determining the cost of such performance.

(c) No provision of this section (except subsection (b) (3)) shall be deemed to prohibit, or authorize the prohibition of, the inclusion of any of the following items as items of cost in the performance of any war contract:

(1) A proper proportion of the ordinary, reasonable, and necessary expenses, not properly chargeable as direct costs in the performance of any war contract and not charged to capital account under chapter 1 of the Internal Revenue Code, paid or incurred in the performance period for general research, engineering, and development.

(2) A reasonable allowance for the amortization of ordinary, reasonable, and necessary expenditures of the character described in paragraph (1) (paid or incurred in any profit period beginning after December 31, 1935), if such expenditures have been charged to capital account for the purposes of chapter 1 of the Internal Revenue Code.

(3) A reasonable allowance for the amortization of expenditures of the character described in paragraph (1) (paid or incurred in any profit period beginning after December 31, 1935, and before January 1, 1942), if (A) such expenditures were not charged to capital account for the purposes of chapter 1 of the Internal Revenue Code or the corresponding title of a prior revenue law, and (B) the contractor, in accordance with such regulations as the Secretary of the Treasury may prescribe, elects, with respect to all such contracts completed within the profit period and all such contracts completed within subsequent profit periods, to treat all such expenditures as having been charged to capital account and consents to pay to the Secretary the amount by which his liability under such chapter and corresponding title and under chapter 2E of the Internal Revenue Code for profit periods beginning after December 31, 1935, and before January 1, 1942, would have been increased if such expenditures had been so charged.

(4) A proper proportion of the ordinary, reasonable, and necessary expenses paid or incurred in the performance period for advertising for the retention of goodwill.

(d) All provisions of law (including penalties) applicable in respect of the tax imposed by chapter 1 of the Internal Revenue Code shall apply in respect of the payment required to be made by this section.

(e) Subsections (a) and (b) and (c) shall apply only to war contracts completed within profit periods beginning after December 31, 1941.

OVERTIME COMPENSATION

SEC. 4. (a) For the duration of the national emergency declared by the President to exist as of May 27, 1941, the workweek for labor in excess of which overtime compensation must be paid under the provisions of section 7 of the Fair Labor Standards Act of 1938, as amended, shall be a workweek of forty-eight hours in lieu of the workweek of forty hours now provided in such section.

(b) For the duration of the national emergency declared by the President to exist on May 27, 1941, all laws of the United States, and regulations thereunder, relating to the pay or hours of labor of employees of persons performing contracts with the United States or any agency thereof, or of subcontractors of such persons, are suspended to the extent that they require the payment of (1) overtime compensation to any employee for employment during any workweek prior to the completion of forty-eight hours of labor by such employee during such workweek or (2) compensation for labor on Saturdays, Sundays, holidays, or during the night at a rate higher than that which would be applicable if such labor were not performed on Saturday, Sunday, a holiday, or during the night.

(c) For the duration of the national emergency declared by the President to exist on May 27, 1941, it shall be unlawful for a war contractor to pay, pursuant to any contract or agreement, to any employee for labor on Saturday, Sunday, a holiday, or during the night, compensation at a rate higher than that which would be applicable if such labor were not performed on Saturday, Sunday, a holiday, or

during the night. No war contractor shall be held liable for any act done, or omitted to be done, pursuant to the requirements of this subsection.

(d) The Secretary of War, the Secretary of the Navy, and the Chairman of the United States Maritime Commission shall exercise the authority conferred upon them by section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, to recover or retain for the United States any amount estimated in the contract price of any war contract for the payment of overtime compensation, or of premium compensation for employment on Saturdays, Sundays, holidays, or during the night, which is not so paid by reason of the enactment of this section. For the purposes of section 3 of this Act any amounts withheld or recovered under the provisions of this subsection shall not be considered as part of the contract prices for the contracts with respect to which such amounts are withheld or retained.

(e) During the national emergency declared to exist by the President on May 27, 1941, notwithstanding any other provision of law—

(1) the Secretary of War, the Secretary of the Navy, and the United States Maritime Commission are respectively authorized and directed to prescribe regulations with regard to the working hours and overtime employment of employees of the Department of War, the Coast Guard and Department of the Navy, and the United States Maritime Commission, respectively; and

(2) overtime compensation for employment in excess of forty hours in any workweek, computed at the rate of one and one-half times the rate of compensation applicable for labor not in excess of such forty hours, is authorized to be paid to employees of the Department of War, the Coast Guard and Department of the Navy, and the United States Maritime Commission, respectively, who, on the date of enactment of this Act, are entitled to receive overtime compensation only if and to the extent that such Secretary or Commission, as the case may be, determines that overtime compensation is being paid to a substantial majority of employees of war contractors, to whom the laws and regulations specified in section 4 (a) and (b) are applicable, performing similar services.

PRODUCTION BONUSES

SEC. 5. (a) The War Production Board is directed to formulate, and notwithstanding any other provision of law to require war contractors to put into effect when so formulated, plans for the payment, at the conclusion of each workweek, to production employees whose volume and efficiency of production during such workweek is determined according to the plan to justify such payment, of production bonuses. The bonus to any employee for any workweek may equal but not exceed the regular compensation payable to such employee for labor during such workweek. In order to enable war contractors to make such payments in accordance with the plans so formulated and put into effect, there are authorized to be appropriated such sums as may be necessary.

(b) The Secretary of War, the Secretary of the Navy, and the United States Maritime Commission are directed to formulate and notwithstanding any other provision of law put into effect, with respect to production employees employed in shipyards, docks, arsenals, loading plants, and other facilities at which articles essential to the prosecution of the war are produced by the United States, plans for the payment, at the conclusion of each workweek, to employees whose volume and efficiency of production is determined according to the plan to justify such payment, of production bonuses. Such bonuses shall be subject to the same limitations as in the case of production bonuses to employees of war contractors. There are authorized to be appropriated such sums as may be necessary to carry out the provisions of this subsection.

(c) It shall be unlawful for any war contractor having in effect a plan formulated under this section to make, from funds appropriated by Congress, any payments under such plan otherwise than in accordance with the terms thereof. Any war contractor violating any of the provisions of this subsection shall upon conviction thereof be fined not more than $5,000, or be imprisoned for not more than one year, or both.

(d) This section and all plans in effect thereunder shall cease to be in effect upon the termination of the national emergency declared to exist by the President on May 27, 1941.

RESTRICTIVE EMPLOYMENT CONTRACTS

SEC. 6. (a) It shall be unlawful for any war contractor to enter into a restrictive agreement with respect to the employment of any individual in the performance of a war contract, but this subsection shall not be deemed to prohibit the renewal of any such agreement which was in effect on the date of the enactment of this Act.

(b) No officer, agency, or instrumentality of the United States in the executive branch of the Government shall issue or enforce any decision or order which directs or has the effect of directing a war contractor, otherwise than in accordance with the provisions of a restrictive employment contract not prohibited under subsection (a), to discriminate against any individual in regard to hire, terms, or tenure of employment, because of such individual's failure to be, become, or remain a member of, or to resume membership in, any labor organization.

PENALTIES

SEC. 7. Any person who violates any provision of section 4 (c) or section 6 (a) shall, upon conviction thereof, be fined not more than $5,000 or be imprisoned for not more than one year, or both.

[Committee Print]

ANALYSIS OF THE PROVISIONS OF THE COMMITTEE SUBSTITUTE FOR H. R. 6709

Section 3 of the substitute contains a new proposal for the limitation of profits on war contracts. It was formulated and drafted with a view to meeting the merited objections which were raised against the original proposal. The objections to the original proposal were:

(1) It failed to take into account the length of time it took to complete a contract, thus favoring the contractor with a rapid turn-over and penalizing the contractor having a slow turn-over.

(2) It failed to take into account the ratio of fixed capital to gross sales, thus penalizing the contractor whose fixed capital represented by plant, etc., was large in relation to his turn-over.

(3) It failed to take into account cases in which the Government put up all or part of the contract price in advance of completion, thus in effect allowing the contractor a return on Government funds.

(4) It failed to specify that general research, experiment, and development expenses should constitute a proper element of cost.

(5) It failed to specify that advertising expenses incurred to retain goodwill should constitute a proper element of cost.

The new proposal provides for a maximum of 8 percent per annum return on each dollar of cost incurred by the contractor from the time it was incurred until the contract is completed or the contractor reimbursed by an advance payment before completion. In addition the contractor is allowed a return on his plant investment used in performing the contract to the extent of a maximum of 10 percent per annum on the first $1,000,000 of such investment and 6 percent on the excess over a million dollars. The cushion of $6,000 is also retained but is related to the time which it takes to complete the contract having the largest cost. This does not mean that there is a separate cushion for each contract, but that if the contract having the greatest cost took 2 years to complete, the cushion for all the contracts in the aggregate would be $12,000. Similarly if the contract having the largest costs took only one-half a year to complete, the cushion for all the contracts in the aggregate would be $3,000.

The manner in which the new proposal operates may be likened to the lending of money by a bank and the payment of interest by the borrower—the contractor being the lender of the amounts representing the costs incurred and the United States the borrower of such amounts. If every dollar of cost were incurred by the contractor on the first day of the contract he would in effect be lending the United States that amount until the contract was completed or the contractor reimbursed before that time, and under the proposal would be entitled to retain as profits 8 percent per annum of the amount of such costs, for the period beginning with the first day of the contract and ending with completion or reimbursement. We all know, however, that all the costs are not incurred on the first day. Wages, for example, are usually paid weekly, and a contractor who keeps his books on a cash receipts and disbursements basis will not incur the

first week's wage cost until Saturday of that week. Thus, with respect to the costs representing the first week's wages, he will be entitled to the 8 percent per annum only for the period beginning on that Saturday and not on the preceding Monday.

This approach to the problem of the time element in the performance of a contract—a problem which must be solved to put the contractor with a rapid turn-over and the contractor with a slow turn-over on exactly the same footing—requires that the costs incurred on each day be taken into account. This does not mean that the contractor has to keep books so that he can determine his costs on each day. With respect to indirect costs, or overhead, for example, it would be impossible to determine how much of such overhead was incurred on any particular day. With respect to direct costs, such as wages and materials, however, it is possible to determine what wage costs and material costs were incurred on any day if the contractor keeps any sort of cost accounting records. If a contractor does keep records which enable him to determine what direct costs were incurred on each day, those actually incurred are used as the direct costs for that day. If he does not keep such records, the proposal does not require him to do so, but simply states that in that event the contractor may assume that his direct costs were incurred ratably over the period of the contract. For example, if the total direct costs were $10,000 and the contract took 10 days to complete, the contractor is permitted to assume that $1,000 of direct costs was incurred on each day.

In the case of overhead, it is impossible, as I have indicated, to determine how much was incurred on any day, and thus the proposal assumes that overhead expenses are incurred ratably over the period of the contract. Thus if the total overhead were $120 and the contract took 10 days to perform, the proposal assumes that $12 of overhead expense was not incurred on each day, and calls that $12 the indirect costs attributable to any day.

Having found the direct costs actually incurred, or assumed for a particular day, the indirect costs attributable to that day are added to them to give the total daily cost for that day. Having found this daily cost, 8 percent per annum thereof is computed from that day to the end of the period. The same operation is followed for the next day, and so on through the contract period. The 8 percent amounts thus determined are aggregated for the contract and all other contracts completed within the same taxable year, and the result is the permissible profit (excluding the "cushion" and the interest on plant investment) on those contracts. If the actual profit (i. e., the excess of the aggregate of the contract prices over the aggregate of the costs of performance) is more than the permissible profit so determined, the remainder must be repaid to the Treasury.

The following is a simple illustration of how the proposal will operate. Assume a contractor has but one contract for $100,000 which he starts on Monday and completes on Thursday. The performance period of the contract will thus be 4 days. Further assume that this contractor keeps cost-accounting records which enable him to determine the direct costs actually incurred on each day, and that they are as follows:

	Direct	Indirect	Total (no reimbursement)	8 percent per annum of—
Monday	$15,000	$5,000	$20,000	$20,000 for 4 days equals $17.52.
Tuesday	18,000	5,000	23,000	$23,000 for 3 days equals $15.12.
Wednesday	11,000	5,000	16,000	$16,000 for 2 days equals $7.
Thursday	16,000	5,000	21,000	$21,000 for 1 day equals $4.60.

Permissible profit (without regard to "cushion" and interest on plant investment), $44.24.

The above table indicates that the total direct costs are $60,000, and the total indirect costs $20,000—a total cost of $80,000. The latter, the proposal assumes, are incurred ratably over the 4-day period, resulting in indirect costs for each day of $5,000. The total daily costs for Monday are $20,000, and 8 percent per annum of this amount is computed for 4 days. The total daily costs for Tuesday are $23,000, and 8 percent per annum of this amount is computed for 3 days. The total daily costs for Wednesday are $16,000, and 8 percent of this amount is computed for 2 days. The total daily cost for Thursday is $21,000, and 8 percent per annum of this amount is computed for 1 day. The 8-percent figures are then aggregated, resulting in $44.24, approximately, which is the permissible profit without regard to the cushion and the interest on plant investment.

If we assume the plant investment (disregarding depreciation and amortization) is $1,000,000, 10 percent per annum of this amount for 4 days is approximately $10.96. The $6,000 "cushion" reduced to a 4-day basis is approximately $66.84. Hence the total permissible profit would be the sum of $44.24, return on cost; $1,096, return on plant investment; $66.84, cushion; which equals $1,207.08, total permissible profit.

Since the total contract cost was $80,000, and the plant investment $1,000,000, we can assume that this contractor has a minimum invested capital of approximately $1,080,000 represented by about $80,000 of working capital and $1,000,000 of fixed capital. If this assumption is valid his permitted return under the proposal for the example given on this assumed minimum invested capital will be about 10.2 percent per annum.

To illustrate how the permitted return on an assumed invested capital will be reduced when the plant investment used in the performance of the contract exceeds a million dollars, if such plant investment in the above case were $10,000,000 instead of $1,000,000, the permitted return on the plant investment under the proposal would be 10 percent per annum for 4 days of the first million and 6 percent per annum for 4 days on the remainder. Thus the total permitted return on a total assumed invested capital of $10,080,000, represented by $80,000 of working capital and $10,000,000 of plant investment, would be approximately $7,127, or about 6.5 percent per annum.

The more favorable treatment to the first million dollars of plant investment is proposed for the reason that small business finds it extremely difficult, with the ordinary business risks, the competition of their larger competitors, and the necessity of putting some of their earnings aside for a rainy day, to operate on a 6 percent per annum margin. In order to extend this more favorable treatment to small business, however, it is necessary to extend to everyone the 10 percent per annum on the first million dollars of plant investment, because otherwise the business with a plant investment of $1,000,001 would, simply because of that one extra dollar, be denied a return represening the difference between $100,000 (10 percent of $1,000,000) and $60,000 (6 percent of $1,000,001), that is, the one extra dollar would cost him approximately $40,000 of permitted return.

In the example given above of the $100,000 contract begun on Monday and completed on Thursday, it was assumed that the contractor received no payment under the contract until it was completed. Obviously if he were paid the whole contract price in advance, he would not have required any working capital of his own, or he could have devoted his working capital to other productive uses; and in that case he would not have been entitled to any return on the costs incurred since they were incurred not with his own funds but with Government funds. So if the whole of the contract price were paid in advance, the contractor, under the proposal would be entitled only to his return on plant investment for the period his plant was used, plus the $6,000 cushion reduced to a 4-day basis.

Let us assume, however, that at the end of the first day of the contract the United States advanced the contractor 30 percent of the contract price, or $30,000. For the next 3 days the contractor would have the use of that $30,000, and the proposal assumes that it will be used ratably over the period beginning with the day after payment and ending with the day the contract is completed—in other words, that $10,000 of the advance payment will be used on each of the last 3 days. Under this assumption, using the same example as previously used, the following result is obtained:

	Direct	Indirect	Reimbursement	Total direct and indirect minus reimbursement	8 percent per annum of—
Monday	$15,000	$5,000	None	$20000	$20,000 for 4 days equals $17.52.
Tuesday	18,000	5,000	$10,000	13,000	$13,000 for 3/days equals $11.40.
Wednesday	11,000	5,000	10,000	6,000	$6,000 for 2 days equals $2.64.
Thursday	16,000	5,000	10,000	11,000	$2.42.

Permissible profit (without regard to cushion and interest on plant investment), $33.98.

It will be noted that the permissible profit on the costs of performance has dropped from $44.24 to $33.98 by reason of this advance payment. The contractor is getting exactly the same return on his own money but is being denied a return on the Government money. In other words, by reason of the advance payment

the contractor has embarked only $50,000 of his own money instead of $80,000, and is treated accordingly.

Coming now to research, experiment, and development expenses, the new proposal expressly recognizes that expenditures of this character are proper elements of cost, but the new proposal also safeguards the interests of the United States when these expenditures are treated as elements of cost. There are three paragraphs dealing with this kind of expenditure:

First, there are research, experiment, and development expenses which are incurred during the time the contract in question is being performed. The first paragraph deals with expenses so incurred that are not capitalized but are charged currently against income, permitting them to be treated in the appropriate amount (depending on the proper allocation of indirect costs to the contract) as items of cost of performance.

Second, there are research, experiment, and development costs incurred in taxable years beginning after December 31, 1935, which were capitalized and not charged currently against income. The second paragraph permits the contractor, as an element of cost, a reasonable allowance for the amortization of these expenditures so charged to capital account (again depending on the proper allocation of indirect costs to the contract in question.)

Third, there are research, experiment, and development costs that were incurred in taxable years beginning after December 31, 1935, and before January 1, 1942, which were charged currently against income and not capitalized. The third paragraph permits the contractor to treat these expenses as if they had been capitalized and allows him a reasonable allowance for their amortization, if the contractor agrees to pay to the United States the amount by which his income and excess profits taxes would have been increased if these expenses had been capitalized rather than taken as deductions against current income for tax purposes. In other words, the proposal does not propose to permit the contractor, having deducted these expenses for tax purposes, to capitalize them for profit limitation purposes in order to get them allowed all over again through amortization, unless he is willing to go back and treat them as not having been deducted for tax purposes.

The other kind of expense which the new proposal expressly recognizes as a proper element of cost is a reasonable amount for advertising for the retention of goodwill. Because of the necessities of the war the Government has required many businesses to devote their entire energies and production to war uses. These businesses over a period of years have built up a substantial goodwill which they must retain to facilitate resumption after the war of full peacetime production. Unless the United States allows as an element of cost such advertising as is necessary to retain this goodwill, as distinguished from advertising to build up a greater goodwill, that which has been developed in the past will be virtually destroyed without any compensation by the United States. It will mean the ruin of businesses which, by reason largely of the goodwill which they have developed, are able to contribute so much to the war production program. For this reason the new proposal specifically recognizes the retention of goodwill as a proper element of cost.

EXPLANATION OF THE LABOR PROVISIONS OF COMMITTEE SUBSTITUTE NO. 2

OVERTIME

Subsection 4 (a) substitutes for the 40-hour overtime provision of the Fair Labor Standards Act a provision permitting employment up to 48 hours in a workweek without the payment of overtime, for the duration of the national emergency. Existing contracts are not abrogated and payment of overtime within the 48-hour week is left entirely to agreement between employer and employee.

Subsection 4 (b) suspends for the duration of the national emergency certain provisions of law governing the pay and hours of labor of persons working on public contracts to the extent that such laws require payment of overtime within the 48-hour workweek, or require payment of double time for Saturday, Sunday, holiday, or night work.

Subsection 4 (c) prohibits, during the national emergency, the payment of double time for Saturday, Sunday, holiday, or night work to employees of war contractors, and relieves the war contractor of any civil liability for failing to make such payments.

Subsection 4 (d) directs the various department heads to recapture for the United States any part of the contract price of any war contract which repre-

sents the amount which it was estimated that the war contractor would have to pay in overtime and double time and which he does not pay by reason of the enactment of the bill.

Subsection 4 (c) directs the various department heads to place those employees of their respective departments who are now receiving overtime, on the same footing with respect to the payment of overtime, as employees of war contractors doing similar work.

PRODUCTION BONUSES

Section 5 (a) directs the War Production Board to formulate and put into effect production bonus systems. Such bonuses are to be paid by war contractors from funds appropriated by Congress.

RESTRICTIVE EMPLOYMENT CONTRACTS

Section 6 prohibits war contractors from entering into new restrictive employment contracts but not from renewing such existing contracts. A restrictive employment agreement is defined in section 1 (g) to include the closed-shop contract and other forms of union-security contracts.

This in effect freezes for the duration of the emergency the status of the closed-shop contract.

Senator WALSH. The committee stands adjourned until 10:30 o'clock tomorrow morning.

(Whereupon, the committee adjourned at 12:15 p. m. until 10:30 a. m. Wednesday, September 30, 1942.)

RENEGOTIATION OF CONTRACTS

WEDNESDAY, SEPTEMBER 30, 1942

UNITED STATES SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON FINANCE,
Washington, D. C.

EXECUTIVE SESSION

The subcommittee met at 10:30 a. m., pursuant to adjournment, in room 310, Senate Office Building, Senator David I. Walsh (chairman) presiding.

Senator WALSH. The committee will come to order.

Senator MCKELLAR. Mr. Chairman, as far as the War Department is concerned, I think we will rest for the present, if somebody else wants to be heard.

Senator WALSH. Very well.

Mr. F. M. BRADLEY (counsel, Price Adjustment Board, Maritime Commission). Mr. Chairman, this matter that we are going to discuss, we would just as soon not have the benefit of the press. It is a family discussion.

Senator WALSH. Very well, sir. We will hear from the representative of the Treasury Department first, then. Will the representative of the Treasury Department come forward, please?

Mr. EICHHOLZ. Yes, sir.

Senator WALSH. Do you want to say anything, representative of the Treasury, other than to have this memorandum filed?

Mr. EICHHOLZ. I have just a few brief comments to make, Mr. Chairman, on the general subject.

Senator WALSH. Do you want to make your statement in public or executive session?

Mr. EICHHOLZ. Whatever pleases the committee.

Senator WALSH. Come forward then.

STATEMENT OF ROBERT B. EICHHOLZ, ASSISTANT TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Senator WALSH. Will you give your full name for the record and your position in the Treasury Department?

Mr. EICHHOLZ. Robert B. Eichholz, assistant tax legislative counsel.

Senator WALSH. Are you prepared to make a statement giving the views of the Treasury on this matter?

Mr. EICHHOLZ. I have a more-or-less informal statement to make, Mr. Chairman.

Senator WALSH. We shall be pleased to have it.

Mr. EICHHOLZ. As we see it, Mr. Chairman, the problem that this committee is faced with is a broader problem than that of taxation and profit limitation.

I might illustrate by a very simple example. Suppose that two different contractors are making the same item for the Army or the Navy and it costs one contractor a thousand dollars to make that item and its costs the other contractor $800 and the first contractor makes a 4-percent profit, and the second contractor make a 10-percent profit. Even though the second contractor is making a much larger profit, the net cost to the Government is much less in the case of the second contractor. In other words, profits are only one of the items of cost that go into paying for the munitions necessary to win the war.

Now Congress has appropriated vast sums of money for the prosecution of the war and it is entitled to see that the country is getting its money's worth. If the problem were merely one of controlling profits, it would be fairly easy. We have an excess-profits tax on the books. The Finance Committee has determined on a 90-percent rate with various cushions necessary to take care of hard cases and we feel that, so far as the profit picture alone is concerned, that excess-profits tax is adequate.

Senator MCKELLAR. Is what?

Mr. EICHHOLZ. Is adequate; but that isn't the whole story.

Senator MCKELLAR. Would you mind stopping right there?

Senator WALSH. Let him finish that thought.

Senator MCKELLAR. Yes; go ahead.

Mr. EICHHOLZ. The excess-profits tax does nothing about excessive costs other than profits. The problem is one of controlling prices as a whole rather than one of controlling profits alone.

Now, if you adopt a profit limitation, an over-all flat profit limitation, you still have done nothing about controlling costs. As a matter of fact, it might make the situation worse because all that a profit limitation is, in essence, is an extra 100 percent excess-profits tax, and what happens under a 100 percent excess-profits tax? There is no incentive left to a contractor to reduce his costs. If he is wasteful, wasteful of labor, wasteful of materials, it does not reduce his profit. The expense of his wastefulness comes out of the Government's pocket.

We feel that under the excess-profits tax, there still is some incentive left to reduce costs because there still is a 10- or a 20-percent margin left that the contractor can keep; but under a 100-percent rate there is no incentive left to reduce costs and, as a matter of fact, in many instances, there is an incentive to increase costs.

Of course, there are the usual devices of padding costs, padding the pay roll, and so on, but in addition there are any number of expenditures that a contractor can make, which may be of some ultimate benefit to him, and which, in one way or another, he can charge to his Government business and, therefore, increase the cost to the Government at no expense to himself, and simply increase the net cost to the Government of the munitions that it is buying.

Senator WALSH. Would you mind an interruption?

Mr. EICHHOLZ. Certainly not, sir.

Senator WALSH. The Government has inspectors?

Mr. EICHHOLZ. Yes.

Senator WALSH. Connected with all these contracts?

Mr. EICHHOLZ. Yes.

Senator WALSH. Why can't they control costs, why can't they say to a contractor, "I won't okay the purchase price fixed on that lumber, I won't okay your padded pay roll, I think you are paying too much for the work done by these men?"

Mr. EICHHOLZ. In many cases, they can, sir; but, with the tremendous volume that there is, there probably just aren't enough accountants and auditors to go around and do the really thorough job that is necessary.

Furthermore, the problem is broader than merely striking out unwarranted expenditures. A good deal of money can be saved to the Government by a contractor having the incentive to figure out ways of doing something cheaper than he has been doing it.

Now, if all that happens when he figures out a way to do it cheaper is that he gets a profit limitation applied to him, and he keeps nothing for himself, the incentive is very much reduced.

We think, so far as section 403 is concerned, that renegotiation is not open to the same objections. In some cases it may have to be applied in such a fashion that, in the case of contractors having an enormous number of contracts with the Government, both sides may have to look primarily to the over-all profit picture and see whether the amount of money the contractor is making is excessive. Insofar as they devote themselves only to profits, the renegotiation statute would be open to the same objection, but there is considerable leeway for a broader inerpretation.

The price control boards are free to inquire, not only into the profits that a contractor is making, but they are also free to inquire into the various other elements that go to make up a price. Efficiency and economy of operation and so forth.

We do feel that section 403 is about the best mechanism that we, so far, have been able to think of to meet this very vital problem of controlling prices. It is the control of prices that is probably most essential in keeping the cost of implements of war down. A profit limitation only cuts down maybe the 5, 10, 15 percent of the price that goes to profit, but it leaves the 85, 90, 95 percent to ride free, and in many cases, probably encourages that 85 or 90 percent to go even higher.

We therefore feel, Mr. Chairman, that it would be wise not to repeal section 403 and replace it by an over-all profit limitation. We think the section should be retained with such perfecting amendments as the subcommittee may desire and that we should try our best to use it as a very valuable mechanism for control of the price of munitions.

I might add that the perfecting amendments which have been agreed upon by all the departments concerned, have our full support.

In the case of the definition of "subcontract," on which as I understand, there is disagreement, we take no position one way or the other.

I might also add that I understand Senator Vandenberg was under the impression that the Treasury Department was opposed to the amendment which would authorize a credit of excess-profits taxes against amounts refunded by way of renegotiation. We are not opposed to that at all.

Senator VANDENBERG. Excuse me. I said you were opposed to writing it into the law and wanted to leave it to regulation.

Mr. EICHHOLZ. We have no objection to its being written in the law, Senator. I think what we did object to was writing into the law a provision which would compel the Commissioner of Internal Revenue after a renegotiation agreement, to refund, independently to refund excess-profits taxes paid, but we see no objection to the excess-profits tax being credited against the amount due under 403, and we have no objection to its being written into the law.

Senator VANDENBERG. All right.

Mr. EICHHOLZ. That is all I have to say.

Senator WALSH. Did the Treasury originally draft section 403?

Mr. EICHHOLZ. No; it did not.

Senator WALSH. Suggest it or give its approval?

Mr. EICHHOLZ. The Treasury did not feel it was most intimately concerned with section 403 but, at the time the section was under discussion, I believe that it did cooperate with the War Department and Navy Department, and the W. P. B. in working out an adequate provision.

Senator WALSH. It did not originate with the Treasury.

Senator MCKELLAR. As I understand it, the Department approved it but just in a general way.

Mr. EICHHOLZ. That is correct, Senator.

Senator MCKELLAR. And the other departments approved it.

Senator WALSH. Now, you have prepared for the committee a statement entitled, "Statement of the Treasury Department Regarding Profit-Limiting Provisions of the Vinson-Trammell Act and Procedure Thereunder," which covers the experience and history of the administration of this law by the Treasury to date?

Mr. EICHHOLZ. That is correct. It is descriptive only.

Senator WALSH. Are there some cases still pending?

Mr. HERMAN T. REILING (Bureau of Internal Revenue). Yes. On the last page it shows the number of cases still pending.

Senator WALSH. It does?

Mr. REILING. Yes, sir.

Senator WALSH. Have you—in this statement—without mentioning names, given illustrations of cases showing the amount refunded?

Mr. EICHHOLZ. We have given no specific cases.

Senator WALSH. Have you given the total amount?

Mr. REILING. We have given the total amount.

Senator WALSH. What is the total to date?

Mr. REILING. The total Army and Navy contracts run in excess of $7,000,000.

Senator WALSH. That is on naval vessels and naval aircraft.

Mr. REILING. Naval vessels and naval aircraft.

Senator WALSH. To date?

Mr. REILING. To August 31. That is the last date for which we had figures.

Senator WALSH. Now, have you recouped anything from the limitation put for a brief time on Army aircraft?

Mr. REILING. About $70,000.

Senator WALSH. That was only in operation a short time.

Mr. REILING. As a matter of fact, it was only very small contracts, which would have been completed within the time in which the limit was in effect on the Army contracts. I might say also, on the Navy end of it, that, as you recall, it applied only to contracts entered into the enactment in March 1934, and that the suspension of the act came before some of the larger vessels were completed and also before some of the expansion on aircraft.

Senator WALSH. What was the date, for the record?

Mr. REILING. The enactment?

Senator WALSH. When the law was suspended.

Mr. REILING. It was suspended as of December 31, 1939.

Senator WALSH. And, of course, we were just previous to that beginning the large expanding program.

Mr. REILING. That is right.

Mr. EICHHOLZ. That repeal coincided with the imposition of the excess-profits tax, Senator.

Senator WALSH. Yes.

This statement of the Treasury Department will be filed with the record.

(The statement above referred to is as follows:)

STATEMENT OF TREASURY DEPARTMENT REGARDING PROFIT-LIMITING PROVISIONS OF THE VINSON-TRAMMELL ACT AND PROCEDURE THEREUNDER

I. History of Act

Act of March 27, 1934, 48 Stat. 505.

Section 3 of this act, sometimes referred to as the Vinson-Trammell Act, provides for a limitation of profit on contracts and subcontracts for the manufacture or construction of complete naval vessels and naval aircraft, or any portion thereof, in cases where the award exceeds $10,000. The Attorney General ruled that this limitation applies only to new constuction and not to contracts for furnishing replacements needed in making repairs to existing vessels (37 Op. A. G. 47). The allowable profit on contracts coming within these provisions is limited to 10 percent of the total contract price and is to be computed separately with respect to each contract or subcontract. The excess profit is required to be paid into the Treasury and, if not voluntarily paid, is to be collected under the usual methods employed to collect income taxes. The contractor or subcontractor is required to make a report to the Secretary of the Navy upon completion of the contract or subcontract and a copy of such report is required to be transmitted to the Secretary of the Treasury.

Act of June 25, 1936, 49 Stat. 1926.

This act amended the profit-limiting provisions of the Vinson-Trammell Act to allow a contractor or subcontractor to combine all contracts or subcontracts completed in any income-taxable year (commencing with taxable years beginning after December 31, 1935), in determining whether a profit in excess of 10 percent had been made. Prior to this amendment the contractor or subcontractor was required to pay into the Treasury any excess profit realized in respect of a particular contract, even though within the same income-taxable year he completed another contract at a loss. This act also allowed a contractor or subcontractor incurring a net loss on all contracts and subcontracts completed in any income-taxable year (commencing with taxable years beginning after December 31, 1935), to carry forward such loss and take it as a credit in determining the excess profit, if any, on contracts and subcontracts completed in the next succeeding income-taxable year. This act also provided that contracts and subcontracts for certain types of scientific equipment should not be subject to the limitation of profit.

Act of April 3, 1939, 53 Stat. 560.

Section 14 of this act provides that contracts for Army aircraft, or any portion thereof, shall be subject to the limitation of profit contained in the Vinson-Trammell Act. It also increased the allowable profit from 10 to 12 percent in the case of Army and Navy aircraft, retaining the allowable profit of 10 percent in the case of naval vessels. A more liberal net loss carry-over is also provided in respect of contracts for Army and Navy aircraft, a contractor incurring a net loss in respect of such contracts being permitted to carry forward such net loss and take it as a credit in determining the excess profit, if any, during the next succeeding 4 income-taxable years. Also, if in any income-taxable year the contractor's profit on Army and Navy aircraft is less than 12 percent, the contractor is allowed to carry forward the deficiency in profit and take it as a credit in determining the excess profit, if any, during the next succeeding 4 income-taxable years. These provisions, increasing the allowable profit and providing for a more liberal net loss carry-over, together with the deficiency in profit carry-over, are applicable only to contracts or subcontracts for the manufacture of Army and Navy aircraft and are not applicable to contracts or subcontracts for the construction of naval vessels.

Act of June 28, 1940, 54 Stat. 676.

This act changed the allowable profit on naval vessels and Army or Navy aircraft to 8 percent of the contract price, or 8.7 percent of the cost of perform-

ing the contract or subcontract on other than prime contracts made on a cost-plus-a-fixed-fee basis, in lieu of the 10 percent previously applicable to naval vessels and the 10 percent previously applicable to Army and Navy aircraft. Provision was made for the termination on June 30, 1942, of this reduction in allowable profit, unless the Congress shall otherwise provide. This act also provided, in the case of a contract or subcontract entered into after the date of its approval and during the period of the national emergency declared to exist by the President on September 8, 1939, that the profit-limiting provisions should be applicable only to contracts or subcontracts where the award exceeds $25,000. Provision was also made for charging against a contract or subcontract a percentage of the cost of specialized additional equipment and facilities acquired to facilitate, during the national emergency, the completion of naval vessels or Army or Navy aircraft or portions thereof in private plants, the charge against a contract or subcontract to be made pursuant to a certification to the Commissioner of Internal Revenue by the Secretary of War or the Secretary of the Navy, as the case may be, after agreement with the contractor or subcontractor. Such certification is to be made under regulations prescribed by the President. Due to the repeal of the profit-limiting provisions of the Second Revenue Act of 1940 referred to below, no excess profit became due and payable under the amendments made by the act of June 28, 1940.

Act of September 9, 1940, 54 Stat. 883.

This act, which is cited as the Second Supplemental National Defense Appropriation Act, 1941, amends the profit-limiting provisions of section 2 (b) of the act of June 28, 1940, by removing from the operation of such section contracts and subcontracts entered into after September 9, 1941, for the manufacture of Army and Navy aircraft. The effect of this amendment is to increase the allowable profit under the Vinson-Trammell Act on contracts for Army and Navy aircraft from 8 to 12 percent and to retain the allowable profit of 8 or 8.7 percent on naval vessels as fixed by the act of June 28, 1940. However, the profit-limiting provisions were repealed shortly after the adoption of this amendment. *Section 401, Second Revenue Act of 1940, 54 Stat. 1003.*

This section of the Second Revenue Act of 1940 suspends the profit-limiting provisions of the Vinson-Trammell Act and those of section 2 (b) of the act of June 28, 1940, in the case of all contracts and subcontracts which are entered into during taxable years to which the excess-profits tax is applicable. The suspension is also applicable to contracts and subcontracts which were entered into prior to the date when the contractor or subcontractor became subject to the excess-profits tax and which were not completed before such date.

II. Procedure

Pursuant to the provisions of the Vinson-Trammell Act, regulations thereunder were promulgated by the Treasury Department and the Navy Department and, after the act was extended to Army contracts for aircraft, by the War Department. Under the regulations the duty of determining the correct amount of excess-profit liability on contracts and subcontracts coming within the scope of the act and regulations is upon the Commissioner of Internal Revenue. The regulations also provide, among other things, for the manner of determining the cost of performing contracts and subcontracts, and the manner in which reports should be made by the contractors and subcontractors. The regulations last published in this respect are those contained in T.D. 5000, a copy of which is submitted herewith to show the procedure followed with respect to the costs allowed in determining the excess-profit due and payable. The elements of cost enumerated in T.D. 5000 are in substance the same as those stated in the prior regulations.

III. Excess Profit on Army and Navy Contracts and Subcontracts Assessed Under Vinson-Trammell Act Up to Aug. 31, 1942

(a) *Navy vessels and Navy aircraft*

Number of reports filed (Form 937)	3,982
Number of reports closed	2,961
Number of reports pending or in field	1,021
Original excess profit reported	$5,987,541.95

Additional excess profit:		
Assessed	$1,287,504.74	
Interest	210,082.84	
Penalty	93,781.77	
		$1,597,429.35
Total		7,584,971.30
Overassessments:		
Allowed	$132,033.50	
Interest	176.17	
Penalty	125.90	
		132,335.69
Net amount assessed		7,452,635.61

(b) Army aircraft

Number of reports filed (Forms 937-A)		51
Number of reports closed		27
Number of reports pending or in field		24
Original excess profit reported		$57,310.72
Additional excess profit:		
Assessed	$12,631.64	
Interest	1,159.43	
		13,791.07
Total		71,101.79
Overassessments allowed		1,033.77
Net amount assessed		70,068.02

(T. D. 5000)

TITLE 26—INTERNAL REVENUE

CHAPTER I

BUREAU OF INTERNAL REVENUE

SUBCHAPTER A—PART 26

EXCESS PROFITS ON CONTRACTS FOR NAVAL VESSELS AND ARMY AND NAVY AIRCRAFT

Regulations under section 2 (b) of the act of June 28, 1940, and other provisions*

TREASURY DEPARTMENT,
OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, D. C.
WAR DEPARTMENT,
OFFICE OF THE SECRETARY OF WAR,
Washington, D. C.
NAVY DEPARTMENT,
OFFICE OF THE SECRETARY OF THE NAVY,
Washington, D. C.

To Officers and Employees of the Treasury Department, the War Department, the Navy Department, and Others Concerned:

TABLE OF CONTENTS

*Section 26.0 to 26.20 issued under the authority contained in sections 2 (b), 3, and 4 of the Act of March 27, 1934, 48 Stat. 505 (34 U. S. C. 496), as amended by the Act of of April 3, 1939, 53 Stat. 560 (10 U. S. C., Sup. 311; 34 U. S. C., Sup., 496), and section 3 of the Act of March 27, 1934, 48 Stat. 505 (35 U. S. C. 496), as amended by the Act of June 25, 1936, 49 Stat. 1926 (34 U. S. C., Sup., 496) and as further amended and made applicable to contracts and subcontracts for Army aircraft by section 14 of such Act of April 3, 1939.

Section 26.0. *Introductory.*—(a) Section 2 (b) of the Act entitled "An Act to expedite national defense, and for other purposes," approved June 28, 1940 (Public, No. 671, 76th Cong., 3rd Sess.), reads as follows:

> "(b) After the date of approval of this Act no contract shall be made for the construction or manufacture of any complete naval vessel or any Army or Navy aircraft, or any portion thereof, under the provisions of this section or otherwise, unless the contractor agrees, for the purposes of section 3 of the Act of March 27, 1934 (48 Stat. 505; 34 U. S. C. 496), as amended—
>
> (1) to pay into the Treasury profit in excess of 8 per centum (in lieu of the 10 per centum and 12 per centum specified in such section 3) of the total contract prices of such contracts within the scope of this subsection as are completed by the particular contracting party within the income taxable year;
>
> (2) that any profit in excess of 8% per centum of the cost of performing such contracts except prime contracts made on a cost-plus-a-fixed-fee basis as are completed by the contracting party within the income taxable year shall be considered to be profit in excess of 8 per centum of the total contract prices of such contracts; and
>
> (3) that he will make no subcontract which is within the scope of such section 3, unless the subcontractor agrees to the foregoing conditions."

(b) Section 14 of the Act entitled "AN ACT to provide more effectively for the national defense by carrying out the recommendations of the President in his message of January 12, 1939, to the Congress," approved April 3, 1939, 53 Stat. 560 (10 U. S. C., Sup., 311), reads in part as follows:

> "SEC. 14. All the provisions of section 3 of the Act of March 27, 1934, as amended (48 Stat. 505; 49 Stat. 1926), and as amended by this section shall be applicable with respect to contracts for aircraft or any portion thereof for the Army to the same extent and in the same manner that such provisions are applicable with respect to contracts for aircraft, or any portion thereof for the Navy: *Provided*, That the Secretary of War shall exercise all functions under such section with respect to aircraft for the Army which are exercised by the Secretary of the Navy with respect to aircraft for the Navy * * *."

(c) Section 3 of the Act entitled "AN ACT To establish the composition of the United States Navy with respect to the categories of vessels limited by the treaties signed at Washington, February 6, 1922, and at London, April 22, 1930, at the limits prescribed by those treaties; to authorize the construction of certain naval vessels; and for other purposes," approved March 27, 1934, 48 Stat. 505 (34 U. S. C. 496), as amended by the Act of June 25, 1936, 49 Stat. 1926 (34 U. S. C., Sup. 496) and as further amended by section 14 of the Act of April 3, 1939, 53 Stat. 560 (34 U. S. C., Sup., 496), reads as follows:

> "SEC. 3. The Secretary of the Navy is hereby directed to submit annually to the Bureau of the Budget estimates for the construction of the foregoing vessels and aircraft; and there is hereby authorized to be appropriated such sums as may be necessary to carry into effect the provisions of this Act; *Provided*, That no contract shall be made by the Secretary of the Navy for the construction and/or manufacture of any complete naval vessel or aircraft,

or any portion thereof, herein, heretofore, or hereafter authorized unless the contractor agrees—

"(a) To make a report, as hereinafter described, under oath, to the Secretary of the Navy upon the completion of the contract.

"(b) To pay into the Treasury profit, as hereinafter provided shall be determined by the Treasury Department, in excess of 10 per centum of the total contract prices for the construction and or manufacture of any complete naval vessel or portion thereof, and in excess of 12 per centum of the total contract prices for the construction and or manufacture of any complete aircraft or portion thereof, of such contracts within the scope of this section as are completed by the particular contracting party within the income taxable year, such amount to become the property of the United States, but the surety under such contracts shall not be liable for the payment of such excess profit: *Provided*, That if there is a net loss on all such contracts or subcontracts for the construction and or manufacture of any complete naval vessel or portion thereof completed by the particular contractor or subcontractor within any income taxable year, such net loss shall be allowed as a credit in determining the excess profit, if any, for the next succeeding income taxable year, and that if there is a net loss, or a net profit less than 12 per centum, as aforesaid on all such contracts or subcontracts for the construction and or manufacture of any complete aircraft or portion thereof completed by the particular contractor or subcontractor within any income taxable year, such net loss or deficiency in profit shall be allowed as a credit in determining the excess profit, if any, during the next succeeding four income taxable years, and that the method of ascertaining the amount of excess profit, initially fixed upon shall be determined on or before June 30, 1939: *Provided further*, That if such amount is not voluntarily paid the Secretary of the Treasury shall collect the same under the usual methods employed under the internal-revenue laws to collect Federal income taxes: *Provided further*, That all provisions of law (including penalties) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934, and not inconsistent with this section, shall be applicable with respect to the assessment, collection, or payment of excess profits to the Treasury as provided by this section, and to refunds by the Treasury of overpayments of excess profits into the Treasury: *And provided further*, That this section shall not apply to contracts or subcontracts for scientific equipment used for communication, target detection, navigation, and fire control as may be so designated by the Secretary of the Navy, and the Secretary of the Navy shall report annually to the Congress the names of such contractors and subcontractors affected by this provision, together with the applicable contracts and the amounts thereof: *And provided further*, That the income-taxable years shall be such taxable years beginning after December 31, 1935, except that the above provisos relating to the assessment, collection, payment, or refunding of excess profit to or by the Treasury shall be retroactive to March 27, 1934.

"(c) To make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading the provisions of this Act, but any subdivision of any contract or subcontract involving an amount in excess of $10,000 shall be subject to the conditions herein prescribed.

"(d) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and audit by any person designated by the Secretary of the Navy, the Secretary of the Treasury, and/or by a duly authorized Committee of Congress.

"(e) To make no subcontract unless the subcontractor agrees to the foregoing conditions.

"The report shall be in form prescribed by the Secretary of the Navy and shall state the total contract price, the cost of performing the contract, the net income, and the per centum such net income bears to the contract price. A copy of such report shall be transmitted to the Secretary of the Treasury for consideration in connection with the Federal income tax returns of the contractor for the taxable year or years concerned.

"The method of ascertaining the amount of excess profits to be paid into the Treasury shall be determined by the Secretary of the Treasury in agreement with the Secretary of the Navy and made available to the public. The method initially fixed upon shall be so determined on or before June 30, 1934: *Provided*, That in any case where an excess profit may be found to be owing to the United States in consequence hereof, the Secretary of the Treasury shall allow credit for any Federal income taxes paid or remaining to be paid upon the amount of such excess profit.

"The contract or subcontracts referred to herein are limited to those where the award exceeds $10,000."

(d) Sections 3, 4, and 12 of the Act of June 28, 1940, approved June 28, 1940 (Public, No. 671, 76th Cong., 3rd Sess.), read, respectively, as follows:

"Sec. 3. The provisions of section 3 of the Act of March 27, 1934 (48 Stat. 505), as amended by the Acts of June 25, 1936 (49 Stat. 1926), and April 3, 1939 (53 Stat. 560; U. S. C., Supp. V, title 34, sec. 496), and as made applicable to contracts for aircraft or any portion thereof for the Army by such Act of April 3, 1939, shall, in the case of contracts or subcontracts entered into after the date or approval of this Act and during the period of the national emergency declared by the President on September 8, 1939, to exist, be limited to contracts or subcontracts where the award exceeds $25,000."

"Sec. 4. In the case of every contract or subcontract for the construction or manufacture of any complete naval vessel or Army or Navy aircraft or any portion thereof which is entered into (Whether before or after the date of approval of this Act), the Secretary of War or the Secretary of the Navy, as the case may be, after agreement with the contractor or subcontractor, shall certify to the Commissioner of Internal Revenue as to (a) the necessity and cost of special additional equipment and facilities acquired to facilitate, during the national emergency declared by the President on September 8, 1939, to exist, the completion of such naval vessel or Army or Navy aircraft or portion thereof in private plants; and (b) the percentage of cost of such special additional equipment and facilities to be charged against such contract or subcontract. For all purposes of section 3 of the Act of March 27, 1934 (48 Stat. 505; 34 U. S. C. 496), as amended, such certification shall be subject to such regulations as the President may prescribe, but shall be binding upon the Commissioner of Internal Revenue, unless, within five days after receipt of such certification, he make formal objection thereto to the Secretary of the Navy or the Secretary of War as the case may be. The part of such cost chargeable against the contract or subcontract in pursuancee of such certification, shall, for the purposes of such section 3, be considered to be a reduction of the contract price of the contract or subcontract. The amount charged against the contract or subcontract in pursuance of such certification shall, for the purposes of such section 3, be applied against and reduce the cost or other basis of such special additional equipment and facilities as of the date of installation thereof: *Provided*, That the Secretary of War or the Secretary of the Navy, as the case may be, shall report to the Congress, every three months, the cost of such special additional equipment and facilities to be borne by the Government under each contract."

"Sec. 12. The provisions of all preceding sections of this Act shall terminate June 30, 1942, unless the Congress shall otherwise provide."

Pursuant to the authority prescribed by section 2 (b) of the Act of June 28, 1940 (Public No. 671, 76th Cong., 3rd Sess.), section 14 of the Act of April 3, 1939, and section 3 of the Act of March 27, 1934, as amended, the following regulations are hereby prescribed: *

SEC. 20.1 *Definitions.*—As used in these regulations the term—

(a) "*Act*" means the Act of June 28, 1940 (Public, No. 671, 76th Cong., 3rd Sess.).

(b) "*Act of March 27, 1934, as amended*" means section 3 of the Act of March 27, 1934, 48 Stat. 505 (34 U. S. C. 496), as amended by the Act of June 25, 1936, 49 Stat. 1926 (34 U. S. C., Sup., 496), and as further amended and made applicable to contracts and subcontracts for Army aircraft by the Act of April 3, 1939, 53 Stat. 560 (34 U. S. C., Sup., 496).

(c) "*Secretary of the Department concerned*" means the Secretary of War or the Secretary of the Navy as the case may be.

(d) "*Person*" includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture or other unincorporated organization or group, through or by means of which any business, financial operation or venture is carried on.

(e) "*Contract*" means an agreement made by authority of the Secretary of the Department concerned for the construction or manufacture of any complete naval vessel or Army or Navy aircraft, or any portion thereof, entered into after the date of enactment of the Act (June 28, 1940) and before July 1, 1942.

(f) "*Contractor*" means a person entering into a direct contract with the Secretary of the Department concerned or his duly authorized representative.

(g) *"Subcontract"* means an agreement entered into by one person with another person for the construction or manufacture of any complete naval vessel or Army or Navy aircraft, or any portion thereof, the prime contract for such vessel or aircraft or portion thereof having been entered into between a contractor and the Secretary of the Department concerned or his duly authorized representative after the date of enactment of the Act (June 28, 1940) and before July 1, 1942. The term "subcontract" does not include such an agreement even though entered into after June 28, 1940, if the prime contract with respect thereto was entered into on or before June 28, 1940, but does include such an agreement entered into after June 30, 1942, if the prime contract with respect thereto was entered into on or before June 30, 1942.

(h) *"Subcontractor"* means any person other than a contractor entering into a subcontract.

(i) *"Contracting party"* means a contractor or subcontractor as the case may be.

(j) *"Contract price"* or *"total contract price"* means the amount or total amount to be received under a contract or subcontract as the case may be.

(k) *"Income-taxable year"* means the calendar year, the fiscal year ending during such calendar year, or the fractional part of such calendar or fiscal year upon the basis of which the contracting party's net income is computed and for which its income tax returns are made for Federal income tax purposes.*

SEC. 26.2. *Scope of regulations.*—These regulations deal with liability for excess profit on (1) contracts for the construction or manufacture of any complete naval vessel or Army or Navy aircraft, or any portion thereof, entered into after the date of enactment of the Act (June 28, 1940) and before July 1, 1942, and (2) subcontracts made with respect to any such contract. As to contracts for naval vessels and aircraft, entered into on or before June 28, 1940, and subcontracts made with respect to any such contract, see Treasury Decision 4906 (sections 17.0 to 17.19, inclusive, Title 26, Code of Federal Regulations, 1939 Sup.). As to contracts for Army aircraft entered into on or before June 28, 1940, and subcontracts made with respect to any such contract, see Treasury Decision 4909 (sections 16.0 to 16.18, inclusive, Title 26, Code of Federal Regulations, 1939 Sup.). As to the date of completion of a contract or subcontract within the scope of these regulations, see section 26.5 of these regulations.*

SEC. 26.3. *Contracts and subcontracts under which excess profit liability may be incurred.*—Except as otherwise provided with respect to contracts or subcontracts for certain scientific equipment (see section 26.4 of these regulations), every contract entered into after June 28, 1940, and before July 1, 1942, is subject to the provisions of the Act relating to excess profit liability if—

(1) it is entered into prior to the termination of the period of national emergency declared by the President on September 8, 1939, to exist (see Proclamation No. 2352), and is awarded for an amount exceeding $25,000; or

(2) it is entered into after the termination of such period of national emergency and is awarded for an amount in excess of $10,000.

Every subcontract made pursuant to such a contract is subject to the provisions of the Act relating to excess profit liability if—

(a) it involves an amount in excess of $25,000 and was entered into prior to the termination of such period of national emergency and before July 1, 1942; or

(b) it involves an amount in excess of $10,000 and was entered into after the termination of such period of national emergency or after June 30, 1942, whichever is the earlier.

If a contracting party places orders with another party, aggregating an amount in excess of $25,000 (or $10,000 as the case may be), for articles or materials which are destined to become a component part of a complete naval vessel or Army or Navy aircraft, or any portion thereof, the placing of such orders shall constitute a subcontract within the scope of the Act, unless it is clearly shown that each of the orders involving $25,000 (or $10,000 as the case may be) or less is a bona fide separate and distinct subcontract for articles or materials which are not destined to become and do not become a component part of any such vessel or aircraft, or any portion thereof, constructed or manufactured under one particular contract or subcontract by the contracting party placing the orders, and is not a subdivision made for the purpose of evading the provisions of the Act.*

SEC. 26.4. *Contracts or subcontracts for scientific equipment.*—No excess profit liability is incurred upon a contract or subcontract if at the time or prior to the time such contract or subcontract is made it is designated by the Secretary of the Department concerned as being exempt under the provisions of the Act of March 27, 1934, as amended, pertaining to scientific equipment used for communication, target detection, navigation, and fire control.*

SEC. 26.5. *Completion of contract defined.*—The date of delivery of the vessel, aircraft, or portion thereof, covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of the Department concerned and the Secretary of the Treasury or their duly authorized representatives. In case a contract is for two or more vessels or aircraft, if it appears that the contract constitutes a single undertaking as to such vessels or aircraft and if the work of constructing or manufacturing such vessels or aircraft is prosecuted as a single undertaking, then the date of delivery of the vessel or aircraft last delivered under such contract shall be considered the date of completion of the contract. Except as otherwise provided in the first sentence of this section, the replacement of defective parts of delivered articles or the performance of other guarantee work in respect of such articles will not operate to extend the date of completion. As to the treatment of the cost of such work as a cost of performing a contract or subcontract, see section 26.9(h) of these regulations. As to a refund in case of adjustment due to any subsequently incurred additional costs, see section 26.19 of these regulations. If a contract or subcontract is at any time canceled or terminated, it is completed at the time of the cancelation or termination.*

SEC. 26.6. *Manner of determining liability.—The first step* in the determination of the excess profit to be paid to the United States by a contracting party with respect to contracts and subcontracts completed within an income-taxable year is to ascertain the total contract prices of all contracts and subcontracts completed by the contracting party within the income-taxable year. As to total contract prices, see section 26.8 of these regulations.

The second step is to ascertain the cost of performing such contracts and subcontracts and to deduct such cost from the total contract prices of such contracts and subcontracts as computed in the first step. See section 26.9 of these regulations.

The amount remaining after such subtraction is the amount of net profit or net loss upon the contracts and subcontracts completed within the income-taxable year.

The third step, in case there is a net profit upon such contracts and subcontracts, is to subtract from the amount of such net profit as computed in the second step, the sum of ——.

(1) Whichever is the lesser of the following: (A) An amount equal to 8 percent of the total contract prices of the contracts (including prime contracts made on a cost-plus-a-fixed-fee basis) and subcontracts completed within the income-taxable year, or (B) an amount equal to 8.7 percent of the total cost of performing such contracts (except prime contracts made on a cost-plus-a-fixed-fee basis) and subcontracts plus 8 percent of the total contract prices of prime contracts made on a cost-plus-a-fixed-fee basis;

(2) The amount of any net loss sustained in a prior income-taxable year and allowable as a credit in determining the excess profit for the income-taxable year (see section 26.10 of these regulations); and

(3) The amount of any deficiency in profit sustained in a prior income-taxable year (on a contract or subcontract for Army or Navy aircraft or any portion thereof) and allowable as a credit in determining the excess profit for the income-taxable year (see section 26.10 of these regulations).

The amount remaining after such subtraction is the amount of excess profit for the income-taxable year.

The fourth step is to ascertain the amount of credit allowed for Federal income taxes paid or remaining to be paid upon the amount of such excess profit (see section 26.11 of these regulations) and then subtract from the amount of such excess profit the amount of credit for Federal income taxes.

The amount remaining after this subtraction is the amount of excess profit to be paid to the United States by the contracting party for the income-taxable year.*

SEC. 26.7. *Computation of excess-profit liability.*—The application of the provisions of section 26.6 of these regulations may be illustrated by the following examples:

Example (1).—On February 1, 1941, the B Corporation which keeps its books and makes its Federal income tax returns on a calendar year basis entered into a contract coming within the scope of the Act, the total contract price of which was $200,000. On March 1, 1941, the corporation entered into another such contract, the total contract price of which was $40,000. Both contracts (neither of which was made on a cost-plus-a-fixed-fee basis) were completed within the calendar year 1941, the first at a cost of $155,000 and the second at a cost of $45,000. During the year 1940 the B Corporation sustained an allowable net loss of $2,500 and an allowable deficiency in profit of $1,000 on contracts and subcontracts coming within the scope of the Act and completed within the income-taxable year 1940. For purposes of the Federal income tax, the net income of the B Corporation for the year 1941 amounted to $96,000, which included the total net profit of $40,000 upon the two contracts. For the purposes of this example, it is assumed that for the year 1941 the B Corporation paid a Federal income tax of $20,500 upon its entire net income. The excess profit liability is $14,600 computed as follows:

Total contract prices:

Contract No. 1	$200,000	
Contract No. 2	40,000	
		$240,000
Less: Cost of performing contracts:		
Contract No. 1	155,000	
Contract No. 2	45,000	
		200,000
Net profit on contracts		40,000
Less:		
(1) 8.7 percent of cost of performing contracts (8.7 percent of $200,000=$17,400), which amount is less than 8 percent of total contract prices (8 percent of $240,000=$19,200)	17,400	
(2) Net loss from 1940	2,500	
(3) Deficiency in profit from 1940	1,000	
		20,900
Excess profit for year 1941		19,100
Less: Credit for Federal income taxes (assumed Federal income tax on $19,100 at the rates for 1941)		4,500
Amount of excess profit payable to the United States		14,600

Example (2).—On February 1, 1941, the B Corporation which keeps its books and makes its Federal income tax returns on a calendar year basis entered into a contract coming within the scope of the Act, the total contract price of which was $200,000. On March 1, 1941, the corporation entered into another such contract on a cost-plus-a-fixed-fee basis, the estimated cost being $100,000 and the stipulated fee being $7,000. Both contracts were completed within the calendar year 1941, the first at a cost of $155,000 and the second at a cost of $90,000. During the year 1940 the B Corporation sustained an allowable net loss of $2,500 and an allowable deficiency in profit of $1,000 on contracts and subcontracts coming within the scope of the Act. For purposes of the Federal income tax, the net income of the B Corporation for the year 1941 amounted to $96,000, which included the total net profit of $52,000 on the two contracts. For the purposes of this example, it is assumed that for the year 1941 the B Corporation paid a Federal income tax of $20,500 upon its entire net income. The excess profit liability is $21,255 computed as follows:

Total contract prices:

Contract No. 1	$200,000	
Contract No. 2 ($90,000 cost plus $7,000 fee)	97,000	
		$297,000
Less: Cost of performing contracts:		
Contract No. 1	$155,000	
Contract No. 2	90,000	
		245,000
Net profit on contracts		$52,000

Less:		
(1) 8.7 percent of cost of performing contract No. 1 plus 8 percent of total contract price of contract No. 2 (8.7 percent of $155,000 plus 8 percent of $97,000= $21,245), which amount is less than 8 percent of total contract prices (8 percent of $297,000=$23,760)	$21,245	
(2) Net loss from 1940	2,500	
(3) Deficiency in profit from 1940	1,000	
		$24,745
Excess profit for year 1941		$27,255
Less: Credit for Federal income taxes (assumed Federal income tax on $27,255 at the rates for 1941		6,000
Amount of excess profit payable to the United States		*$21,255

SEC. 26.8. *Total contract price.*—The total contract price of a particular contract or subcontract (see section 26.1 of these regulations) may be received in money or its equivalent. If something other than money is received, only the fair market value of the thing received, at the date of receipt, is to be included in determining the amount received. Bonuses earned for bettering performance and penalties incurred for failure to meet the contract guarantees are to be regarded as adjustments of the original contract price. Trade or other discounts granted by a contracting party in receipt of a contract or subcontract performed by such party are also to be deducted in determining the true total contract price of such contract or subcontract. In the case of a contract made on a cost-plus-a-fixed-fee basis the total contract price is the actual, rather than the estimated, cost of performing the contract plus the stipulated fee and any other amounts received by the contracting party for performing such contract.

For the purposes of the Act and these regulations, the contract price of a contract or subcontract shall be reduced by the part of the cost of special additional equipment and facilities acquired by the contracting party and chargeable against the contract or subcontract in pursuance of a certification made by the Secretary of the Department concerned in accordance with the provisions of section 4 of the Act. See Executive Order No. 8465 and Joint Rules issued under such order (I. R. B. 1940-30, 15).*

SEC. 26.9. *Cost of performing a contract or subcontract.*—(a) *General rule.*—The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs, including therein expenditures for materials, direct labor and direct expenses, incurred by the contracting party in performing the contract or such contract; and (2) the proper proportion of any indirect costs (including therein a reasonable proportion of management expenses) incident to and necessary for the performance of the contract or subcontract.

(b) *Elements of cost.*—No definitions of the elements of cost may be stated which are of invariable application to all contractors and subcontractors. In general, the elements of cost may be defined for purposes of the Act as follows:

(1) Manufacturing cost, which is the sum of factory cost (see paragraph (c) of this section) and other manufacturing cost (see paragraph (d) of this section);

(2) Miscellaneous direct expenses (see paragraph (e) of this section);

(3) General expenses, which are the sum of indirect engineering expenses, usually termed "engineering overhead" (see paragraph (f) of this section) and expenses of distribution, servicing and administration (see paragraph (g) of this section); and

(4) Guarantee expenses (see paragraph (h) of this section).

(c) *Factory cost.*—Factory cost is the sum of the following:

(1) *Direct materials.*—Materials, such as those purchased for stock and subsequently issued for contract operations and those acquired under subcontracts, which become a component part of the finished product or which are used directly in fabricating, converting or processing such materials or parts.

(2) *Direct productive labor.*—Productive labor, usually termed "shop labor," which is performed on and is properly chargeable directly to the article manufactured or constructed pursuant to the contract or subcontract, but which ordinarily does not include direct engineering labor (see subparagraph (3) of this paragraph).

(3) *Direct engineering labor.*—The compensation of professional engineers and other technicists (including reasonable advisory fees), and of draftsmen, properly chargeable directly to the cost of the contract or subcontract.

(4) *Miscellaneous direct factory charges.*—Items which are properly chargeable directly to the factory cost of performing the contract or subcontract but which do not come within the classifications in subparagraphs (1), (2), and (3) of this paragraph, as for example, royalties which the contracting party pays to another party and which are properly chargeable to the cost of performing the contract or subcontract (but see paragraph (d) of this section).

(5) *Indirect factory expenses.*—Items, usually termed "factory overhead," which are not directly chargeable to the factory cost of performing the contract or subcontract but which are properly incident to and necessary for the performance of the contract or subcontract and consist of the following:

(A) *Labor.*—Amounts expended for factory labor, such as supervision and inspection, clerical labor, timekeeping, packing and shipping, stores supply, services of tool crib attendants, and services in the factory employment bureau, which are not chargeable directly to productive labor of the contract or subcontract.

(B) *Materials and supplies.*—The cost of materials and supplies for general use in the factory in current operations, such as shop fuel, lubricants, heat-treating, plating, cleaning and anodizing supplies, nondurable tools and gauges, stationery (such as time tickets and other forms), and boxing and wrapping materials.

(C) *Service expenses.*—Factory expenses of a general nature, such as those for power, heat and light (whether purchased or produced), ventilation and air-conditioning and operation and maintenance of general plant assets and facilities.

(D) *Fixed charges and obsolescence.*—Recurring charges with respect to property used for manufacturing purposes of the contract or subcontract, such as premiums for fire and elevator insurance, property taxes, rentals and allowances for depreciation of such property, including maintenance and depreciation of reasonable standby equipment; and depreciation and obsolescence of special equipment and facilities necessarily acquired primarily for the performance of the contract or subcontract, except special additional equipment and facilities with respect to which the Secretary of the Department concerned has made a certification binding upon the Commissioner of Internal Revenue, pursuant to section 4 of the Act, in the case of such contract or subcontract. See Executive Order No. 8465 and Joint Rules issued under such Order (I. R. B. 1940-30, 15). In making allowances for depreciation, consideration shall be given to the number and length of shifts.

(E) *Miscellaneous indirect factory expenses.*—Miscellaneous factory expenses not directly chargeable to the factory cost of performing the contract or subcontract, such as purchasing expenses; ordinary and necessary expenses of rearranging facilities within a department or plant; employees' welfare expenses; premiums or dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to factory employees; factory accident compensation (as to self-insurance, see paragraph (g) of this section); but not including any amounts which are not incident to services, operations, plant, equipment or facilities involved in the performance of the contract or subcontract.

(d) *Other manufacturing cost.*—Other manufacturing cost as used in paragraph (b) of this section includes items of manufacturing costs which are not properly or satisfactorily chargeable to factory costs (see paragraph (c) of this section) but which upon a complete showing of all pertinent facts rae properly to be included as a cost of performing the contract or subcontract, as for instance, payments of royalties and amortization of the cost of designs purchased and patent rights over their useful life; and "deferred" or "unliquidated" experimental and development charges. For example, in case experimental and development costs have been properly deferred or capitalized and are amortized in accordance with a reasonably consistent plan, a proper portion of the current charge, determined by a ratable allocation which is reasonable in consideration

of the pertinent facts, may be treated as a cost of performing the contract or subcontract. In the case of general experimental and development expenses which may be charged off currently, a reasonable portion thereof may be allocated to the cost of performing the contract or subcontract. If a special experimental or development project is carried on in pursuance of a contract, or in anticipation of a contract which is later entered into, and the expense is not treated as a part of general experimental and development expenses or is not otherwise allowed as a cost of performing the contract, there clearly appearing no reasonable prospect of an additional contract for the type of article involved, the entire cost of such project may be allowed as a part of the cost of performing the contract.

(e) *Miscellaneous direct expenses.*—Miscellaneous direct expenses as used in paragraph (b) of this section include—

(1) *Cost of installation and construction.*—Cost of installation and construction includes the cost of materials, labor and expenses necessary for the erection and installation prior to the completion of the contract and after the delivery of the product or material manufactured or constructed pursuant to the contract or subcontract.

(2) *Sundry direct expenses.*—Items of expense which are properly chargeable directly to the cost of performing a contract or subcontract and which do not constitute guarantee expenses (see paragraph (h) of this section) or direct costs classified as factory cost or other manufacturing cost (see paragraphs (c) and (d) of this section), such as premiums on performance or other bonds required under the contract or subcontract; State sales taxes imposed on the contracting party; freight on outgoing shipments; fees paid for wind tunnel and model basin tests; demonstration and test expenses; crash insurance premiums; traveling expenses. In order for any such item to be allowed as a charge directly to the cost of performing a contract or subcontract, (1) a detailed record shall be kept by the contracting party of all items of a similar character, and (2) no item of a similar character which is properly a direct charge to other work shall be allowed as a part of any indirect expenses in determining the proper proportion thereof chargeable to the cost of performing the contract or subcontract. As to allowable indirect expenses, see paragraphs (c) (5), (f), (g), and (j) of this section.

(f) *Indirect engineering expenses.*—Indirect engineering expenses usually termed "engineering overhead," which are treated in this section as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), compromise the general engineering expenses which are incident to and necessary for the performance of the contract or subcontract, such as the following:

(1) *Labor.*—Reasonable fees of engineers employed in a general consulting capacity, and compensation of employees for personal services to the engineering department, such as supervision, which is properly chargeable to the contract or subcontract, but which is not chargeable as direct engineering labor (see paragraph (c) (3) of this section).

(2) *Material.*—Supplies for the engineering department, such as paper and ink for drafting and similar supplies.

(3) *Miscellaneous expenses.*—Expenses of the engineering department, such as (A) maintenance and repair of engineering equipment, and (B) services purchased outside of the engineering department for blueprinting, drawing, computing, and like purposes.

(g) *Expenses of distribution, servicing and administration.*—Expenses of distribution, servicing and administration, which are treated in this secton as a part of general expenses in determining the cost of performing a contract or subcontract (see paragraph (b) of this section), comprehend the expenses incident to and necessary for the performance of the contract or subcontract, which are incurred in connection with the distribution and general servicing of the contracting party's products and the general administration of the business, such as—

(1) *Compensation for personal services of employees.*—The salaries of the corporate and general executive officers and the salaries and wages of administrative clerical employees and of the office services employees such as telephone operators, janitors, clearers, watchmen, and office equipment repairmen.

(2) *Bidding and general selling expenses.*—Bidding and general selling expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract. The treatment of bidding and general selling expenses as a part of general expenses in accordance with this paragraph is in lieu of any direct charges which otherwise might be made for such expenses. The term "bidding expenses" as used in this section includes all expenses in connection with preparing and submitting bids.

(3) *General servicing expenses.*—Expenses which by reference to all the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract and which are incident to delivered or installed articles and are due to ordinary adjustments or minor defects; but including no items which are treated as a part of guarantee expenses (see paragraph (h) of this section) or as a part of direct costs, such as direct materials, direct labor, and other direct expense.

(4) *Other expenses.*—Miscellaneous office and administrative expenses, such as stationery and office supplies; postage; repair and depreciation of office equipment; contributions to local charitable or community organizations to the extent constituting ordinary and necessary business expenses; employees' welfare expenses; premiums and dues on compensation insurance; employers' payments to unemployment, old age and social security Federal and State funds not including payments deducted from or chargeable to employees or officers; pensions and retirement payments to administrative office employees and accident compensation to office employees (as to self-insurance, see the following subparagraph).

Subject to the exception stated in this subparagraph, in cases where a contracting party assumes its own insurable risks (usually termed 'self-insurance"), losses and payments will be allowed in the cost of performing a contract or subcontract only to the extent of the actual losses suffered or payments incurred during, and in the course of, the performance of the contract or subcontract and properly chargeable to such contract or subcontract. If, however, a contracting party assumes its own insurable risks (a) for compensation paid to employees for injuries received in the performance of their duties, or (b) for unemployment risks in States where insurance is required, there may be allowed as a part of the cost of performing a contract or subcontract a reasonable portion of the charges set up for purposes of self-insurance under a system of accounting regularly employed by the contracting party, as determined by the Commissioner of Internal Revenue, at rates not exceeding the lawful or approved rates of insurance companies for such insurance, reduced by amounts representing the acquisition cost in such companies, provided the contracting party adopts and consistently follows this method with respect to self-insurance in connection with all contracts and subcontracts subsequently performed by him.

Allowances for interest on invested capital are not allowable as costs of performing a contract or subcontract.

Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: Entertainment expenses; dues and memberships other than of regular trade associations; donations except as otherwise provided above; losses on other contracts; profits or losses from sales or exchanges of capital assets; extraordinary expenses due to strikes or lockouts; fines and penalties; amortization of unrealized appreciation of values of assets; expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacated or abandoned, or not adaptable for future use in performing contracts or subcontracts; increases in reserve accounts for contingencies, repairs, compensation insurance (except as above provided with respect to self-insurance) and guarantee work; Federal and State income and excess-profits taxes and surtaxes); cash discount earned up to one percent of the amount of the purchase, except that all discounts on subcontracts subject to the Act will be considered; interest incurred or earned; bond discount or finance charges; premiums for life insurance on the lives of officers; legal and accounting fees in connection with reorganizations, security issues, capital stock issues and the prosecution of claims against the United States (including income tax matters); taxes and expenses on issues and transfers of capital stock; losses on investments; bad debts; and expenses of collection and exchange.

In order that the cost of performing a contract or subcontract may be accounted for clearly, the amount of any excess profits repayable to the United States pursuant to the Act should not be charged to or included in such cost.

(h) *Guarantee expenses.*—Guarantee expenses include the various items of factory cost, other manufacturing cost, cost of installation and construction, indirect engineering expenses and other general expenses (see paragraphs (c) to (g), inclusive, of this section) which are incurred after delivery or installation of the article manufactured or constructed pursuant to the particular contract or subcontract and which are incident to the correction of defects or deficiencies which the contracting party is required to make under the guarantee provisions of the particular contract or subcontract. If the total amount of such guarantee expenses is not ascertainable at the time of filing the report required to be filed with the collector of internal revenue (see section 26.16 of these regulations) and the contracting party includes any estimated amount of such expenses as part of the claimed total cost of performing the contract or subcontract, such estimated amount shall be separately shown on the report and the reasons for claiming such estimated amount shall accompany the report; but only the amount of guarantee expenses actually incurred will be allowed. If the amount of guarantee expenses actually incurred is greater than the amount (if any) claimed on the report and the contracting party has made an overpayment of excess profit, a refund of the overpayment shall be made in accordance with the provisions of section 26.19 of these regulations. If the amount of guarantee expenses actually incurred is less than the amount claimed on the report and an additional amount of excess profit is determined to be due, the additional amount of excess profit shall be assessed and paid in accordance with the provisions of section 26.19 of these regulations.

(i) *Unreasonable compensation.*—The salaries and compensation for services which are treated as a part of the cost of performing a contract or subcontract include reasonable payments for salaries, bonuses, or other compensation for services. As a general rule, bonuses paid to employees (and not to officers) in pursuance of a regularly established incentive bonus system may be allowed as a part of the cost of performing a contract or subcontract.

The test of allowability is whether the aggregate compensation paid to each individual is for services actually rendered incident to, and necessary for, the performance of the contract or subcontract, and is reasonable. Excessive or unreasonable payments whether in cash, stock or other property ostensibly as compensation for services shall not be included in the cost of performing a contract or subcontract.

(j) *Allocation of indirect costs.*—No general rule applicable to all cases may be stated for ascertaining the proper proportion of the indirect costs to be allocated to the cost of performing a particular contract or subcontract. Such proper proportion depends upon all the facts and circumstances relating to the performance of the particular contract or subcontract. Subject to a requirement that all items which have no relation to the performance of the contract or subcontract shall be eliminated from the amount to be allocated, the following methods of allocation are outlined as acceptable in a majority of cases:

(1) *Factory indirect expenses.*—The allowable indirect factory expenses (see paragraph (c) (5) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct productive labor (see paragraph (c) (2) of this section) attributable to the contract or subcontract bears to the total direct productive labor of the production department or particular section thereof during the period within which the contract or subcontract is performed, except that if the indirect factory expenses are incurred in different amounts and in different proportions by the various producing departments consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination of the true profit and excess profit.

(2) *Engineering indirect expenses.*—The allowable indirect engineering expenses (see paragraph (f) of this section) shall ordinarily be allocated or "distributed" to the cost of the contract or subcontract on the basis of the proportion which the direct engineering labor attributable to the contract or subcontract (see paragraph (c) (3) of this section) bears to the total direct engineering labor of the engineering department or particular section thereof during the period within which the contract or subcontract is performed. If the expenses of the engineering department are not sufficient in

amount to require the maintenance of separate amounts, the engineering indirect costs may be included in the indirect factory expenses (see paragraph (c) (5) of this section) and allocated or distributed to the cost of performing the contract or subcontract as a part of such expenses, provided the proportion so allocated or distributed is proper under the facts and circumstances relating to the performance of the particular contract or subcontract.

(3) *Administrative expenses (or "overhead").*—The allowable expenses of administration (see paragraph (g) of this section) or other general expenses except indirect engineering expenses, bidding and general selling expenses, and general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of the proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacturing cost and the total cost of installation and construction during the period within which the contract or subcontract is performed.

(4) *Bidding, general selling, and general servicing expenses.*—The allowable bidding and general selling expenses and general servicing expenses (see paragraph (g) and (3) of this section) shall ordinarily be allocated or distributed to the cost of performing a contract or subcontract on the basis of—

(i) The proportion which the contract price of the particular contract or subcontract bears to the total sales made (including contracts or subcontracts completed) during the period within which the particular contract or subcontract is performed, or

(ii) The proportion which the sum of the manufacturing cost (see paragraph (b) of this section) and the cost of installation and construction (see paragraph (e) of this section) attributable to the particular contract or subcontract bears to the sum of the total manufacuring cost and the total cost of installation and construction during the period within which the contract or subcontract is performed, except that special consideration shall be given to the relation which certain classes of such expenses bear to the various classes of articles produced by the contracting party in each case in which such consideration is necessary in order to make a fair and reasonable determination of the true profit and excess profit. See section 26.14 of these regulations.*

SEC. 26.10. *Credit for net loss or for deficiency in profit in computing excess profit.*—The term "net loss," as applied to contracts and subcontracts coming within these regulations, means the amount by which the cost of performing any such contract or subcontract completed by a particular contracting party within the income-taxable year exceeds the total contract price of such contract or subcontract. As to the meaning of income-taxable year, see section 26.1 of these regulations.

The term "deficiency in profit," as applied to contracts and subcontracts for the construction or manufacture of Army or Navy aircraft coming within these regulations, means the amount by which the allowable profit upon all such contracts and subcontracts completed by a particular contracting party within an income-taxable year exceeds the net profit upon all such contracts and subcontracts. For the purposes of this section, the term "allowable profit," means an amount equal to (A) 8 percent of the total contract prices of all contracts (including prime contracts made on a cost-plus-a-fixed-fee basis) and subcontracts completed within the income-taxable year, or (B) an amount equal to 8.7 percent of the total cost of performing such contracts (except prime contracts made on a cost-plus-a-fixed-fee basis) and subcontracts plus 8 percent of the total contract prices of prime contracts made on a cost-plus-a-fixed-fee basis, whichever of such amounts (A) or (B) is the lesser.

A net loss or a deficiency in profit sustained by a contracting party with respect to contracts and subcontracts coming within these regulations and completed within an income-taxable year is allowable as a credit in computing the contracting party's excess profit on contracts and subcontracts coming within these regulations and completed within the first succeeding income-taxable year. The amount of such credit is the sum of the following: (A) The total net loss on contracts and subcontracts for the construction or manufacture of naval vessels completed within an income-taxable year reduced by the excess of the net profit over the allowable profit on contracts and subcontracts for the construction or manufacture of Army or Navy aircraft completed within such year,

and (B) the total deficiency in profit and the total net loss on contracts and subcontracts for the construction or manufacture of Army or Navy aircraft completed within such year reduced by the excess of the net profit over the allowable profit on all contracts and subcontracts for the construction or manufacture of naval vessels completed within such year. Any portion of such credit which is attributable to contracts or subcontracts for the construction or manufacture of naval vessels shall be applied against the excess profit before the portion, if any, attributable to contracts or subcontracts for the construction or manufacture of Army or Navy aircraft is so applied. If, after the application of such credit, there is a remainder, the portion of the amount of such remainder which is attributable to contracts or subcontracts for the construction or manufacture of Army or Navy aircraft is allowable as a credit in computing the contracting party"s excess profit on contracts or subcontracts coming within these regulations and completed during the next three succeeding income-taxable years.

Credit for such a net loss or deficiency in profit may be claimed in the contracting party's annual report of profit filed with the collector of internal revenue (see section 26.16 of these regulations), but it shall be supported by separate schedules for each contract or subcontract involved showing total contract prices, costs of performance and pertinent facts relative thereto, together with a summarized computation of the net loss or deficiency in profit. The net loss or deficiency in profit claimed is subject to verification and adjustment. As to preservation of books and records, see section 26.14 of these regulations.

Net loss or deficiency in profit sustained on contracts and subcontracts completed within one income-taxable year may not be considered in computing net loss or deficiency in profit sustained on contracts and subcontracts completed within another income-taxable year.

The provisions of this section may be illustrated by the following examples:

Example (1).—On July 1, 1940, the A Corporation, which keeps its books and makes its Federal income tax returns on a calander year basis, entered into the following contracts (none of which was on a cost-plus-a-fixed-fee basis) coming within these regulations:

(1) A contract for the construction of a naval vessel at a contract price of $100,000, which was completed in 1940 at a cost of $170,000.

(2) A contract for the construction of naval aircraft at a contract price of $200,000, which was completed in 1940 at a cost of $190,000.

(3) A contract for the construction of Army aircraft at a contract price of $300,000, which was completed in 1940 at a cost of $250,000.

(4) A contract for the construction of naval aircraft at a contract price of $500,000, which was completed in 1941 at a cost of $450,000.

On contract No. 1 the net loss was $70,000 ($170,000 minus $100,000) and accordingly, there was no excess of the net profit over the allowable profit.

On contracts Nos. 2 and 3 the total of the contract prices was $500,000 and the total cost was $440,000, resulting in a net profit of $60,000. The allowable profit on such contracts was $38,280 (8.7 percent of $440,000), which amount is less than $40,000 (8 percent of $500,000). On such contracts the excess of the net profit ($60,000) over the allowable profit ($38,280) was $21,720, and there was no deficiency in profit because the allowable profit did not exceed the net profit.

The amount of allowable credit is $48,280, computed as follows:

Net loss on naval vessel contract (No. 1)		$70,000
Less: Excess of net profit over allowable profit on aircraft contracts (Nos. 2 and 3)		21,720
		$48,280
Deficiency in profit and net loss on aircraft contracts (Nos. 2 and 3)	None	
Less: Excess of net profit over allowable profit on naval vessel contract (No. 1)	None	
		None
Amount of allowable credit from year 1940		$48,280

On the contract for naval aircraft completed in 1941 (No. 4), there was a net profit of $50,000 ($500,000 minus $450,000). The allowable profit on such contract was $39,150 (8.7 percent of $450,000), which amount is less than $40,000 (8 percent of $500,000). Accordingly, the excess of the net profit over the allowable profit was $10,850. Against this amount the credit of $48,280 from 1940 may

be taken, with the result that there is no excess profit for the year 1941. The remainder of the credit of $48,280 may not be used in subsequent years because none of the credit was attributable to contracts or subcontracts for the construction or manufacture of Army or Navy aircraft.

Example (2).—On July 1, 1940, the B Corporation, which keeps its books and makes its Federal income tax returns on a calendar year basis, entered into the following contracts (none of which was on a cost-plus-a-fixed-fee basis) coming within these regulations:

(1) A contract for the construction of a naval vessel at a contract price of $100,000, which was completed in 1940 at a cost of $120,000.

(2) A contract for the construction of Navy aircraft at a contract price of $200,000, which was completed in 1940 at a cost of $188,000.

(3) A contract for the construction of Army aircraft at a contract price of $300,000, which was completed in 1941 at a cost of $275,000.

(4) A contract for the construction of a naval vessel at a contract price of $400,000, which was completed in 1942 at a cost of $360,000.

On contract No. 1 the net loss was $20,000 ($120,000 minus $100,000) and, accordingly, there was no excess of the net profit over the allowable profit.

On contract No. 2 the net profit was $12,000 ($200,000 minus $188,000) and the allowable profit was $16,000 (8 percent of $200,000), which amount is less than $16,350 (8.7 percent of $188,000). Accordingly, on such contract there was a deficiency in profit of $4,000 ($16,000 minus $12,000). There was no excess of the net profit over the allowable profit, the latter being larger in amount.

The amount of allowable credit is $24,000, computed as follows:

Net loss on naval vessel contract (No. 1)		$20,000
Less: Excess of net profit over allowable profit on aircraft contract (No. 2)		None
		$20,000
Deficiency in profit on aircraft contract (No. 2)	$4,000	
Net loss on aircraft contract (No. 2)	None	
	$4,000	
Less: Excess of net profit over allowable profit on naval vessel contract (No. 1)	None	
		4,000
Amount of allowable credit from year 1940		$24,000

On the contract for Army aircraft completed in 1941 (No. 3), there was a net profit of $25,000 ($300,000 minus $275,000). The allowable profit on such contract was $23,925 (8.7 percent of $275,000), which amount is less than $24,000 (8 percent of $300,000). Accordingly, the excess of the net profit over the allowable profit was $1,075. Against this amount the credit of $24,000 from 1940 may be taken, with the result that there is no excess profit for the year 1941. After applying such credit there is an unused remainder of the credit amounting to $22,925 ($24,000 minus $1,075).

On the Navy vessel contract completed in 1942 (No. 4) there was a net profit of $40,000 ($400,000 minus $360,000). The allowable profit on such contract was $31,320 (8.7 percent of $360,000), which amount is less than $32,000 (8 percent of $400,000). Accordingly, the excess of the net profit over the allowable profit is $8,680. Against this amount there may be taken as a credit such part of the unused remainder of the allowable credit from 1940 ($22,925) as is attributable to the contract for Navy aircraft (No. 2). Of the original credit of $24,000 from 1940, only $4,000 was attributable to contract No. 2, and hence $4,000 is the only part of the unused remainder ($22,925) which may be taken as a credit against the excess profit on contract No. 4.*

SEC. 26.11. *Credit for Federal income taxes.*—For the purpose of computing the amount of excess profit to be paid to the United States, a credit is allowable against the excess profit for the amount of Federal income taxes paid or remaining to be paid on the amount of such excess profit. The "Federal income taxes" in respect of which this credit is allowable include the income taxes imposed by chapter 1 and subchapter A of chapter 2 of the Internal Revenue Code, as amended, and the excess-profits taxes imposed by subchapter B of chapter 2 of the Internal Revenue Code, as amended. This credit is allowable for these taxes only to the extent that it is affirmatively shown that they have been finally determined and paid or remain to be paid and that they were imposed upon the excess profit against which the credit is to be made. In case such a credit has

been allowed and the amount of Federal income taxes imposed upon the excess profit is redetermined, the credit previously allowed shall be adjusted accordingly.*

SEC. 26.12. *Failure of contractor to require agreement by subcontractor.*—Every contract or subcontract coming within the scope of the Act and these regulations is required by the Act and the Act of March 27, 1934, as amended, to contain, among other things, an agreement by the contracting party to make no subcontract unless the subcontractor agrees—

(a) To make a report, as described in the Act of March 27, 1934, as amended, under oath to the Secretary of the Department concerned upon the completion of the subcontract;

(b) To pay into the Treasury excess profit, as determined by the Treasury Department, in the manner and amounts specified in the Act;

(c) To make no subdivision of the subcontract for the same article or articles for the purpose of evading the provisions of the Act and the Act of March 27, 1934, as amended;

(d) That the manufacturing spaces and books of its own plant, affiliates, and subdivisions shall at all times be subject to inspection and audit as provided in the Act of March 27, 1934, as amended.

If a contracting party enters into a subcontract with a subcontractor who fails to make such agreement, such contracting party shall, in addition to its liability for excess profit determined on contracts or subcontracts performed by it, be liable for any excess profit determined to be due the United States on the subcontract entered into with such subcontractor. In such event, however, the excess profit to be paid the United States in respect of the subcontract entered into with such subcontractor shall be determined separately from any contract or subcontracts performed by the contracting party entering into the subcontract with such subcontractor.*

SEC. 26.13. *Evasion of excess profit.*—The Act of March 27, 1934, as amended, provides that the contracting party shall agree to make no subdivisions of any contract or subcontract for the same article or articles for the purpose of evading its provisions. If any such subdivision or subcontract is made for the purpose of evading the provisions of the Act or the Act of March 27, 1934, as amended, it shall constitute a violation of the agreement, and the cost of completing a contract or subcontract by a contracting party which violates such agreement shall be determined in a manner necessary clearly to reflect the true excess profit of such contracting party.*

SEC. 26.14. *Books of account and records.*—It is recognized that no uniform method of accounting can be prescribed for all contracting parties subject to the provisions of the Act and the Act of March 27, 1934, as amended. Each contracting party is required by law to make a report of its true profits and excess profit. Such party must, therefore, maintain such accounting records as will enable it to do so. See section 26.9 of these regulations. Among the essentials are the following:

(1) The profit or loss upon a particular contract or subcontract shall be accounted for and fully explained in the books of account separately on each contract or subcontract.

(2) Any cost accounting methods, however standard they may be and regardless of long continued practice, shall be controlled by, and be in accord with, the objectives and purposes of the Act and the Act of March 27, 1934, as amended, and of any regulations prescribed thereunder.

(3) The accounts shall clearly disclose the nature and amount of the different items of cost of performing a contract or subcontract.

In cases where it has been the custom in the past to use so-called "normal" rates of overhead expense or administrative expenses, or "standard" or "normal" prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract, if the method of accounting employed is such as clearly to reflect, in the final determination upon the books of account, the actual profit derived from the performance of the contract or subcontract and if the necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts. As to the elements of cost, see section 26.9 of these regulations.

All books, records, and original evidences of costs (including, among other things, production orders, bills or schedules of materials, purchase requisitions, purchase orders, vouchers, requisitions for materials, standing expense orders, inventories, labor time cards, pay rolls, cost distribution sheets) pertinent to the determination of the true profit, excess profit, deficiency in profit or net loss

from the performance of a contract or subcontract shall be kept at all times available for inspection by internal-revenue officers, and shall be carefully preserved and retained so long as the contents thereof may become material in the administration of the Act and the Act of March 27, 1934, as amended. This provision is not confined to books, records, and original evidences pertaining to items which may be considered to be a part of the cost of performing a contract or subcontract. It is applicable to all books, records, and original evidences of costs of each plant, branch or department involved in the performance of a contract or subcontract or in the allocation or distribution of costs to the contract or subcontract.*

SEC. 26.15. *Report to Secretary of Department concerned.*—Upon the completion of a contract or subcontract coming within the scope of the Act and these regulations, the contracting party is required to make a report, under oath, to the Secretary of the Department concerned. As to the date of completion of a contract or subcontract, see section 26.5 of these regulations. Such report shall be in the form prescribed by the Secretary of the Department concerned and shall state the total contract price, the cost of performing the contract, the net income from such contract, and the per centum such income bears to the contract price and the cost of performing the contract. The contracting party shall also include as a part of such report a statement showing—

(1) the manner in which the indirect costs were determined and allocated to the cost of performing the contract or subcontract (see section 26.9 of these regulations);

(2) the name and address of every subcontractor with whom a subcontract was made, the object of such subcontract, the date when completed and the amount thereof; and

(3) the name and address of each affiliate or other organization, trade or business owned or controlled directly or indirectly by the same interests as those who so own or control the contracting party, together with a statement showing in detail all transactions which were made with such affiliate or other organization, trade or business and are pertinent to the determination of the excess profit.

A copy of the report required to be made to the Secretary of the Department concerned is required to be transmitted by the contracting party to the Secretary of the Treasury. Such copy shall not be transmitted directly to the Secretary of the Treasury but shall be filed as a part of the annual report. See section 26.16 of these regulations.*

SEC. 26.16. *Annual reports for income-taxable years.*—(a) *General requirements.*—Every contracting party completing a contract or subcontract within the scope of these regulations shall file with the collector of internal revenue for the collection district in which the contracting party's Federal income tax returns are required to be filed an annual report on the prescribed form of the profit and excess profit on all such contracts and subcontracts completed within the particular income-taxable year. There shall be included as a part of such report a statement, preferably in columnar form, showing separately for each such contract or subcontract completed by the contracting party within the income-taxable year the total contract price, the cost of performing the contract or subcontract and the resulting profit or loss on each contract or subcontract together with a summary statement showing in detail the computation of the net profit or net loss upon all contracts and subcontracts completed within the income-taxable year and the amount of the excess profit, if any, for the income-taxable year covered by the report. A copy of the report made to the Secretary of the Department concerned (see section 26.15 of these regulations) with respect to each contract or subcontract covered in the annual report, shall be filed as a part of such annual report. In case the income-taxable year of the contracting party is a period of less than 12 months (see section 26.1 of these regulations), the report required by this section shall be made for such period and not for a full year.

(b) *Time for filing annual reports.*—Annual reports of contracts and subcontracts coming within the scope of the act and these regulations completed by a contracting party within an income-taxable year must be filed on or before the 15th day of the ninth month following the close of the contracting party's income-taxable year. It is important that the contracting party render on or before the due date an annual report as nearly complete and final as it is possible for the contracting party to prepare. An extension of time granted the contracting party for filing its Federal income tax return does not serve to extend the time for filing the annual report required by this section. Author-

ity consistent with authorizations for granting extensions of time for filing Federal income tax returns is hereby delegated to the various collectors of internal revenue for granting extensions of time for filing the reports required by this section. Application for extensions of time for filing such reports should be addressed to the collector of internal revenue for the district in which the contracting party files its Federal income tax returns and must contain a full recital of the causes for the delay.*

SEC. 26.17. *Payment of excess profit liability.*—The amount of the excess-profit liability to be paid to the United States shall be paid on or before the due date for filing the report with the collector of internal revenue. See section 26.16 of these regulations. At the option of the contracting party, the amount of the excess profit liability may be paid in four equal installments instead of in a single payment, in which case the first installment is to be paid on or before the date prescribed for the payment of the excess profit as a single payment, the second installment on or before the 15th day of the third month, the third installment on or before the 15th day of the sixth month, and the fourth installment on or before the 15th day of the ninth month, after such date.*

SEC. 26.18. *Liability of surety.*—The surety under contracts entered into with the Secretary of the Department concerned for the construction or manufacture of any complete naval vessel or Army or Navy aircraft, or any portion thereof, shall not be liable for payment of excess profit due the United States in respect of such contracts.*

SEC. 26.19. *Determination of liability for excess profit, interest and penalties; assessment, collection, payment, refunds.*—The duty of determining the correct amount of excess profit liability on contracts and subcontracts coming within the scope of the Act and these regulations is upon the Commissioner of Internal Revenue. Under section 3 (b) of the Act of March 27, 1934, as last amended, all provisions of law (including the provisions of law relating to interest, penalties and refunds) applicable with respect to the taxes imposed by Title I of the Revenue Act of 1934, and not inconsistent with section 3 of the Act of March 27, 1934, as last amended, are applicable with respect to the assessment, collection, or payment of excess profits on contracts and subcontracts coming within the scope of the Act and these regulations and to refunds of overpayments of profits into the Treasury under the Act. Claims by a contracting party for the refund of an amount of excess profit, interest, penalties, and additions to such excess profits shall conform to the general requirements prescribed with respect to claims for refund of overpayments of taxes imposed by Title I of the Revenue Act of 1934 and, if filed on account of any additional costs incurred pursuant to guarantee provisions in a contract, shall be supplemented by a statement under oath showing the amount and nature of such costs and all facts pertinent thereto.

Administrative procedure for the determination, assessment and collection of excess profit liability under the Act and these regulations and the examination of reports and claims in connection therewith will be prescribed from time to time by the Commissioner of Internal Revenue.*

SEC. 26.20. *Applicability of prior regulations.*—The regulations prescribed in Treasury Decision 4906 (sections 17.0 to 17.19, inclusive, Title 26, Code of Federal Regulations, 1939 Sup.) and Treasury Decision 4909 (sections 16.0 to 16.18, inclusive, Title 26, Code of Federal Regulations, 1939 Sup.) shall not apply to contracts entered into after June 28, 1940, and before July 1, 1942, nor to subcontracts made with respect to such contracts. To this extent such regulations are hereby superseded.*

TIMOTHY C. MOONEY,
Acting Commissioner of Internal Revenue.

Approved: July 29, 1940.

JOHN L. SULLIVAN,
Acting Secretary of the Treasury.

Approved: August 2, 1940.

HENRY L. STIMSON,
Secretary of War.

Approved: August 6, 1940.

FRANK KNOX,
Secretary of the Navy.

(Filed with the Division of the Federal Register August 7, 1940.)

INTERNAL REVENUE BULLETIN 1940-33-10391

I. T. 3400

Treatment of interest paid on indebtedness, the proceeds of which are used solely to acquire special additional equipment and facilities or working capital for the operation thereof, the cost, or portion of the cost, of which is borne by the Government and is chargeable against a contract or subcontract, for the purpose of determining the cost of performing a contract or subcontract coming within the scope of the provisions of section 3 (b) of the Act of March 27, 1934, as amended, section 14 of the Act of April 3, 1939, or section 2 (b) of the Act of June 28, 1940.

The regulations contained in section 17.9 (g) 4 of Treasury Decision 4906 (C. B. 1939-2, 404) and section 16.8 (g) 4 of Treasury Decision 4909 (C. B. 1939-2, 422) provide that interest incurred or earned shall not be considered in determining the cost of performing a contract or subcontract coming within the scope of section 3 (b) of the Act of March 27, 1934, as amended, and section 14 of the Act of April 3, 1939, relating to excess profits on contracts and subcontracts for naval vessels or Army or Navy aircraft or any portion thereof. This provision of the regulations, prescribing a general rule as to interest, is not to be construed as preventing an annual allowance for reasonable interest (not in excess of 4 percent per annum) paid on indebtedness, the proceeds of which are used solely to acquire special additional equipment and facilities, the cost, or portion of the cost, of which is borne by the Government and, pursuant to a certification made in accordance with the provisions of Executive Order 8165 and the Joint Rules issued thereunder (I. R. B. 1940-30, 15) and in accordance with the provisions of section 4 of the Act of June 28, 1940 (Public, No. 671, Seventy-sixth Congress, third session; I. R. B. 1940-30, 12), is chargeable against a contract or subcontract coming within the scope of such section 3 (b) or section 14.

Such provision of the regulations is also not to be construed as preventing an annual allowance for reasonable interest (not in excess of 4 per cent per annum) paid on indebtedness in case such indebtedness is necessarily incurred to provide, and the proceeds of such indebtedness are used solely to provide, working capital for the operation of such special additional equipment and facilities, the cost, or portion of the cost, of which is borne by the Government and is so chargeable against such a contract or subcontract. No such allowance shall be made unless the contracting party keeps special accounts on his books and special bank accounts clearly showing such use of the funds in the performance of such contracts and subcontracts.

An annual allowance under the preceding paragraphs for interest paid on any indebtedness shall be reduced by all interest earned within the year on the proceeds of such indebtedness.

Interest allowable under the provisions of the preceding paragraphs shall be treated as an indirect factory expense and be allocated to the cost of performing a particular contract or subcontract in accordance with the provisions of the regulations relating to the allocation of indirect factory expense.

The provisions of the preceding paragraphs are equally applicable in determining the cost of performing contracts and subcontracts coming within the scope of section 2 (b) of the Act of June 28, 1940 (Public, No. 671, Seventy-sixth Congress, third session; I. R. B. 1940-30, 12), relating to payment into the Treasury of profit in excess of the specified 8 per cent and 8.7 per cent.

Senator MCKELLAR. I asked permission to interrupt the witness to ask some questions, but in view of his subsequent testimony, it is not necessary for me to ask those questions. He has, in substance, answered the question I had.

I would like to state, for the information of the committee, exactly how this section 403 was brought about. I believe it would be helpful.

Congressman Case, of South Dakota, introduced on the floor of the House an amendment fixing profits. This was in the big war bill of $33,000,000,000 last spring when that was before the House. He introduced an amendment limiting all profits and war contracts to 6 percent and that was overwhelmingly carried, as I remember, in the

House. The committee had an idea that it would go into conference, and did not pay very much attention to it.

When it came over to the Senate, I, as acting chairman of the Appropriations Committee at the time, appointed a subcommittee of two Senators to consider it, and I considered it myself. I took the papers out home. I came to the conclusion that the War Department, the Navy Department, and the Maritime Commission, and W. P. B. were correct in their contention that there would not be much saving on a limitation of that kind. It would affect big contracts one way and probably, to our loss, and on small contracts, to our advantage.

Senator Thomas, of Oklahoma, and Senator Overton, of Louisiana, were the members of the committee and they reported a sliding scale percentage to be allowed.

Senator WALSH. Profits.

Senator MCKELLAR. Profit. My recollection is that on small contracts it began at 10 percent and went down to 2 on the large ones. These several departments were just as much opposed to that as they were to the other. They said that it would be unworkable and they felt it might bring about a slowing-up of production, and nobody wanted a slowing-up of production.

Senator WALSH. That has been our position from the very beginning.

Senator MCKELLAR. We had them all before us and they testified that way as to the 6 percent and then they came again and testified as to the sliding scale of 10 percent, and as I recall, what brought this section about was this: Mr. Nelson was on the stand and he was very much opposed to the sliding-scale contract. I said, "Mr. Nelson, aren't you in favor of cutting down these wasteful practices, in the interest of the Government?" "Oh, yes, Senator, I am; I am very much interested in it."

I said, "Well, if neither of these plans suit you, why do you not suggest a plan?"

He said that he had his attorneys working on one.

I said, "I think I can suggest a plan to you that will certainly serve the purpose. Why couldn't you put a provision in each contract of renegotiation; why couldn't you say that whenever the Secretary of either of the Departments, or the Chairman, in the case of the Maritime Commission, finds that the profits are excessive after examination, that he will have a right to renegotiate and refix the price fixed in the contract?"

"Why," he said, "Senator, I think that would be very well."

I asked what they thought of it. General Somervell was present, and as I recall, Admiral Moreell and Admiral Land. They all said that on the face of it, it looked like it might work, but that they would like to look into it further. I said, "Well, we will adjourn right now."

It was in the middle of the morning and I said, "You gentlemen go back to your offices and get your lawyers together and prepare an amendment along that line."

Now, that is the genesis of section 403. They came in the next morning. I never saw departmental officials act more fairly and promptly and squarely and honestly than they did. They came back the next morning with a provision that applied only to future contracts and pointed out one or two differences. The committee dis-

cussed it with them right there in the open. We added a good many amendments, most of which the Departments approved, and some of which they were not so certain about. But they did give us the opinion that in their judgment, it would not slow down production the way it was finally put in the bill.

That is the origin of section 403. The departments themselves, worked it out, and they worked it out very well, and I want to commend them in the strongest terms. It has, and will continue to bring about a tremendous saving, and I don't believe that we will pay the enormous prices that we paid, for instance, in the last war, when there were many exorbitant and excessive prices paid, as we all know.

Now, that is the origin of it. I thought it would be helpful to put it in at this time.

Senator WALSH. I want to commend the Senator from Tennessee for originating the section, which no department of the Government has opposed from the very beginning.

Senator MCKELLAR. Mr. Chairman, I have a statement that Senator Hayden put into the record while I was necessarily away some weeks ago, and I would like at this point to have that inserted in this record.

Senator WALSH. That may be done.

(The copy of Senator McKellar's remarks above referred to is as follows:)

ADDRESS OF HON. KENNETH McKELLAR

SAVINGS UNDER RENEGOTIATED CONTRACTS AND UNDER GENERAL APPROPRIATION BILLS

Speech of Hon. Kenneth McKellar, of Tennessee, in the Senate of the United States, Monday, August 3, 1942

Mr. MCKELLAR. Mr. President, I am greatly pleased by the tremendous savings which have been brought about in the expenditures of the Government under the provisions of section 403 (a) of the Sixth Supplemental National Defense Appropriation Act, approved April 28, 1942. Section 403 (a) was first placed in the bill by the Senate Appropriations Committee, was agreed to by the Senate, was subsequently agreed to by the House conferees, and adopted by the House.

Mr. President, this act was passed after many conferences with the departments named in the act and after the various departments had gone over it most carefully and felt that it would accomplish a great deal in the reduction of excessive prices fixed in the contracts.

After the passage of the bill each of the several departments established a committee to investigate prices. The Army established a committee of five members, the Navy a committee of like number, the Maritime Commission a committee of four members. One of the members of each of these committees represents the W. P. B.

These committees organized and began work immediately, and with the greatest success. The provisions of this act were primarily the work of the Senate Appropriations Committee, but they were drafted with the full cooperation of the several departments. In like manner, the several departments have cooperated to the fullest extent in carrying out the terms of the act.

I desire to call the especial attention of the Senate to the fact that to date the measure has been attended with the greatest success. Already, as evidence of their good faith, many of the companies voluntarily have made reductions. Reductions to June 15 in the War Department alone total $556,997,514, and it is firmly believed that within a year more than a billion dollars will be saved.

The Navy Department has already saved $348,786,246, and it estimates it will save a half a billion more this year. The Maritime Commission has already saved, under this law, $28,500,000, and it estimates it will save sixty-five million more this year.

It must be said that the companies having contracts with the Government have shown the finest spirit of cooperation and reasonableness, and that the Department officials have been exceedingly vigilant and attentive in the enforcement of this act.

Mr. President, I wish to express to the departments my great appreciation for their very active cooperation in the matter of saving the Government these very large sums.

I happen to be a member of the Joint Committee on Reduction of Nonessential Expenditures appointed last winter. This committee is commonly known as the Byrd committee, being presided over by the Senator from Virginia [Mr. Byrd]. This committee made recommendations of reductions in December 1941 in almost the same amounts as appropriations were reduced. Following action taken by the Appropriations Committee, two agencies—the Civilian Conservation Corps and the Alley Dwelling Authority—were abolished; the appropriation for the Work Projects Administration was reduced from $875,000,000 to $280,000,000; the appropriation for National Youth Administration was reduced from $151,000,000 to $46,000,000; appropriations for travel pay were reduced in the amount of $3,981,931 below the Budget estimates, exclusive of travel pay eliminated for the C. C. C., and many other reductions and savings were made—in all, aggregating $3,312,269,450. The Appropriations Committees of both the House and the Senate united to effect savings wherever they could.

To eptomize, or put into figures the reports and statements to date, they show the following:

Savings, War Department, to June 15, 1942	$550,000,000
Savings on contracts in the War Department now being examined	500,000,000
Savings, Navy Department, already accomplished	348,786,242
Further estimated savings in Navy Department during the year	500,000,000
Savings, U. S. Maritime Commission	28,500,000
Anticipated savings, Maritime Commission, remainder of year	65,000,000
Total	1,908,286,242
To be added to the above sums is a reduction of all kinds of nonmilitary appropriations and nonessential appropriations made by the Congress for the present fiscal year	1,313,983,208
Grand total	3,312,269,450

In proof of the savings as stated, I ask leave to have printed in the Record as a part of my remarks, a letter from the Under Secretary of War, Hon. Robert P. Patterson, a letter from K. H. Rockey, Chairman of the Price Adjustment Board of the Navy Department, a letter from Admiral Land, Chairman of the Maritime Commission, and a letter from Mr. Donald M. Nelson, Chairman of the War Production Board. These letters all refer to the renegotiation of war contracts, and I desire that all be published together in order to make a complete report up to this date.

The VICE PRESIDENT. Without objection, the letters will be printed in the Record.

The letters referred to are as follows:

WAR DEPARTMENT,
OFFICE OF THE UNDER SECRETARY,
Washington, D. C., June 30, 1942.

HON. KENNETH MCKELLAR,
United States Senate, Washington, D. C.

MY DEAR SENATOR: This letter is in answer to your oral inquiry of General Somervell with reference to the progress had in renegotiating contracts of the Department in accordance with section 403 of the Sixth Supplemental Appropriation Act of 1942.

The Price Adjustment Board has interviewed many War Department contractors for the purpose of renegotiating contracts in which excessive profits were being received. Cooperation on the part of the contractors has, almost without exception, been excellent. Between April 15 and June 15, 1942, voluntary refunds and price reductions on existing contracts and reduced prices on new contracts entered into with existing War Department contractors arising, respectively, from renegotiation and negotiation, totaled $556,997,514.

A large number of other contractors are presently under review by the Board. Conferences with these contractors and studies of their financial statements indicate probable refunds and price reductions on existing contracts and savings on new contracts to be entered into with those contractors in excess of $500,000,000.

As time goes on, the Board will expand the number of contractors reviewed and, it is hoped, will continue to obtain substantial savings for the War Department.

Sincerely yours,

ROBERT P. PATTERSON.
Under Secretary of War.

NAVY DEPARTMENT,
Washington, July 3, 1942.

HON. KENNETH MCKELLAR,
United States Senate.

MY DEAR SENATOR MCKELLAR: In accordance with your telephone request, I am pleased to inform you that reductions in prices effected and in process of renegotiation, including voluntary refunds from contractors, amount at the present time to $348,786,246. However, this is only a tentative figure, and a more complete investigation may develop an even higher amount.

At the present time the Price Adjustment Board of the Navy Department has over 175 contractors and subcontractors under investigation, and its representatives are in the plants of 65 of these contractors. As a result of the Board's

activities, it is expected that further savings of over $500,000,000 will be made during the balance of this coming year.

Yours very truly,

K. H. ROCKEY,
Chairman, Price Adjustment Board.

UNITED STATES MARITIME COMMISSION,
Washington, July 25, 1942.

The Honorable KENNETH MCKELLAR,
United States Senate, Washington, D. C.

DEAR SENATOR MCKELLAR: In accordance with your recent conversations with me and members of the Price Adjustment Board of the United States Maritime Commission, I am pleased to inform you that during recent months the reductions in prices effected by our various contract divisions and our Price Adjustment Board, including voluntary refunds and reductions now in the process of renegotiation, amount to more than $28,500,000 at the present time.

The activities of the Price Adjustment Board are now expanding quite rapidly. The results of its work to date and the attitude evidenced by contractors and subcontractors as the result of the contract renegotiations wih them reflect upon the Board favorably and indicate that it is carrying out its duties satisfactorily, The attitude of contractors toward renegotiations to date has been cooperative and understanding.

You appreciate that it is most difficult because of the many factors involved to predict what further reductions in contract prices will be effected during the balance of this year, but our present estimate amounts to $65,000,000.

Sincerely yours,

E. S. LAND,
Chairman.

WAR PRODUCTION BOARD,
Washington, D. C., July 15, 1942.

Hon. KENNETH MCKELLAR,
United States Senate.

DEAR SENATOR MCKELLAR: In your letter of July 6, you inquire about the work of the War Production Board in reference to renegotiation of contracts under section 403 of the War Appropriations Act. In particular, you ask about savings effected by the War Production Board.

I wish to advise that all our work of this character has been done in cooperation with the War Department, the Navy Department, and the Maritime Commission. As mentioned in your remarks in the CONGRESSIONAL RECORD of July 1, War Production Board has a representative member on each of the price-adjustment boards carrying on renegotiation for War, Navy, and Maritime Commission. Our representative has participated, therefore, in the activities of each of those boards and has cooperated in every way in accomplishing the results already reported to you by them. Moreover, the Cost Analysis Section of the War Production Board has contributed information and assisted in developing the methods of renegotiation being followed by the boards.

We are glad to make our contribution in this manner, which I am sure you will recognize as the most effective form which our participation can take. It means, however, that any figures of savings which I might report would be duplicated in the figures reported to you by the direct contracting agencies. I might, however, add that even before the United States entered the war, our Cost Analysis Section was instrumental in calling attention to cases in which substantial price reductions were subsequently obtained.

In accordance with the request you made during the recent hearing on our budget before the Senate Appropriations Committee, I have asked the Maritime Commission and the Procuremert Division of the Treasury to get their figures on price adjustments to you as soon as possible.

Sincerely yours,

DONALD M. NELSON.

Senator WALSH. Just one question: How many contracts were examined in that connection, do you recall?

Mr. REILING. It shows on the last page.

Senator WALSH. Just put it in the record.

Mr. REILING. 2,961.

Senator WALSH. Contracts?

Mr. REILING. Contracts and subcontracts.

Senator WALSH. Were submitted for scrutiny?

Mr. REILING. That is right.

Senator WALSH. And, again, the amount collected?

Mr. REILING. And the additional amount collected as a result of the scrutiny was $1,597,000. In other words, we collected approximately 20 percent, better than 20 percent, close to 25 percent more than they had reported.

Senator WALSH. More than they reported?

Mr. REILING. More than they had reported on the return. You see, we had reported $5,987,000.

Senator WALSH. In other words, you collected, as a result of the administration of this law, 20 percent more than they had returned or were willing to return to the Government as their profits.

Mr. REILING. That is right.

Senator CLARK. How much was that figure?

Mr. REILING. Well, the amount reported on the reports is 5,987,000. This is on the Navy contracts, and we collected, in addition to that, 1,597,000, making a total of 7,584,000.

Senator MCKELLAR. May I ask if this isn't correct, that while only $7,000,000, or about the $7,000,000 figure that you gave, was actually paid back into the Treasury, that the Navy Department savings were very much greater? The reason I ask that question is because I have a letter here from Mr. Rockey, under date of July 3, saying that their savings up to that time had been $348,736,246. I imagine that they simply retained that money and used it for the purposes for which it was appropriated. Is that correct, sir?

Mr. REILING. Of course, I have no way of knowing how much the Navy Department saved by reason of the fact that the statute was on the books and the contractors had no reason to bid for a price which would give them greater than 10-percent allowable profit.

Senator MCKELLAR. All you can testify to is the amount that was collected and returned back into the Treasury?

Mr. REILING. That is right.

Senator WALSH. These commissions were all made under the circumstances of competitive bidding?

Mr. REILING. That is right.

Senator CLARK. My objection to this renegotiation was that they did not turn the money back into the Treasury; the War Department, the Navy Department, the Maritime Commission kept the money and spent it. It seems to me that these savings ought to go back into the Treasury and be subject to reappropriation by Congress for whatever purpose Congress wants to use them.

Senator MCKELLAR. I see no objection to that.

Mr. JOHN KENNEY (Special Assistant to the Under Secretary, Navy Department). What Mr. Reiling is speaking about has been recoveries into the Treasury under the Vinson-Trammell Act.

Mr. REILING. That is right.

Senator CLARK. As a matter of fact, a very small portion of the money gained in renegotiation has been turned into the Treasury; isn't that true?

Mr. KENNEY. I don't know exactly what the figures are; I know that several million dollars that have been sent back to the Treasury. The only money sent back to the Treasury is actual cash refunded—cash refunds which are received by the Department.

Senator CLARK. Senator McKellar's figures show that, under the renegotiation statute approximately $2,000,000,000 have been saved under the contract and the Treasury states that a very small proportion of that—I asked that question in the full committee—a very small proportion of it has been turned back into the Treasury; the difference being, of course, that when the money is turned into the Treasury, Congress has control of it and can appropriate for any purpose it wishes; while it is retained in the departments, they have control of it and can spend it.

Mr. KENNEY. The Navy does not retain any money that is covered back under section 403. To a great extent the reductions Mr. Rockey has cited in his letter, relate to contract-price reductions.

Senator WALSH. If the renegotiation takes place before the contract is closed, the money goes to the Army, if it is an Army contract, and if the negotiation takes place when the contract is closed and finished and there is a repayment, it goes to the Treasury; isn't that right?

Mr. KENNEY. No——

Senator VANDENBERG. In most instances, there isn't a repayment, there is just a reduction in the price; isn't that the situation?

Mr. MAURICE H. KARKER (Chairman, Price Adjustment Board, War Department). That is true, but any recapture for past periods of an excess profit is recovered in the Treasury as miscellaneous receipts. That reduction is on future delivery.

Mr. EICHHOLZ. Any time money is paid back under section 403 it goes into the Treasury. It is simply where there is a reduction in contract price which is applicable to future payments that there is nothing to pay back into the Treasury.

Senator VANDENBERG. The vast bulk of this saving is simply a reduction in the money paid out.

Senator WALSH. I think the record ought to be made clear that some of the questions asked by Senator McKellar were about the money that has been saved by reason of the administration of the renegotiation law, rather than the Vinson-Trammell Act.

Now, is there anyone else who wants to be heard before we get to the Maritime Commission? Any representative of the Army or Navy or anyone else?

(No response.)

Senator WALSH. Now, the representative of the Maritime Commission would like to have his testimony heard. You may proceed.

STATEMENT OF F. M. BRADLEY, COUNSEL, PRICE ADJUSTMENT BOARD, MARITIME COMMISSION

Mr. BRADLEY. As heretofore stated, the War and Navy Departments and the Maritime Commission are in full accord on the amendments submitted by Judge Patterson yesterday, with one exception.

We do have to object to the War Department's proposed definition of "subcontract." The Navy Department and the Maritime Commission are now in full agreement on a definition. The record should clearly show this, as on September 22, 1942, the situation was other-

wise. Judge Patterson indicated yesterday that the War Department would not force this issue if we insisted on the definition of "subcontract" contained in the Navy draft, Committee Print No. 4. The definition of "subcontract" is the only difference between Committee Print No. 3 submitted by the War Department, and Committee Print No. 4 submitted by the Navy Department.

Our position has previously been stated in a letter from Admiral Land printed in the Finance Committee record of September 22, 1942. The matter is so vital, however, that we feel it necessary to make a further statement.

The definition of the War Department exempts "standard commercial fabricated or semifabricated articles ordinarily sold for civilian use." To this definition we take exception for the following reasons:

One. A merchant ship and its component parts to a considerable degree are "articles ordinarily sold for civilian use."

Senator McKellar. Let me ask you, could you exempt merchant ships from the definition?

Mr. Bradley. I think, Senator, we are very close to an agreement. They indicated they would not push their definition, and the Navy is with us, and when I finish we will ask that they adopt the Navy definition, which is entirely satisfactory to us.

Senator McKellar. All right.

Senator Walsh. What you say in No. 1, in other words, is this—that, so far as the Maritime Commission is concerned, this law would give no benefit?

Mr. Bradley. It would be hurtful because it would exclude most of the work that we are doing.

Senator Walsh. Proceed.

Mr. Bradley. Two. At the present time, by reason of quantity production, the parts of ships going into the Liberty fleet are standardized in the interest of speed and production. When does an article become standard? Is it the first 10 the first 100, or the first 1,000 articles that make them standard? For instance, steel plate, lifeboats, davits, hoists, anchor chains, engines, winches, and so forth are being manufactured today in quantities undreamed of 3 years ago.

Three. The War Department definition will interfere with the administration of the recapture clause of the Merchant Marine Act of 1936. For years a subcontract has been defined by our Regulations to include materialmen under section 505 (b) of that act. Much money has been recaptured where profits exceeded 10 percent of contract price.

That is similar to the Vinson-Trammell Act.

As a result of the Board of Tax Appeals decision in the *Aluminum Company case*, claims for refunds and refusals to repay under the recapture clause are already coming in. These must be resisted by the Commission. If the Congress were now to exclude materialmen in defining "subcontract" for the purposes of Public Law No. 528, section 403, it would seriously impede the adminstration of the recapture provisions of laws previously enacted.

Four. Much has been said to indicate that O. P. A. price ceilings control profits. To this we cannot agree. These ceilings contemplate relatively normal volume. Unanticipated volume under the ceilings may well create excessive profits, for increased volume means lower costs and therefor greater profits. For instance, we are told of an

article with a ceiling price of about $100 per unit. That article is actually being sold to the Government for war purposes for approximately $40 per unit, by reason of large orders. Another instance is a compound with a ceiling price of about $60 per ton. This is being sold in great volume to the Government for war purposes at approximately $20 per ton. Obviously, excessive profits are possible under such circumstances.

Lastly, we believe that Congress intended, by Public Law No. 528, section 403, to provide a method of eliminating and controlling profiteering. We also believe that it intended to equally subject to the law all companies making excessive profits out of the war.

Articles ordinarily sold for civilian use are being sold in great volume for war purposes, some according to special orders, others as usual, but in ballooned volume. Is it fair to say that a manufacturer of ready-made goods, making excessive profits out of the war effort, shall be let alone while his neighbor who is making similar but tailor-made goods must be renegotiated?

We agree with the Navy definition. The War Department indicates that they will accept this definition. So, we ask the adoption of the definition that will permit us to administer Public Law No. 528, section 403 equally and fairly and that will not hamper the effect of existing recapture statutes.

Senator VANDENBERG. Where does it leave basic raw materials?

Mr. BRADLEY. I think it leaves them out.

Senator VANDERBERG. You mean out of renegotiation?

Mr. BRADLEY. Well, under the definition.

Senator VANDENBERG. I mean from your point of view. What do you say about basic raw materials?

Mr. BRADLEY. Basic raw materials?

Senator VANDENBERG. Copper, for instance.

Mr. BRADLEY. The question there is whether you want to renegotiate them or not. I think Congress intended to do it, the way it was originally stated.

Senator VANDENBERG. I am asking you. What happens to basic raw materials under the definition you want?

Mr. BRADLEY. They are excluded.

Senator VANDENBERG. They would not be renegotiated.

Mr. BRADLEY. They would not be renegotiated; no, sir. The article or commodity must be specifically destined to become a component part of the article called for under the contract. You cannot identify raw materials as being specifically destined to go under a particular contract.

Senator MCKELLAR. How would your plan affect the administration of section 403?

Mr. BRADLEY. We think it would help it.

Senator MCKELLAR. You think it would help it?

Mr. BRADLEY. Very definitely, rather than hinder it. It is a broader definition and it permits us to administer it equally and fairly.

Senator MCKELLAR. You do not think it would stop or hinder production?

Mr. BRADLEY. No, sir.

Senator MCKELLAR. You cannot see it that way?

Mr. BRADLEY. We cannot see it that way; no, sir.

Senator VANDENBERG. Where is your definition?

Mr. BRADLEY. It is in the Navy draft, No. 4, committee print No. 4.

Let me give you an example. It does two things. Let us take a boiler manufacturer who has a contract for 100 boilers. Due to the tremendous volume, he parcels out part of that contract to another contractor to produce the same article called for under the original contract.

This definition puts the man who normally would be a subcontractor on the same level as the original prime contractor, because as part of the war effort, his subcontract calls for the identical article that was called for in the original prime contract, finished, complete, ready for delivery. Then we take his subcontractors, and put them in the same position that the subcontractors, the term including material men, would be under the original prime contract.

Senator WALSH. Those manufacturers of parts, in the illustration you gave, are they subject to this law under the Army amendment?

Mr. BRADLEY. No, sir.

Senator WALSH. Isn't it possible, using your illustration, for collusion to exist between the contractor of the boiler who sells the boiler to the Government, and the contractor from whom he gets these parts, isn't there an opportunity for hidden profit there?

Mr. BRADLEY. Yes; but not under our definition.

Senator WALSH. No; that seems to be the weakness in the Army amendment.

Mr. BRADLEY. That was brought out by Commander Brown, assistant general counsel, on the 22d, when he spoke of the corporate family. You should look at the whole picture.

Senator MCKELLAR. Let me say this: I am tremendously interested in you gentlemen getting together on this amendment, because I feel quite sure that all of you want to have the best and fairest possible administration of this law. I am convinced of that by what you are doing and what you are saying.

Now, can't you get together with these gentlemen and agree? I am talking to all as well as you, in asking this. I want you to get together.

Senator WALSH. Didn't I understand the Army to say that there was a question of policy here? That if the committee and the Senate accepted the Navy point of view, they would not object?

Mr. BRADLEY. I so understood it, Senator.

Senator WALSH. But they wanted to put the two alternatives before us for our study and consideration.

Mr. BRADLEY. Yes, sir.

Senator WALSH. But I do not understand there is any hostility between you.

Mr. BRADLEY. Oh, no.

Senator WALSH. Or that there is direct and complete opposition to this proposal of the Maritime Commission and the Navy.

Mr. BRADLEY. No; our relations are entirely cordial and we are in thorough and complete cooperation.

Senator WALSH. And it is very proper to put it before the committee.

Mr. WILLIAM L. MARBURY. Purchases Division, Legal Branch, War Department. I do think that it might be well for us to sit down and see whether or not, in the light of the situation, we might agree on

some slight change in the wording of the Navy amendment which would accomplish the result, and I would like to suggest that we do that today.

Senator WALSH. Speaking for ourselves, I think Senator Vandenberg and the other members agree that our disposition is to reach out, as far as possible, to limit profits. Isn't that right, Senator Vandenberg?

Senator VANDENBERG. Totally so; so long as you don't impair the war effort, and so long as you do not drive war contractors needlessly crazy.

What I would like to know is, under the Navy definition, what would be excluded from renegotiation which is now included?

Mr. KENNEY. Those articles not specifically destined to become a part of an article called for under an original contract.

Mr. BRADLEY. Senator Vandenberg asked specifically what articles would be included under our definition.

Senator VANDENBERG. Excluded under your definition, which are now included in renegotiation.

Mr. KENNEY. The definition that has been included in the committee print No. 4 is the same definition of subcontractor that we had been using prior to the *Aluminum Co. case*, and that definition includes the first tier of subcontracts below the prime contractor, with three minor exceptions. One with reference to supplies, materials, articles, or equipment specifically destined to become a component part. In other words, if you have a particular type of aluminum forging or steel forging that is only manufactured for a war product, that is a subcontract within the meaning of that statute, even though it may be below the first tier. Then there are two other instances. Where a subcontractor is selling a finished article, is furnishing a portion of the finished article that the prime contractor is furnishing, any contract he enters into is likewise classified as a subcontract.

In other words, if A has a contract to furnish 100 automobiles to the Government and he sublets a portion of that contract to furnish 50 of those automobiles to the Government, any contract of the person who is to furnish the 50 makes is also a subcontract.

Senator VANDENBERG. Take copper, would that be a prime contract or a subcontract?

Mr. BRADLEY. The purchase of copper would in most instances probably be excluded from the sttaute because copper would probably not be purchased raw by the prime contractor.

Senator WALSH. It would be processed before the prime contractor purchased it?

Mr. BRADLEY. Yes.

Senator MCKELLAR. And therefore come within this law.

Senator VANDENBERG. On the contrary, it would not. Does it, or doesn't it?

Mr. KENNEY. I would say it would not unless the raw material was sold directly to the prime contractor.

Senator WALSH. On your amendment, it would be.

Mr. BRADLEY. It would be if you could identify its destination as being under a war contract; merely identify it. Usually you can't from our standpoint. The War Department may have a different slant on it, because they will run into a different type of contractor.

Senator McKellar. How would the lumber equation work out there?

Mr. Kenney. Lumber would be included within the definition of subcontract if lumber was sold to the prime contractor.

Senator Vandenberg. It seems to me that there is a reason for treating raw materials differently than finished products, particularly in metals and ores the raw material is recognized by this committee as being a product which is not replaced, and going back to copper, it is mined once, and that is all there is to it, and we recognize the depletion involved, and I don't believe that technical consideration ought to be submitted to renegotiators.

Mr. Kenney. May I point out also, Senator Vandenberg, that in paragraph I of the statute, there has been excluded from the purview of the statute agreements for commodities, the minimum price for the sale of which has been fixed by a public regulatory body. That will, in itself, exclude a certain number of raw materials, we believe. The Bituminous Coal Act establishes a minimum price at which coal may be sold, so that would be excluded under that section.

Senator Vandenberg. Well, the whole point is that we have spent a week in this committee on the tax bill, trying to legitimately recognize the fact, but there are some raw materials which when, once produced, are really a drain upon the capital account, and we allowed definite and specific consideration for it.

Senator McKellar. Depletion.

Senator Vandenberg. Depletion is one phase of it. I don't believe that a thing as technical as that, as it has been demonstrated to be in our hearings, could possibly be adequately considered by renegotiators who have no intimate professional information on the subject.

Mr. Bradley. It is a vanishing asset.

Senator Vandenberg. A vanishing asset is the thing I am talking about.

Senator Walsh. Take the case of lumber. If the prime contractor purchases the lumber it is subject to renegotiation but if the prime contractor purchases the lumber in crates, it is not subject to it, not subject to renegotiation.

Senator Vandenberg. I think it would be fine if you could get together on a decision.

Mr. Kenney. I think you will find under a practical application of the Navy definition of "subcontract" that most raw materials will be excluded, unless it falls into the two categories, that it has been specifically destined to the finished article, or it is sold directly to the prime contractor.

Senator Vandenberg. I can see the necessity for a little latitude at that point, but I can't see any justice in submitting vanishing assets to a renegotiator who cannot possibly be competently equipped to deal with the vanishing-asset value.

Mr. Kenney. Well, that is particularly true, Senator, where a price at which that has been sold has been fixed by a public regulatory body.

Senator Vandenberg. It is true in almost every instance.

Mr. Kenney. It is certainly true of gold and silver but there would be nothing——

Senator Vandenberg. Please don't talk about gold and silver if you are talking about doing something to profiteers.

Senator Walsh. Does the Navy desire to be heard?

Mr. Kenney. I am from the Navy, Senator.

Senator WALSH. Do you desire to make a statement?

Mr. KENNEY. No.

Senator WALSH. Will you make an effort to reach an agreement?

Mr. KENNEY. Yes, sir; we will.

Senator WALSH. And submit it to the committee. Is there anyone else who desires to be heard?

(No response.)

Senator VANDENBERG. Are there any of the critics of the bill to be heard?

Senator WALSH. May I suggest that in the record you will find proposed amendments from manufacturers and producers and that you gentlemen study them and give us your views about them, and there will be put in the record today some further amendments, that are proposed by other than department representatives, and I suggest that they be studied and that your views be presened to the committee.

Mr. MARBURY. We will present you with a statement on our position on the amendments, sir.

Senator WALSH. We will now hear from Mr. Foreman.

STATEMENT OF H. E. FOREMAN, MANAGING DIRECTOR, THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC.

Senator WALSH. State your full name for the record, please.

Mr. FOREMAN. Herbert E. Foreman, managing director of the Associated General Contractors of America, Washington, D. C.

Senator WALSH. That association includes what kind of contractors and how many?

Mr. FOREMAN. We have a membership of approximately 3,000 that are doing about 80 percent or better of the war construction work throughout the United States.

Senator WALSH. You may proceed.

Mr. FOREMAN. This law, as now constituted, has developed many serious problems as the same applies to construction contractors. The continuing contingency until 3 years after the war affects the credit of construction contractors and consequently their capacity to handle war construction work. Furthermore, the law is not clear as to the liability of the prime contractor for such excess profits as may be found to have been paid to a subcontractor.

The law is not clear and, in fact, appears contradictory with regard to the size of contracts to be subject to its provision. While only contracts of $100,000 or more are to contain a renegotiation provision, the policies and procedures issued by the War Department point out that this does not mean that contracts smaller in scope are not likewise subject to renegotiation. It is difficult to understand such a circumstance where one contractor is placed on notice is not required with respect to another class of contracts, yet all are subject to the same procedures.

The law, as presently in effect, does not limit the number of renegotiations that may be had nor provide a means for making any renegotiation final until the law shall run its course, namely, 3 years after the war.

The law is not absolutely clear as to whether individual contracts are to be renegotiated separately or all contracts held by a given contractor are to be renegotiated collectively and there is a probability

that it can and may be done both ways with respect to the same contracts and the same contractor.

The present law does not make proper provision for the handling of tax reports and the payment of taxes. The present law does include a retroactive feature imposing a new condition on contracts in existence as of April 28, 1942. Under the present law every contract subject to it becomes a cost-plus contract—the type of contract that the Congress determine to bar at the time that the defense program was first undertaken. If the committee feels that the war effort is advanced by the retention of this law, then substantial amendments should be made so as to clarify and correct the ambiguities and injustices arising from the present law.

Study has been given to the proposed amendments presented by the War Department and largely concurred in by the Navy Department and the Maritime Commission. While these do to some extent clarify patent ambiguities in the present law, they generally do so at the expense of placing almost unlimited discretion in the hands of the various departments. They provide quite unusual powers to exempt certain classes of contracts without clear definition as to the types and would appear to place the administrative officials in a rather precarious position in making these determinations.

These proposed amendments do not yet spell out in so many words the exact liability of a given contractor for excess profits held by a subcontractor. They do not indicate how far back along the line the renegotiation shall carry, whether only to the subcontractors of the second degree or on back to the third, fourth, and fifth, until the point is reached where raw materials are obtained.

There is no ample clarification as to the position of contracts less than $100,000. As a matter of fact, there is a definite new ambiguity in that all contracts over $100,000 must include a renegotiation clause, while it is otherwise proposed that if the total volume of business did not exceed $250,000, there should be no renegotiation.

Under this circumstance, a given contractor might have a single contract over $100,000, containing the renegotiation clause, but less than $250,000 and thereby not subject to renegotiation. While, on the other hand, another contractor might have many contracts of less than $100,000, none of which contained the renegotiation provisions in the contract—the total would exceed $250,000 and as a consequence, under present interpretations, would be subject to renegotiation.

With respect to clauses of contracts subject to renegotiation, it is recommended that all construction contracts let on a fixed-fee basis be specifically exempted from renegotiation, either separately or in conjunction with other contracts, for the reason that the fixed fee is a service fee and not a profit and has already been certified to by the Secretary of an appropriate department as being within the limits set by Congress and as being reasonable and that the best interests of the United States would be served by letting the particular contract on such basis.

A great many construction contracts have been let and are being let as a result of competitive bidding. The competitive bidding procedure long ago set up up as a proper means of safeguarding public interests in the procurement of construction needs of the Government. The successful bidder being the low bidder has already saved the Government money to the extent that his bid is less than that of his

competitor. He has assumed all risks and has guaranteed his performance with a surety bond.

It would appear that there is no reason to renegotiate other than contracts which were originally negotiated, that is, neither secured after competitive bidding nor on a known fee.

In the testimony of the War Department it was noted that there was an intention to consider all of the contracts held by a given contractor and renegotiate these at the same time. This may be a proper procedure on contracts for manufactured products, but it should not be standard and subject to no flexibility with regard to construction contracts. An option should be provided to renegotiate the individual contract or handle them collectively as might appear just and equitable.

The reason for this assertion is that, in order to handle the unusually large projects under the war program, it has been necessary for contractors to form combinations in the form of joint ventures. Thus we have a circumstance that three or four contractors may undertake a single job jointly, one or more of whom are partners of other joint ventures with entirely different partners. Thus a very complicated and impossible situation will result unless an optional provision is inserted.

On the subject of contracts on which the final estimate has not been paid on April 28, 1942, making these all subject to the renegotiation clause—this presents a serious situation with respect to contract law and upsets one of the cardinal principles on which all contracts are founded.

With regard to construction contracts, there are many situations where the work was entirely or substantially completed at the time that this law was passed and the final estimate was being held up pending adjustment of minor items. There are many cases where the adjustment of these final items was held up unusually long because of the volume of work being handled by the departments concerned and where, under ordinary circumstances, payment would have been made and the law would have no application.

It is recommended that the committee give consideration to some provision with respect to contracts which had been substantially completed at the time the law was passed. Without a doubt the most needed amendments are those which would cast out all construction profits upon which tax reports and payments have been made prior to the passage of the law, and in order to fix a definite time during which renegotiation shall take place and in order that the taxpayer may know on what he must make his future tax report. Such an amendment would appear to be of first importance to this committee in order to facilitate the operation of the revenue laws and to avoid the necessity for credits and offsets, and so forth.

It is desired here to offer a specific amendment which it is believed will completely be germane to the subject of the revenue laws and which will clarify the position of the taxpayer to a major degree. The amendment is as follows:

Section 403, Public, 528, shall be administered so as to facilitate tax reports and collections under the revenue laws. To enable the taxpayer to report earnings for the taxable year such renegotiation of contracts as are authorized under section 403, Public, 528, shall be had previous to the date before which a taxpayer must make report under the revenue laws on earnings from such

contracts for the taxable year, and such renegotiation shall not consider profits earned or reported during a previous taxable year. Any such renegotiation shall be final and conclusive for the taxable year after the last filing date for a taxable year.

That is the extent of my statement, Mr. Chairman.

Mr. MARBURY. We should like to have an opportunity to study the statement and make a reply.

Senator WALSH. That will be permitted, and the reply will be welcome.

Are there any questions to be asked of the witness?

Senator MCKELLAR. I would like to have a copy of the statement, if I may.

Senator WALSH. Have you extra copies of your statement?

Mr. FOREMAN. I have. I notice there are some typographical errors in one or two places, but I think it is reasonably intelligible.

Senator WALSH. Very well.

Mr. FOREMAN. Thank you, sir.

Senator WALSH. Do any of the departments desire to make a comment on the statement just made? That will be made later, I assume. That will be all.

I want to put in the record a letter and statement from the American Institute of Architects.

(The letter and statement above referred to are as follows:)

STATEMENT OF THE AMERICAN INSTITUTE OF ARCHITECTS

SEPTEMBER 29, 1942.

Hon. DAVID I. WALSH,
Chairman, Subcommittee of Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR WALSH: The architects and the engineers are very much worried by the wording of the proposed draft on profit limitation, which is under consideration by your subcommittee.

No doubt the subcommittee's attention has been principally concentrated on the limitation of profits of manufacturing concerns and construction contractors, but it appears to us that the wording of the draft is such that, if passed in this form, the many contracts between the Army, the Navy, and some other agencies and architects and engineers for professional services might be subject to the same interpretation as to limitation of profits—that is, limitation to 5 percent of their costs in their own offices and field organizations.

Such a limitation would be analogous to limiting a lawyer to a personal compensation of 5 percent of the cost of operating his own office, and it would seem to us to be obvious that no lawyer, doctor, or other professional man could hope to stay in business on this basis.

We attach a statement on this subject, which we hope you will present for your subcommittee's consideration in this connection. For the convenience of the members of the subcommittee, we are taking the liberty of sending copies of this letter and statement to them.

The writer is ready to confer with you briefly on this subject at any moment, at your convenience, if you will be kind enough to spare this time in the interests of the body of architects in this country.

With kindest regards,

Very sincerely yours,

D. K. FISHER, JR.,
Washington Representative, The American Institute of Architects.
SEPTEMBER 29, 1942.

PROFIT LIMITATION—STATEMENT FROM THE WASHINGTON REPRESENTATIVE OF THE AMERICAN INSTITUTE OF ARCHITECTS RE OUTLINE DRAFT OF PROPOSED TAX LIMITING EXCESSIVE PROFITS AFTER OTHER TAXES DATED SEPTEMBER 7, 1942

1. The proposed draft appears to include contracts furnishing professional services only, on the same basis as contracts furnishing manufactured articles (guns, tanks, etc.) or construction.

2. Contractors furnishing professional services only, such as architects, engineers, and lawyers, use a negligible amount of materials or of capital in the process of furnishing their personal services. Their costs are wholly overhead costs (such as rent, heat, light, telephone, etc., for their offices; stationery, drafting supplies, and so forth; authorized travel expenses, and so forth) and the salaries of employees (relatively very few in number compared to labor pay rolls in manufacturing or construction).

3. In the majority of contracts for professional services on war projects, the basis of compensation is either (*a*) a fixed fee, or (*b*) reimbursement of certain of the costs, plus a fixed fee, the latter to cover many of the overhead costs and all of the personal compensation of the principals furnishing the services.

In most instances, the fixed fee item is determined by the Army, Navy, or agency officer concerned at rates far lower than have been established by years of accepted peacetime practice.

4. The established peacetime practice has been that compensation for professional services be determined by a percentage of the cost of the project designed (not by the costs of the designer's services). Such fees have varied from 6 percent or more of the cost of small projects to as low as 1¼ percent on very large or repetitive projects.

5. The compensation of architects and engineers has been notoriously modest, even in the best of times, and these practitioners have weathered their lean years only by accepting privations to which comparably educated and experienced persons in industry and business are not accustomed. It must be obvious that if this condition has obtained, on fees averaging, say, 4 percent of the cost of the projects they have designed, they cannot now hope to remain in practice of their professions and in readiness to serve their country, if their compensation is limited to 5 percent of whatever portion of that assumed average fee was their actual former profits.

6. Of the approximately 15,000 registered architects recently in practice, a large number have already been forced out of practice by the restrictions on critical materials. The services of the remaining stronger offices can only continue to be available in the war effort, if the principals are permitted to continue to make a fair modest income.

7. It is requested that specific attention be given to this subject in the wording of legislation, and that the high standards of architectural and engineering services be not completely destroyed by inadvertent inclusion of their contract relations to the war effort in provisions intended to regulate quite different conditions.

D. K. ESTE FISHER, Jr.,
Washington Representative, The American Institute of Architects.

STATEMENT OF LARUS & BRO. CO., INC.

UNITED STATES SENATE,
COMMITTEE ON RULES,
September 29, 1942.

Hon. DAVID I. WALSH,
United States Senate.

MY DEAR DAVID: Enclosed is a letter I have received from Mr. W. Brooks George, Larus & Bro. Co., Inc., Richmond, Va.

I shall appreciate your kindness in writing Mr. George.

With best wishes, I am,

Faithfully yours,

HARRY F. BYRD.

Enclosure.

LARUS & BRO. CO., INC.,
Richmond, Va., September 28, 1942.

Re renegotiation of war contracts.

Senator HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: On Tuesday, September 22, Mr. William L. Marbury, Purchasers Division, Legal Branch, Service of Supplies, War Department, appeared before the Senate Finance Committee concerning renegotiation of war contracts. From page 38 of the September 22 report, Hearing Before the Committee on Finance, United States Senate, we quote a statement by Mr. Marbury:

"If a statutory definition is adopted, it might properly exclude agreements for raw materials or standard commercial fabricated or semifabricated articles. The prices of articles of this character are subject to regulation by the Office of Price Administration and are reasonably susceptible of such generalized treatment. Any excessive profits resulting from increased volumes of such business can be satisfactorily handled by the excess-profits tax. If the contracts and purchases of these supplies and materials are excluded, renegotiation will be limited to prime contracts and to subcontracts with those doing specialized war work."

From the above we believe it is the intention of the War Department to exempt from renegotiation all war contracts for raw materials or standard commercial fabricated articles ordinarily sold for civilian use, subject to regulation by Office of Price Administration.

On pages 44 and 45 of the hearings Mr. Marbury filed with the Senate Finance Committee suggested amendments to the Renegotiation Act, but it does not seem to us that he has definitly cleared up his intentions as they were stated on page 38. Under "Exceptions," paragraph 4 (b) of Mr. Marbury's suggested amendments, we have added an additional suggested amendment, 4 (b) (3), which we believe will definitely clear up this problem.

If it is still the intention of the War Department to exclude standard fabricated articles subject to Office of Price Administration ceiling prices, we would like to see this amendment, 4 (b) 3, adopted and made part of the Renegotiation Act.

With best wishes,

Cordially yours,

LARUS & BRO. CO., INC.,
W. BROOKS GEORGE,
Assistant to Vice President.

RENEGOTIATION OF CONTRACTS

(P. 45)

* * * * * * *

4. EXCEPTIONS

A new subsection (i) is added at the end of the present statute permitting certain exemptions from its terms.

(a) Governmental contracts: The contracts with any Federal or local agency or any foreign government are completely exempted.

(b) Permissive exceptions: The Secretary is authorized to exempt—

(1) Contracts to be performed outside the United States; and

(2) Contracts where the profits can be determined with reasonable certainty when the price is established, such as certain classes of agreements, specified in the statute as agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of 30 days.

(3) Contracts for raw materials or standard commercial fabricated or semi-fabricated articles, ordinarily sold for civilian use subject to regulation by the Office of Price Administration or other Fedeal authority where the contract price is at or below the maximum ceiling price fixed by such authority and prevailing during the life of such contract or contracts.

AMENDMENTS SUBMITTED BY MINNESOTA MINING & MANUFACTURING CO., ST. PAUL, MINN.

AMENDMENT

to section 403 of Public Law No. 528, approved April 28, 1942, Seventy-seventh Congress, second session, suggested by John L. Connolly (representing Minnesota Mining & Manufacturing Co., St. Paul, Minn.

PROPOSED AMENDMENT

Add the following as paragraph 5 to section 403 (a):

"(5) The term 'subcontract' means any purchase order or agreement with a prime contractor to perform all or part of the work or to make or furnish any article required for the performance of a contract with the Government, except orders or agreements to furnish (i) raw or natural resource materials; (ii) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use; (iii) articles of a type not specially designed for the performance of such contract with the Government by a prime contractor; or (iiii) articles for the general operation or maintenance of the contractor's plant. The term 'article" includes any material, part, appliance, assembly, machinery, supply, equipment, or other personal property."

EXPLANATION

1. The amendment above proposed confines subcontracts to those of the first degree. Subcontractors of subcontractors are excluded. It is believed that confining renegotiation to prime contractors and subcontractors of the first degree will adequately serve the purposes of the Government. Extending renegotiation to subcontractors of the *n*th degree would immeasurably increase the work of the Government without affording proportional benefits. It is impossible to predict the volume of and the time required to renegotiate all contracts that in some degree or other are connected with the war effort or have to do with work or materials flowing into that effort.

2. The amendment proposed eliminates consideration of subcontractors who are materialmen. In general, maximum prices are set for materials that are furnished to prime contractors. The fixation of these maximum prices necessarily affords protection to the Government and sufficiently prevents excessive profits arising out of contracts dealing with materials.

3. The amendment proposed says that no one who furnishes "articles of a type not specially designed for the performance" of a prime contract is to be considered as a subcontractor. Cost figures and profits relating to furnishing of articles not so designed, but so designed that they are suitable for civilian use, could with reasonable certainty be ascertained by both the prime contractor and the materialman on the contract date. The elements of speculation and prophetic estimation as to probable costs and profits that attend the proposed manufacture and delivery of an article of special design for a Government contract and therefore the contract price are absent where the article is not so specially designed.

4. The amendment proposed leaves to taxation the recapture of profits made by those dealing with the prime contractors who do not fall within the definition of a subcontractor. This is a salutary purpose. It is believed that section 403 never would have been enacted if it had been more fully realized that recapture of profits could be adequately accomplished by taxation. The more the accomplishment of the Government's objectives can be left to the more definite machinery and processes of taxation, the better will be the general results and the more business incentives will be maintained and fostered.

5. Greater certainty is required in the provisions of the act, and the proposed amendment furnishes this in part.

JOHN L. CONNOLLY,
Vice President and General Counsel,
Minnesota Mining & Manufacturing Co. of St. Paul, Minn.

SEPTEMBER 29, 1942.

STATEMENT OF POLICY OF THE BUREAU OF INTERNAL REVENUE

Advice is requested as to the policy of the Bureau of Internal Revenue with respect to the adjustment of income and excess-profits taxes in cases in which Government war contracts are renegotiated and it is determined by the renegotiating department or agency that excessive profits have been, or are likely to be, paid to the contractor or subcontractor, and in cases where, pursuant to action by the Comptroller General, an item for which a taxpayer has been reimbursed is disallowed as an item of cost chargeable to a cost-plus-a-fixed-fee contract, the taxpayer being required to repay to the Government the amount of such disallowance.

Under title IV of the Sixth Supplemental National Defense Appropriation Act, 1942 (Public Law 538, 77th Cong., 2d sess.), certain Government departments or agencies are authorized and directed to require contractors or subcontractors to renegotiate the contract price with respect to designated contracts and subcontracts in case any amounts or excessive profits have been, or are likely to be, realized therefrom and to recover such excessive profits paid, or to withhold payment if the profits have not been paid.

The determination of the amount of the excessive profits and the making of an agreement with the contractor or subcontractor in regard to the method by which repayment to the Government of the excessive profits is to be effected are matters within the jurisdiction of the particular renegotiating department or agency. The Bureau of Internal Revenue has no authority to function in the determination or collection of these excessive profits. The Bureau, however, upon request of the parties to the renegotiation will advise them of the manner in which the renegotiation will affect the contractor's Federal income and excess-profits taxes.

The determination of tax liabilities and the collection thereof are under the administration of the Bureau, together with the making of rulings and closing agreements, under section 3760 of the Internal Revenue Code, with the taxpayer with respect to either actual tax liability for any taxable year or prospectively with respect to proposed transactions.

In case the renegotiating agreement provides for reduced contract prices to be retroactively applied to prior taxable years for which returns have been filed and the income and excess-profits taxes paid or assessed, repayment to the Government of the excessive profits on which such taxes have been paid or assessed will be involved in the settlement. This raises the question, "If the contractor or subcontractor repays the entire amount of such excessive profits to the Government, should the Bureau be required to refund the income and excess-profits taxes paid on such excessive profits?" The position of the Bureau is that only the amount of such profits in excess of the Federal income and excess profits taxes paid or assessed thereon should be repaid by the contractor or subcontractor, and no refund or abatement of such taxes should be made, since the taxes should be considered as a recapture of a portion of the excessive profits and as such a proper offset against the total excessive profits. The remainder of the excessive profits would be recaptured through repayment thereof to the Government by the contractor or subcontractor. The repayment should not be allowed as a deduction in the income and excess-profits tax returns of the taxpayer for any taxable year. To do so would result in a double tax benefit where the income and excess-profits taxes have been offset against the excessive profits. Even though the right to such offset is foregone by the taxpayer and the offset is not made, the repayment should not be allowed as a deduction in the taxpayer's returns, since the taxpayer should not be permitted to forego the right to the offset for the sake of obtaining a deduction for a year for which the deduction

will result in a greater tax benefit. This may be illustrated by the following example:

Example.—The M Corporation filed a return for the calendar year 1941 on March 15, 1942, reporting therein an amount of $1,000,000, which was subsequently in the year 1942 held by one of the designated renegotiating agencies to be excessive profits realized in performance of a contract, on which excessive profits income and excess-profits taxes aggregating $400,000 were paid. The $400,000 taxes should not be refunded and the remainder of the excessive profits, or $600,000, should be repaid by the corporation to the Government. The amount of $600,000 repaid to the Government will not constitute an allowable deduction from gross income for any taxable year. This produces the correct results. Excessive profits, before Federal taxes, of $1,000,000 would have been recaptured by the Government, $400,000 through the medium of taxes and $600,000 by direct repayment to the Government, with no aftermath affecting Federal taxes. To hold otherwise, for instance, to hold that the $1,000,000 should be repaid to the Government and allow such repayment as a deduction for income tax purposes for the year 1942, when the effective rate of tax, for example, is 75 percent, would produce the following incorrect result: The tax benefit in 1942 would be $750,000. The taxpayer would have paid $1,400,000 to the Government and derived a tax benefit of $750,000. The taxpayer, therefore, would have paid only $650,000 net to the Government, whereas the excessive profits admittedly were $1,000,000. Different results would be obtained in other cases depending upon the factors of income and effective rates of taxes being different from those in this example.

In case the renegotiating agreement determines reduced contract prices to be charged during the year of the agreement or subsequent thereto, or a repayment is to be made in lieu thereof which is not applicable to profits for a year for which an income tax return has been filed, and on which profits income and excess-profits taxes have not been assessed or paid, gross income to be reported in the returns for such years should be reduced to conform with the reduced prices, or in case of repayment, a deduction may be taken in computing net income, provided excessive profits determined to have been realized and received by the taxpayer are repaid to the Government. Likewise, in case the reduced contract prices are determined for the immediately preceding taxable year or repayment is to be made in lieu thereof, and the income and excess profits tax returns for such year have not been filed at the time of such determination, the gross income for such preceding year may be reported to conform with the reduced prices agreed upon, or a deduction may be taken in computing net income, as the case may be, provided the taxpayer repays to the Government the excessive profits determined to have been realized. No deduction from gross income will be allowed for any other taxable year for the amount of such excessive profits so repaid. This may be illustrated by the following example:

Example.—The X Corporation filed a return for the calendar year 1942 on March 15, 1943. In February 1943 it was determined that the taxpayer had realized during 1942 excessive profits in the amount of $1,000,000 and the parties agree that during 1943 repayment of such excessive profits will be made to the Government in designated amounts per month until the entire amount of the $1,000,000 excessive profits is repaid. The gross income to be reported by the corporation in its return for 1942 should not include the $1,000,000, and no tax attributable to excessive profits will thus be assessed or paid. No deduction from gross income will be allowed for any year for the amount of the excessive profits excluded from gross income and repaid to the Government.

In cases of renegotiation agreements with respect to years for which income and excess-profits tax returns have not been filed and income and excess-profits taxes not assessed and paid, the reduction in gross income may be made, or the deduction may be taken in computing net income, as the case may be, although the renegotiating agreement has not been completed, provided at the time of filing the return the negotiations have progressed to such a stage that the amount of the reduction in gross income, or the amount of the repayment in lieu thereof, is certain, and in filing the income and excess-profits tax return such reduction is made or such deduction is taken.

The Bureau, upon request of the parties to the renegotiation, in any case will advise them relative to the amount of excessive profits previously recaptured through the medium of income and excess-profits taxes paid thereon.

In addition to the above stated considerations for the basis of the position of the Bureau that refunds of income and excess-profits taxes should not be allowed in such cases, it may be stated that if the Bureau should be required to make refunds of the taxes paid on excessive profits repaid to the Government because such excessive profits have been determined before the taxes, instead of after the taxes, entirely ignoring the previous recapture of a portion of the excessive profits through the medium of such taxes, and appropriation from Congress to provide funds for such refunds would be necessary. The estimate of the sum necessary for such purpose logically would be based upon information from the negotiating agencies relative to the income and excess-profits taxes paid on the excessive profits recaptured by such agencies without reducing the excessive profits by the amount of such taxes previously paid thereon.

What has been said above applies with equal force to cases involving a cost-plus-a-fixed-fee contract where an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to such contract and the taxpayer is required to repay to the United States the amount disallowed.

PROPOSED AMENDMENTS

SEPTEMBER 28, 1942.

RENEGOTIATION OF CONTRACTS

Amendment of the renegotiation statute is needed to cover specifically the following:

1. The exemption from renegotiation from the term "contract" and/or "subcontract" (including contractor and subcontractor) of raw materials or standard commercial articles.

In lieu of the amendment proposed by Mr. Marbury, War Department, and set out on page 41 of the hearings before the Senate Finance Committee, revised September 22 and 23, 1942, the following amendment is suggested as preferable thereto.

[NOTE.—The subdivisions are marked with the letters and figures which they would carry in the section.]

"(a) (5). The term "contract" or "subcontract" shall apply to any agreement or purchase order to supply articles to the War Department, Navy Department, or Maritime Commission, or to any agreement to perform all or any part of the work required for the performance of another contract except to agreements or purchase orders to furnish (i) raw materials when unalloyed or unprocessed beyond the final refining in commercial shapes or final treatment process of the natural element, (ii) standard commercial fabricated or semifabricated articles ordinarily sold for civilian use and with respect to which at the time of making the agreement or placing the purchase order there was a general market price or a recognized differential therefrom or a ceiling price fixed by a Federal governmental agency, or (iii) articles for the general operation or maintenance of a plant owned by the contractor or subcontractor in those cases in which the Government is not obligated to reimburse the contractor or subcontractor for all cost of such articles. The term "article" includes any material, part assembly, machinery, equipment, or other personal property."

With this amendment, clause (f) of section 403 of the Sixth Supplemental National Defense Appropriation Act, approved April 28, 1942, should also be amended, by adding at the end thereof the following sentence:

"(f) In every case in which renegotiation shall take place under this Section the contractor or subcontractor shall be permitted to retain out of his profits for the period covered by the renegotiation—after due allowance for all taxes—a sum equal to not less than 5% of the combined net sales price of his war materials on which profits were realized during the period."

The "natural-resource products" amendment placed in the hearing record (supra, p. 57) by Senator George would be helpful with perhaps some refinement of language to make certain that it covers situations outlined in subdivisions (i), (ii), and (iii), as referred to in the first amendment set out herein.

The following amendment to section 403 (a) of the present renegotiation law would correlate therewith the profit limitation provision, after taxes, on volume of business as provided by Senator George's proposed bill on this, and it may be simpler to work this into the present renegotiation statute than to have it repealed and the profit limitation bill enacted. Subdivision (b) of this amendment seems fair in that it applies the average normal profit, after taxes, per unit of production of a particular commodity which in the normal case would be a standard article in volume of production during the years 1937–40, inclusive. This amendment would be in lieu of those heretofore suggested, and reads as follows:

"SEC. 403. (a) For the purposes of this section, the term 'Department' means the War Department, the Navy Department, and the Maritime Com-

mission, respectively; in the case of the Maritime Commission, the term 'Secretary' means the Chairman of such Commission; the terms 'renegotiate' and 'renegotiation' include the refixing by the Secretary of the Department of the contract price; *and the term 'excessive profits' means profits in excess of the higher amount of the following: (a) 6% on sales after all taxes, or (b) average normal profit, after all taxes, per unit of production of a particular commodity, as determined for the pre-war years of 1937–1938–1939 and 1940.* For the purposes of subsections (d) and (e) of this section, the term 'contract' includes a subcontract and the term 'contractor' includes a subcontractor."

2. Authority in the War and Navy Departments and Maritime Commission to give a taxpayer an agreement or certificate of final renegotiation except in the case of fraud or mutual mistake of fact. The procedure for securing such final renegotiation certificate or agreement should not be complicated or too cumbersome.

3. Authority in the War and Navy Departments and Maritime Commission for over-all renegotiation of contracts on an annual or fiscal year basis of the taxpayer.

4. Provision eliminating from the renegotiation requirement and procedure, all contracts or subcontracts less than $100,000. This is needed to make the renegotiation problem of the departments workable and administrable. Such a provision would eliminate a great many of the contracts and enable the departments to concentrate their renegotiation work on the large and substantial contracts. The high corporate normal, sur-, and excess-profits tax rates will operate with sufficient impact on the small cases to warrant their exclusion from the renegotiation provision.

5. The War and Navy Departments and Maritime Commission should be required to issue regulations governing policy and procedure for renegotiation of contracts so that this information is available as a guide to the public.

STATEMENT OF TREASURY DEPARTMENT ON PROPOSED AMENDMENTS

GENERAL COUNSEL,
TREASURY DEPARTMENT,
Washington, October 2, 1942.

Hon. DAVID I. WALSH,
United States Senate, Washington, D. C.

MY DEAR SENATOR: In connection with the deliberations of the subcommittee of the Finance Committee designated to consider amendments to section 403 of the Sixth Supplemental National Defense Appropriation Act, you have requested the comments of the Treasury Department with respect to the suggested amendments to that act contained in "Committee Print No. 5."

While the amendments contained in this print differ in many details from the amendments which have been proposed by the War, Navy, and Treasury Departments and by the Maritime Commission, I shall confine my comments to what I believe to be the salient feature of Committee Print No. 5. I refer to the proposal to limit the definition of excessive profits in such a way as to leave subject to renegotiation only those profits which exceed 5 percent of the contractor's total war business after deduction of Federal income and excess profits taxes.

In the testimony of Mr. Robert Eichholz of this Department before the subcommittee on September 30, he indicated that the problem of securing war materials as cheaply as possible involves more than taxation and profit limitation alone. In cases in which the Government is being charged an excessive price for implements of war, the contractor's profit is only one of the cost elements of such price. The excessiveness of profits, by which I mean the amount remaining to the contractor after deduction of all direct and indirect manufacturing costs, will be adequately controlled by the excess profits tax amendments agreed upon by the Finance Committee, while the contractor will at the same time be left an adequate incentive to efficient and economical operation. Mr. Eichholz also pointed out that a flat profit limitation provision does not serve to control cost elements other than profits. Indeed, such a limitation may often operate to increase such cost elements because it eliminates incentives to efficiency and thereby encourages wasteful expenditure of labor and materials. He stated that it was, therefore, the view of the Treasury Department that a flat profit limitation provision would be an undesirable substitute for section 403. Admittedly, if section 403 is so administered as to take into account only a contractor's profits and to limit those profits by agreement, the section is open to the same objections as may be made to a profit limitation provision. The Department feels, however, that section 403 offers a real possibility of an effective approach to the problem of controlling excessive prices if such prices are renegotiated primarily with an eye to the reasonableness of all elements of cost.

Committee Print No. 5 in effect incorporates in section 403 the evils of a flat profit limitation provision, in that the contractor is guaranteed a return, after deduction of Federal taxes, of 5 percent of his sales. It is thus open to the same criticisms which are applicable to profit limitation. Under the provisions of the print, no matter how excessive a price may be, no renegotiation may be undertaken if the contractor's profits do not exceed the 5-percent figure. The renegotiating agencies are thus forced to look primarily at the contractor's profits rather than to the reasonableness of the costs for which he is being reimbursed by the Government.

Furthermore, the 5-percent figure appears to be unduly high if used as a minimum below which renegotiation cannot operate. Without having had the opportunity to make a detailed study of the effects of this provision as it might apply to particular taxpayers, it is nevertheless believed that the overwhelming majority of concerns holding substantial war contracts will net 5 percent on

their sales after payment of the income and excess-profits taxes contained in H. R. 7378. The elaborate renegotiation mechanism would thus apply only to a very few companies, probably mostly very small companies with a slow capital turnover. If, on the other hand, the 5-percent figure were lowered to 2 or 3 percent, the provision would operate very erratically. Companies enjoying rapid rates of turnover would escape renegotiation, while companies having slow rates of turnover would not.

It should also be observed that Committee Print No. 5 proposed to include in the measure of profits not subject to the renegotiation 5 percent of "net sales and the gross amount received for services, including the amounts billed by the contractor or subcontractor under any cost-plus-a-fixed-fee contract and allowed for reimbursement." This language would apparently include contracts such as facilities and construction contracts which contemplate no profits to the contractor. It would also include contracts such as management contracts which contemplate an extremely small return to the contractor. In the case of companies holding such contracts together with fixed price and cost-plus-a-fixed-fee contracts, the company would be allowed much greater than a 5-percent return on the latter types of contracts because a much less than 5-percent return would be received on the former types of contracts.

In any event, it is believed that a measure of profits not subject to renegotiation should not be cast in terms of profits after deduction of Federal income and excess-profits taxes. Renegotiation involves arriving at a reasonable price for articles purchased from a contractor. The reasonableness of a price should be possible to determine without reference to individual and corporate taxes on income. The implication that a contractor is entitled to a fixed rate of return on his sales after all taxes, would appear to be that such a contractor is to be given a favored position not enjoyed by other taxpayers under our revenue laws. I feel that the question of what is a reasonable profit on a war contract is separate and distinct from the question of the percentage of income to be left the contractor after payment of Federal income and excess-profits taxes. The former question is a procurement problem and the latter is a tax problem. I feel that it is unwise to combine these two questions in the way which is attempted by Committee Print No. 5.

In addition, the proposed deduction of income and excess-profits taxes would result in substantial administrative difficulties. Since the tax liabilities of many contractors may not be finally determined for many years to come, renegotiation agreements would have to be reopened far in the future to take account of tax deficiencies later assessed or tax refunds later returned to the contractor. Where the tax initially paid by the contractor in respect to any year was sufficient to cause his net profit after taxes to be less than 5 percent, and a substantial part of the tax were later refunded thus making his net return after taxes more than 5 percent, section 403 would discriminate in his favor unless the renegotiating agency were able to commence renegotiation at the time of the refund. It is not clear under Committee Print No. 5, however, that the renegotiating agency would be permitted to renegotiate at that time. On the other hand, if the tax initially paid by the contractor were insufficient to reduce his net return after taxes below 5 percent, and his contracts were therefore renegotiated, a later deficiency asserted against him might be sufficient to reduce his net return after taxes below 5 percent. In such a case it is not clear what remedy the contractor would have to recover the profits which he had returned to the Government by way of the renegotiation procedure.

We want you to feel that we shall be glad to cooperate with your subcommittee in its further study of this complicated problem and to place before you all data on the subject which is in our possession.

Sincerely yours,

RANDOLPH E. PAUL,
General Counsel.

Senator WALSH. The committee will stand adjourned subject to the call of the Chair.

(Whereupon, at 12 o'clock noon, the committee adjourned subject to the call of the Chair.)

EXPLANATION OF COMMITTEE PRINT NO. 5

SUBSECTION (A)

This subsection is the same as existing law except for the addition of the definition of "volume" in paragraph (4).

SUBSECTION (B)

This subsection follows the clarification of existing law suggested by the War and Navy Departments, with such variations as are necessary to bring it into line with other provisions of this print—particularly those providing for renegotiation on a taxable year basis.

PARAGRAPH (C) (1)

This paragraph revises the existing law to make it clear that renegotiation is to be conducted on the basis of overall contract profits, as suggested by the Departments, with an additional provision to make it clear that such profits are to be considered with respect to taxable years used for Federal income-tax purposes ending after April 30, 1942.

PARAGRAPH (C) (2)

This paragraph contains provisions similar to those in subsection (c) of the existing law revised as suggested by the War Department. It also provides, as desired by the War and Navy Departments, that sureties shall not be liable for repayment of excessive profits. In addition, it provides that for renegotiation, consideration is to be given only to profits which remain after Federal income taxes, and that in no event shall such profits be deemed to be excessive if less than 5 percent of volume on contracts subject to renegotiation.

PARAGRAPH (C) (3)

This paragraph is new and enumerates factors to be taken into account in the determination of excessive profits; many of these factors appear in the War Department's statement of Principles, Policy, and Procedure, released August 10, 1942.

PARAGRAPH (C) (4)

This paragraph follows the procedure suggested by the Departments for imposing a limitation of time within which to commence renegotiation. The provision has been revised to impose a limitation period of 6 months and to provide for renegotiation on the basis of taxable years used for Federal income-tax purposes.

PARAGRAPH (C) (5)

This paragraph provides, as suggested by the Departments, for final agreements in the event of an agreement between a Secretary and a contractor as to the amount of excessive profits. Proper provision is made for reopening in case of fraud, malfeasance, or mistake.

SUBSECTION (D)

This subsection is the same as existing law except that it is provided that any cost allowable for Federal income-tax purposes shall not be disallowed.

SUBSECTION (E)

This subsection is unchanged from existing law. If not repealed, it should be amended to apply to estimated costs of production, rather than actual.

SUBSECTIONS (F) AND (G)

These subsections have been revised to provide that the operation of the section shall terminate at the cessation of hostilities except as to contracts previously made. As in existing law, it provides that pending court proceedings shall not be affected.

SUBSECTIONS (I) AND (J)

These subsections are new and provide exemptions from the section with respect to various classes of contracts, including those proposed by the Departments.

SUBSECTION (K)

This subsection makes the amendments effective as of the date of enactment of the original section 403 and provides that any provision of a contract inconsistent with the amendments shall be invalid.

SUBSECTION (L)

This subsection provides immunity from damages or penalties on account of anything done in good faith pursuant to section 403 or on account of any contract price fixed pursuant to negotiation or renegotiation.

WAR AND NAVY DEPARTMENTS AND MARITIME COMMISSION COMMENTS ON PROPOSED AMENDMENTS TO SECTION 403, PUBLIC, 528

OCTOBER 3, 1942.

Senator DAVID I. WALSH,
Chairman, Subcommittee of the Senate Finance Committee on Amendments to Section 403, Senate Office Building.

DEAR SENATOR WALSH: Following the suggestion made by Senator McKellar, the War Department, Navy Department, and Maritime Commission have conferred further with respect to the definition of "subcontract" and the exclusion of raw materials from renegotiation under Section 403 and have agreed on provisions which are believed to meet the views expressed by members of the subcommittee.

The new definition of subcontract, which should be substituted for the definition now set forth in paragraph (a) (5) of Committee Print No. 3 reads as follows:

"(5) The term 'subcontract' means any purchase order or agreement to perform all or any part of the work, or to make or furnish any article, required for the performance of another contract or subcontract. The term 'article' includes any material, part, assembly, machinery, equipment, or other personal property."

In order to exclude contracts and subcontracts for raw materials from the act we recommend that the proposed subsection (i) of Committee Print No. 3 be revised to read as follows:

(i) (1) The provisions of this section shall not apply to—

(I) any contract by a Department with any other department, bureau, agency, or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or any agency thereof; or

(II) any contract or subcontract for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined, or treated beyond the first form or state suitable for industrial use; and the Secretaries are authorized by joint regulation, to define, interpret, and apply this exemption.

(2) The Secretary of a Department is authorized, in his discretion, to exempt from some or all of the provisions of this section 403—

(I) any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska;

(II) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of thirty days; and

(III) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract are otherwise adequate to prevent excessive profits.

A point made at the hearing that the requirement under subsection (b) to insert the renegotiation provision in contracts and subcontracts of $100,000 or more is somewhat inconsistent with the provision of subsection (c) (5), exempting from renegotiation contractors with war sales of $250,000 or less is believed to have merit. Accordingly, we recommend that the figure of $250,000 in subsection (c) (5) be reduced to $100,000.

With these modifications the War Department, Navy Department, and Maritime Commission concur in recommending the adoption of the amendments set forth in Committee Print No. 3. Consequently, Committee Print No. 4 as originally submitted by the Navy Department is hereby withdrawn.

The subcommittee also requested our comments on Committee Print No. 5; the amendments proposed by the lumber and coal associations and the proposals of the Associated General Contractors of America, Inc.

In substance Committee Print No. 5 is a revision of section 403 to embody the principles set forth in the original proposal by Senator George (Committee Print No. 1). We feel that this proposal is unsound.

In the first place, like the original proposal by Senator George, it deals only with the elimination of excessive profits and not with the control of prices. By limiting renegotiation to the end of the fiscal year the proposed amendment will merely recapture profits which have already accrued and will not permit the continuous control of prices for future performance. As was pointed out at the hearing on September 29, we believe that the control of current prices is vital in order to control costs and to promote efficient use of manpower, productive equipment, and materials. This the proposed amendment would not assist.

Secondly, by fixing a floor of 5 percent of net sales and gross receipts from services after taxes this proposal would cause serious difficulties. The wide diversity of conditions in war industries makes any single floor unfair and unworkable. If the floor below which renegotiation could not go is fixed low enough to be proper for industries with a large turn-over and heavy Government financing, it will be too low for others with a small turn-over, and high capital, and using their own funds. On the other hand, if the figure is set on the basis of these latter companies, it would allow excessive profits for the first type of producer. As we pointed out in our original statement, any such floor will be the minimum, and in many cases will result in higher prices than those now being paid. Of course, the provision for renegotiation above the floor is more flexible than the provision for 100-percent tax on any excess above the floor, but this change is not sufficient to eliminate the serious disadvantages of any proposal which sets a fixed percentage based on sales after taxes and applicable to the varied types of war industries.

The amendments proposed by Lumber and Timber Products War Committee, National Coal Association, and National Lumber Manufacturers' Association would add four new subsections lettered (k) through (n) inclusive, to section 403. Our comments thereon are briefly as follows:

1. Subsection (k) would exempt contracts and subcontracts for the purchase of raw materials, natural resource products, or any general commercial commodity subject to a price ceiling.

The Maritime Commission and the Navy Department both stated most strongly at the hearings that any exemption of general commercial commodities would prevent them from adequately supervising prices of a large part of the articles directly or indirectly procured by them. In view of this the War Department is not disposed to insist on its earlier position and prefers to concur in the attitude of the Navy Department and Maritime Commission. The new definition of "subcontract" and the addition to subsection (l) discussed above conform to this view but will exempt raw materials.

We, therefore, oppose the proposal to add this subsection (k).

2. The second proposed amendment would provide that deductions from gross income shall be allowed for any year for the amount of any excessive profits excluded from gross income and repaid to the Government.

The purpose of this amendment, it is stated, is to insure that a contractor will not be required both to refund excessive profits and also to pay taxes on the same amount.

We believe that this matter is adequately covered by the amendments already proposed and agreed to by the Treasury. The problem really has two aspects:

(*a*) If the renegotiation occurs during the fiscal year, and reductions in price or refunds are made, the gross income of the company for the taxable period is accordingly reduced. The Treasury has recognized this in its rulings and stated in the hearings that it had no objections to a specific provision to this effect in the new revenue law.

(*b*) If the negotiation occurs after the close of the taxable year and taxes have already been paid or are payable with respect to the excessive profits, the matter is covered by the amendments proposed by the Departments. Under subsection (c) (2) the Secretary of a department is expressly directed to give

the contractor credit for any Federal taxes paid or payable with respect to the excessive profits.

Thus, we feel that by the amendments already proposed the problem will be fully dealt with, and that the suggested addition of subsection (l) would be confusing and unnecessary.

3. The third proposal is to add a subsection (m) forbidding renegotiation of a contract or subcontract more than once and making it final except for fraud or willful misrepresentation.

We do not believe that this proposal is feasible or desirable. In some cases it will be necessary to revise the contract price more than once where conditions are uncertain or the contract is for a long period. In addition, where over-all renegotiation for a fiscal period is followed the performance of a contract may fall within two fiscal periods and therefore necessarily be dealt with twice. The amendments submitted by the Departments go as far as we feel is necessary or desirable to provide for final agreements, exemptions from further renegotiation, and periods of limitation.

4. The fourth amendment proposed would limit section 403 to any contract involving $100,000 or more.

The purpose of this new subsection is to exempt small contractors. The difficulty is, however, that a contractor might do a very large amount of war business and still be exempt under this amendment if each of his contracts were not less than $100,000. We feel that it is sounder to base the exemption on the aggregate sales under his war contracts or subcontracts during a fiscal period.

Our proposed amendments therefore provide that subsection (c), providing for renegotiation, shall not apply to any contractor or subcontractor whose aggregate war sales do not exceed $250,000. As we have stated above, we now believe that this figure in subsection (c) (5) might be reduced to $100,000 to conform to subsection (b).

In his statement on behalf of the Associated General Contractors of America, Inc., Mr. H. E. Foreman objected to certain ambiguities in the statute and to its failure (1) to limit the time of renegotiation, the number of renegotiations, and the size of contracts subject to renegotiation; (2) to provide for over-all renegotiation; (3) to provide for offset of taxes and excessive profits. All of these points are adequately covered by amendments proposed by the War and Navy Departments. He also urged the exemption of cost-plus-a-fixed-fee contracts, contracts let on a competitive basis, and contracts substantially completed before April 28, and he proposed that renegotiation be required before the date for filing tax returns.

Without dealing in detail with these suggestions we believe that the proposals already made for exemption and for limiting renegotiation meet the needs in such cases and that blanket exemptions as proposed by Mr. Foreman would free from renegotiation certain contracts which should remain subject to such control.

For the reasons stated above at the hearing we concur in urging the adoption of Committee Print No. 3 with the modifications stated at the beginning of this letter. In conclusion may we express our appreciation to the Finance Committee and to the subcommittee for the opportunity to state our views on this matter.

Sincerely yours,

ROBERT P. PATTERSON,
Under Secretary of War.
FORRESTAL,
Under Secretary of the Navy.
THOMAS M. WOODWARD,
Commissioner, United States Maritime Commission.