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EXCESS PROFITS TAX ON CORPORATIONS, 1950

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-FIRST CONGRESS

SECOND SESSION

ON

H. R. 9827

AN ACT TO PROVIDE REVENUE BY IMPOSING A CORPORATE EXCESS PROFITS TAX, AND FOR OTHER PURPOSES

DECEMBER 4, 5, 6, 7, AND 8, 1950

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EXCESS PROFITS TAX ON CORPORATIONS, 1950

MONDAY, DECEMBER 4, 1950

UNITED STATES SENATE,
Committee on Finance,
Washington, D. C.

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

Present: Senators George, Byrd, Hoey, Kerr, Millikin, Taft, and Butler.

Also present: Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation; and Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will be in order. Mr. Secretary, we are beginning hearings on H. R. 9827, which the House of Representatives has under consideration today and tomorrow. A copy of the bill is inserted in the record at this point.

(H. R. 9827 is as follows:)

[H. R. 9827, 81st Cong., 2d sess.]

AN ACT To provide revenue by imposing a corporate excess profits tax, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Excess Profits Tax Act of 1950".

TITLE I—EXCESS PROFITS TAX

SEC. 101. IMPOSITION OF EXCESS PROFITS TAX.

Effective with respect to taxable years ending after June 30, 1950, chapter 1 of the Internal Revenue Code is hereby amended by adding after section 424 the following new subchapter:

"SUBCHAPTER D—EXCESS PROFITS TAX

"Part I—Rate and Computation of Tax

"SEC. 430. IMPOSITION OF TAX.

"(a) GENERAL RULE. In addition to other taxes imposed by this chapter, there shall be levied, collected, and paid for each taxable year ending after June 30, 1950, upon the adjusted excess profits net income, as defined in Section 431, of every corporation (except a corporation exempt under section 452) an excess profits tax equal to whichever of the following amounts is the lesser:

"(1) 30 per centum of the adjusted excess profits net income, or

"(2) an amount which when added to the tax imposed for the taxable year under this chapter, determined without regard to the tax imposed by section 102 and without regard to the tax imposed by this subchapter, equals 67 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credits provided in section 26 (h) and (i).

For computation of tax in the case of a short taxable year, see section 433 (a) (2).

"(b) TAXABLE YEARS BEGINNING BEFORE JULY 1, 1950, AND ENDING AFTER JUNE 30, 1950.—In the case of a taxable year beginning before July 1, 1950, and ending after June 30, 1950, the tax imposed by subsection (a) shall be an amount equal to that portion of a tentative tax, determined under subsection (a), which the number of days in such taxable year after June 30, 1950, bears to the total number of days in such taxable year.

"(c) MUTUAL INSURANCE COMPANIES.—In the case of a mutual insurance company other than life or marine, if the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax imposed under this section shall be an amount which bears the same proportion to the amount ascertained under this section, computed without reference to this subsection, as the excess over $75,000 of such gross amount received bears to $50,000.

"(d) DEFERMENT OF PAYMENT IN CASE OF ABNORMALITY.—If the adjusted excess profits net income (computed without reference to section 442, 443, or 444) for the taxable year of a taxpayer which claims on its return, in accordance with regulations prescribed by the Secretary, the benefits of section 442, 443, or 444, is in excess of 50 per centum of its normal tax net income for such year, the amount of tax payable at the time prescribed for payment may be reduced as follows:

"(1) If the application of section 442, 443, or 444 is made in accordance with tentative rates of return described in section 445 (d), by an amount equal to 80 per centum of the amount of the reduction in the tax so claimed.

"(2) If the application of section 442, 443, or 444 is made in accordance with the base period yearly rate of return described in section 445 (b) or the base period rate of return described in section 445 (c), by an amount equal to 100 per centum of the amount of the reduction in the tax so claimed.

The amount of the reduction in tax, to the extent it exceeds the claimed reduction in tax finally determined, shall be payable within one year after such final determination. The running of the statute of limitations provided in section 275 or 276 on the beginning of distraint or a proceeding in court for collection, in respect of such reduction in tax, shall be suspended for the period beginning with the date such tax would be payable but for this subsection and ending with the date falling sixty days after such final determination.

"SEC. 431. DEFINITION OF ADJUSTED EXCESS PROFITS NET INCOME.

"The term 'adjusted excess profits net income' in the case of any taxable year means the excess profits net income (as defined in section 433) minus the sum of:

"(1) EXCESS PROFITS CREDIT.—The amount of the excess profit credits allowed under section 434; and

"(2) UNUSED EXCESS PROFITS CREDITS.—The amount of the unused excess profits credit adjustment for the taxable year computed in accordance with section 432.

If such sum is less than $25,000, it shall be increased to $25,000.

"SEC. 432. UNUSED EXCESS PROFITS CREDIT ADJUSTMENT.

"(a) COMPUTATION OF UNUSED EXCESS PROFITS CREDIT ADJUSTMENT.—The unused excess profits credit adjustment for any taxable year shall be the aggregate of the unused excess profits credit carry-overs and unused excess profits credit carry-back to such taxable year.

"(b) DEFINITION OF UNUSED EXCESS PROFITS CREDIT.—The term 'unused excess profits credit' means the excess, if any, of the excess profits credit for any taxable year ending after June 30, 1950, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year. The unused excess profits credit for a taxable year of less than 12 months shall be an amount which is such part of the unused excess profits credit determined under the preceding sentence as the number of days in the taxable year is of the number of days in the 12 months ending with the close of the taxable year. The unused excess profits credit for a taxable year beginning before July 1, 1950, and ending after June 30, 1950, shall be an amount which is such part of the unused excess profits credit determined under the preceding provisions of this subsection as the number of days in such taxable year after June 30, 1950, is of the total number of days in such taxable year.

"(c) AMOUNT OF CARRY-BACK AND CARRY-OVER.—

"(1) UNUSED EXCESS PROFITS CREDIT CARRY-BACK.—If for any taxable year beginning after July 1, 1950, the taxpayer has an unused excess profits credit, such unused excess profits credit shall be an unused excess profits credit carry-back for the preceding taxable year.

"(2) UNUSED EXCESS PROFITS CREDIT CARRY-OVER.—If for any taxable year ending after June 30, 1950, the taxpayer has an unused excess profits credit, such unused excess profits credit shall be an unused excess profits credit carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such unused excess profits credit over the sum of the adjusted excess profits net income for each of the intervening taxable years computed—

"(A) by determining the unused excess profits credit adjustment for each intervening taxable year without regard to such unused excess profits credit or to any unused excess profits credit for any succeeding year, and

"(B) without regard to the last sentence of section 431.

For the purpose of the preceding sentence the unused excess profits credit for any taxable year beginning after July 1, 1950, shall first be reduced by the amount, if any, of the adjusted excess profits net income for the preceding taxable year computed—

"(C) by determining the unused excess profits credit adjustment for such preceding taxable year without regard to such unused excess profits credit, and

"(D) without regard to the last sentence of section 431.

If such preceding taxable year began prior to July 1, 1950, the reduction referred to in the preceding sentence shall be an amount which is such part of the reduction determined under the preceding sentence as the number of days in such taxable year after June 30, 1950, is of the total number of days in such preceding taxable year.

"(d) NO CARRY-BACK TO TAXABLE YEARS ENDING PRIOR TO JULY 1, 1950.—As used in this section the term 'preceding taxable year' does not include any taxable year ending prior to July 1, 1950.

"SEC. 433. EXCESS PROFITS NET INCOME.

"(a) TAXABLE YEARS ENDING AFTER JUNE 30, 1950.—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year increased or decreased by the following adjustments:

"(1) ADJUSTMENTS.—

"(A) Dividends Received.—The credit for dividends received shall apply, without limitation (except the limitation relating to dividends in kind), to all dividends on stock of all corporations, except that no credit for dividends received shall be allowed with respect to dividends (actual or constructive) on stock of foreign personal holding companies or dividends on stock which is not a capital asset;

"(B) Disallowance of Certain Credits.—In computing such normal-tax net income the credits provided in section 26 (h) and (i) shall not be allowed;

"(C) Gains and Losses From Sales or Exchanges of Capital Assets, Etc.—There shall be excluded gains and losses from sales or exchanges of capital assets and gains and losses, from sales or exchanges of property, to which section 117 (j) is applicable;

"(D) Income From Retirement or Discharge of Bonds, and So Forth.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

"(E) Refunds and Interest on Agricultural Adjustment Act Taxes.—There shall be excluded income attributable to refund of tax paid under the Agricultural Adjustment Act of 1933, as amended, and interest upon any such refund;

"(F) Deductions on Account of Retirement or Discharge of Bonds, and So Forth.—If during the taxable year the taxpayer retires or

discharges any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, the following deductions for such taxable year shall not be allowed:

"(i) The deduction allowable under section 23 (a) for expenses paid or incurred in connection with such retirement or discharge;

"(ii) The deduction for losses allowable by reason of such retirement or discharge; and

"(iii) In case the issuance was at a discount, the amount deductible for such year solely because of such retirement or discharge;

"(G) Recoveries of Bad Debts.—There shall be excluded income attributable to the recovery of a bad debt unless a deduction with reference to such debt was allowable from gross income for any taxable year for which an excess profits tax was imposed under this subchapter or subchapter E of chapter 2.

"(H) Life Insurance Companies.—In the case of a life insurance company, there shall be deducted from the normal tax net income the excess of (1) the product of (i) the figure determined and proclaimed under section 202 (b) and (ii) the excess profits net income computed without regard to this subparagraph, over (2) the adjustment for certain reserves provided in section 202 (c).

"(I) Nontaxable Income of Certain Industries With Depletable Resources.—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 451, there shall be excluded nontaxable income from exempt excess output of mines and timber blocks provided in section 451: in the case of a natural gas company, as defined in section 451, there shall be excluded nontaxable income from exempt excess output provided in section 451; and in the case of a producer of minerals, or a producer of logs or lumber from a timber block, there shall be excluded nontaxable bonus income provided in section 451. In respect of nontaxable bonus income provided in section 451 (c), a corporation described in section 451 (c) (2) shall be deemed a producer of minerals for the purposes of this subparagraph.

"(J) Net Operating Loss Deduction Adjustment.—The net operating loss deduction shall be adjusted as follows: In lieu of the reduction provided in section 122 (c), such reduction shall be in the amount by which the excess profits net income computed with the exceptions and limitations specified in section 122 (d) (1), (2), (3), and (4) and computed without regard to subparagraph (B), without regard to any credit for dividends received, and without regard to any credit for interest received provided in section 26 (a) exceeds the excess profits net income (computed without the net operating loss deduction).

"(K) Taxes Paid by Lessee.—If under a lease for a term of more than 20 years entered into prior to December 1, 1950, the lessee is obligated to pay any portion of the tax imposed by this chapter upon the lessor with respect to the rentals derived by such lessor from such lessee, or is obligated to reimburse the lessor for any portion of the tax imposed by this chapter upon the lessor with respect to the rentals derived by such lessor from such lessee, such payment or reimbursement of the tax imposed by this chapter shall be excluded by the lessor and a deduction therefor shall not be allowed to the lessee.

"(L) Bad Debts in Case of Banks.—In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23 (k).

"(M) Blocked Foreign Income.—There shall be excluded income derived from sources within any foreign country to the extent that such income would, but for monetary, exchange, or other restrictions imposed by such foreign country, have been includible in the gross income of the taxpayer for any taxable year which preceded its first taxable year under this subchapter. The determination of the extent to which income so derived shall be considered to have been includible, but for such restrictions, in the gross income of the taxpayer for years which preceded

its first taxable year under this subchapter shall be made under regulations prescribed by the Secretary. Where income derived from sources within any foreign country is includible (without regard to this sentence) in a taxable year succeeding the first taxable year under this subchapter, and but for monetary, exchange, or other restrictions imposed by such foreign country would have been includible in the gross income of the taxpayer for its first taxable year under this subchapter, such income, in case such first taxable year began before July 1, 1950, shall be considered (in the application of this subparagraph) as having been includible in gross income of a taxable year which preceded such first taxable year in an amount equal to that portion of such income as the number of days prior to July 1, 1950, in such first taxable year bears to the total number of days in such first taxable year. Deductions properly chargeable and allocable to income excluded under this subparagraph shall not be allowed.

"(2) TAXABLE YEAR LESS THAN TWELVE MONTHS.—

"(A) General Rule.—If the taxable year is a period of less than twelve months the excess profits net income for such taxable year (referred to in this paragraph as the 'short taxable year') shall be placed on an annual basis by multiplying the amount thereof by the number of days in the twelve months ending with the close of the short taxable year and dividing by the number of days in the short taxable year. The tax imposed by section 430 shall be such part of the tax computed on such annual basis as the number of days in the short taxable year is of the number of days in the twelve months ending with the close of the short taxable year.

"(B) Exception.—If the taxpayer establishes its adjusted excess profits net income for the period of twelve months beginning with the first day of the short taxable year, computed as if such twelve-month period were a taxable year, under the law applicable to the short taxable year, and using the credits applicable in determining the adjusted excess profits net income for such short taxable year, then the tax for the short taxable year shall be reduced to an amount which is such part of the tax computed on such adjusted excess profits net income so established as the excess profits net income for the short taxable year is of the excess profits net income for such twelve-month period. The taxpayer (other than a taxpayer to which the next sentence applies) shall compute the tax and file its return without the application of this subparagraph. If, prior to one year from the date of the beginning of the short taxable year, the taxpayer has disposed of substantially all its assets, in lieu of the twelve-month period provided in the preceding provisions of this subparagraph, the twelve-month period ending with the close of the short taxable year shall be used. For the purposes of this subparagraph, the excess profits net income for the short taxable year shall not be placed on an annual basis as provided in subparagraph (A), and the excess profits net income for the twelve-month period used shall in no case be considered less than the excess profits net income for the short taxable year. The benefits of this subparagraph shall not be allowed unless the taxpayer, at such time as regulations prescribed hereunder require, makes application therefor in accordance with such regulations and such application, in case the return was filed without regard to this subparagraph, shall be considered a claim for credit or refund. The Secretary shall prescribe such regulations as he may deem necessary for the application of this subparagraph.

"(C) Section 47 (c) Not Applicable.—The provisions of section 47 (c) shall not apply to the tax imposed by this subchapter.

"(b) TAXABLE YEARS IN BASE PERIOD.—For the purposes of computing the average base period net income, the excess profits net income for any taxable year within, or beginning or ending within, the base period shall be the normal-tax net income, as defined in section 13 (a) (2) as in effect for such taxable year, increased or decreased by the following adjustments (for additional adjustments in case of certain reorganizations, see part II of this subchapter):

"(1) NET OPERATING LOSS DEDUCTION.—The net operating loss deduction provided by section 23 (s) shall not be allowed;

"(2) GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.—There shall be excluded gains and losses from sales or exchanges of capital assets and gains and losses to which section 117 (j) is applicable;

"(3) INCOME FROM RETIREMENT OR DISCHARGE OF BONDS, ETC.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

"(4) DEDUCTIONS ON ACCOUNT OF RETIREMENT OR DISCHARGE OF BONDS, ETC.—If during the taxable year the taxpayer retires or discharges any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, the following deductions for such taxable year shall not be allowed:

"(A) The deduction allowable under section 23 (a) for expenses paid or incurred in connection with such retirement or discharge;

"(B) The deduction for losses allowable by reason of such retirement or discharge; and

"(C) In case the issuance was at a discount, the amount deductible for such year solely because of such retirement or discharge;

"(5) REPAYMENT OF PROCESSING TAX TO VENDEES.—The deduction under section 23 (a), for any taxable year, for expenses shall be decreased by an amount which bears the same ratio to the amount deductible on account of any repayment or credit by the corporation to its vendee of any amount attributable to any tax under the Agricultural Adjustment Act of 1933, as amended, as the excess of the aggregate of the amounts so deductible in the base period over the aggregate of the amounts attributable to taxes under such Act collected from its vendees which were includible in the corporation's gross income in the base period and which were not paid, bears to the aggregate of the amounts so deductible in the base period;

"(6) DIVIDENDS RECEIVED.—The credit for dividends received shall apply, without limitation (except the limitation relating to dividends in kind), to all dividends on stock of all corporations, except that no credit for dividends received shall be allowed with respect to dividends (actual or constructive) on stock of foreign personal holding companies or dividends on stock which is not a capital asset;

"(7) INSTALLMENT SALES.—Income from installment sales shall be computed (in lieu of in the manner provided in section 44) under the accrual method and as if the taxpayer had reported such income on the accrual method for all taxable periods. This paragraph shall be applicable only for the purpose of computing the average base period earnings in determining the excess profits credit for any taxable year for which an election made under section 453 (a) is applicable, and shall have no application in the computation under section 435 (f) of the base period capital addition.

"(8) LONG-TERM CONTRACTS.—Income from long-term contracts shall be computed under the percentage of completion method and as if the taxpayer had reported such income on the percentage of completion method for all taxable periods. This paragraph shall be applicable only for the purpose of computing the average base period earnings in determining the excess profits credit for any taxable year for which an election under section 453 (b) is applicable and shall have no application in the computation under section 435 (f) of the base period capital addition.

"(9) JUDGMENTS, INTANGIBLE DRILLING AND DEVELOPMENT COSTS, CASUALTY LOSSES, AND OTHER ABNORMAL DEDUCTIONS.—Under regulations prescribed by the Secretary for the determination, for purposes of this paragraph, of the classification of deductions for any taxable year or years within, or beginning or ending within, the base period, if—

"(A) any class of similar deductions for the taxable year attributable to a claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing;

"(B) any class of similar deductions for the taxable year attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines;

"(C) any class of similar deductions for the taxable year under section 23 (f) for losses arising from fires, storms, shipwreck, or other casualty, or from theft, or arising from the demolition, abandonment,

or loss of useful value of property, not compensated for by insurance or otherwise; or

"(D) any other class of deductions for the taxable year,

exceeded 115 per centum of the average amount of deductions of such class for the four previous taxable years, the deductions of such class shall, subject to the rules provided in paragraph (10), be disallowed in an amount equal to such excess.

"(10) RULES FOR APPLICATION OF PARAGRAPH (9).—For the purpose of paragraph (9)—

"(A) If the taxpayer was not in existence for four previous taxable years, then the average amount specified in such paragraph shall be determined for the previous taxable years it was in existence and the succeeding taxable years which begin before the beginning of the taxpayer's second taxable year under this subchapter. If the number of such suceeding years is greater than the number necessary to obtain an aggregate of four taxable years, there shall be omitted so many of such succeeding years, beginning with the last, as are necessary to reduce the aggregate to four.

"(B) Deductions of any class for any taxable year shall not be disallowed under such paragraph unless the amount of deductions of such class to be disallowed for such year exceeds 5 per centum of the average excess profits net income for the taxable years within, or beginning or ending within, the base period, computed without the disallowance of any class of deductions under such paragraph. For the purpose of the preceding sentence a deficit in excess profits net income for any taxable year shall be counted as zero.

"(C) Deductions shall not be disallowed under such paragraph unless the taxpayer establishes that the excess is not a cause or a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a cause or a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

"(D) The amount of deductions of any class to be disallowed under such paragraph with respect to any taxable year shall not exceed the amount by which the deductions of such class for such taxable year exceed the deductions of such class for the taxable year for which the tax under this subchapter is being computed.

"(E) If the taxpayer's average base period net income is determined under section 435 (e), there shall not be disallowed under such paragraph any amount which is to be taken into account under section 435 (e) (4) for the purpose of determining the total payroll of the taxpayer.

"(11) TAXES PAID BY LESSEE.—If under a lease for a term of more than 20 years entered into prior to December 1, 1950, the lessee is obligated to pay any portion of the tax imposed by this chapter upon the lessor with respect to the rentals derived by such lessor from such lessee, or is obligated to reimburse the lessor for any portion of the tax imposed by this chapter upon the lessor with respect to the rentals derived by such lessor from such lessee, such payment or reimbursement of the tax imposed by this chapter shall be excluded by the lessor and a deduction therefor shall not be allowed to the lessee.

"(12) BAD DEBTS IN CASE OF BANKS.—In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23 (k).

"SEC. 434. EXCESS PROFITS CREDIT—ALLOWANCE.

"(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. For allowance of excess profits credit in case of certain reorganizations, see part II of this subchapter.

"(b) FOREIGN CORPORATIONS.—In the case of a foreign corporation engaged in trade or business within the United States, the first taxable year of which

under this subchapter begins on or before July 1, 1950, which was in existence on January 1, 1946, and which at any time during each of the taxable years which began or ended during the base period was engaged in trade or business within the United States, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other foreign corporations the excess profits credit for any taxable year shall be an amount computed under section 436.

"(c) SPECIAL RULE IN CONNECTION WITH REGULATED PUBLIC UTILITIES.—Notwithstanding subsection (a), in the case of a regulated public utility (as defined in section 446) the excess profits credit for any taxable year shall be an amount computed under section 435, section 436, or section 446, whichever results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

"(d) SPECIAL RULE FOR RAILROAD LESSOR-LESSEE CORPORATIONS.—Notwithstanding the provisions of subsection (a), in the case of a railroad corporation subject to Part I of the Interstate Commerce Act, substantially all of the railroad properties of which have been leased to another such railroad corporation or corporations by an agreement entered into prior to July 1, 1950, where the lease is for a term of more than 20 years and requires the lessee to pay the taxes of the lessor under this chapter, the aggregate of the excess profits credit and the unused excess profits credit adjustment of each of such corporations, computed without regard to this subsection, may be equitably apportioned among each of such corporations by agreement among such corporations approved by the Secretary.

"SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

"(a) AMOUNT OF EXCESS PROFITS CREDIT.—The excess profits credit for any taxable year, computed under this section, shall be—

"(1) DOMESTIC CORPORATIONS.—In the case of a domestic corporation the sum of—

"(A) 85 per centum of the average base period net income,

"(B) if the average base period net income of the taxpayer is determined under subsection (d) of this section or under section 442, the amount of the base period capital addition, computed under subsection (f),

"(C) 12 per centum of the net capital addition (as defined in subsection (g) (1)) for the taxable year, and

"(D) the amount of the credit provided in subsection (h) (1) (relating to net additions to borrowed capital) for the taxable year,

minus the sum of 12 per centum of the net capital reduction (as defined in subsection (g) (2)) for the taxable year and the amount of the borrowed capital reduction for the taxable year, computed under subsection (h) (2).

"(2) FOREIGN CORPORATIONS.—In the case of a foreign corporation, 85 per centum of the average base period net income.

"(b) BASE PERIOD.—As used in this subchapter the term 'base period' means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and before April 1, 1950, and which began before January 1, 1950, the term 'base period' means the period of 48 consecutive months ending with the close of such preceding taxable year.

"(c) AVERAGE BASE PERIOD NET INCOME—DETERMINATION.—

"(1) DEFINITION.—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (d), subject to the exception that if the taxpayer is entitled to the benefits of subsection (e) of this section, or section 442, 443, or 444, then the average base period net income shall be the amount determined under subsection (e) or such section, whichever results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

"(2) CROSS REFERENCE.—For the computation of the average base period net income in the case of certain reorganizations, see part II of this subchapter.

"(d) AVERAGE BASE PERIOD NET INCOME—GENERAL AVERAGE.—The average base period net income determined under this subsection shall be determined as follows:

"(1) By computing the excess profits net income for each month in the base period. The excess profits net income for any month during any part of which the taxpayer was in existence shall be the excess profits net income for the taxable year in which such month falls divided by the number of full calendar months in such year, but in no case shall the excess profits net income for any month be less than zero. The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

"(2) By eliminating from the base period whichever of the following twelve months results in the higher average base period net income—

"(A) The twelve consecutive months the elimination of which produces the highest average base period net income, or

"(B) The twelve months which remain after retaining in the base period the thirty-six consecutive months which produce the highest average base period net income.

"(3) By computing the aggregate of the excess profits net income for each of the thirty-six months remaining in the base period.

"(4) By dividing by 3 the amount ascertained under paragraph (3).

"(e) AVERAGE BASE PERIOD NET INCOME—ALTERNATIVE BASED ON GROWTH.—

"(1) TAXPAYERS TO WHICH SUBSECTION APPLIES.—A taxpayer shall be entitled to the benefits of this subsection if—

"(A) the taxpayer commenced business before the beginning of its base period; and

"(B) the total assets of the taxpayer, determined under paragraph (3), did not, as of the beginning of its base period, exceed $20,000,000; and

"(C) the total payroll of the taxpayer (as determined under paragraph (4)) for the last half of its base period is 130 per centum or more of its total payroll for the first half of its base period, or the gross receipts of the taxpayer (as determined under paragraph (5)) for the last half of its base period is 150 per centum or more of its gross receipts for the first half of its base period.

"(2) COMPUTATION.—The average base period net income determined under this subsection shall be determined as follows:

"(A) By computing (in the manner provided by the second sentence of subsection (d) (1)) the excess profits net income for each of the last 24 months in the base period.

"(B) By computing the aggregate of the excess profits net income for each such month.

"(C) By dividing by 2 the amount ascertained under subparagraph (B).

"(D) By computing the aggregate of the excess profits net income for each of the last twelve months in the base period.

The average base period net income determined under this subsection shall be the amount ascertained under subparagraph (C) or subparagraph (D), whichever is the larger.

"(3) TOTAL ASSETS.—For the purposes of this subsection the taxpayer's total assets as of any day shall be determined as of the beginning of such day and shall be an amount equal to the sum of the cash and the property other than cash used in the taxpayer's business. Such property shall be included in an amount equal to its adjusted basis for determining gain upon sale or exchange.

"(4) TOTAL PAYROLL.—As used in this subsection the term 'total payroll' with respect to any period means the sum of the salaries, wages, commissions, and other compensation paid or incurred by the taxpayer during such period for personal services actually rendered by employees, excluding the amount thereof which is allowable as a deduction under section 23 (p) and excluding any compensation paid in any medium other than cash. In the event that a taxable year falls partly within such period, there shall be allocated, for the purposes of this paragraph, to the portion of the period within such year an amount of the salaries, wages, commissions, and other compensation for such year in the same proportion as the number of months in such year within the period bears to the total number of months in such year.

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"(5) GROSS RECEIPTS.—As used in this subsection the term 'gross receipts' with respect to any period means the sum of:

"(A) The total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, and

"(B) The gross income, attributable to a trade or business regularly carried on by the taxpayer, received or accrued during such period excluding therefrom—

"(i) Gross income derived from the sale, exchange, or other disposition of property;

"(ii) Gross income derived from discharge of indebtedness of the taxpayer;

"(iii) Dividends on stocks of corporations; and

"(iv) Income attributable to recovery of bad debts.

In the event that a taxable year falls partly within such period, there shall be allocated, for the purposes of subparagraphs (A) and (B), to the portion of the period within such year an amount of the total gross receipts (as defined in such subparagraphs) for such year in the same proportion as the number of months in such year within the period bears to the total number of months in such year.

"(f) CAPITAL ADDITIONS IN BASE PERIOD.—

"(1) BASE PERIOD CAPITAL ADDITION.—The amount of the base period capital addition referred to in subsection (a) (1) (B) shall be the sum of—

"(A) 12 per centum of the net base period equity capital addition, computed under paragraph (2) (C),

"(B) the amount of the base period borrowed capital addition, computed under paragraph (3) (D),

minus the sum of 12 per centum of the net base period equity capital reduction, computed under paragraph (2) (D), and the amount of the base period borrowed capital reduction, computed under paragraph (3) (E); except that the base period capital addition shall in no case be less than zero.

"(2) NET BASE PERIOD CAPITAL ADDITION OR REDUCTION.—

"(A) The net increase in equity capital during any period shall, for the purposes of this subsection, be the amount, if any, by which the equity capital (as defined in section 437 (c)) at the end of such period exceeds the equity capital at the beginning of such period. The amount ascertained under this subparagraph shall be reduced by the excess, if any, of the inadmissible assets (as defined in section 440) of the taxpayer at the end of such period over the inadmissible assets at the beginning of such period. The net decrease in equity capital shall in no case be less than zero.

"(B) The net decrease in equity capital during any period shall, for the purposes of this subsection, be the amount, if any, by which the equity capital (as defined in section 437 (c)) at the beginning of such period exceeds the equity capital at the end of such period. The amount ascertained under this subparagraph shall be reduced by the excess, if any, of the inadmissible assets (as defined in section 440) of the taxpayer at the beginning of such period over the inadmissible assets at the end of such period. The net decrease in equity capital shall in no case be less than zero.

"(C) The net base period equity capital addition shall be the excess of—

"(i) the net increase, if any, in equity capital during the period covered by the last 2 taxable years of the taxpayer which precede its first taxable year under this subchapter, over

"(ii) one-half of the amount by which the net increase, if any, in equity capital during the earlier taxable year in such period exceeds the net decrease, if any, in equity capital during the later taxable year in such period.

"(D) The net base period equity capital reduction shall be the excess of—

"(i) the net decrease, if any, in equity capital during the period covered by the last 2 taxable years of the taxpayer which precede its first taxable year under this subchapter, over

"(ii) one-half of the amount by which the net decrease, if any, in equity capital during the earlier taxable year in such period exceeds the net increase, if any, in equity capital during the later taxable year in such period.

"(3) BASE PERIOD BORROWED CAPITAL ADDITION OR REDUCTION.—

"(A) The adjustment for the net increase in borrowed capital during any period shall, for the purposes of this subsection, be an amount equal to (i) one-third of the amount by which the daily borrowed capital (as determined under section 439 (c)) for the day following the close of such period exceeds the daily borrowed capital for the first day of such period, times (ii) the average interest rate for the day following the close of such period. The adjustment for the net increase in borrowed capital shall in no case be less than zero.

"(B) The adjustment for the net decrease in borrowed capital during any period shall, for the purposes of this subsection, be an amount equal to (i) one-third of the amount by which the daily borrowed capital (as determined under section 439 (c)) for the first day of such period exceeds the daily borrowed capital for the day following the close of such period, times (ii) the average interest rate for the first day of such period. The adjustment for the net decrease in borrowed capital shall in no case be less than zero.

"(C) The average interest rate for any day shall, for the purposes of subparagraphs (A) and (B), be an amount equal to the amount ascertained by dividing the aggregate of 1 year's interest on the daily borrowed capital for such day by the amount of the daily borrowed capital for such day.

"(D) The amount of the base period borrowed capital addition shall, for the purposes of paragraph (1) (B), be the excess of—

"(i) the adjustment, if any, for the net increase in borrowed capital during the period covered by the last 2 taxable years of the taxpayer which precede its first taxable year under this subchapter, over

"(ii) one-half of the amount by which the adjustment, if any, for the net increase in borrowed capital during the earlier taxable year in such period exceeds the adjustment, if any, for the net decrease in borrowed capital during the later taxable year in such period.

"(E) The amount of the base period borrowed capital reduction shall, for the purposes of paragraph (1), be the excess of—

"(i) the adjustment, if any, for the net decrease in borrowed capital during the period covered by the last 2 taxable years of the taxpayer which precede its first taxable year under this subchapter, over

"(ii) one-half of the amount by which the adjustment, if any, for the net decrease in borrowed capital during the earlier taxable year in such period exceeds the adjustment, if any, for the net increase in borrowed capital during the later taxable year in such period.

"(g) CAPITAL CHANGES.—

"(1) NET CAPITAL ADDITIONS.—The net capital addition for the taxable year shall, for the purposes of this section, be the excess, divided by the number of days in the taxable year, of the aggregate of the daily capital addition for each day of the taxable year over the aggregate of the daily capital reduction for each day of the taxable year.

"(2) NET CAPITAL REDUCTION.—The net capital reduction for the taxable year shall, for the purposes of this section, be the excess, divided by the number of days in the taxable year, of the aggregate of the daily capital reduction for each day of the taxable year over the aggregate of the daily capital addition for each day of the taxable year.

"(3) DAILY CAPITAL ADDITION.—The daily capital addition for any day of the taxable year shall, for the purposes of this section, be the sum of the following:

"(A) The aggregate of the amounts of money and property paid in for stock, or as paid-in surplus, or as a contribution to capital, after the beginning of the taxable year and prior to such day. Such property paid in shall be included in an amount equal to its basis (unadjusted) for determining gain upon sale or exchange. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 113 (b) (2).

"(B) The amount, if any, by which the equity capital (as defined in section 437 (c)) at the beginning of the taxable year exceeds the equity capital at the beginning of the taxpayer's first taxable year under this subchapter.

The amount ascertained under this paragraph shall be reduced by the excess, if any, of the inadmissible assets (as defined in section 440) of the taxpayer at the beginning of such day over the inadmissble assets at the beginning of its first taxable year under this subchapter. The daily capital addition shall in no case be less than zero.

"(4) DAILY CAPITAL REDUCTION.—The daily capital reduction for any day of the taxable year shall, for the purposes of this section, be the sum of the following:

"(A) Distributions to shareholders previously made during such taxable year which are not out of the earnings and profits of such taxable year; and

"(B) The amount, if any, by which the amount of the equity capital (as defined in section 437 (c)) at the beginning of the taxpayer's first taxable year under this subchapter exceeds the amount of the equity capital at the beginning of the taxable year.

The amount ascertained under this paragraph shall be reduced by the excess, if any, of the inadmissible assets (as defined in section 440) of the taxpayer at the beginning of its first taxable year under this subchapter over its inadmissible assets at the beginning of such day. The daily capital reduction shall in no case be less than zero.

"(5) CROSS REFERENCE.—For special rules applicable to this subsection with respect to distributions to shareholders, see section 437 (g).

"(h) ADDITIONS AND REDUCTIONS IN BORROWED CAPITAL.—

"(1) CREDIT FOR ADDITION TO BORROWED CAPITAL.—The amount of the credit referred to in subsection (a) (1) (D) shall, for any taxable year, be an amount equal to (A) one-third of the excess of the average borrowed capital for such year (as determined under section 439 (c)) over the daily borrowed capital for the first day of the taxpayer's first taxable year under this subchapter, multiplied by (B) the average interest rate for the taxable year; except that such credit shall in no case exceed an amount equal to 3 per centum of such excess.

"(2) BORROWED CAPITAL REDUCTION.—The amount of the borrowed capital reduction referred to in subsection (a) (1) shall, for any taxable year, be an amount equal to (A) one-third of the excess of the daily borrowed capital for the first day of the taxpayer's first taxable year under this subchapter (as determined under section 439 (c)) over the average borrowed capital for the taxable year, multiplied by (B) the average interest rate for the last preceding taxable year during which the taxpayer had borrowed capital; except that such reduction shall in no case exceed an amount equal to 3 per centum of such excess.

"(3) DEFINITION OF AVERAGE INTEREST RATE.—The average interest rate for any taxable year shall be the amount ascertained by dividing the total interest accrued for such year with respect to borrowed capital by the amount of the average borrowed capital for such year.

"SEC. 436. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

"The excess profits credit for any taxable year computed under this section shall be the sum of the following:

"(1) The basic equity capital credit computed under section 437,

"(2) The new capital credit, if any, computed under section 438 (a),

"(3) The borrowed capital credit, if any, computed under section 439,

reduced by the amount computed under section 440 (relating to inadmissible assets).

"SEC. 437. BASIC EQUITY CAPITAL CREDIT.

"(a) DEFINITION.—The basic equity capital credit for any taxable year shall be the amount shown in the following table:

"If the adjusted equity capital for such year (determined under subsection (b)) is:	The credit shall be:
Not over $5,000,000	12% of the adjusted equity capital.
Over $5,000,000 but not over $10,000	$600,000, plus 10% of the excess over $5,000,000.
Over $10,000,000	$1,100,000, plus 8% of the excess over $10,000,000.

"(b) ADJUSTED EQUITY CAPITAL.—The adjusted equity capital for any taxable year (hereinafter in this subsection referred to as 'the taxable year') shall be the sum of—

"(1) the equity capital (as defined in subsection (c)) as of the beginning of the taxable year;

"(2) the capital addition for the taxable year computed under subsection (d); and

"(3) the recent loss adjustment computed under subsection (f),

minus the capital reduction for the taxable year computed under subsection (e). If the amount of the adjusted equity capital so computed is over $5,000,000, such amount shall be reduced by the net new capital addition computed under section 438.

"(c) DEFINITION OF EQUITY CAPITAL.—The equity capital of the taxpayer as of any time shall be the total of its assets held at such time reduced by the total of its liabilities at such time. For such purposes, the amount attributable to each asset shall be determined by ascertaining the adjusted basis thereof (or, in the case of money, the amount thereof) and the adjusted basis shall be the adjusted basis for determining gain upon sale or exchange. In the case of an insurance company, its reserves shall be treated as liabilities and not as assets. In the case of assets subject to a mortgage or other lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as a liability of the taxpayer whether or not the taxpayer assumed or agreed to pay such indebtedness.

"(d) CAPITAL ADDITION FOR THE TAXABLE YEAR.—The capital addition for the taxable year shall be the aggregate of the daily capital addition for each day of the taxable year, divided by the number of days in such year. The daily capital addition for each day of the taxable year shall be the aggregate of the amount of money and property paid in after the beginning of such taxable year and prior to such day for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining gain upon sale or exchange. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 113 (b) (2).

"(e) CAPITAL REDUCTION FOR THE TAXABLE YEAR.—The capital reduction for the taxable year shall be the aggregate of the daily capital reduction for each day of the taxable year, divided by the number of days in such year. The daily capital reduction for each day of the taxable year shall be the amount of the distributions previously made during the taxable year which are not out of the earnings and profits of such taxable year.

"(f) RECENT LOSS ADJUSTMENT.—

"(1) DETERMINATION.—The recent loss adjustment for any taxable year shall be the excess of the aggregate of the net operating loss for each taxable year in the recent loss period over the aggregate of the net income for each taxable year in such period. For purposes of this subsection, the term 'recent loss period' means whichever of the following periods results in a higher recent loss adjustment—

"(A) the base period, or

"(B) the period beginning January 1, 1940, and ending December 31, 1949.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) Net Operating Loss.—The net operating loss for any taxable year means the net operating loss as defined in section 122 (a), determined under the law applicable to such taxable year.

"(B) NET INCOME.—The net income for any taxable year means the net income computed with the exceptions, additions, and limitations provided in section 122 (d) (other than paragraph (6) of section 122 (d)), under the law applicable to such taxable year.

"(3) Special Rules.—

"(A) Only Part Of Taxable Year Included In Recent Loss Period.—For purposes of this subsection, the net operating loss or net income for a taxable year only part of which is within the recent loss period shall be such part of the net operating loss or net income for such taxable year, computed without regard to this subparagraph, as the number of of months in such taxable year falling within the recent loss period is of the total number of months in such taxable year. For purposes of this subsection, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

"(B) Recent Losses of Component Corporations.—The recent loss adjustment shall be separately computed for each corporation which is a component corporation of the taxpayer within the meaning of part II of this subchapter, and the amount so computed shall be added to the recent loss adjustment of the taxpayer. For purposes of such computation, the recent loss period of the component corporation shall not include any period after the date of the transaction in which such corporation became a component corporation of the taxpayer. The recent loss adjustment of the component corporation, for the purpose of computing the adjusted equity capital of any corporation (including the component corporation) other than the taxpayer for a taxable year ending after such date shall be reduced by the amount with respect to such component corporation which, under this subsection, is added to the recent loss adjustment of the taxpayer.

"(g) RULES FOR APPLICATION OF THIS SECTION, SECTION 438, AND SECTION 435 (g).—For the purposes of this section, section 438, and section 435 (g)—

"(1) DISTRIBUTIONS TO SHAREHOLDERS.—A distribution by a corporation of its stock or rights to acquire its stock shall not be regarded as money or property paid in for stock, or as paid-in surplus, or as a contribution to capital, and such a distribution shall not be considered as a distribution by a corporation to its shareholders.

"(2) DISTRIBUTIONS IN FIRST 60 DAYS OF TAXABLE YEAR.—So much of the distributions (taken in the order of time) to shareholders made during the first 60 days of any taxable year as does not exceed the accumulated earnings and profits as of the beginning thereof (computed without regard to this paragraph) shall be considered to have been made on the last day of the preceding taxable year. This paragraph shall not apply with respect to distributions made during the first 60 days of the taxpayer's first taxable year under this subchapter.

"(3) COMPUTATION OF EARNINGS AND PROFITS OF TAXABLE YEAR.—For the purposes of subsection (e) of this section and section 435 (g) (4) (A), in determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this chapter for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made.

"(4) EXCHANGES.—For the purpose of determining the amount of property paid in for stock, or as paid-in surplus, or as a contribution to capital—

"(A) If the basis (unadjusted) of the property for determining gain upon a sale or exchange is determined by reference to the basis of the property in the hands of the transferor, proper adjustment shall be made for the amount of any liability of the transferor assumed upon the exchange and of any liability subject to which such property was so received, for the amount of any other liability of the taxpayer constituting consideration for the property so received, and for the aggregate of the amount of money and the fair market value of other property (other than such stock and other than such liabilities) transferred to the transferor.

"(B) If the property consists of an indebtedness of the taxpayer, the amount of such property shall be considered equal to the amount of the indebtedness.

"(5) ELECTION UNDER SECTION 453.—In the case of a taxpayer electing under section 453, the adjusted equity invested capital, the net new capital addition, and the net capital addition shall be computed in a manner consistent with the method of accounting so elected, except as to installment sales made prior to the first taxable year under this subchapter in the case of a taxpayer electing under section 453 (a), and except as to contracts begun before the first taxable year under this subchapter in the case of a taxpayer electing under section 354 (b).

"(6) CROSS-REFERENCES.—For special rules affecting determination of basis of property acquired in certain intercorporate liquidations, see part III.

"SEC. 438. CAPITAL CHANGES.

"(a) NEW CAPITAL CREDIT.—The new capital credit for any taxable year shall be 12 per centum of the amount of the net new capital addition for the taxable year, except that the new capital credit shall be zero if the adjusted equity capital for the taxable year, computed without regard to the last sentence of section 437 (b), is $5,000,000 or less.

"(b) NET NEW CAPITAL ADDITION.—The net new capital addition for the taxable year shall be the excess, divided by the number of days in the taxable year, of the aggregate of the daily new capital addition for each day of the taxable year over the aggregate of the daily capital reduction (determined under section 437 (e)) for each day of the taxable year.

"(c) DAILY NEW CAPITAL ADDITION.—The daily new capital addition for any day of the taxable year shall, for the purposes of this section, be the sum of the following:

"(1) The aggregate of the amounts of money and property (other than excluded capital as defined in subsection (d)) paid in for stock, or as paid-in surplus, or as a contribution to capital, after the beginning of such taxable year and prior to such day. Such property paid in shall be included in an amount equal to its basis (unadjusted) for determining gain upon sale or exchange. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 113 (b) (2).

"(2) The amount, if any, by which the equity capital at the beginning of the taxable year minus the amount of excluded capital (as defined in subsection (d)) paid in before the beginning of the taxable year and after the beginning of the taxpayer's first taxable year under this subchapter exceeds the equity capital at the beginning of such first taxable year.

"(d) DEFINITION OF EXCLUDED CAPITAL.—The term 'excluded capital' means the amount of money or property paid in for stock, or as paid-in surplus, or as a contribution to capital, to the taxpayer—

"(1) by a corporation in an exchange to which section 112 (b) (3), (4), (5), or (10), or so much of section 112 (c), (d), or (e) as refers to section 112 (b) (3), (4), (5), or (10), is applicable (or would be applicable except for section 371 (g)), or would have been applicable if the term 'control' had been defined in section 112 (h) to mean the ownership of stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote or more than 50 per centum of the total value of shares of all classes of stock.

"(2) by a transferor corporation if immediately after such transaction the transferor and the taxpayer are members of the same controlled group. As used in this paragraph, a controlled group means one or more chains of corporations connected through stock ownership with a common parent corporation if (A) more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock, of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and (B) the common parent corporation owns directly more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock, of at least one of the other corporations.

In determining the amount of any property so paid in, such property shall be included in an amount determined in the manner provided in subsection (c) (1).

"SEC. 439. BORROWED CAPITAL CREDIT.

"(a) AMOUNT OF CREDIT—GENERAL RULE.—Except as provided in subsection (b), the borrowed capital credit shall be an amount equal to one-third of the

deduction allowable for such year with respect to interest on borrowed capital plus one-third of the interest element accrued or paid, if not allowable as an interest deduction, on conditional sales contracts; except that such credit shall in no case (1) exceed an amount equal to 3 per centum of the average borrowed capital for such year as computed under subsection (c) or (2) be less than an amount equal to 1 per centum of the average borrowed capital for such year as computed under subsection (c) excluding from the computation of the daily borrowed capital for any day any indebtedness evidenced by an obligation the original maturity of which was for a term of less than five years.

"(b) INSURANCE COMPANIES.—In the case of an insurance company, the borrowed capital credit for any taxable year shall be the sum of the following:

"(1) the amount of the credit allowed under subsection (a), plus,

"(2) an amount equal to 1 per centum of the mean of the pro rata unearned premiums, determined at the beginning and end of the taxable year, plus,

"(3) in the case of a life insurance company an amount equal to one-third of the sum of:

"(A) the product of (i) the mean of the amount of the adjusted life insurance reserves, determined at the beginning and end of the taxable year, and (ii) its average rate of interest assumed in computing such reserves, plus

"(B) the product of (i) the mean of the amount of the reserves on insurance contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time with reference to which the computation was made, life, health, or accident contingencies, determined at the beginning and end of the taxable year, and (ii) its average rate of interest assumed in computing such reserves.

The average rate of interest assumed by the taxpayer during the taxable year shall be calculated in the manner provided in section 201 (c) (4).

"(c) DEFINITION OF BORROWED CAPITAL.—

"(1) AVERAGE BORROWED CAPITAL.—The average borrowed capital for any taxable year shall be the aggregate of the daily borrowed capital for each day of such taxable year, divided by the number of days in such taxable year.

"(2) DAILY BORROWED CAPITAL.—The daily borrowed capital for any day of any taxable year shall be the amount, as of the beginning of such day, of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, or conditional sales contract. In the case of property of the taxpayer subject to a mortgage or other lien, the amount of indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the taxpayer whether or not the taxpayer assumed or agreed to pay such indebtedness.

"SEC. 440. ADMISSIBLE AND INADMISSIBLE ASSETS.

"(a) DEFINITIONS.—For the purposes of this subchapter—

"(1) The term 'inadmissible assets' means—

"(A) Stock in corporations, except stock in a foreign personal holding company, and except stock which is not a capital asset; and

"(B) Obligations described in section 22 (b) (4) any part of the interest from which is excludible from gross income or allowable as a credit against net income.

"(2) The term 'admissible assets' means all assets other than inadmissible assets.

"(b) RATIO OF INADMISSIBLES TO TOTAL ASSETS.—The amount by which the sum referred to in section 436 shall be reduced for any taxable year shall be an amount which is the same percentage of such sum as the percentage which the total of the inadmissible assets is of the total of admissible and inadmissible assets. For such purposes, the amount attributable to each asset held at any time during such taxable year shall be determined by ascertaining the adjusted basis thereof (or, in the case of money, the amount thereof) for each day of such taxable year so held and adding such daily amounts. The determination of such daily amounts shall be made under regulations prescribed by the Secretary. The adjusted basis shall be the adjusted basis for determining gain upon sale or exchange as determined under section 113.

"SEC. 441. FOREIGN CORPORATIONS AND CORPORATIONS ENTITLED TO BENEFITS OF SECTION 251—INVESTED CAPITAL.

"(a) COMPUTATION OF CREDIT.—Notwithstanding section 436, in the case of a foreign corporation engaged in a trade or business within the United States, and in the case of a corporation entitled to the benefits of section 251, the excess profits credit computed under section 436 shall be determined in accordance with rules and regulations prescribed by the Secretary, under which—

"(1) GENERAL RULE.—The excess profits credit shall be the basic equity capital credit computed under section 437, reduced by the amount computed under section 440 (relating to inadmissible assets). In computing the basic equity capital credit for the purposes of this section (A) the adjusted equity capital for any taxable year shall be the aggregate of the equity capital as of the beginning of each day of such taxable year divided by the number of days in such year, (B) the term 'assets' as used in section 437 (c) shall be considered as referring to United States assets, and (C) the term 'liabilities' as used in such section shall be considered as referring to United States liabilities. In the application of section 440, the terms 'admissible assets' and 'inadmissible assets' shall include only United States assets.

"(2) EXCEPTION.—If the Secretary determines that the United States assets of the taxpayer cannot satisfactorily be segregated from its other assets or that the United States liabilities of the taxpayer cannot satisfactorily be segregated from its other liabilities, the adjusted equity capital of the taxpayer shall be an amount (in lieu of the amount ascertained under paragraph (1)) which is the same percentage of the equity capital of the taxpayer, determined under section 437 (c) as of the end of the last day of the taxable year without the application of this paragraph, which the net income for the taxable year from sources within the United States is of the total net income of the taxpayer for such year.

"(b) DEFINITIONS.—As used in this section—

"(1) the term 'United States assets' means assets held by the taxpayer in the United States, determined in accordance with rules and regulations prescribed by the Secretary.

"(2) the term 'United States liabilities' means the liabilities of the taxpayer which are directly related to its United States assets, determined in accordance with rules and regulations prescribed by the Secretary.

"SEC. 442. AVERAGE BASE PERIOD NET INCOME—ABNORMALITIES DURING BASE PERIOD.

"(a) GENERAL.—If for any taxable year within, or beginning or ending within, the base period a taxpayer which commenced business prior to January 1, 1946, establishes that:

"(1) normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during such taxable years, of events unusual and peculiar in the experience of such taxpayer, or

"(2) the business of the taxpayer was depressed because of temporary economic circumstances unusual in the case of such taxpayer,

and if the amount determined under subsection (c) exceeds 110 percent of the excess profits net income for the 12 calendar months in which an abnormality is determined to exist under this subsection and if no such abnormality is determined to exist for at least one period of 12 calendar months exclusive of the 12-month period eliminated under subsection (b) (2), the taxpayer's average base period net income shall be the amount determined in accordance with the provisions of this section or section 435, whichever is higher.

"(b) AVERAGE BASE PERIOD NET INCOME.—The average base period net income determined under this section shall be determined as follows:

"(1) By computing the excess profits net income or deficit in excess profits net income for each month in the base period. The excess profits net income or the deficit in excess profits net income for any month shall be the excess profits net income or deficit in excess profits net income, as the case may be, for the taxable year in which such month falls divided by the number of calendar months in such year.

"(2) By eliminating from the base period whichever of the twelve-month periods corresponding to the calendar year the elimination of which produces the highest remaining aggregate excess profits net income or the lowest aggregate deficit in excess profits net income.

"(3) By substituting for the aggregate excess profits net income or aggregate deficit in excess profits net income, as the case may be, of any remain-

ing twelve-month period corresponding to the calendar year an amount determined under subsection (c).

"(4) By computing the aggregate of the excess profits net income, or substitute excess profits net income, for each of the thirty-six months remaining in the base period, reduced by the sum of the deficits in excess profits net income for each of such months.

"(5) By dividing by 3 the amount ascertained under paragraph (4).

"(c) ADJUSTMENT.—The excess profits net income for any 12 calendar months in which an abnormality is determined to exist under subsection (a) shall be an amount which bears the same relation to the aggregate of the taxpayer's excess profits net income for the remaining calendar months of the base period in which no abnormality has been determined to exist (exclusive of the 12-month period eliminated under subsection (b) (2)) as the taxpayer's industry index for the calendar months in which the abnormality has been determined to exist bears to the aggregate of the taxpayer's industry indices for such remaining calendar months.

"(d) TAXPAYER'S INDUSTRY INDEX.—For purposes of this section the taxpayer's industry index for any 12 calendar months in the base period shall be the index proclaimed by the Secretary in accordance with the provisions of section 445 for that industry classification to which is attributable the largest amount of the taxpayer's average monthly gross receipts for such 12 calendar months.

"(e) GROSS RECEIPTS.—As used in this section 'average monthly gross receipts' with respect to any period means the figure ascertained as follows:

"(1) By computing the total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business;

"(2) By computing the gross income, attributable to a trade or business regularly carried on by the taxpayer, received or accrued during such period, excluding therefrom—

"(A) Gross income derived from the sale, exchange, or other disposition of property;

"(B) Gross income derived from discharge of indebtedness of the taxpayer;

"(C) Dividends on stocks of corporations; and

"(D) Income attributable to recovery of bad debts; and

"(3) By dividing the sum of the amounts computed under paragraphs (1) and (2) by the number of months in such period.

In the event that a taxable year falls partly within such period, there shall be allocated, for the purposes of paragraphs (1) and (2), to the portion of the period within such year an amount of the total gross receipts (as defined in such paragraphs) for such year in the same proportion as the number of months in such year within the period bears to the total number of months in such year.

"(f) RULES FOR APPLICATION OF SECTION.—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section 430 (d). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Secretary. If average base period net income has been determined under the provisions of this section for any taxable year, the Secretary may by regulations prescribe the extent to which this subsection may be waived for purposes of determining the tax under this subchapter for a subsequent taxable year.

"SEC. 443. CHANGE IN PRODUCT OR SERVICES.

"(a) IN GENERAL.—In the case of any taxpayer which commenced business on or before January 1, 1946, and which establishes that—

"(1) during the 36-month period ending December 31, 1949, there was a substantial change in the products or in the services furnished,

"(2) more than thirty-three and one-third per centum of its net income for any one of the three consecutive taxable years immediately following the taxable year in which the change referred to in paragraph (1) occurred is attributable to such changed products or services, and

"(3) its net income for any one of the taxable years in which it has met the requirement of paragraph (2) exceeds one hundred and twenty-five per centum of its average net income for the taxable year or years which ended after December 31, 1945, and prior to the taxable year in which such change occurred,

its average base period net income for each excess profits tax taxable year, beginning with the year in which the change in product or service was made, shall be the amount computed in accordance with subsection (b) or section 435 (adjusted in a manner consistent with the provisions of subsection (g) of this section, relating to the exclusion of certain capital additions and reductions), whichever is the larger.

"(b) AVERAGE BASE PERIOD NET INCOME.—The average base period net income determined under this section shall be computed as follows:

"(1) If the taxable year in which the taxpayer met the requirements of subsections (a) (2) and (3) ends prior to January 1, 1950, by multiplying the amount of the taxpayer's total assets for December 31, 1949, by the base period rate of return for the taxpayer's industry;

"(2) If the taxable year in which the taxpayer met the requirements of subsections (a) (2) and (3) ends subsequent to December 31, 1949, by multiplying the amount of the taxpayer's total assets for the last day of such taxable year by the base period rate of return for the taxpayer's industry.

"(c) TOTAL ASSETS.—For the purposes of this section the taxpayer's total assets for any day shall be determined as of the end of such day and shall be an amount equal to the sum of the cash and the property other than cash used in the taxpayer's business. Such property shall be included in an amount equal to its adjusted basis for determining gain upon sale or exchange.

"(d) TAXPAYER'S INDUSTRY CLASSIFICATION.—For purposes of this section the taxpayer's industry classification for any day shall be that industry classification proclaimed by the Secretary in accordance with the provisions of section 445 to which is attributable the largest amount of the taxpayer's gross receipts for the taxable year which includes such day.

"(e) BASE PERIOD RATE OF RETURN.—For purposes of this section the base period rate of return for any excess profits tax taxable year shall be that rate of return for the taxpayer's industry classification proclaimed by the Secretary in accordance with the provisions of section 445.

"(f) GROSS RECEIPTS.—As used in this section the term 'gross receipts' when used with respect to any period means the sum of the following:

"(1) The total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of a taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, and

"(2) The gross income, attributable to a trade or business regularly carried on by the taxpayer, received or accrued during such period, excluding therefrom—

"(A) Gross income derived from the sale, exchange, or other disposition of property;

"(B) Gross income derived from discharge of indebtedness of the taxpayer;

"(C) Dividends on stocks of corporations; and

"(D) Income attributable to recovery of bad debts.

"(g) CAPITAL ADDITIONS AND CAPITAL REDUCTIONS.—In determining the net capital addition or the net capital reduction, as the case may be, of a corporation the excess profits tax liability of which has been determined by employing average base period net income computed in accordance with this section, no regard shall be had to any capital addition or capital reduction made on or prior to the day for which the total assets of the taxpayer were determined.

"(h) RULES FOR APPLICATION OF SECTION.—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section 430 (d). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Secretary. If average base period net income has been determined under the provisions of this section for any taxable year, the Secretary may by regulations prescribe the extent

to which this subsection may be waived for purposes of determining the tax under this subchapter for a subsequent taxable year.

"SEC. 444. AVERAGE BASE PERIOD NET INCOME—NEW CORPORATION.

"(a) NEW CORPORATION.—A taxpayer which commenced business after the beginning of its base period, and which is not an acquiring corporation of a component corporation which was in existence (as determined under section 461 (d)) prior to the beginning of such base period, shall be a new corporation for purposes of this section and its average base period net income shall be the amount determined in accordance with subsection (b) or section 435 (adjusted in a manner consistent with the provisions of subsection (f) of this section, relating to the exclusion of certain capital additions and reductions), whichever is the larger.

"(b) AVERAGE BASE PERIOD NET INCOME.—The average base period net income of a new corporation determined under this section shall be computed as follows:

"(1) For the taxpayer's first taxable year, if such taxable year is an excess profits tax taxable year, by multiplying the amount of the taxpayer's total assets for the last day of such taxable year by the base period rate of return for the taxpayer's industry;

"(2) For the taxpayer's second taxable year, if such taxable year is an excess profits tax taxable year, by multiplying the amount of the taxpayer's total assets for the last day of such taxable year by the base period rate of return for the taxpayer's industry;

"(3) For the taxpayer's third taxable year, if such taxable year is an excess-profits tax taxable year, by multiplying the amount of the taxpayer's total assets for the last day of such taxable year by the base period rate of return for the taxpayer's industry;

"(4) For the taxpayer's fourth taxable year and for succeeding taxable years, if such fourth and succeeding taxable years are excess-profits tax taxable years, by multiplying the amount of the taxpayer's total assets for the last day of the taxpayer's third taxable year, or for December 31, 1949, whichever day is later, by the base period rate of return for the taxpayer's industry.

"(c) TOTAL ASSETS.—For the purposes of this section the taxpayer's total assets for any day shall be determined as of the end of such day and shall be an amount equal to the sum of the cash and the property other than cash used in the taxpayer's business. Such property shall be included in an amount equal to its adjusted basis for determining gain upon sale or exchange.

"(d) TAXPAYER'S INDUSTRY CLASSIFICATION.—For purposes of this section the taxpayer's industry classification for any day shall be that industry classification proclaimed by the Secretary in accordance with the provisions of section 445 to which is attributable the largest amount of the taxpayer's gross receipts for the taxable year which includes such day, except that the industry classification applicable to the taxable year in which falls the thirty-fifth month following the month in which the taxpayer commenced business shall apply to all succeeding excess-profits tax taxable years.

"(e) BASE PERIOD RATE OF RETURN.—For purposes of this section the base period rate of return for any excess-profits tax taxable year shall be that rate of return for the taxpayer's industry classification proclaimed by the Secretary in accordance with the provisions of section 445.

"(f) CAPITAL ADDITIONS AND CAPITAL REDUCTIONS.—In determining the net capital addition or the net capital reduction, as the case may be, of any new corporation the excess-profits tax liability of which has been determined by employing average base period net income computed in accordance with this section, no regard shall be had to any capital addition or capital reduction made on or prior to the day for which the total assets of the taxpayer were determined.

"(g) GROSS RECEIPTS.—As used in this section the term 'gross receipts' when used with respect to any period means the amount computed as follows:

"(1) By computing the total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business,

(2) By computing the gross income, attributable to a trade or business regularly carried on by the taxpayer, received or accrued during such period, excluding therefrom—

"(A) Gross income derived from the sale, exchange, or other disposition of property;

"(B) Gross income derived from discharge of indebtedness of the taxpayer;

"(C) Dividends on stocks of corporations; and

"(D) Income attributable to recovery of bad debts.

"(h) RULES FOR APPLICATION OF SECTION.—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section 430 (d). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Secretary. If average base period net income has been determined under the provisions of this section for any taxable year, the Secretary may by regulations prescribe the extent to which this subsection may be waived for purposes of determining the tax under this subchapter for a subsequent taxable year.

"SEC. 445. INDUSTRY BASE PERIOD RATES OF RETURN.

"(a) INDUSTRY CLASSIFICATION.—The Secretary, not later than March 1, 1951, shall determine and proclaim a classification of taxpayers by industry, such classification to be generally in accord with the classification regularly used by the Treasury Department in compiling published statistics from corporation income tax returns.

"(b) BASE PERIOD YEARLY RATE OF RETURN.—The Secretary shall determine and proclaim for each industry classification under subsection (a) the rate of return for each of the four calendar years 1946 through 1949 and indices based thereon. Each such industry base period yearly rate of return shall be obtained by dividing the sum of the aggregate net income and the aggregate interest deduction for all corporations in the particular industry classification filing income tax returns for such year by the average of the aggregate total assets of such corporations for such year.

"(c) BASE PERIOD RATE OF RETURN.—The Secretary shall determine and proclaim for each industry classification under subsection (a) the rate of return for the forty-eighth month period ending December 31, 1949, obtained by dividing the sum of the aggregate net income for such period and the aggregate interest deduction for such period for all corporations in the particular industry classification filing income tax returns for taxable years in such period by the aggregate total assets of such corporations for such period.

"(d) TENTATIVE RATES OF RETURN.—The Secretary, not later than March 1, 1951, shall determine and proclaim for each industry classification, tentative base period yearly rates of return, tentative indices based thereon, and a tentative base period rate of return. Such tentative rates of return shall be effective, subject to the provisions of section 430 (d) concerning deferment of tax, until such time as the base period yearly rates of return and base period rates of return are determined and proclaimed.

"SEC. 446. EXCESS PROFITS CREDIT—REGULATED PUBLIC UTILITIES.

"(a) The excess profits credit for any taxable year computed under this section shall be the regulated public utilities credit (as defined in subsection (b)) reduced by the amount computed under section 440 (relating to inadmissible assets).

"(b) The regulated public utilities credit for any taxable year shall be an amount which is the sum of the following:

"(1) The tax imposed by sections 13, 14, and 15 for such taxable year, and

"(2) an amount computed by applying to the sum of the following the per centum prescribed in subsection (c):

"(A) the adjusted equity capital for such taxable year (as computed under section 437 (b) without regard to the last sentence thereof, and

"(B) the average borrowed capital for such taxable year (as defined in section 439 (c))

less the deduction allowable for such year with respect to interest on indebtedness included in borrowed capital under section 439 (c).

"(c) The per centum referred to in subsection (b) (2) shall be—

"(1) 6 per centum in the case of a corporation engaged in the furnishing or sale of—

"(A) telephone service, telegraph service, electric energy, gas, or water, or

"(B) transportation (not included in paragraph (3) below) on an intrastate, suburban, municipal, or interurban electric railroad, or on an intrastate, municipal, or suburban trackless trolley system, or a municipal or suburban bus system—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, or by an agency or instrumentality of the United States or by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof.

"(2) 6 per centum in the case of a corporation engaged as a common carrier in the furnishing or sale of transportation by pipe line of oil or gas, if subject to the jurisdiction of the Interstate Commerce Commission or the Federal Power Commission.

"(3) 5 per centum in the case of a corporation engaged in the furnishing or sale of transportation by common carrier—

"(A) by railroad, subject to the jurisdiction of the Interstate Commerce Commission, or

"(B) by air, subject to the jurisdiction of the Civil Aeronautics Board.

"(d) For the purposes of this subchapter the term 'regulated public utility' means a corporation described in subsection (c) substantially all of whose excess profits net income for the taxable year is derived from sources described in subsection (c).

"SEC. 447. PERSONAL SERVICE CORPORATIONS.

"(a) DEFINITION.—As used in this subchapter, the term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists of gains, profits, or income derived from trading as a principal. For the purposes of this subsection, an individual shall be considered as owning, at any time, the stock owned at such time by his spouse or minor child or by any guardian or trustee representing them.

"(b) ELECTION AS TO TAXABILITY.—If a personal service corporation signifies, in its return under this chapter for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, and the provisions of Supplement S of this chapter shall apply to the shareholders in such corporation who were such shareholders on the last day of such taxable year of the corporation. Such corporation shall not be exempt for such year if it is a member of an affiliated group of corporations filing consolidated returns under section 141.

"SEC. 448. CORPORATIONS ENGAGED IN MINING OF STRATEGIC MINERALS.

"(a) EXEMPTION FROM TAX.—In the case of any domestic corporation engaged in the mining of a strategic mineral or a critical mineral, the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

"(b) DEFINITIONS.—For the purposes of this section—

"(1) the term 'strategic mineral' means antimony, chromite, manganese, nickel, platinum (including the platinum group metals), quicksilver, sheet mica, tantalum, tin, tungsten, vanadium, fluorspar, flake graphite, vermiculite, long-fibre asbestos in the form of amosite, chrysotile or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), monazite, quartz crystals, and uranium, and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States.

"(2) the term 'critical mineral' means a mineral (other than a strategic mineral) (A) which the certifying agency has certified to the Secretary that additional production thereof within the United States is essential for the defense effort, and (B) which is mined from—

"(i) a mineral property which was developed and brought into production subsequent to June 25, 1950; or

"(ii) a mineral property which has been in production prior to June 25, 1950, but was not in production on such date; or

"(iii) a mineral property from which, during the period it was in production during 1946, 1947, 1948, and 1949, the aggregate gross income derived therefrom was less than the aggregate of the deductions (allowable under section 23 without regard to any net operating loss deduction) attributable to such property during such period of production.

"(3) the term 'certifying agency' means the department, official, corporation, or agency utilized or created to carry out the authority of the President under section 303 (a) of the Defense Production Act of 1950 to make provision for the encouragement of exploration, development, and mining of critical and strategic minerals and metals.

"(c) Certification During Taxable Year of Taxpayer.—In determining under subsection (a) the portion of the adjusted excess profits net income which is attributable to the mining of a mineral which is a strategic or critical mineral by reason of a certification made during the taxable year, such portion shall be an amount which bears the same ratio to the portion of the adjusted excess profits net income, determined without regard to this subsection, attributable to such mining during the entire taxable year as the number of days for which the taxpayer held the mineral property during the taxable year and after the date of the making of the certification bears to the number of days for which the taxpayer held the property during such taxable year.

"(d) Application of Section to Lessor.—In the case of a mining property operated under al ease, income attributable to such property derived by a lessor corporation shall, for the purposes of this section, be considered to be income of a corporation engaged in mining.

"SEC. 449. CAPITALIZATION OF ADVERTISING, ETC., EXPENDITURES.

"(a) Election to Charge to Capital Account.—For the purpose of computing erated under a lease, income attributable to such property derived by a lessor prescribed by law for filing its return for its first taxable year under this subchapter, to charge to capital account so much of the deductions for taxable years in its applicable base period on account of expenditures for advertising or the promotion of good will, as, under rules and regulations prescribed by the Secretary, may be regarded as capital investments. Such election must be the same for all such taxable years, and must be for the total amount of such expenditures which may be so regarded as capital investments. In computing the excess profits credit, no amount on account of such expenditures shall be charged to capital account:

"(1) For taxable years in the base period unless the election authorized in this subsection is exercised, or

"(2) For any taxable year prior to the beginning of the base period.

The election provided by this subsection shall be available with respect to expenditures to establish, maintain or increase the circulation of a newspaper, magazine or other periodical notwithstanding the provisions of section 204 (b) (2) of the Revenue Act of 1950.

"(b) Effect of Election.—If the taxpayer exercises the election authorized under subsection (a)—

"(1) The net income for each taxable year in the base period shall be considered to be the net income computed with such deductions disallowed, and such deductions shall not be considered as having diminished earnings and profits. This paragraph shall be retroactively applied as if it were a part of the law applicable to each taxable year in the base period; and

"(2) The treatment of such expenditures as deductions for a taxable year in the base period shall, for the purposes of section 450 (b) be considered treatment which was not correct under the law applicable to such year.

"SEC. 450. ADJUSTMENT IN CASE OF POSITION INCONSISTENT WITH PRIOR INCOME TAX LIABILITY.

"(a) Definitions.—For the purposes of this section—

"(1) Taxpayer.—The term 'taxpayer' means any person subject to a tax under the applicable revenue act.

"(2) INCOME TAX.—The term 'income tax' means an income tax imposed by this chapter or subchapter A of chapter 2 of this title; Title I and Title IA of the Revenue Acts of 1938, 1936, and 1934; Title I of the Revenue Acts of 1932 and 1928; Title II of the Revenue Acts of 1926 and 1924; Title II of the Revenue Acts of 1921 and 1918; Title I of the Revenue Act of 1917; Title I of the Revenue Act of 1916; or section II of the Act of October 3, 1913; a war profits or excess profits tax imposed by chapter 2E of this title; Title III of the Revenue Acts of 1921 and 1918; or Title II of the Revenue Act of 1917; or an income, war profits, or excess profits tax imposed by any of the foregoing provisions, as amended or supplemented.

"(3) PRIOR TAXABLE YEAR.—A taxable year ending after June 30, 1950, shall not be considered a prior taxable year.

"(4) The term 'predecessor of the taxpayer' means—

"(A) A person which is a component corporation of the taxpayer within the meaning of Part II; and

"(B) A person which on July 1, 1950, or at any time thereafter, controlled the taxpayer. The term 'controlled' as herein used shall have the same meaning as 'control' under section 112 (h); and

"(C) Any person in an unbroken series ending with the taxpayer if subparagraph (A) or (B) would apply to the relationship between the parties.

"(b) CIRCUMSTANCES OF ADJUSTMENT.—

"(1) If—

"(A) in determining at any time the tax of a taxpayer under this subchapter an item affecting the determination of the excess profits credit is treated in a manner inconsistent with the treatment accorded such item in the determination of the income-tax liability of such taxpayer or a predecessor for a prior taxable year or years, and

"(B) the treatment of such item in the prior taxable year or years consistently with the determination under this subchapter would effect an increase or decrease in the amount of the income taxes previously determined for such taxable year or years, and

"(C) on the date of such determination of the tax under this subchapter correction of the effect of the inconsistent treatment in any one or more of the prior taxable years is prevented (except for the provisions of section 3801) by the operation of any law or rule of law (other than section 3761, relating to compromises),

then the correction shall be made by an adjustment under this section. If in a subsequent determination of the tax under this subchapter for such taxable year such inconsistent treatment is not adopted, then the correction shall not be made in connection with such subsequent determination.

"(2) Such adjustment shall be made only if there is adopted in the determination a position maintained by the Secretary (in case the net effect of the adjustment would be a decrease in the income taxes previously determined for such year or years) or by the taxpayer with respect to whom the determination is made (in case the net effect of the adjustment would be an increase in the income taxes previously determined for such year or years) which position is inconsistent with the treatment accorded such item in the prior taxable year or years which was not correct under the law applicable to such year.

"(3) BURDEN OF PROOF.—In any proceeding before the Tax Court or any other court the burden of proof in establishing that an inconsistent position has been taken (A) shall be upon the Secretary, in case the net effect of the adjustment would be an increase in the income taxes previously determined for the prior taxable year or years, or (B) shall be upon the taxpayer, in case the net effect of the adjustment would be a decrease in the income taxes previously determined for the prior taxable year or years.

"(c) METHOD AND EFFECT OF ADJUSTMENT.—

"(1) The adjustment authorized by subsection (b), in the amount ascertained as provided in subsection (d), if a net increase, shall be added to, and, if a net decrease, shall be subtracted from, the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent position is adopted.

"(2) If more than one adjustment under this section is made because more than one inconsistent position is adopted with respect to one taxable year under this subchapter, the separate adjustments, each an amount ascertained as provided in subsection (d), shall be aggregated, and the aggregate net

increase or decrease shall be added to or subtracted from the tax otherwise computed under this subchapter for the taxable year with respect to which such inconsistent positions are adopted.

"(3) If all the adjustments under this section, made on account of the adoption of an inconsistent position or positions with respect to one taxable year under this subchapter, result in an aggregate net increase, the tax imposed by this subchapter shall in no case be less than the amount of such aggregate net increase.

"(4) If all the adjustments under this section, made on account of the adoption of an inconsistent position or positions with respect to a taxable year under this subchapter (hereinafter in this paragraph called the current taxable year), result in an aggregate net decrease, and the amount of such decrease exceeds the tax imposed by this subchapter (without regard to the provisions of this section) for the current taxable year, such excess shall be subtracted from the tax imposed by this subchapter for each succeeding taxable year, but the amount of the excess to be so subtracted shall be reduced by the reduction in tax for intervening taxable years which has resulted from the subtraction of such excess from the tax imposed for each such year.

"(d) ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.—In computing the amount of an adjustment under this section there shall first be ascertained the amount of the income taxes previously determined for each of the prior taxable years for which correction is prevented. The amount of each such tax previously determined for each such taxable year shall be (1) the tax shown by the taxpayer, or by the predecessor, upon the return for such prior taxable year, increased by the amounts previously assessed (or collected without assessment) as deficiencies and decreased by the amounts previously abated, credited, refunded, or other wise repaid in respect of such tax; or (2) if no amount was shown as the tax by such taxpayer or such predecessor upon the return, or if no return was made by such taxpayer or such predecessor, then the amounts previously assessed (or collected without assessment) as deficiencies, but such amounts previously assessed, or collected without assessment, shall be decreased by the amounts previously abated, credited, refunded or otherwise repaid in respect of such tax. There shall then be ascertained the increase or decrease in each such tax previously determined for each such year which results solely from the treatment of the item consistently with the treatment accorded such item in the determination of the tax liability under this subchapter. To the increase or decrease so ascertained for each such tax for each such year there shall be added interest thereon computed as if the increase or decrease constituted a deficiency or an overpayment, as the case may be, for such prior taxable year. Such interest shall be computed to the fifteenth day of the third month following the close of the excess profits tax taxable year with respect to which the determination is made. There shall be ascertained the difference between the aggregate of such increases, plus the interest attributable to each, and the aggregate of such decreases, plus the interest attributable to each, and the net increase or decrease so ascertained shall be the amount of the adjustment under this section with respect to the inconsistent treatment of such item.

"(e) INTEREST IN CASE OF NET INCREASE OR DECREASE.—

"(1) If an adjustment under this section results in a net decrease, or more than one adjustment results in an aggregate net decrease, the portion of such net decrease or aggregate net decrease, as the case may be, subtracted from the tax which represents interest shall be included in gross income of the taxable year in which falls the date prescribed for the payment of the tax under this subchapter.

"(2) If an adjustment under this section results in a net increase, or more than one adjustment results in an aggregate net increase, the portion of such net increase or aggregate net increase, as the case may be, which represents interest shall be allowed as a deduction in computing net income for the taxable year in which falls the date prescribed for the payment of the tax under this subchapter.

"SEC. 451. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES.

"(a) DEFINITIONS.—For the purposes of this section and section 433 (a)—

"(1) PRODUCER; LESSOR; NATURAL GAS COMPANY.—The term 'producer' means a corporation which extracts minerals from a mineral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term 'lessor' means a corporation which owns an

economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term 'natural gas company' means a corporation engaged in the withdrawal or transportation by pipeline, of natural gas.

"(2) MINERAL UNIT, NATURAL GAS UNIT, AND TIMBER UNIT.—The term 'mineral unit' means a unit of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term 'natural gas unit' means a unit of natural gas sold by a natural gas company. The term 'timber unit' means a unit of timber recovered from the operation of a timber block.

"(3) EXCESS OUTPUT.—The term 'excess output' means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

"(4) NORMAL OUTPUT.—The term 'normal output' means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950 (hereinafter called 'base period'), of the person owning the mineral property or the timber block (whether or not the taxpayer). The term 'normal output,' in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950 (hereinafter called 'base period'), of the person owning the natural gas property (whether or not the taxpayer). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the base period by the number of months for which the mineral property, natural gas property, or timber block was in operation during the base period and by multiplying the amount so ascertained by twelve. In any case in which the taxpayer establishes, under regulations prescribed by the Secretary, that the operation of any mineral property, natural gas property, or timber block is normally prevented for a specified period each year by physical events outside the control of the taxpayer, the number of months during which such mineral property, natural gas property, or timber block is regularly in operation during a taxable year shall be used in computing the average annual mineral units, natural gas units, or timber units, instead of twelve. Any mineral property, natural gas property, or timber block, which was in operation for less than six months during the base period, shall, for the purposes of this section, be deemed not to have been in operation during the base period.

"(5) NATURAL GAS PROPERTY.—The term 'natural gas property' means the property of a natural gas company used for the withdrawal, storage, and transportation by pipeline, of natural gas, excluding any part of such property which is an emergency facility under section 124A.

"(6) MINERAL PROPERTY.—The term 'mineral property' means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

"(7) MINERALS.—The term 'minerals' means ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulphur, and talc.

"(8) TIMBER BLOCK.—The term 'timber block' means an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture.

"(9) NORMAL UNIT PROFIT.—The term 'normal unit profit' means the average profit for the base period per mineral unit for such period, determined by dividing the net income with respect to minerals recovered from the mineral property (computed with the allowance for depletion computed in accordance with the basis for depletion applicable to the current taxable year) during the base period by the number of mineral units recovered from the mineral property during the base period.

"(10) ESTIMATED RECOVERABLE UNITS.—The term 'estimated recoverable units' means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property

at the end of the taxable year plus the excess output for such year. All estimates shall be subject to the approval of the Secretary, the determinations of whom for the purposes of this section, shall be final and conclusive.

"(11) EXEMPT EXCESS OUTPUT.—The term 'exempt excess output' for any taxable year means a number of units equal to the following percentages of the excess output for such year:

"100 per centum if the excess output exceeds 50 per centum of the estimated recoverable units;

"95 per centum if the excess output exceeds 33⅓ but not 50 per centum of the estimated recoverable units;

"90 per centum if the excess output exceeds 25 but not 33⅓ per centum of the estimated recoverable units;

"85 per centum if the excess output exceeds 20 but not 25 per centum of the estimated recoverable units;

"80 per centum if the excess output exceeds 16⅔ but not 20 per centum of the estimated recoverable units;

"60 per centum if the excess output exceeds 14²⁄₇ but not 16⅔ per centum of the estimated recoverable units;

"40 per centum if the excess output exceeds 12½ but not 14²⁄₇ per centum of the estimated recoverable units;

"30 per centum if the excess output exceeds 10 but not 12½ per centum of the estimated recoverable units;

"20 per centum if the excess output exceeds 5 but not 10 per centum of the estimated recoverable units.

"(12) UNIT NET INCOME.—The term 'unit net income' means the amount ascertained by dividing the net income (computed with the allowance for depletion) from the coal or iron ore or the timber recovered from the coal mining property, iron mining property, or timber block, as the case may be, during the taxable year by the number of units of coal or iron ore, or timber, recovered from such property in such year. In respect of a natural gas property, the term 'unit net income' means the amount ascertained by dividing the net income, computed in accordance with regulations prescribed by the Secretary, from such property during the taxable year by the number of natural gas units sold in such year.

"(b) NONTAXABLE INCOME FROM EXEMPT EXCESS OUTPUT.—

"(1) GENERAL RULE.—For any taxable year for which the excess output of mineral property which was in operation during the base period exceeds 5 per centum of the estimated recoverable units from such property, the nontaxable income from exempt excess output for such year shall be an amount equal to the exempt excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

"(2) COAL AND IRON MINES.—For any taxable year, the nontaxable income from exempt excess output of a coal mining or iron mining property which was in operation during the base period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year, or an amount determined under paragraph (1), whichever the taxpayer elects in accordance with regulations prescribed by the Secretary.

"(3) TIMBER PROPERTIES.—For any taxable year, the nontaxable income from exempt excess output of a timber block which was in operation during the base period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year.

"(4) COAL AND IRON MINES AND TIMBER PROPERTIES NOT IN OPERATION DURING BASE PERIOD.—For any taxable year, the nontaxable income from exempt excess output of a coal mining or iron mining property or a timber block, which was not in operation during the base period, shall be an amount equal to one-sixth of the net income for such taxable year (computed with the allowance for depletion) from the coal mining or iron mining property or from the timber block, as the case may be.

"(5) NATURAL GAS COMPANIES.—In the case of a natural gas company any of the natural gas property of which was in operation during the base period, the nontaxable income from exempt excess output for any taxable year shall be an amount equal to the excess output for such year multiplied by one-half of the unit net income for such year.

"(c) NONTAXABLE BONUS INCOME.—The term 'non-taxable bonus income' means the amount of the income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of:

"(1) A mineral product or timber, the exhaustion of which gives rise to an allowance for depletion under section 23 (m), but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the output in excess of such quota; or

"(2) A mineral product extracted or recovered from mine tailings by a corporation which owns no economic interest in the mineral property from which the ore containing such tailings was mined, but such amount shall not exceed the net income attributable to the output in excess of such quota.

"(d) RULE IN CASE INCOME FROM EXCESS OUTPUT INCLUDES BONUS PAYMENT.—In any case in which the income attributable to the excess output includes bonus payments (as provided in subsection (c)), the taxpayer may elect, under regulations prescribed by the Secretary, to receive either the benefits of subsection (b) or subsection (c) with respect to such income as is attributable to excess output above the specified quota.

"SEC. 452. EXEMPT CORPORATIONS.

"The following corporations, except a member of an affiliated group of corporations filing consolidated returns under section 141, shall be exempt from the tax imposed by this subchapter:

"(a) Corporations exempt under section 101 from the tax imposed by this chapter.

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

"(c) Regulated investment companies, as defined in section 361 without the application of section 361 (b) (4).

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

"(e) Foreign corporations not engaged in trade or business within the United States.

"(f) Domestic corporations satisfying the following conditions:

"(1) If 95 per centum or more of the gross income of such domestic corporation for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources other than sources within the United States; and

"(2) If 50 per centum or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

"SEC. 453. RELIEF FOR INSTALMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

"(a) ELECTION TO ACCRUE INCOME.—Any taxpayer computing income from instalment sales under the method provided by section 44 (a) may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Secretary, its income from instalment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Such election shall be irrevocable when once made and shall apply also to all subsequent taxable years to which this subchapter is applicable and the income from instalment sales for each taxable year before the first year with respect to which the election is made which ended after June 30, 1950, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of instalment sales made in taxable years ending before July 1, 1950.

"(b) INCOME FROM LONG-TERM CONTRACTS.—Any taxpayer computing income from contracts the performance of which requires more than 12 months may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations and shall be irrevocable when once made, and shall also apply to all subsequent taxable years to which this subchapter is applicable. The net income of the taxpayer for each year to which this subchapter is applicable prior to the year with respect to which the election is made shall be adjusted for the purposes of this subchapter.

Income described in this section shall not be considered abnormal income under section 454.

"(c) ADJUSTMENT ON ACCOUNT OF CHANGES WITH RESPECT TO INSTALLMENT BASIS TAXPAYERS AND WITH RESPECT TO TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.—If an adjustment specified in subsection (a) or subsection (b) is, with respect to any taxable year, prevented, on the date of the election by the taxpayer under subsection (a) or subsection (b), as the case may be, or within two years from such date, by any provision or rule of law (other than this subsection and other than section 3761, relating to compromises), such adjustment shall nevertheless be made if in respect of the taxable year for which adjustment is sought a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within two years after the date such election is made. If at the time of the mailing of such notice of deficiency or the filing of such claim for refund, the adjustment is so prevented, then the amount of the adjustment authorized by this subsection shall be limited to the increase or decrease in any tax imposed by this chapter previously determined for such taxable year which results solely from the effect of subsection (a) or subsection (b), as the case may be, and such amount shall be assessed and collected, or credited or refunded, in the same manner as if it were deficiency or an overpayment, as the case may be, for such taxable year and as if on the date of such election, two years remain before the expiration of the period of limitation upon the assessment or the filing of claim for refund for the taxable year. The tax previously determined shall be ascertained in accordance with section 450 (d). The amount to be assessed and collected under this section in the same manner as if it were a deficiency or to be refunded or credited in the same manner as if it were an overpayment, shall not be diminished by any credit or set-off based upon any item, inclusion, deduction, credit, exemption, gain or loss, other than one resulting from the effect of subsection (a) or subsection (b), as the case may be. Such amount, if paid, shall not be recovered by a claim or suit for refund, or suit for erroneous refund based upon any item, inclusion, deduction, credit, exemption, gain or loss, other than one resulting from the effect of subsection (a) or subsection (b), as the case may be.

"(d) CROSS REFERENCES.—In the case of a taxpayer making an election under this section—

"(1) For adjustment of excess profits net income for taxable years in the base period see section 432 (b) (7) and (8); and

"(2) for adjustment of the base equity capital credit see section 437 (g) (5).

"SEC. 454. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

"(a) DEFINITIONS.—For the purposes of this section—

"(1) ABNORMAL INCOME.—The term 'abnormal income' means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) SEPARATE CLASSES OF INCOME.—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

"(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

"(3) NET ABNORMAL INCOME.—The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

"(b) AMOUNT ATTRIBUTABLE TO OTHER YEARS.—The amount of the net abnormal income that is attributable to any previous of future taxable year or years shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

"(c) COMPUTATION OF TAX FOR CURRENT TAXABLE YEAR.—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

"(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

"(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

"(d) COMPUTATION OF TAX FOR FUTURE TAXABLE YEAR.—The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

"(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

"(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

"(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

"(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable year from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

"(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1) (B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1) (B) with respect to such net abnormal income, then the portions of such net abnormal income at-

tributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

"(e) APPLICATION OF SECTION.—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

"(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

"(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

"(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

"SEC. 455. CORPORATIONS COMPLETING CONTRACTS UNDER MERCHANT MARINE ACT.

"(a) If the Federal Maritime Board certifies to the Secretary that the taxpayer has completed within the taxable year any contracts or subcontracts which are subject to the provisions of section 505 (b) of the Merchant Marine Act of 1936, as amended, then the tax imposed by this subchapter for such taxable year shall be, in lieu of a tax computed under section 430, a tax computed under subsection (b) of this section, if, and only if, the tax computed under subsection (b) is less than the tax computed under section 430.

"(b) The tax computed under this subsection shall be the excess of—

"(1) A tentative tax computed under section 430 with the normal-tax net income increased by the amount of any payments made, or to be made, to the Federal Maritime Board with respect to such contracts or subcontracts; over

"(2) The amount of such payments.

"Part II—Excess Profits Credit Based on Income in Connection With Certain Exchanges

"SEC. 461. DEFINITIONS.

"For the purposes of this Part—

"(a) ACQUIRING CORPORATION.—The term 'acquiring corporation' means—

"(1) A corporation which has acquired—

"(A) substantially all the properties of another corporation and the whole or a part of the consideration for the transfer of such properties is the transfer to such other corporation of all the stock of all classes (except qualifying shares) of the corporation which has acquired such properties, or

"(B) substantially all the properties of another corporation and the sole consideration for the transfer of such properties is the transfer to such other corporation of voting stock of the corporation which has acquired such properties, or

"(C) before December 1, 1950, properties of another corporation solely as paid-in surplus or a contribution to capital in respect of voting stock owned by such other corporation, or

"(D) substantially all the properties of a partnership in an exchange to which section 112 (b) (5), or so much of section 112 (c) or (e) as refers to section 112 (b) (5), or to which a corresponding provision of a prior revenue law, is or was applicable.

"(E) properties either from one or more corporations or from one or more partnerships or from one or more corporations and one or more

partnerships in an exchange, not otherwise described in this subsection, to which section 112 (b) (5), or so much of section 112 (c) or (e) as refers to section 112 (b) (5), or to which a corresponding provision of a prior revenue law, is or was applicable.

For the purpose of subparagraphs (B) and (C) in determining whether such voting stock or such paid-in surplus or contribution to capital is the sole consideration, the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded. Subparagraph (B) or (C) shall apply only if the corporation transferring such properties is forthwith completely liquidated in pursuance of the plan under which the acquisition is made, and the transaction of which the acquisition is a part has the effect of a statutory merger or consolidation.

"(2) A corporation which has acquired property from another corporation in a transaction with respect to which gain or loss was not recognized under section 112 (b) (6) of Chapter 1 or a corresponding provision of a prior revenue law;

"(3) A corporation the result of a statutory merger of two or more corporations; or

"(4) A corporation the result of a statutory consolidation of two or more corporations.

"(b) COMPONENT CORPORATION.—The term 'component corporation' means—

"(1) In the case of a transaction described in subsection (a) (1), the corporation which transferred the assets;

"(2) In the case of a transaction described in subsection (a) (2), the corporation the property of which was acquired;

"(3) In the case of a statutory merger, all corporations merged, except the corporation resulting from the merger; or

"(4) In the case of a statutory consolidation, all corporations consolidated, except the corporation resulting from the consolidation; or

"(5) In the case of a transaction specified in subsection (a) (1) (D), the partnership whose properties were acquired.

"(6) In the case of a transaction specified in subsection (a) (1) (E), the partnerships or corporations whose properties were acquired.

"(c) INCOME OF CERTAIN COMPONENT CORPORATIONS NOT INCLUDED.—For the purposes of section 434, section 462, section 463, and section 464 in the case of a corporation which is a component corporation in a transaction described in subsection (a)—

"(1) Except as provided in paragraphs (2), (3), and (4), for the purpose of computing, for any taxable year ending after June 30, 1950, the excess profits credit of such component corporation or of an acquiring corporation of which the acquiring corporation in such transaction is not a component, no account shall be taken of the excess profits net income, or of the average base period net income if computed under section 444 (relating to new corporations), of such component corporation for any period before the day after such transaction, or of the excess profits net income, or of the average base period net income if computed under section 444 (relating to new corporations), for any period before the day after such transaction of its component corporations in any transaction before such transaction, and no account shall be taken of the capital reduction of such component corporation either immediately before such transaction or for any prior period, or of the capital addition or capital reduction either immediately before such transaction or for any prior period of its component corporations in any transaction before such transaction.

"(2) Except as provided in paragraphs (3) and (4), in case such transaction occurred in a taxable year of such component corporation ending after June 30, 1950, for the purpose of computing the excess profits credit of such component corporation for such taxable year, the amount of its average base period net income shall be limited to an amount which bears the same ratio to such average base period net income (computed without regard to this paragraph but with the application of paragraph (1) in case of a prior transaction described in subsection (a) with respect to such component corporation or a component corporation thereof), as the number of days in such taxable year before the day after such transaction bears to the total number of days in such taxable year.

"(3) Except as provided in paragraph (4), in the case of a transaction described in subsection (a) (1) (E), for the purpose of computing the excess

profits credit of such component corporation or of an acquiring corporation of which the acquiring corporation in such transaction is not a component, no account shall be taken of that portion of the excess profits net income, or of the average base period net income if computed under section 444, of such component corporation, or of its component corporation in any transaction before such transaction, for any period before the day after such transaction which is allocable to the acquiring corporation in such transaction under section 462 (e), and no account shall be taken of that portion of the capital addition or capital reduction of such component corporation or of its component corporation in any transaction before such transaction either immediately before such transaction or for any prior period which is allocable to the acquiring corporation in such transaction under section 462 (e);

"(4) In the case of a transaction described in subsection (a) (1) (E) which occurred in a taxable year of such component corporation ending after June 30, 1950, for the purpose of computing the excess profits credit of such component corporation for such taxable year, the amount of its average base period net income shall be limited to the sum of the following:

"(A) An amount which bears the same ratio to such average base period net income (computed without regard to this paragraph but with the application of paragraphs (1) and (3) in case of a prior transaction described in subsection (a) with respect to such component corporation or a component corporation thereof), as the number of days in such taxable year before the day after such transaction bears to the total number of days in such taxable year; and

"(B) An amount which bears the same ratio to that portion of its average base period net income as is allocable to such component corporation in such transaction under section 462 (e) (computed without regard to this paragraph but with the application of paragraphs (1) and (3) in case of a prior transaction described in subsection (a) with respect to such component corporation or a component corporation thereof), as the number of days in such taxable year after the day of such transaction bears to the total number of days in such taxable year.

For the purposes of section 462, in the case of a corporation which is a component corporation in a transaction described in subsection (a), in computing for any taxable year the average base period net income of the acquiring corporation in such transaction or of a corporation of which such acquiring corporation becomes a component corporation, no account shall be taken of the excess profits net income of such component corporation for any period beginning with the day after such transaction.

"(d) For purposes of sections 443 and 444 (relating to new corporations), any taxpayer which is an acquiring corporation shall be considered to have been in existence for any period during which it or any of its component corporations was in existence. Except for purposes of the previous sentence, a component corporation in a transaction described in subsection (a) other than one described in subsection (a) (1) (E) shall be deemed not to have been in existence prior to the day after such transaction for purposes of determining the applicability of section 444 (relating to new corporations).

"(e) COMPONENT CORPORATIONS OF COMPONENT CORPORATIONS.—If a corporation is a component corporation of an acquiring corporation, under subsection (b) or under this subsection, it shall (except for the purposes of section 462 (d) (1) and (2) and section 463 (a) (1), and (3)) also be a component corporation of the corporation of which such acquiring corporation is a component corporation.

"(f) SOLE PROPRIETORSHIP.—For the purposes of sections 461 (a) (1) (D), 461 (b) (5), and 462 (g), a business owned by a sole proprietorship shall be considered a partnership."

"SEC. 462. RECOMPUTATION OF EXCESS PROFITS NET INCOME.

"(a) IN GENERAL.—In the case of a taxpayer which is an acquiring corporation, its average base period net income (for the purpose of the credit computed under section 435) shall be the amount computed under section 435 without reference to this section or the amount under section 435 after the recomputation of its excess profits net income in the manner provided in this section, whichever is the greater. The excess profits net income under section 435 (d) (1) of such acquiring corporation recomputed with the application of this section shall be the excess profits net income for each month of the acquiring corporation's base

period increased or decreased, as the case may be, by the addition or reduction resulting from including the excess profits net income for that month of all component corporations in the manner provided in subsection (b).

"(b) METHOD OF RECOMPUTATION OF EXCESS PROFITS NET INCOME OF ACQUIRING CORPORATION.—

"(1) The excess profits net income for each month in the base period of the acquiring corporation shall be determined in the case of the acquiring corporation, and of any component corporation, as provided in section 435 (d) (1) without regard, however, to that part of such section which provides that in no event shall the excess profits net income of any corporation for any month be less than zero.

"(2) For the purposes of this section, if, for any full month of the acquiring corporation's base period during which such corporation was in existence as provided in section 461 (d), either the acquiring corporation or any component corporation was not in existence, such corporation's excess profits net income for such month shall, notwithstanding the last sentence of section 435 (d) (1), be an amount equal to 1 per centum of the excess of

"(A) the equity capital (as defined in section 437 (c)) of such corporation at the close of the day before the transaction described in section 461 (a) occurred, or at the close of the base period of such corporation, whichever is earlier, over

"(B) an amount equal to the same percentage of such equity capital as would be applicable under section 440 in reduction of the excess profits credit (based on invested capital) of such corporation if section 440 were applied on the day before the transaction described in section 461 (a) occurred, or at the close of the base period of such corporation, whichever is earlier.

In case either the acquiring corporation or any component corporation owned stock in any other such corporation on the first day of such owning corporation's first taxable year under this subchapter, the amounts computed under subparagraphs (A) and (B) with respect to such corporations shall be adjusted, under regulations prescribed by the Secretary, to such extent as may be necessary to prevent the excess profits net income of such corporations for the base period of the acquiring corporation from reflecting money or property having been paid in by either of such corporations to the other for stock or as paid-in surplus or as a contribution to capital, or from reflecting stock of either having been paid in for stock of the other or as paid-in surplus or as a contribution to capital. For the purposes of this paragraph, stock in either such corporation which has in the hands of the other corporation a basis determined with reference to the basis of stock previously acquired by the issuance of such other corporation's own stock shall be deemed to have been paid in for the stock of such other corporation.

"(3) For every month of the acquiring corporation's base period there shall be added to the excess profits net income or deficit in excess profits net income of the acquiring corporation for that month the excess profits net income or deficit in excess profits net income of each component corporation for that month. The excess profits net income of the acquiring corporation for any month, recomputed as provided in the previous sentence, shall, in no event, be less than zero.

"(c) USE BY ACQUIRING CORPORATION OF ALTERNATIVE AVERAGE BASE PERIOD NET INCOME BASED ON GROWTH PROVIDED FOR IN SECTION 435 (e).—

"(1) In the case of a transaction described in section 461 (a), other than a transaction described in section 461 (a) (1) (E), in which the acquiring corporation and all the component corporations were in existence (without regard to the provisions of section 461 (d)) and had commenced business more than 48 months before the close of the base period of the acquiring corporation, the acquiring corporation, for purposes of determining its qualification under section 435 (e) (1), shall combine with its total payroll and its total gross receipts, for any portion of such acquiring corporation's base period as preceded such transaction, the total payroll and total gross receipts of such component corporations for such period. The allocation of payroll and gross receipts amounts of a component corporation to such portion of such base period shall be made in accordance with the rules provided in section 435 (e) (4) and 435 (e) (5). For purposes of qualifying under section 435 (e) (1) (B) (relating to total assets of the taxpayer), such acquiring corporation shall combine its total assets on the date specified in section 435 (e) (1) (B) with the total assets of such component cor-

porations on such date. In the event, however, that such transaction occurred during the base period of the acquiring corporation, section 435 (e) shall be inapplicable in determining the acquiring corporation's average base period net income where that determination is based upon the excess profits net income of the acquiring corporation computed under section 435 (d) (1) without reference to the recomputation provided for by this section.

"(2) In the case of a transaction described in section 461 (a), other than a transaction described in section 461 (a) (1) (E), in which either the acquiring corporation or one or more component corporations was in existence (without regard to the provisions of section 461 (d) and had commenced business more than 36 months before the close of the base period of the acquiring corporation and was entitled to the benefits of section 435 (e) prior to such transaction but in which either the acquiring corporation or one or more of such component corporations was not in existence (without regard to the provisions of section 461 (d)) or had not commenced business more than 48 months before the close of the base period of such acquiring corporation, if such transaction occurred during the base period of the acquiring corporation, section 435 (e) shall be inapplicable in determining the acquiring corporation's average base period net income based ether upon its excess profits net income computed under section 435 (d) (1) without reference to this section or upon its excess profits net income recomputed under that section in the manner provided in this section. In any such case, if such transaction occurred after the close of the base period of such acquiring corporation, the monthly excess profits net income of the corporation entitled to the benefits of section 435 (e) for any month of the acquiring corporation's base period shall be, for purposes of the recomputation provided by this section, 1/12th of the credit to which such corporation was entitled under section 435 (e).

"(3) In the case of a transaction described in section 461 (a) (1) (E) in which the component corporation was in existence and had commenced business more than 48 months before the close of the base period of the acquiring corporation, and, immediately prior to such transaction, was entitled to the benefits of section 435 (e), if such transaction occurred after the close of the base period of the component corporation, both the component corporation and the acquiring corporation shall be entitled to compute their average base period net income by the use of the method provided in section 435 (e) without reference to the tests prescribed under that section with respect to qualifying thereunder. If the transaction occurred during the base period of the acquiring corporation, the payroll and gross receipts of the component corporation for the period prior to the day of the transaction shall be allocated as between the component corporation and the acquiring corporation in the same ratio as the excess profits net income and the average base period net income computed under section 444 of the component corporation are allocated under subsection (e), and such allocated payroll and gross receipts amounts shall be treated by the component corporation and by the acquiring corporation as the payroll and gross receipts of the component corporation and the acquiring corporation for the period prior to the transaction. The acquiring corporation in such a case shall be considered, for purposes of section 435 (e), as having commenced business at the time the component corporation commenced business. In the application of the test prescribed in section 435 (e) (1) (B) (relating to total assets of the taxpayer) the component corporation and the acquiring corporation shall each be considered as having the total assets of the component corporation as of the date applicable for purposes of section 435 (e) (1) (B).

"(4) For the purposes of this subsection, in any case subject to the application of paragraphs (1) and (2), where, for purposes of section 435 (e), the gross receipts of a corporation are referred to in the determination of the average base period net income under that section, the Secretary shall prescribe by regulation such rules as may be necessary in order to insure that such gross receipts shall not be distorted by reason of transactions between companies which are parties to the transaction described in section 461 (a).

"(d) USE BY ACQUIRING CORPORATION OF ALTERNATIVE AVERAGE BASE PERIOD NET INCOME PROVIDED FOR NEW CORPORATION IN SECTION 444.—An acquiring corporation in a transaction described in section 461 (a), other than a transaction described in section 461 (a) (1) (E), if it was not in existence (as determined under section 461 (d)) prior to January 1, 1946, shall be entitled to determine its

average base period net income for purposes of section 444 in the manner provided in section 444 subject, however, to the following exceptions:

"(1) Where the transaction occurred after the close of the third taxable year of the acquiring corporation and of the component corporation or corporations, the average base period net income of the acquiring corporation after the transaction shall be determined, for purposes of section 444, in lieu of in the manner provided by section 444 (b), by adding the average base period net incomes of the acquiring corporation and of the component corporation or corporations as previously determined under that section at the close of the third taxable years of such corporations.

"(2) Where the transaction occurred prior to the close of the third taxable year of either the acquiring corporation (determined without regard to section 461 (d)) or of one or more of the component corporations, but after the close of the third taxable year of one or more of such corporations, the average base period net income of the acquiring corporation for purposes of section 444 shall be determined, in lieu of in the manner provided by subsection (b), by adding the average base period net incomes previously determined under section 444 at the close of the third taxable year of the corporations in existence for more than three taxable years and an average base period net income amount computed by the method specified in section 444 for each corporation not in existence for three taxable years by applying the industry rate of return for such corporation to the total assets of such corporation immediately prior to such transaction.

An acquiring corporation in a transaction referred to in section 461 (a) (1) (E) shall not be entitled to determine its average base period net earnings by reference to section 444 except to the extent that it is entitled to an allocable portion of the average base period net income of a component corporation so computed and allocated to the acquiring corporation in the manner prescribed by subsection (e) of this section.

"(e) ALLOCATION RULE.—In the case of a transaction described in section 461 (a) (1) (E), the amount of the component corporation's excess profits net income for any month which shall be taken into account by the acquiring corporation in the recomputation of its excess profits net income as provided in subsection (b) shall be such portion of the component corporation's total excess profits net income for that month as the fair market value of the assets transferred by the component corporation to the acquiring corporation bears to the fair market value of the total assets of the component corporation as they existed at the close of the day before the transaction. In any such case, that amount of the average base period net income, if computed under section 444 (relating to new corporations), of the component corporation which is allocable to the acquiring corporation shall be such portion of the component corporation's total average base period net income computed under that section as the fair market value of the assets transferred by the component corporation to the acquiring corporation bears to the fair market value of the total assets of the component corporation as they existed at the close of the day before the transaction. Pursuant to regulations prescribed by the Secretary, in lieu of the amount of the component corporation's excess profits net income for any month, or of the component corporation's average base period net income computed under section 444, referred to above and determined as prescribed above, there may be included an amount agreed upon by the acquiring corporation and the component corporation and any other corporation a party to such transaction, provided the Secretary consents thereto. In no case shall the total of the excess profits net incomes, or the total of the average base period net incomes computed under section 444, provided for in such agreement be in excess of 100 per centum of the excess profits net income, or of the average base period net income computed under section 444, of the component corporation. In any case in which an agreement between the parties and consent thereto by the Secretary is not obtained, a final determination of the fair market values of the properties for the purposes of this subsection shall be binding upon all parties claiming a right to the credit of the component corporation.

"(f) (1) If, after December 31, 1945—

"(A) the taxpayer acquired stock in another corporation, and thereafter such other corporation became a component corporation of the taxpayer, or

"(B) a corporation (hereinafter called 'first corporation') acquired stock in another corporation (hereinafter called 'second corporation'), and thereafter the first and second corporations became component corporations of the taxpayer,

then to the extent that the consideration for such acquisition was not the issuance of the taxpayer's or first corporation's, as the case may be, own stock, the average base period net income of the taxpayer shall be reduced, and the transferred capital addition and reduction adjusted, in respect of the income and capital addition and reduction of the corporation whose stock was so acquired and in respect of the income and capital addition and reduction of any other corporation which at the time of such acquisition was connected directly or indirectly through stock ownership with the corporation whose stock was so acquired and which thereafter became a component corporation of the taxpayer, in such amounts and in such manner as shall be determined in accordance with regulations prescribed by the Secretary. For the purposes of this paragraph, stock which has, in the hands of the taxpayer or first corporation, as the case may be, a basis determined with reference to the basis of stock previously acquired by the issuance of the taxpayer's or first corporation's, as the case may be, own stock, shall be considered as having been acquired in consideration of the issuance of the taxpayer's or first corporation's, as the case may be, own stock.

"(2) If during the taxable year for which tax is computed under this subchapter the taxpayer acquires assets in a transaction which constitutes in an acquiring corporation, the amount includible under subsection (a), attributable to such transaction, shall be limited to an amount which bears the same ratio to the amount computed without regard to this subsection as the number of days in the taxable year after such transaction bears to the total number of days in such taxable year.

"(g) In the case of a partnership which is a component corporation by virtue of section 461 (b) (5) and (6), the computations required by this Part shall be made, under rules and regulations prescribed by the Secretary, as if such partnership had been a corporation.

"(h) In the case of a taxpayer which becomes an acquiring corporation in any taxable year ending after June 30, 1950, if, at the beginning of the first taxable year of such corporation which ends after June 30, 1950, and at all times until the taxpayer became an acquiring corporation—

"(1) the taxpayer owned not les than 75 per centum of each class of stock of each of the qualified component corporations involved in the transaction in which the taxpayer became an acquiring corporation; or

"(2) one of the qualified component corporations involved in the transaction owned not less than 75 per centum of each class of stock of the taxpayer, and of each of the other qualified component corporations involved in the transaction,

the average base period net income of the taxpayer shall not be less than (A) the average base period net income of that one of its qualified component corporations involved in the transaction the average base period net income of which is greatest, or (B) the average base period net income of the taxpayer computed without regard to the base period net income of any of its qualified component corporations involved in the transaction. As used in this subsection, the term 'qualified component corporation' means a component corporation which was in existence on the date of the beginning of the taxpayer's base period.

"SEC. 463. CAPITAL CHANGES.

"(a) TAXPAYER USING PART II OF THIS SUBCHAPTER.—For the purposes of section 435 (g), if the transaction which constitutes the taxpayer an acquiring corporation occurs in a taxable year of the taxpayer which ends after June 30, 1950, and the taxpayer's average base period net income is computed under section 435 after the redetermination of its excess profits net income in the manner provided in section 462, the following rules shall apply in computing the daily capital addition and daily capital reduction of the taxpayer for each day after such transaction:

"(1) The transferred capital addition or transferred capital reduction of the component corporation shall be treated as if it were a capital addition or reduction as the case may be, of the taxpayer.

"(2) The transferred capital addition of the component corporation shall be its daily capital addition as of the time immediately before the transaction (computed under section 435 (g), but without regard to the reduction of the amount ascertained under section 435 (g) (3) on account of inadmissible assets as defined in section 440, but with the application of paragraph (6) of this subsection).

"(3) The transferred capital reduction of the component corporation shall be its daily capital reduction as of the time immediately before the trans-

action (computed under section 435 (g), but without regard to the reduction of the amount ascertained under section 435 (g) (4) on account of inadmissible assets as defined in section 440, but with the application of paragraph (7) of this subsection).

"(4) In computing the daily capital addition of the taxpayer, money or property paid in to the taxpayer by any of its component corporations, and property consisting of stock in any such component corporation paid in by shareholders of such component corporation, shall be disregarded.

"(5) In computing the daily capital reduction of the taxpayer, distributions by the taxpayer to any of its component corporations not out of earnings and profits shall be disregarded.

"(6) In computing the transferred capital addition of the component corporation, money or property paid in to such component corporation by the taxpayer or any other component corporation and property consisting of stock in the taxpayer or any other component corporation paid in by shareholders of the taxpayer or other component corporation, shall be disregarded.

"(7) In computing the transferred capital reduction of the component corporation, distributions by such component corporation to the taxpayer or any other component corporation shall be disregarded.

"(8) The daily capital addition and daily capital reduction of the taxpayer to which any amount is added under paragraph (1) shall be the amount thereof computed before its reduction under section 435 (g) (3) or (4), as the case may be, on account of inadmissible assets as defined in section 440.

"(b) RULE WHERE ACQUIRING CORPORATION IS COMPONENT OF TAXPAYER.—In cases where an acquiring corporation is a component of the taxpayer, and the transaction which constitutes such corporation an acquiring corporation occurs in a taxable year of such corporation which ends after June 30, 1950, for the purpose of determining the daily capital addition or reduction of the taxpayer the above rules shall be applied in a similar manner to determine the daily capital addition or reduction of such acquiring corporation for each day after such transaction.

"SEC. 464. CAPITAL ADDITIONS IN BASE PERIOD.

"In the case of transactions described in section 461 (a) in which one or more of the corporations which were parties to the transaction had capital additions in the base period as defined in section 435 (f) then, for purposes of determining the average base period net income of the acquiring corporation based upon its excess profits net income recomputed as provided in section 462, such capital additions shall be treated, pursuant to regulations prescribed by the Secretary, in a manner consistent with the method provided for the determination of such capital additions in section 435 (f).

"SEC. 465. FOREIGN CORPORATIONS.

"The term 'corporation' as used in this part does not include a foreign corporation.

"Part III—Adjusted Basis of Assets Received in Certain Intercorporate Liquidations

"SEC. 470. ADJUSTED BASIS OF ASSETS RECEIVED IN CERTAIN INTERCORPORATE LIQUIDATIONS.

"(a) BASIS OF ASSETS ACQUIRED IN INTERCORPORATE LIQUIDATION.—The property received by a transferee in an intercorporate liquidation attributable to a share of stock having in the hands of the transferee a basis determined to be a cost basis, shall be considered to have an adjusted basis at the time so received determined as follows:

"(1) The aggregate of the property (other than money) held by the transferor at the time of the acquisition by the transferee of control of the transferor (or, if such share was acquired after the acquisition of such control, at the time of the acquisition of such share, or if such control was not acquired, at the time immediately prior to the receipt of any property in the intercorporate liquidation in respect of such share) shall be deemed to have an aggregate basis equal to the amount obtained by (A) multiplying the amount of the adjusted basis at such time of such share in the hands of the transferee by the aggregate number of share units in the transferor at such time (the interest represented by such share being taken as the share unit), and

(B) adjusting for the amount of money on hand and the liabilities of the transferor at such time.

"(2) The basis which property of the transferor is deemed to have under paragraph (1) at the time therein specified shall be used in determining the basis of property subsequently acquired by the transferor the basis of which is determined with reference to the basis of property specified in paragraph (1).

"(3) The basis which property of the transferor is deemed to have under paragraphs (1) and (2) at the time therein specified shall be used in determining all subsequent adjustments to the basis of such property.

"(4) The property so received by the transferee shall be deemed to have, at the time of its receipt, the same basis it is deemed to have under the foregoing provisions of this subsection in the hands of the transferor, or in the case of property not specified in paragraph (1) or (2), the same basis it would have had in the hands of the transferor.

"(5) Only such part of the aggregate property received by the transferee in the intercorporate liquidation as is attributable to such share shall be considered as having the adjusted basis which property is deemed to have under paragraphs (1), (2), (3), and (4) of this subsection.

"(b) BASIS FOR EQUITY CAPITAL CREDIT.—The adjusted basis which property received by the transferee in an intercorporate liquidation is considered to have under the provisions of subsection (a) at the time of its receipt shall be thereafter treated as the adjusted basis, in lieu of the adjusted basis otherwise prescribed, in computing any amount, determined by reference to the basis of such property in the hands of the transferee, entering into the computation of the equity capital of the transferee, or of any other corporation the computation of the equity capital of which is determined by reference to the basis of such property in the hands of the transferee.

"(c) STATUTORY MERGERS AND CONSOLIDATIONS.—If a corporation owns stock in another corporation and such corporations are merged or consolidated in a statutory merger or consolidation, then for the purposes of this section and section 437 such stock shall be considered to have been acquired (in such statutory merger or consolidation) by the corporation resulting from the statutory merger or consolidation, and the properties of such other corporation attributable to such stock to have been received by such resulting corporation as a transferee from such other corporation as a transferor in an intercorporate liquidation.

"(d) DETERMINATIONS.—

"(1) REGULATIONS.—Any determination which is required to be made under this section (including determinations in applying this section in cases where there is a series of transferees of the property and cases where the stock of the transferor is acquired by the transferee from another corporation, and the determinations of the basis and adjusted basis which property or items thereof have or are considered to have) shall be made in accordance with regulations which shall be prescribed by the Secretary. If the transferor or the transferee is a foreign corporation, the provisions of this section shall apply to such extent and under such conditions and limitations as may be provided in such regulations.

"(2) APPLICATION TO LIQUIDATION EXTENDING OVER LONG PERIOD.—The Secretary is authorized to prescribe rules similar to those provided in this section with respect to the days within the period beginning with the date on which the first property is received in the intercorporate liquidation and ending with the day of its completion; and the extent to which, and the conditions and limitations under which, such rules are to be applicable.

"(e) DEFINITIONS.—

"(1) INTERCORPORATE LIQUIDATION.—As used in this section, the term 'intercorporate liquidation' means the receipt (whether or not after December 31, 1949) by a corporation (hereinafter called the 'transferee') of property in complete liquidation of another corporation (hereinafter called the 'transferor') to which

"(A) the provisions of section 112 (b) (6), or the corresponding provision of a prior revenue law, is applicable or

"(B) a provision of law is applicable prescribing the nonrecognition of gain or loss in whole or in part upon such receipt (including a provision of the regulations applicable to a consolidated income or

excess profits tax return but not including section 112 (b) (7), (9), or (10) or a corresponding provision of a prior revenue law),

but only if none of such property so received is a stock or a security in a corporation the stock or securities of which are specified in the law applicable to the receipt of such property as stock or securities permitted to be received (or which would be permitted to be received if they were the sole consideration) without the recognition of gain.

"(2) CONTROL.—As used in this section, the term 'control' means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the ownership of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), but only if in both cases such ownership continues until the completion of the intercorporate liquidation."

TITLE II—MISCELLANEOUS AMENDMENTS AND PROVISIONS

SEC. 201. CONSOLIDATED RETURNS.

Effective with respect to taxable years ending after June 30, 1950, section 141 of the Internal Revenue Code (relating to consolidated returns) is hereby amended to read as follows:

"SEC. 141. CONSOLIDATED RETURNS.

"(a) PRIVILEGE TO FILE CONSOLIDATED RETURNS.—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

"(b) REGULATIONS.—The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

"(c) COMPUTATION AND PAYMENT OF TAX.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such return; except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations. If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 109), the increase of 2 per centum provided in the preceding sentence shall be applied only on the amount by which the consolidated corporation surtax net income of the affiliated group exceeds the portion (if any) of the consolidated corporation surtax net income attributable to the Western Hemisphere trade corporations included in such group. For the purposes of the tax imposed by section 430, the sum of the excess profits credit and the unused excess profits credit adjustment of the affiliated group shall not be increased under the last sentence of section 431 to an amount in excess of $25,000 for the entire group.

"(d) DEFINITION OF 'AFFILIATED GROUP'.—As used in this section, an 'affiliated group' means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

"(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent cor-

poration) is owned directly by one or more of the other includible corporations; and

"(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term 'stock' does not include nonvoting stock which is limited and preferred as to dividends.

"(e) DEFINITION OF 'INCLUDIBLE CORPORATION'.—As used in this section, the term 'includible corporation' means any corporation except—

"(1) Corporations exempt from taxation under section 101.

"(2) Insurance companies subject to taxation under section 201 or 207.

"(3) Foreign corporations.

"(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from sources within possessions of the United States.

"(5) Corporations organized under the China Trade Act, 1922.

"(6) Regulated investment companies subject to tax under Supplement Q.

"(7) Any corporation described in section 447, or in section 452 (d), (f), and (g) (without regard to the exception in the initial clause of section 452), but not including such a corporation which has made and filed a consent, for the taxable year or any prior taxable year beginning after December 31, 1943, to be treated as an includible corporation. Such consent shall be made and filed at such time and in such manner as may be prescribed by the Secretary.

"(f) INCLUDIBLE INSURANCE COMPANIES.—Despite the provisions of paragraph (2) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of this chapter shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

"(g) SUBSIDIARY FORMED TO COMPLY WITH FOREIGN LAW.—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this chapter as a domestic corporation.

"(h) SUSPENSION OF RUNNING OF STATUTE OF LIMITATIONS.—If a notice under section 272 (a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with which such corporation made a consolidated return for such taxable year.

"(i) ALLOCATION OF INCOME AND DEDUCTIONS.—For allocation of income and deductions of related trades or businesses, see section 45."

SEC. 202. FOREIGN TAX CREDIT.

(a) That portion of section 131 (a) of the Internal Revenue Code which precedes paragraph (1) thereof is hereby amended by inserting after "subchapter E" the following: "and except, with respect to the tax imposed under subchapter D, only to the extent provided in subsection (j)".

(b) Section 131 of such code is hereby amended by adding at the end thereof the following new subsection:

"(j) TAX IMPOSED BY SUBCHAPTER D.—This section shall be applicable for purposes of the tax imposed by subchapter D, but the tax paid or accrued to any country shall be deemed to be the amount of such tax reduced by the amount of the credit allowed under this section with respect to such tax against the tax imposed by this chapter without regard to subchapter D. The amount of the credit taken under this subsection shall be subject to each of the following conditions:

"(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's excess profits net income from sources within such country bears to its entire excess profits net income for the same taxable year; and

"(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's excess

profits net income from sources without the United States bears to its entire excess profits net income for the same taxable year."

SEC. 203. EXPENDITURES FOR ADVERTISING AND GOOD WILL.

Section 23 (a) (1) (C) of the Internal Revenue Code (relating to expenditures for advertising and good will) is hereby amended to read as follows:

"(C) Expenditures for Advertising and Good Will.—If a corporation has, for the purpose of computing its excess profits tax credit under Chapter 2E, or subchapter D of this Chapter, claimed the benefits of the election provided in section 733 or section 449, as the case may be, no deduction shall be allowable under subparagraph (A) to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733 or section 449, as the case may be, may be regarded as capital investments."

SEC. 204. TECHNICAL AMENDMENTS.

(a) Section 3779 of the Internal Revenue Code (relating to extensions of time for payment of taxes by corporations expecting carry-backs) is hereby amended by striking "710 (c) (3)" where it appears in subsection (b) and inserting in lieu thereof "432 (c)", and by striking the words "four equal" where they appear in subsections (c), (g) and (i).

(b) Section 3780 (a) of such code (relating to tentative carry-back adjustments) is hereby amended by striking "710 (c) (3)" and inserting in lieu thereof "432 (c)"

(c) Section 3807 of such code (relating to period of limitations in case of related taxes under chapter 1 and chapter 2) is repealed.

(d) Section 114 (b) (4) (B) of such code is hereby amended by striking out "731 and 735" and inserting in lieu thereof "448 and 451".

(e) Section 122 (d) (6) of such code (relating to the computation of the net operating loss deduction) shall not apply with respect to any taxable year ending after June 30, 1950.

(f) Supplement S of chapter 1 of such code is hereby amended by striking out "section 725" wherever appearing therein and inserting in lieu thereof "section 447".

(g) The amendments made by this section shall be applicable with respect to taxable years ending after June 30, 1950.

SEC. 205. FILING OF RETURNS FOR TAXABLE YEARS ENDING AFTER JUNE 30, 1950, AND BEFORE DECEMBER 31, 1950.

In the case of a corporation subject to the tax imposed by subchapter D of chapter 1 of the Internal Revenue Code for a taxable year ending after June 30, 1950, but prior to December 31, 1950, such corporation shall after the date of the enactment of this Act and before March 15, 1951, make a return for such taxable year with respect to the tax imposed by chapter 1 of the Internal Revenue Code for such taxable year. The return required by this section for such taxable year shall constitute the return for such taxable year for all purposes of the Internal Revenue Code; and no return for such taxable year, with respect to any tax imposed by chapter 1 of such code, filed on or before the date of the enactment of this Act shall be considered for any of such purposes as a return for such year. The taxes imposed by chapter 1 of such code (determined with the amendments made by this Act) for such taxable year shall be paid on March 15, 1951, in lieu of the time prescribed in section 56 (a) of such code. All payments with respect to any tax for such taxable year imposed by chapter 1 of such code under the law in effect prior to the enactment of this Act, to the extent that such payments have not been credited or refunded, shall be deemed payments made at the time of the filing of the return required by this section on account of the tax for such taxable year under chapter 1 determined with the amendments made by this Act.

The CHAIRMAN. The full membership of the committee is not present this morning but we expect other members to come in as soon as they can be relieved of some pressing engagements on which they were called just a few minutes before we convened.

We will be glad to have you proceed to discuss this bill before us with such preliminary general statement as you wish to make or to incorporate in the record.

STATEMENT OF HON. JOHN W. SNYDER, SECRETARY OF THE TREASURY, ACCOMPANIED BY J. S. GRAHAM, ASSISTANT SECRETARY OF THE TREASURY; J. T. LYNCH, GENERAL COUNSEL OF THE TREASURY, AND MEMBERS OF THE STAFF

Secretary SNYDER. I am glad to have an opportunity to discuss with you the bill H. R. 9827 providing for additional profits taxes, which is now under consideration in the House of Representatives.

In the Revenue Act of 1950 the Congress called for the consideration of excess-profits taxation at this session, and on November 14 last the President recommended new taxes in this area to raise about 4 billion dollars of revenue. The pending legislation is directed to this end.

At the outset I wish to express my gratification with your decision to adopt the unusual procedure of beginning public hearings before the House has completed action on the legislation. The events of the past few days in Korea and in other parts of the world testify to the compelling need for the enactment of additional profits taxes at this congressional session. Your resolution to complete this legislation promptly will contribute to our ability to meet the problems confronting us.

Since your schedule is tight, I shall limit my discussion to the essential points at issue. In order that you may have before you the necessary information, I desire, with your permission, to offer for the record the statement I made before the Committee on Ways and Means on November 15, 1950. Is that agreeable, Mr. Chairman?

The CHAIRMAN. That is agreeable. That may be done.

(The statement referred to appears on p. 74.)

Secretary SNYDER. Since that time additional profits taxation has received widespread public consideration, which has clarified the issues involved in the speedy enactment of this legislation.

NEED FOR MORE REVENUE

The over-riding consideration at this time is the Government's need for more revenue. Early in the Korean crisis the Congress, at the request of the President, appropriated 17 billion dollars for defense. These funds have been largely obligated, and last Friday the President asked the Congress to appropriate almost 18 billion dollars more.

No one can foretell how the international situation will develop. Unhappily it is all too clear that, under the best possible circumstances, we shall be confronted with vast defense expenditures for years to come.

The information available at the time of my appearance before the Committee on Ways and Means indicated a deficit for this fiscal year of about 2 billion dollars. In light of the events of the past few days, that estimate may prove to be too low.

The prospects for fiscal year 1952 and subsequent years are far more serious. The President's budget estimates for the coming year will not be completed for some time. As a result of the vast increases in defense costs, the level of governmental expenditures next year may be half again as large as this year. Very substantial tax increases will be required to carry out the essential policy of financing the greatest possible amount of these costs by taxation. The importance of sound

national finance to an adequate defense effort leaves no room for hesitation. We have far too much at stake to risk the consequences of inadequate and tardy financial preparedness.

This Congress can make an important contribution to our national strength in the little time at its disposal by adding the profits tax to the Federal tax structure, to become effective July 1 of this year as recommended by the President and provided in the bill reported by the Committee on Ways and Means.

The enactment of this legislation will make a partial reduction in this year's deficit and make an important contribution toward meeting the defense costs ahead of us. Moreover, with this legislation completed, the new Congress will be free to turn its attention to increasing the over-all revenue strength of our tax system in the light of the enlarged 1952 budget requirements.

THE CASE FOR INCREASED PROFITS TAXES

The interim tax legislation enacted by the Congress earlier this year, with full appreciation by both the Senate and the House of the need for prompt action, added about 3 billion dollars' revenue from individual and 1.5 billion dollars from corporate income taxes. It was recognized at the time that in view of the trend in individual and corporate incomes these additions would leave the two taxes unbalanced. This contributed to the overwhelming endorsement the Congress gave to added profits taxation. The unprecedented and continued growth of corporation profits since then testifies to the wisdom of that action.

The increase in corporate profits this year is the largest in history. During the last quarter of 1949, corporation profits before income taxes were accruing at an annual rate of less than 28 billion dollars. They increased to 37 billion dolars in the second quarter of this year and to 42 billion dollars in the third quarter. For 1950 as a whole, corporate profits will probably aggregate 37 billion dollars, or almost 10 billion dollars more than last year.

The size of corporation profits confirms the President's conclusion that the 4-billion-dollar revenue objective can be met without imposing hardship on corporations.

Senator KERR. I take it that the 37-billion-dollar figure that you used there will be the total of the year?

Secretary SNYDER. That is right.

Senator KERR. From how many corporations?

Secretary SNYDER. That is over 400,000.

Senator KERR. How many of those corporations would be exempt under the proposed legislation?

Secretary SNYDER. About 80 percent of them.

Senator KERR. About 300,000?

Secretary SNYDER. Yes, sir.

Senator KERR. What part of the total 37-billion-dollar profit?

Secretary SNYDER. I beg your pardon?

Senator KERR. What part of the 37-billion-dollar profit would the three-fourths of the total number of corporations which would be exempt under this legislation represent?

Secretary SNYDER. Think we have those figures in the statement a little further on.

Senator KERR. That is in the statement?

Secretary SNYDER. If the figures do not show up later, we will make a note of it and provide you with the answer.

The data indicate also that, if equitably imposed, additional taxes of this magnitude would not interfere with the ability of corporations to maintain present rates of dividends to stockholders and retain record amounts of earnings for reinvestment. Even if corporation profits do not increase above the current level, the pending legislation would leave corporations in a position to devote more than 20 billion dollars to dividends and reinvestment—an amount which equals the 1948 record and exceeds all other years.

COMMENTS ON THE HOUSE BILL

The bill reported by the Committee on Ways and Means represents a major achievement in the short time that was available for its preparation. It contains, in my judgment, the essential features for needed taxation of defense profits.

Critics of the effort to develop a tax on defense profits have pointed to the difficulties experienced under the World War II excess profits tax and have assumed that these difficulties could not be effectively met.

Senator MILLIKIN. I would like to apologize for not getting here sooner, but we could not get away.

Secretary SNYDER. We understand.

When I appeared before the Committee on Ways and Means, I frankly recognized that the imposition of a special tax on defense profits is not without its difficulties. However, I pointed out that by benefiting from past experience substantial equity could be achieved and administrative burdens reduced.

The efforts of the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department have been concentrated on this problem. The House bill, which has been developed on the basis of this work, demonstrates the practicability of profits taxation appropriate to our current requirements. It goes a long way toward meeting the criticisms that have been made of the World War II law.

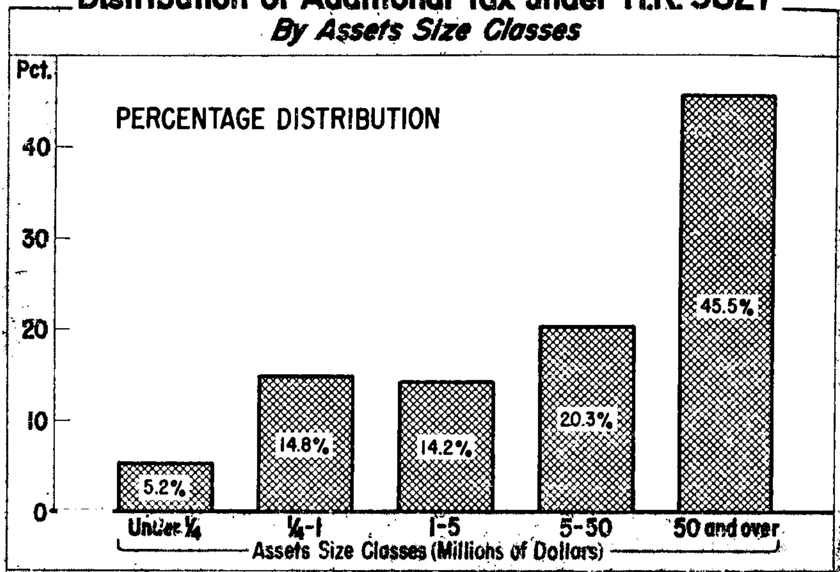
In considering the improvements made in the structure of the World War II law, it may be helpful to your committee to have a brief review of the principal provisions of the bill now before the House. For your convenience, I am attaching a tabular exhibit which gives in some detail a comparision of the provisions of this bill and the World War II law.

That is this exhibit that is with your statement there.

The CHAIRMAN. It is with the statement. Thank you very much. It will be made a part of the record.

Secretary SNYDER. In general, the House bill will exempt more small corporations, provide more liberal credits, and afford greater incentive for the investment of new capital and the organization of new businesses. At the same time it will greatly reduce the problems of administration and taxpayer compliance.

CHART 1



Office of the Secretary of the Treasury.

Substitution of minimum credit for specific exemption

Under the House bill it is estimated that 82 percent of nonfinancial corporations will be exempted compared with 73 percent in 1944 under the World War II excess profits tax.

Senator MILLIKIN. What do you mean by "nonfinancial corporations"?

Secretary SNYDER. Corporations other than banks, insurance companies, investment trusts, real-estate companies, and so forth.

Senator KERR. Will you please illustrate that.

Secretary SNYDER. Well, a company that manufactures furniture is nonfinancial. A financial corporation is a bank, an insurance company, a mutual savings bank, or other similar corporation engaged mainly in making investments or borrowing and lending money. An oil company would be nonfinancial.

Senator KERR. I know an oil company is a nonfinancial. I am perfectly aware of that.

Secretary SNYDER. Is that clear now?

Senator KERR. But I show you they are not in the 82 percent of the nonfinancial corporations that are being exempted.

Secretary SNYDER. You are lucky.

Senator KERR. The thing I am trying to find out is about an investment company, is that a nonfinancial?

Secretary SNYDER. That would be termed financial in this.

Chart 1 shows the distribution of the additional tax liabilities under the bill by assets size classes. The chart indicates that only a small part of the increased tax burden will fall on small corporations. Corporations with assets of less than one-quarter million dollars will pay about 5 percent of the additional tax—that is the large chart right in

back of us—whereas those with assets above $50,000,000 will pay over 45 percent.

The reduction in the number of corporations subject to the profits tax is accomplished mainly because of the substitution of a minimum credit for the specific exemption allowed under the World War II law. Under the prior law the $10,000 specific exemption was granted to all corporations. The size of the exemption was necessarily limited by revenue considerations. The minimum credit of $25,000 provided under the House bill is operative only where the corporation's own excess profits credit under the bill is less than $25,000.

The CHAIRMAN. In other words, where the average earnings base is selected and the credit is $25,000 or more, then this provision does not apply?

Secretary SNYDER. That is correct.

The CHAIRMAN. The same with increased capital?

Secretary SNYDER. That is correct.

The CHAIRMAN. It does not apply. Is there any carry-over of this credit?

Secretary SNYDER. It is not provided, no, sir.

The CHAIRMAN. All right. You may proceed.

Secretary SNYDER. It thus concentrates relief in the lower income corporations and provides a larger favorable area for development of small and new businesses. It also reduces substantially the possible burden of relief claims. A $25,000 minimum credit under the World War II tax would have eliminated about one-quarter of all relief claims.

Liberalization of credits

The House bill retains the optional use of a base period earnings credit or an invested capital credit as was provided in the World War II law. However, it makes substantial revisions in both of these credits.

Taxpayers are given greater leeway than under the World War II law in computing average base period earnings. The bill permits a corporation to make the best 3 of the 4 years 1946–49 and in addition to count as zero any remaining loss years. Under the World War II law taxpayers were required partially to include their worst year; net losses in any of the remaining 3 years were subtracted in full from profits of other years in computing the average.

A further important change is made in computing base period income. H. R. 9827 provides for an upward adjustment in the average earnings base to reflect one-half of the net additions to capital made in 1948 and all additions made in 1949, irrespective of whether the net additions were in the form of equity capital, retained earnings or borrowed capital. This provision alone will accord very substantial benefits to a number of important industries which expanded steadily or at an increasing rate during the base period. In addition to reflecting actual changes in capital investment during the base period, this modification avoids the necessity for retaining the so-called growth formula of the old law. However, the bill does contain a restricted provision for recognizing growth of profits where this may not be adequately reflected through the allowance for capital additions in the base period.

Senator MILLIKIN. I do not quite understand that.

Secretary SNYDER. May I call on the staff for a technical explanation?

Mr. LYNCH. Mr. Senator, the first part dealt with the provision which recognizes the additions to capital in the last 2 years of the base period. This allowance is based on the assumption that where you use the earnings base the additions to capital made at that late period may not have been adequately reflected in earnings. For that reason there is a credit given of 12 percent on equity capital and earnings retained in the business for the last year of the base period and also for one-half of such additions in next to the last year of the base period. And there is also provision for additions on account of borrowed capital.

Senator MILLIKIN. What is the restrictive provision?

Mr. LYNCH. The restrictive provision, I believe, then relates to the growth formula, and under the growth formula it is intended that a company which has had a distinctive growth in the latter years of its base period will be able to take either its 1949 earnings or the average of 1948 and 1949 earnings, whichever is higher. That is the substituted growth provision to reflect preponderant increases in the last 2 years of the base period.

Senator TAFT. Has there ever been any proposal to gear an increased base to increased production or increased productivity? I mean, you invest in new machinery and you have an increase.

Mr. LYNCH. Yes.

Senator TAFT. You put in a new kind of production line that produces twice as much with the same number of men and you get no increase and the Government takes away all of the benefit that you get from such an increased productivity. Is there no way in which there could be some tying in to such an increase?

Mr. LYNCH. To the extent that there is additional capital that would be recognized.

Senator TAFT. Supposing a man invents a new kind of production line which will not take more capital than the old one, but a new method that produces twice as much per man.

Mr. LYNCH. I would like to refer to this fact, that in substitution for section 722 there are a number of provisions that have not been touched upon yet and it might be helpful to defer that until we come to such provisions, Mr. Senator.

Senator TAFT. Thank you.

Senator MILLIKIN. Does a growth corporation have the same alternatives as to the base as all other corporations? Are they chopped off at the end of the years that constitute the base period?

Mr. LYNCH. The basic provisions apply to the growth corporations.

Senator MILLIKIN. Suppose the growth corporation is growing very, very rapidly; why do we chop it off prior to, say, July 1 of 1950?

Mr. LYNCH. The growth formula is applicable only to the base years and does not take into consideration increases after the base years, if that is your inquiry.

Senator MILLIKIN. I am wondering why not.

Mr. LYNCH. There are a number of other provisions to reflect growth after the base period, provisions which are much more liberal than the World War II law, and which give credit for new investment and reflect the effect of a new product introduced toward the end of the base period.

Senator MILLIKIN. Supposing these is no new product, supposing that there is no new investment, but supposing there is an enormous growth, several instances of which are in my mind. Why do we chop them off before July 1, 1950?

Senator KERR. Or at July 1, 1950.

Senator MILLIKIN. I say why do we chop them off before? Why do we not let them reflect the growth up to the time that we are trying to get war excess profits?

Mr. LYNCH. You are speaking of the difference between the end of 1949 and the first part——

Senator MILLIKIN. I have had some instances where it is a very important factor; there have been enormous growths, independent of war, after January 1.

Secretary SNYDER. In the first 6 months of 1950?

Senator MILLIKIN. Yes.

Mr. LYNCH. I will answer that in this very preliminary way: In getting a structure, as to which the several provisions apply, including those for additions to capital, new products, and others referred to, all in combination, it was felt that it would be preferable to limit the base period to the end of 1949. I think they all have to be judged together.

Senator MILLIKIN. I know what you have done, but I am trying to determine the reason why you do not allow a growth corporation to reflect its growth—I am talking about these exceptional growth corporations—up to the time of the commencement of the Korean War?

Mr. LYNCH. Up to June 1?

Senator MILLIKIN. July 1.

Mr. LYNCH. Instead of January 1. I understand.

Senator MILLIKIN. We will not debate that out now, but I wondered if you had given that attention.

Mr. LYNCH. As to fiscal-year corporations, there are provisions which reflect part of 1950.

Senator MILLIKIN. But assume it is a calendar-year corporation.

Mr. LYNCH. I do not believe then they would get that addition in that period.

Mr. KIRBY. One of the difficulties involved is that this tax under the House bill would be prorated for 1950 for a calendar-year corporation so that 1950 profits will be reflected in the tax for 1950. It would not be practicable to compute the actual earnings for the first half of the year and the second half of the year and impose the tax only on the second half of the year. If you brought in as part of their credit the earnings for that same year, you would get a distortion.

Senator MILLIKIN. Would it be a distortion? That is the question. It might be an administrative distortion, but would it be an equitable distortion?

Mr. KIRBY. That is one of the considerations.

Senator MILLIKIN. Or rather a distortion of equity.

Mr. KIRBY. That is one of the considerations.

Senator MILLIKIN. All right.

Secretary SNYDER. Two important changes have been made in the invested capital credit. One has to do with the rate of return allowed in computing the credit and the other with the treatment of borrowed capital.

The House bill retains the principle of allowing higher rates of return for small corporations than for large corporations. As shown below, the rates under the bill are 12 percent on the first $5,000,000 of invested capital, 10 percent on the next $5,000,000, and 8 percent on the amount over $10,000,000. These rates exceed those allowed during World War II by 50 percent or more.

Invested capital brackets	Invested capital allowance		
	World War II law	H. R. 9827	Percent increase
	Percent	*Percent*	*Percent*
Under $5,000,000	8	12	50
$5,000,000 to $10,000,000	6	10	66⅔
Over $10,000,000	5	8	60

That is a recap of the statement I have just made showing the difference.

The borrowed capital allowance has been revised to provide a credit equal to 1⅓ of the interest paid. By making the allowance proportional to the actual interest obligations assumed by each corporation, a serious shortcoming of the old law is avoided. The World War II law provided for the inclusion of 50 percent of borrowed capital in invested capital, and at the same time disallowed 50 percent of the deduction for interest paid. In effect this rule gave taxpayers the benefit of one-half the difference between the statutory rate on invested capital and the rate of interest on borrowed capital. As a result, taxpayers borrowing at interest rates in excess of the statutory rates on invested capital were actually penalized. Those on the other hand with access to very low interest rates were given a relatively large advantage.

Under the prior law the maximum net benefit obtainable on borrowed capital for a corporation borrowing at 6 percent was 1 percent. Under the House bill the credit would be increased by one-third of 6 percent for all corporations borrowing at that rate, thus increasing the net benefit in such cases to 2 percent of the borrowed capital.

New capital allowance

The allowance for new capital invested after the base period has been basically revised by providing a uniform rate of return for all corporations regardless of the type of credit elected. The allowance is a flat 12 percent of new equity capital and retained earnings, plus 133⅓ percent of interest paid on additions to borrowed capital.

This treatment removes a serious defect in the old law. Under that law corporations electing the base period earnings credit received an allowance for capital added subsequent to the base period only if the addition took the form of new equity capital paid into the corporation. Under the revised treatment, no penalty is placed upon the election of the base period earnings credit.

Senator TAFT. What is the difference? How do you determine borrowed capital as against current bank loans?

Secretary SNYDER. You mean the issue of securities?

Senator TAFT. What is the borrowed capital? If you borrow from the RFC?

Secretary SNYDER. That is borrowed capital.

Senator TAFT. That is borrowed capital. If you borrow it from the bank on a note, that is still borrowed capital.

Secretary SNYDER. That receives same treatment.

Senator KERR. The corporation borrows money, say, at 4 percent and it would be permitted a normal return under this provision of 1⅓ percent on whatever amount it had borrowed, above which it would have to pay this excess-profits tax?

Secretary SNYDER. That is correct.

Senator TAFT. Five and a third.

Senator KERR. Do you think that it would be possible for corporations doing business in any other activity than something that was lead-pipe cinch, if there is any such thing, that would be either willing or able to borrow considerable capital with their returns limited to that extent?

Secretary SNYDER. This is a more liberal provision than was in the law before. It has been liberalized considerably, so that there could be greater earnings on borrowed capital.

Senator KERR. That was not the question.

Secretary SNYDER. I understand, but I just wish to say that. We are trying to iron out some of the inequities that were in the prior excess-profits tax law.

Senator KERR. Whatever concession you made it would still be short of being one that would produce any result. That would be more or less immaterial, would it not?

Secretary SNYDER. It would be desirable to iron out all of the inequities.

Senator KERR. You think it is advisable to fix it so that a corporation doing business, wanting to expand on borrowed capital and being in a position where it is entitled to the credit, would have some incentive to do so, do you not?

Secretary SNYDER. Yes, we want to encourage production, there is no question about that. I am sure the House Ways and Means Committee had that objective in mind when they put that provision in the bill.

Senator KERR. Do you think where the outside limit of the profit would be about 1 percent on the borrowed capital that that would be any incentive?

Secretary SNYDER. Well, it is one-third over the borrowing rate or 1⅓ percent on a 4-percent loan.

Senator KERR. On corporations borrowing money, the outside limit you would put there was 6 percent, I believe.

Secretary SNYDER. We just gave that as an example.

The CHAIRMAN. That was an example.

Senator KERR. Do you think that 1⅓ percent would be any incentive?

Secretary SNYDER. In approaching the problem there are many considerations. It is desirable to retard excess borrowing, that is commercial borrowing in an inflationary period, but it is also necessary to provide incentive for production for the defense program.

Senator KERR. Do you not think what you are doing here is to reduce excess borrowing; do you not think what you are doing would eliminate excess borrowing?

Secretary SNYDER. It did not before with a less liberal provision. So we can only rest on experience. However, our purpose in being here

is not to sell you on a bill. We are here to try to help you carry out an obligation that you put upon yourselves and we are working with you. We are trying to help you find a solution to the job ahead of us. And whatever we have offered here is just in the way of trying to arrive at a solution.

Senator KERR. It is your suggestion with reference to a certain objective?

Secretary SNYDER. That is right.

Senator KERR. I was asking in an effort to get some information that would help me to make up my mind as to what I thought about this particular phase of it from you as a man of great experience in the banking field and in the financial field, as to what you thought, that if you thought an outside possibility of profit not to exceed 1 or 1⅓ percent would be an incentive to a corporation to expand its activities with borrowed capital.

Secretary SNYDER. We have to rest on experience of a less liberal provision that showed that business did continue to expand under that. Here we are offering still further incentive. We have to rest on the experience of the past that this is more liberal than that provision in World War II and, therefore, would be greater encouragement to expansion than the previous bill's provision.

The CHAIRMAN. All right, Mr. Secretary. You may proceed.

Credit for new businesses

Secretary SNYDER. One of the most difficult problems arising from under the World War II tax, and one which resulted in a large number of claims for relief, was the treatment of firms beginning operations during or after the base period. Such firms were generally required to use the invested capital allowance or to apply for relief under section 722 (c), which provided for reconstruction of a hypothetical base-period experience.

The approach to this problem taken under H. R. 9827 is more logical and will simplify the development of an earnings credit where the taxpayer is classified in an industry which has experienced a rate of return higher than the statutory allowance on invested capital. The bill provides new corporations with an alternative credit equal to the average rate of return experienced by their respective industries in the base period. Under this formula most new firms will receive substantially more generous credits than they would under the invested capital method.

An alternative credit based on industry experience is provided also to corporations whose incomes increase substantially as a result of the introduction of new products.

The provisions will be of great importance in stimulating new business.

The committee may be interested at this point in what has been done about section 722 of the World War II law. This section specified in considerable detail the circumstances under which taxpayers would be entitled to relief. The law encouraged the filing of about 54,000 claims for relief and was difficult to administer.

As reported to the House, the bill contains no general relief provision comparable to the former section 722. It was considered desirable to avoid the difficulties created by the old provision by adopting the relatively more liberal credit provisions enumerated above. The

Department shares the view of the Committee on Ways and Means that this is a desirable step and that it would remove the basis for much of the criticism directed at the old law.

Integration of income tax and excess-profits tax

Technical difficulties experienced in the administration of the prior excess-profits tax law will be largely avoided through the integration of the income and excess-profits taxes as provided in the bill. By imposing both taxes under chapter 1 of the Internal Revenue Code, and by assessing and collecting them as one tax, interest computations and the statutes of limitations would apply uniformly. For convenience in computing the taxes, the income tax would apply to the entire amount of net income. An additional surtax of 30 percentage points would apply to the adjusted excess-profits net income which together with the 45-percent normal tax and surtax would make a total rate of 75 percent on excess profits.

UNDESIRABLE FEATURES OF THE BILL

Although the liberalized features of the House bill generally accord with the views of the Department, the bill contains some provisions which tend to create, rather than alleviate, inequities.

A substantial amount of revenue is lost in the House bill by giving preferential treatment amounting to virtual exemption of certain types of businesses which are generally subject to public regulation. The bill would allow public utilities regulated by State authorities an alternative credit. It would permit them to receive, before the application of any profits tax, a net return after income taxes of 6 percent of their total investment, including capital stock, reinvested earnings, and borrowed capital. In the case of utilities subject to Federal regulation, notably railroads and other interstate carriers, the corresponding tax-free return is set at 5 percent.

The CHAIRMAN. Is that to be made applicable to intra- as well as interstate regulated utilities? Is there any distinction?

Mr. KIRBY. Mr. Chairman, the intrastate railroads are not——

The CHAIRMAN. I am not talking about railroads. I am talking about other utilities.

Mr. KIRBY. Other utilities. For example, the interurban bus lines are covered by this special provision and are given 6-percent return after taxes.

The CHAIRMAN. There is no distinction between the interstate and intrastate in that particular field?

Secretary SNYDER. That are State-regulated?

The CHAIRMAN. That is correct.

Mr. KIRBY. The interstate railroads are given 5 percent.

The CHAIRMAN. I understand that, yes; but I am speaking of intrastate.

Senator TAFT. Public utility plants, telephone companies.

The CHAIRMAN. Such as local telephone companies.

Mr. KIRBY. They are all given 6 percent.

Senator KERR. Light and power, too.

Mr. KIRBY. Yes. Light and power, gas, and oil pipe lines.

The CHAIRMAN. I got the impression that was applicable only to the interstate utilities.

Mr. KIRBY. No.

Senator MILLIKIN. Are there any intrastate corporations which are outside of the umbrella?

Mr. KIRBY. I am not aware of any.

The CHAIRMAN. If they are regulated, they are under the 6-percent or 5-percent umbrella, under the House bill?

Mr. KIRBY. I cannot be sure at this point, Mr. Chairman, but we will bring to you any information about those that are not under this provision.

The CHAIRMAN. Please do.

Secretary SNYDER. If there are any exceptions, they will be brought to the attention of the committee.

The CHAIRMAN. Yes, sir. You may proceed.

Secretary SNYDER. The adoption of this provision would bring into question the underlying principles of the income tax. It would provide an exemption or exclusion from profits tax at a time when added burdens are imposed on others. If we should accept the principle of granting tax exemptions on the basis of net income after tax, the Federal tax system would lose its effectiveness for equitably distributing tax burdens.

This provision would discriminate among different utilities and bestow special benefits primarily on large companies, regardless of the fact that industry may be enjoying substantial increases in profits.

Another provision of the bill, section 448, would greatly enlarge the area of preferential treatment in the mining industry. I am fully aware of the importance of securing strategic minerals. However, it will require great care to formulate legislation in the interest of defense production without granting unjustified benefits or encouraging unproductive diversion of essential resources. When this matter receives your consideration, the staff will be prepared to place the pertinent facts before you.

The committee may also desire to give attention to restricting the credit for new investment to productive assets used in the business. It is the purpose of the credits for new capital additions, both in the base period and in the taxable years, to provide an additional credit for new investment which is presumed to be reflected in increased earnings of the corporations. If such credit is given for undue accumulations of cash and other nonproductive assets, this purpose will be defeated and unwarranted benefits and abuses will result.

In addition to the above provisions which raise questions of fundamental equity, there are various technical matters which the committee may also wish to consider. The staff will be available to discuss these at the convenience of the committee.

ENFORCEMENT PROBLEMS

It would be a grave omission for me to pass over one of the most pervasive criticisms which will confront you in considering this bill.

Senator KERR. In order for us to understand the word, would you define it?

Secretary SNYDER. For the record, would you give us a definition of "pervasive"?

Mr. KIRBY. It is used here in the sense of a criticism commonly expressed throughout the testimony.

Senator TAFT. Which is widely expressed.

Secretary SNYDER. It is a nice word.

I refer to the view frequently expressed that this type of tax must inevitably encourage wasteful and extravagant expenditures and stimulate, rather than retard, inflation. This claim rests on the assumption that the profits tax will induce businessmen to make expenditures solely because most of the burden would be borne by the Government through a reduction in the revenue collected.

Whether this profits tax will encourage uneconomical spending will depend in part on the spirit with which business approaches its task in this emergency. Consideration of the argument cannot be limited to tax calculations alone. Clearly the entire range of principles governing business decisions is of more fundamental importance. No tax law, however carefully framed, can insure full cooperation by 100 percent of business in the national effort. But in my view the country can have confidence that the majority of businessmen, like all others, will shoulder the increased tax burden forced upon us and continue to do their part.

Our experience with the wartime law indicates that the practice of wasteful expenditures was less widespread than supposed. Established business organizations were generally more concerned with observing efficient and economical procedures essential to their continued success than with exploiting temporary wartime advantages. There were exceptions then, as there will be now, which tax administration must strive to prevent.

Senator MILLIKIN. How are you going to do that, Mr. Secretary?

Secretary SNYDER. I will say here a little later that I think the Congress ought to make clear its intent. May I finish this page and then come back to it?

Senator MILLIKIN. Yes; go ahead.

Secretary SNYDER. The experience gained during the last war will enable the Bureau of Internal Revenue to segregate reasonable from unreasonable deductions more effectively. To support this effort, your committee may wish to consider the desirability of Congress making it clear that it intends unnecessary and unreasonable expenditures to be disallowed for tax purposes.

Senator MILLIKIN. That would give the Bureau vast power over business decision.

Secretary SNYDER. It would give the Bureau and taxpayers the understanding that Congress intends unreasonable expenditures to be disallowed. Of course, the tax courts would also give consideration to the reasonableness of those deductions.

Senator MILLIKIN. There is some question as to whether the tax courts should be empowered with too much control over business decisions. I was really thinking in reverse terms: How can we stop maintaining an unnecessary headquarters in Washington, for example, and all sorts of expenditures of that general type; how can that be disallowed administratively?

Secretary SNYDER. If upon investigation it was found that there is an unnecessary expense in connection with the operation of the corporation, I think it should be disallowed. Such expenditures would not be productive of real benefits to the defense program.

Senator TAFT. What is reasonable and unreasonable advertising—who can tell?

Secretary SNYDER. There has to be some leeway. If a company suddenly starts advertising, taking materially more space——

Secretary TAFT. There is a tremendous leeway of purely individual judgment and you are substituting the Treasury's judgment for the businessman's judgment in that field, if you undertake to limit advertising.

Secretary SNYDER. You would be if you attempted to cut back beyond what they might normally spend, as to the space and the type of advertising, but if they suddenly double it——

Senator TAFT. They tried to do that the last time, to try to cut it back from what they had been doing; they said it was unreasonable in time of war. They said you do not have any problem of selling, ought not to have any advertising. That was the position of some of the Treasury people, at least.

Mr. KIRBY. The test of ordinary and necessary expenditures is in the law now.

Senator TAFT. If you have, for instance, a market, if you have no trouble selling your goods, you ought to stop advertising?

Secretary SNYDER. It is not correct to say that a taxpayer should not continue advertising.

Senator TAFT. I do not think it is correct. I do not see why the Treasury could not say so.

Secretary SNYDER. I do not think the Treasury ever applied that rule.

Senator MILLIKIN. That is the more reason that they should keep their company before the public as they lose their market.

Secretary SNYDER. I am in accord with that. I know you have to keep your name before the public if you are to keep your markets. If there are instances where the Treasury has attempted that, we will certainly look into the matter.

Senator TAFT. In one case the Treasury disallowed a bonus to employees and said that a man that got more than $5,000 for working a machine was getting an unreasonable sum, and any bonus paid him over that was unreasonable. I think they finally backed down, but that was their position.

Secretary SNYDER. With 60,000 employees we are going to have exceptions as you do in the legal profession and we have to watch those things.

Senator TAFT. What I object to is giving the Treasury any such power. It seems to me if you cannot frame a tax that cannot be done without that kind of discretion you ought not to have the tax. That is a suggestion that I am trying to make.

Secretary SNYDER. We feel that with the moral support of the Congress, the test can be equitably and properly applied and the excessiveness can be eliminated to a great extent.

Senator TAFT. You put it rather mildly. You say, "Your committee may wish to consider." We may not wish to consider. I do not object to the statement.

Secretary SNYDER. I chose the words very carefully, Senator.

Senator MILLIKIN. Mr. Secretary, do you consider that you can, basically speaking, have a fair excess-profits tax without going to one of two alternatives, general controls, or otherwise vesting the administration with enormous control to disallow deductions for expenses? Are you not more or less driven to one or the other?

Secretary SNYDER. This type of tax is a most difficult tax to administer, and it is subject to many inequities. We have all agreed that that is true. In peacetime I have taken the stand that I do not think this sort of tax is an appropriate tax, but we are faced with an unusual situation today.

We have had tremendous increases in profits since the Korean situation. Much of the increase, of course, can be traceable directly or indirectly to the impact of the Korean situation and the subsequent events.

I think that we should give earnest consideration to capturing in revenue a portion of those abnormal profits. To arrive at a formula for doing it is a most difficult task, and one on which we have been working for months to try to find the best possible approach. We think that in the suggestions that the Joint Staff and the Treasury staff made to the House Ways and Means Committee many inequities of the World War II law and many of the difficulties of administration have been removed.

Senator MILLIKIN. It has been suggested, for example, that an excess-profits tax—and I agree entirely with the philosophy of the statement you have just made—in the absence of other general controls, affords an excellent springboard for further rounds of wages, and thus increases inflationary spirals.

Have you any comment on that?

Secretary SNYDER. I think if we are going to arrest an inflationary spiral, we will have to give consideration to these controls which Congress has provided.

Senator MILLIKIN. In the absence of general controls there is danger.

Secretary SNYDER. There could well be that danger under the conditions we face.

Senator MILLIKIN. We could encourage inflationary tendencies.

Secretary SNYDER. There could well be that danger.

Senator MILLIKIN. I do not want to ask any embarrassing questions outside of your particular line, and I do not care to ask you embarrassing questions there. Is there any administration policy at the present time for general controls?

Secretary SNYDER. As you know, Mr. Di Salle, from Toledo, Ohio, has just been appointed to that department. I know that it is under active consideration, and has been right along. I could not give you any definite information as to just where those discussions stand or what the intent is at this time.

Senator MILLIKIN. Assuming that our situation, so far as preparedness is concerned, internationally, does not better materially, would you say that in your judgment, general controls are ineviable? I am not talking about today. That they are inevitable, I mean?

Secretary SNYDER. I think with the situation as it looks today, with the increased pressures that are being placed on us, and the necessity for further expansion of our defense program, that in order to avoid inflation of a damaging nature those controls will have to be put into effect.

Senator MILLIKIN. So that you think that those controls, when they come, will have a tendency to remove this criticism of an excess profits tax?

Secretary SNYDER. I think they will, yes, sir, definitely.

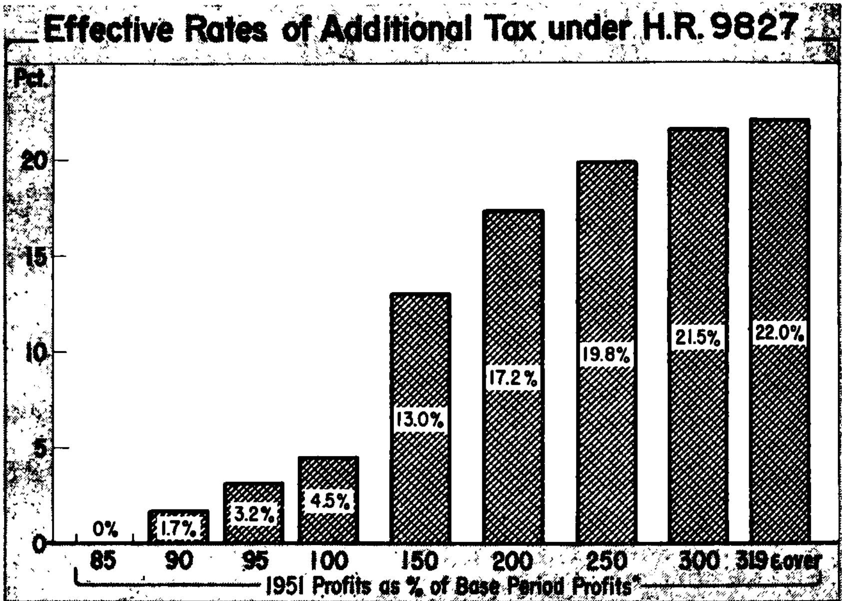
DISTRIBUTION OF TAX

Under the House bill the rate of tax on excess profits would be 75 percent, including the regular 45 percent normal tax and surtax.

Secretary SNYDER. Chart 2 shows the additional tax that would be imposed on corporations subject to this tax.

(Chart 2, referred to, is as follows:)

CHART 2



Office of the Secretary of the Treasury.

*Base period profits equal average of 3 best out of 4 years 1946–49.

Secretary SNYDER. For corporations with current net income equal to their average base period earnings the tax would amount to 4.5 percent of total net income. The effective rate of tax would rise to 13 percent of total net income where current earnings are equal to 150 percent of the base period average and to approximately 17 percent where current earnings are twice the base period average. The maximum effective rate of 22 percent, making a total tax of 67 percent, would be reached at the point where current earnings are slightly more than three times the base period average.

Senator MILLIKIN. Why do you discount the base period average; why not take 100 percent?

Secretary SNYDER. That was partially a matter of raising the revenue.

Senator MILLIKIN. How much additional revenue do you raise by your discount?

Secretary SNYDER. One billion, one hundred million loss in revenue by eliminating the 25 percent cut-back.

Senator MILLIKIN. Is that not in effect retroactive taxation?

Secretary SNYDER. It is a defense tax, applied against the earnings of the corporation. It is a combination of excess-profits tax, plus a defense tax.

Senator MILLIKIN. There is an obvious violation there of the principle of mopping up excess-war-profits taxes. I realize the practical nature of the tax bill, but I say that when we do that we are, in effect, having a retroactive tax as to what we call normal revenue.

Secretary SNYDER. A little later in the testimony here I will touch on that, but the point is that you either are going to have to set a very high rate, if you take the 100 percent credit, on the average of the 3 years out of 4, or cut back the base in order to raise revenue.

Senator MILLIKIN. You would have to increase your general rate or go through this discount procedure.

Secretary SNYDER. Yes.

Senator MILLIKIN. It all comes to the same thing, does it not?

Secretary SNYDER. In terms of revenue.

Senator TAFT. Is there any real justification for saying that it is only a war-profits tax?

Secretary SNYDER. I have never called it that. I called it a defense-profits tax.

Senator TAFT. What I mean to say is this; on page 3, it seems to me you meet that yourself. You say that the tax, the corporate earnings at the beginning of the last quarter of 1949 were $28,000,000,000 and they increased to $37,000,000,000 in the second quarter of this year. In other words, they were already in the second quarter as high as they are going to be on the average for the entire year, according to your later estimate, so that is it not true that this increase in earnings was not due to the war at all, but due to the general inflationary policy of the administration in encouraging the increase in prices long before the Korean War ever came at all?

Secretary SNYDER. We have had very heavy defense spending, Senator, that contributed to those increases.

Senator TAFT. In the second quarter?

Secretary SNYDER. We had a big defense program in process then.

Senator TAFT. We had a perfectly balanced budget. We had about $13,000,000,000 appropriated for defense up to that moment. I am just suggesting that what you are really doing is not getting war profits at all, but taxing the profits that resulted from inflation long before the Korean War ever came.

Secretary SNYDER. The primary purpose of this bill is to raise revenue on the most equitable basis.

Senator TAFT. I understand that. I am just talking about the theory which you have advanced here a little earlier, that the justification for this tax was to get these war profits back, and I suggest there are not any war profits in any amount; that the profits have been somewhat increased, perhaps by the inflation resulting from the war.

Secretary SNYDER. You are going to the other extreme. There have been abnormal profits since Korea from the impact of the defense program.

Senator TAFT. I have no question about that.

Secretary SNYDER. Corporate profits.

Senator TAFT. Abnormal profits?

Secretary SNYDER. Since the Korean incident occurred.

Senator TAFT. They are a little larger, but not much. And you see, the big increase took place, as you say at page 3, it was $28,000,000,000 the last quarter of 1949; $37,000,000,000 for the second quarter, and only $42,000,000,000 in the third quarter. The additional increase in the Korean War was very small. Most of the increase came from the inflationary conditions which had already been created. Is that not the fact?

Secretary SNYDER. This bill will make an important contribution toward meeting budget deficits.

Senator TAFT. If it justifies taking more money from profits, I agree to that. Whether it justifies a so-called war profits, it seems to be a little dubious. That is all I am suggesting.

Secretary SNYDER. You passed a bill up here to draft boys of 18, to send them to war. I think it is just as important that we draft some of the profits to help pay for the expenditures.

Senator TAFT. I am willing to do that. The justification is not the war. They occurred because we had pursued an inflationary policy for a year in trying to force prices up and we overdid it long before the war ever came. I object to trying to take some of those profits and calling them something else.

Secretary SNYDER. We are trying to meet the expenses of this war, not to get into a political debate as to who did what.

Senator TAFT. The first quarter profits would have been just the same without any Korean War at all.

Secretary SNYDER. I am not debating that.

Senator MILLIKIN. Will there be a showing of what war profits have accrued before July 1? Is that indicated any place?

Secretary SNYDER. We can show profits up to the third quarter. You know of many instances where there were price tag mark-ups that had no direct connection with the defense effort.

Senator MILLIKIN. There will be no attempt here to make a case that such-and-such an amount of dollars represents war profits?

Secretary SNYDER. No.

Senator MILLIKIN. I am getting at the end fact. We cannot expect a factual presentation on that from the Treasury? Will we have it from the staff? Mr. Stam, will there be anything of that kind in this case?

Mr. STAM (staff member). That is, trying to break down what is attributable to the war?

Senator MILLIKIN. What are war profits as against other profits.

Mr. STAM. The only way you could approach that would be to try to tie it up to the rate of Government actual expenditures for the military effort, and they would not show up too large a picture.

Secretary SNYDER. That is true.

Senator MILLIKIN. The answer is that there will be no such showing. Then we are required to engage in the assumption that the increase in profits since July 1, if we view this as an excess war profits tax, results from the war.

Mr. STAM. I think, Senator, if I might make the statement there, I think the theory back of this is that some of these organizations were talking about a decline last September in their profits. I mean, take the automobile industry—some of them were figuring on having

some set-back, at least, in September and the fall of last year. That did not occur, of course, as we all know. I think one of the arguments back of this proposal, there is some justification for the cut-back, that they were able to maintain their base period level by virtue of the subsequent events which kept their profits up, instead of letting them go down, which might have happened if they had not had this Korean occurrence. That is the argument, I think, some people advance.

Senator MILLIKIN. There will be no showing here by anybody attempting to segregate the actual war profits from the rest of the profits. That is what I am saying.

Mr. STAM. Yes.

Senator TAFT. How far does that chart go? What is the last line? What is that date?

Secretary SNYDER. That is an estimate for the calendar year 1950.

Senator TAFT. It does not attempt to go up and down by quarters, then?

Secretary SNYDER. No; it does not show that.

Senator TAFT. By annual averages?

Secretary SNYDER. It does not show the fluctuation by quarters.

Senator KERR. Is the information available as to how much the Government has spent thus far in the defense effort as compared to a year ago?

Secretary SNYDER. We can get that, I am sure.

(The information is as follows:)

Total expenditures of the Defense Department for the first 5 months of the present fiscal year amounted to $6,257,000,000, or only $305,000,000 above expenditures of $5,952,000,000 in the comparable period a year ago.

However, during the first 4 months of the present fiscal year the Department of Defense has obligated over $8,000,000,000 for the procurement of major matériel and supplies, or approximately two-thirds of the total currently available for these items during the full fiscal year 1951. Those figures would be larger by the end of November. Obligations mean the money set aside to cover the cost of matériel and supplies that have been ordered, although they may not have been delivered and paid for yet.

Senator BYRD. Along that line, the Government, as a whole, has actually spent $2,000,000,000 less in this fiscal year, compared with the same period of the last fiscal, and spent, approximately, the same on the military expenditures, as they did in the last fiscal year.

Senator TAFT. Up to date.

Senator BYRD. The last report I have in the office is October 31, but I was reading a late report in my office that showed only a slight increase in military expenditures.

Secretary SNYDER. In the actual dollar expenditures.

Senator BYRD. That is right.

Secretary SNYDER. The inflationary effect of a war contract starts the day that the contract is let.

Senator BYRD. I understand that.

Secretary SNYDER. It does not wait until the money is spent.

Senator BYRD. How do you say that the expenditures create these profits?

Secretary SNYDER. I said the defense program.

Senator BYRD. They do not have the money. If they get a contract, they haven't got the money, they do not get the profits until they get the money.

Secretary SNYDER. This does not just touch on people who are contracting with the Government; it affects the whole economy.

Senator BYRD. I understood you to say, and if I am incorrect correct me, that these profits from the corporations were due to the big defense expenditures. Did you say that or not?

Secretary SNYDER. I do not think I said exactly that. I said the pressure of the defense program has helped in creating these profits.

Senator BYRD. The expenditures have been no greater, that is, of consequence, for defense purposes in this fiscal year than they were in the same period of the last fiscal year, and the actual total Government expenditures are $2,000,000,000 less.

Secretary SNYDER. But that, Senator, is not the whole answer. It is the impact.

Senator BYRD. That is one of the answers, though, because they cannot make profits until they get the money, can they?

Secretary SNYDER. These profits that we are talking about are not wholly from companies that have Government contracts. A large part of these extra profits is from companies that may never get a Government contract but are getting an advantage from a program that is resulting in higher levels of business.

Senator BYRD. I want the record corrected, if there is such an impression, if you did not intend to convey it, but the impression I got was that you thought these profits came from war contracts, war payments.

Secretary SNYDER. The impact of the defense program is what I think I said, if I did not say it in those words.

Senator BYRD. We have not paid the money out.

Secretary SNYDER. That is right.

Senator BYRD. I think they have been derelict in view of this emergency in not spending more for national defense than they have, when the Korean War started on June 25, that is, the idea of not spending more than a year ago when we had no war.

Secretary SNYDER. A large amount has been obligated. It is a matter of whether or not you can manufacture the items overnight and collect the money for them.

Senator BYRD. We have had 5 months in which to do this.

Secretary SNYDER. You cannot build airplanes in 5 months.

Senator BYRD. It is a very perilous condition, because we are not prepared.

Secretary SNYDER. We are not going to be any better prepared unless we face this financial situation.

Senator BYRD. Where we spent no more money than we did last year.

Senator MILLIKIN. Your point is that the profits are there because of the fact of war; that that in itself stimulates them?

Secretary SNYDER. Yes; I said the impact of the Korean situation.

Senator MILLIKIN. That stimulates the whole war effort, stimulates the letting of contracts, we hope, but in any event the whole aggregate effect is to stimulate the profits of your economy; is that your point?

Secretary SNYDER. I think that is nearly what I said; if I did not, I will correct it. I think my words were "the impact of the Korean situation." I think that is what I said. Maybe, when I was talking with Senator Taft instead of saying the defense program, I might

have said expenditures. If I did, we will correct that, but what I meant was that it was the impact of the necessity for a large defense program when the Korean situation developed which created the present problem. And many people, through their scare buying at a time when prices were going up, simply caused price-tag mark-ups that created material profits at that time.

Senator MILLIKIN. The accumulation of inventory, for example, general inventory; is that not correct that that caused that?

Secretary SNYDER. Yes; in part.

Senator MILLIKIN. I do not know whether you covered this while I was not here. Have you made any estimate as to what our deficit will be for this fiscal year and for the next fiscal year?

Secretary SNYDER. For the fiscal year 1951 I presented an estimate to the Ways and Means Committee, based on figures obtainable from the budget and the Treasury that there will be a budget deficit, that is, a conventional deficit of $2,000,000,000 in this fiscal year. However, earlier in my statement here, I mentioned that in the light of events since the time of my appearance before the Ways and Means Committee this may be materially larger.

Senator MILLIKIN. Would it be extravagant to say it might be 5 or 6 or 7 billion?

Secretary SNYDER. I doubt if it will be quite that large.

Senator MILLIKIN. Would it be $5,000,000,000?

Secretary SNYDER. With the inability to get the end products into the hands of the Armed Forces——

Senator MILLIKIN. Would you say that $5,000,000,000 would be an extreme?

Secretary SNYDER. The President sent up only last Friday his request for the additional $18,000,000,000. We have not had time to sort out and find out how much of that would be likely to be spent within the remaining 6½ months of this fiscal year.

Senator MILLIKIN. I am not trying to pin you to a figure, but I would like to have a rough figure in mind.

Secretary SNYDER. We do not have that rough figure.

Senator MILLIKIN. If we are going to try to approximate a budget balance—I do not think we can balance it; I think that is out of the picture—but I think we are all interested in getting as close to it as possible, and so, of course, we have to have some kind of an idea as to what it is that we are shooting at. Would it be extreme to say that it might be $5,000,000,000 this year?

Secretary SNYDER. I think that may be large in terms of actual expenditures. The commitments will be made, though. We will need the money. We will not be collecting any excess revenues, because they can all be well used in financing this program.

Senator MILLIKIN. That will reflect very substantially in the expenditures in the next fiscal year?

Secretary SNYDER. They will materially increase in the next year.

Senator MILLIKIN. Would it be exaggerated to say that we might have at the present rate of revenue a deficit of as much as 10 or 15 billion in the next fiscal year?

Secretary SNYDER. We could well have that in fiscal 1952.

Senator MILLIKIN. That is what I am talking about.

Secretary SNYDER. The budget has not been prepared yet for the program for 1952. It is in process of preparation. I just do not have the figures.

Senator TAFT. Can you, also, then make a more definite estimate as to the remaining expenditures for fiscal 1951?

Secretary SNYDER. I think definitely we can.

Senator TAFT. You usually do.

Secretary SNYDER. That is correct.

Senator TAFT. You can the 1st of January.

Secretary SNYDER. I think we will have time to assimilate these programs that are included in the additional $18,000,000,000 and see what part is for procurement or immediate expenditures for troop increases and what part is for long-range programs. By long range I mean that you may not get the end product for a year and a half or 2 years. We have many of the defense items that are of that character, certain types such as the bombers on which you may not get delivery under a year and a half or 2 years. The commitment, however, will be made and the pressure on the economy starts the day that the commitment is made, because the materials are bought and the labor is procured, and that all starts in motion right at that time. So the effects start immediately, whether or not the actual dollar expenditures start.

Senator MILLIKIN. In the interest of getting the picture before the people it would be a gross deception to intimate that what we are doing here in this excess-profits tax is any more than scratching the surface of what we are going to have to raise in the future; is that correct?

Secretary SNYDER. Absolutely correct. And I have made the statement publicly many times that we just do not realize what we face because of the slowness with which we actually spend the dollars. If you could have spent the money on the day the commitment was made, then we would have had a considerably heavier deficit for this fiscal year.

Senator MILLIKIN. There is a certain amount of demagogery in this whole subject, and I want to make clear again that I am in favor of an excess-profits tax and in favor of getting it this year, and I am happy to say that I think we have a better chance to get it this year, but there is a whole lot of fakery that surrounds the subject, to-wit, that if you can get these big, fat, pot-bellied corporations to pay this tax, that the rest of the people will not have to pay anything.

Secretary SNYDER. That I have never led them to believe.

Senator MILLIKIN. I know you have not. I respect you for it. But there are many people who have created that impression, and I will not say in official circles. This and what we did earlier this year is just a commencement of taxes the like of which this country has never seen, if our situation does not better.

Secretary SNYDER. If it worsens, yes.

Senator MILLIKIN. That is, much sooner than the prospects warrant at the present time. Is that not correct?

Secretary SNYDER. I feel that very deeply.

Senator BYRD. May I ask what are the appropriations so far for the fiscal 1951?

Secretary SNYDER. Do you want the over-all?

Senator BYRD. Yes; that is right.

Secretary SNYDER. The over-all budget.

The CHAIRMAN. The over-all for all purposes.

Secretary SNYDER. You are talking about the actual appropriations?

Senator BYRD. What are the appropriations to date, to get the clear picture?

Secretary SNYDER. Not including the request Friday?

Senator BYRD. That is right.

Mr. MAYO. That would be over 50 billion dollars.

Secretary SNYDER. Over 50.

Senator BYRD. They also have a correct figure on that.

Secretary SNYDER. They have it. They do not carry them around in their pockets. We will get it for you.

The CHAIRMAN. Will you get that and put it in the record?

Secretary SNYDER. Yes.

(The information is as follows:)

The figure referred to on total appropriations (including authorizations to treat expenditures as public-debt transactions) for the current fiscal year was 55,383 million dollars as reported on the daily Treasury statement, as of September 30, 1950.

Senator BYRD. A billion more or less these days does not seem to amount to too much. You said that next year we will spend half again more than we spent this year. How much of the seventy-five billion appropriated will be spent in this fiscal year?

Secretary SNYDER. Well, we will have to see if we can get those figures for you.

Senator BYRD. Will you furnish the committee then exactly how much has been appropriated and include the requests that are now made and any further requests that you may have knowledge of for appropriations, and then give the amount of that that will be expended in this fiscal year?

Secretary SNYDER. We will ask the Budget Bureau if they have those figures.

(The information is as follows:)

As indicated above, total appropriations for the current fiscal year were reported on the daily Treasury statement as of September 30, 1950, at slightly over $55,000,000,000. If the President's requests for about $18,000,000,000 more are granted, the total appropriation figure involved for the fiscal year 1951 would be a little over $73,000,000,000. The Secretary's estimate before the House Ways and Means Committee indicated total expenditures this fiscal year of approximately $45,000,000,000. This is likely to be increased slightly if the President's latest requests are granted and some expenditures are made from the resulting appropriations before the year is over.

It is our understanding that the Bureau of the Budget is currently preparing tabulations which will answer these questions more exactly. These tabulations will be presented as part of the 1952 budget.

Senator BYRD. Then, as I understand, when you get that you think half again as much will be spent in 1952 fiscal year?

Secretary SNYDER. That is generally the magnitude that may be involved. These are very difficult figures to get because we have to depend on the people who are spending the money to give us the schedules of what they think they can get committed and delivered before it works back to the Budget Bureau. More precise figures will be included in the January budget.

Senator BYRD. By the same reasoning, give the income that you estimate for this fiscal year and for next fiscal year of taxes that have

already been levied and then add to it the returns from the excess-profits tax.

Senator TAFT. Mr. Secretary, could you not give us a little sketch about that? You said the estimated deficit was $2,000,000,000.

Secretary SNYDER. When I appeared before the Ways and Means Committee.

Senator TAFT. You said it was a deficit of $2,000,000,000 and without this tax. Was it based on what receipts and what expenditures?

Secretary SNYDER. In the testimony before the House Ways and Means Committee I gave an estimate of $45,000,000,000 in expenditures and $43,000,000,000 in revenues.

Senator TAFT. That was the estimate?

Secretary SNYDER. That was the estimate. That appears in the House statement.

The CHAIRMAN. Yes, sir.

Senator BYRD. For this fiscal year?

Secretary SNYDER. For the fiscal year 1951.

Senator BYRD. Then, if you took half of that, you would add $21,000,000,000?

Secretary SNYDER. It would be about that.

Senator BYRD. You would add $21,000,000,000 to your $42,000,000,000, which would make an expenditure of $63,000,000,000.

Secretary SNYDER. It might be higher than that.

Senator BYRD. A good deal larger than that. As a matter of fact, I predict the expenditures will approximate $75,000,000,000 for fiscal 1952.

Secretary SNYDER. We do not have the exact figures. They will be available in the 1952 budget.

Senator BYRD. That will be a staggering deficit and may last for many years.

Secretary SNYDER. There is no question about that. That is why I do not think we can go too far in this bill.

Senator BYRD. How long do you think we can have a deficit of 15 or 20 billion dollars a year and survive?

Secretary SNYDER. I am not going to place any limitations on what we can do. We have to meet this situation the best we can.

Senator BYRD. The fiscal solvency of this country is important, too.

Secretary SNYDER. This is more important than any one of the others: The survival of our Nation.

Senator BYRD. Can we increase this?

Secretary SNYDER. There is no question how far we can increase the deficit if we are faced with destruction. I think we will go our limit there. And we will not sit back and estimate whether we can afford to do it or not. We will go to the limit of our capacity.

Senator BYRD. It is just as essential to save our form of government at the same time.

Secretary SNYDER. I have said that at the same time.

Senator BYRD. There are many economies that can be effected in the Government, if those in charge and in power choose to do it.

Secretary SNYDER. I am certainly in hearty accord with every economy.

Senator BYRD. We can spend recklessly and destroy our form of government even in order to win the war.

Secretary SNYDER. That kind of argument is not going to help us in this situation when we are talking about trying to meet a defense program.

Senator BYRD. There is more need for economy.

Secretary SNYDER. The President has taken very active steps to make economies on the domestic front.

Senator BYRD. I have not been conscious of it.

Secretary SNYDER. It might be well to become conscious of it.

Senator BYRD. It has not been transmitted to Congress yet. It may be in some study stage, but it has not gotten to Congress yet. We hear a lot about economy from the President but no action.

Secretary SNYDER. It is revealed in actual performance.

Senator BYRD. I differ with you completely on that.

The CHAIRMAN. Have you completed your prepared statement?

Secretary SNYDER. I am not quite through with my statement.

The CHAIRMAN. Go ahead then.

Secretary SNYDER. I will be glad to answer any questions. I wanted you to know that I have this to finish.

The CHAIRMAN. That you are going to talk about the revenue yield now?

Secretary SNYDER. Yes.

Senator MILLIKIN. If you intend to get at it, I will pass the question. It is perfectly apparent to me that next year we will have to really get down to business on this tax situation. Has the Treasury formed any tentative thoughts on the kind of taxes that we will have to raise next year?

Secretary SNYDER. Only in a very broad sense. We have been so busy trying to work up this that we have only some long-range studies. We have been having a cross section of various industries and businesses of our economy in talking about this since last summer some time, and we have some broad views, but we have not gotten them prepared.

Senator MILLIKIN. You are not prepared to outline what might be our task next year?

Secretary SNYDER. No, sir. We have not as yet.

REVENUE YIELD OF THE BILL

The revenue yield of the House bill is estimated to fall short of the President's recommendation by about 1 billion dollars. Part of this could be recovered by modifying the objectionable features of the bill to which I have referred.

An important reason for the reduced yield under the House bill is the adoption of a base period earnings credit equal to 85 percent of the average for the three best years instead of the 75-percent figure which I suggested to the Committee on Ways and Means.

Unless the bill is modified to increase its yield, it will not meet the objective set by the President before the recent deterioration in the international situation. The increase in corporation taxes provided in the bill is moderate in relation to the upward surge in profits. It should be remembered that all small corporations and corporations with current income not in excess of the allowed credits would be exempt.

In considering the effect of these increased taxes, it is important to have in mind the extremely liberal method provided for computing base period earnings. The allowance of the 3 best years out of 4 years yields a figure which would usually be substantially above the actual earnings in the extremely prosperous 4 years which followed World War II.

I urge your committee to review carefully the methods by which this bill can be amended to increase the yield from the taxation of corporation profits to meet the 4-billion-dollar goal set by the President. By adding 4 billion dollars to the revenue-producing strength of the tax system, this Congress will contribute substantially to our financial preparedness.

Senator MILLIKIN. Mr. Secretary, is the 4 billion dollars taken out of the air or does it have a demonstrable relationship to our over-all fiscal problem?

Secretary SNYDER. At the time that it was suggested it did have a direct bearing on the fiscal picture.

Senator MILLIKIN. In other words, you were figuring in relation to the anticiapted deficit?

Secretary SNYDER. That is correct.

Senator TAFT. Because your whole deficit is based on cash; is it not? So, you would only get 2 billion dollars; is that not correct? It would be 4 billion dollars on an annual basis, but you would only get 2 billion dollars; is that not right?

Secretary SNYDER. $4 billion on a full year's basis at current levels of income.

Senator TAFT. You are talking about deficits on a cash basis. You would only get 2 billion dollars from this tax during fiscal 1951.

Secretary SNYDER. We estimated that it would very nearly balance the budget when I made my statement before the Ways and Means Committee.

Senator TAFT. That is what I understood. I thought you were going to have something left over.

Secretary SNYDER. We might have a little.

The CHAIRMAN. Of course, Mr. Secretary, the actual yield of this bill will depend on the level of corporate profits in 1951.

Secretary SNYDER. For the next fiscal year, of course.

The CHAIRMAN. Certainly. It could go above the estimated 3.4 if those profits were considerably above the basis on which that was figured.

Secretary SNYDER. The only way that I can see profits going much above the present levels would be through inflation. But, if we put our controls into operation as we let the contracts and withdraw materials and labor from the economy, we are not going to be stacking up increasingly large profits during the important years of the defense effort.

The CHAIRMAN. Have you the figures, or can you furnish them on, say, 100 percent of the average earnings, 90 percent of the average earnings, as well as the 85 percent that is in the bill, as the House has it, with an increase in the rates? What would be the effect on the estimated revenue here if you took 100 percent of your average earnings but put your rate up to 85 percent?

Secretary SNYDER. I think we have a good schedule on that.

The CHAIRMAN. Have you that schedule worked out?

Secretary SNYDER. Yes, sir.

The CHAIRMAN. I want to get it in the record.
(The information is as follows:)

Estimated increase (gross)[1] over present law in the yield[2] of the corporation income and excess profits tax as contained in H. R. 9827 under various assumptions as to the percentage of base period earnings allowed and tax rates

[In billions of dollars]

Excess profits tax rate	Percentage of base period earnings allowed					
	75 percent	80 percent	85 percent	90 percent	95 percent	100 percent
60 percent	1.7	1.5	1.4	1.3	1.2	.1
65 percent	2.2	2.1	1.9	1.8	1.6	1.4
70 percent	2.8	2.6	2.4	2.2	2.0	1.8
75 percent	3.3	3.1	2.9	2.6	2.4	2.2
80 percent	3.9	3.6	3.3	3.1	2.8	2.5
85 percent	4.4	4.1	3.8	3.5	3.2	2.9
90 percent	5.0	4.6	4.3	3.9	3.6	3.2

[1] Before allowance for reduced individual income tax resulting from reduced dividends.
[2] Based on levels of income estimated for the calendar year 1951

Mr. LEAHY. With the 85-percent allowance of base period earnings, the estimate at the 75-percent rate is 2.9 billion dollars' increase. If you increased the rate to 80 percent, you would get 3.3 billion dollars.

The CHAIRMAN. That is your tax rate?

Mr. LEAHY. If you increase the excess profits tax rate to 85 percent you would get 3.8 billion dollars.

Senator TAFT. What effective rate would an 85-percent tax rate give? The 75 percent gives 67 percent according to your statement.

Secretary SNYDER. That is just a ceiling or limitation.

The CHAIRMAN. That is a ceiling.

Secretary SNYDER. The combined profits tax and normal tax would not go above a total of 67 percent.

Senator TAFT. Suppose you start with 75 percent?

Secretary SNYDER. If you raise that 67 to 75 percent?

Senator TAFT. Yes; would that cut down materially your yield from the 85-percent tax?

Mr. LEAHY. I think the 67 percent would materially reduce the yield if you had an 85-percent rate.

Senator TAFT. I understand that. How about the 75 percent total?

Mr. LEAHY. It would be very difficult to make such an estimate. However, I do not think that the loss would be very great.

Senator TAFT. That is from the 3.8 billion dollars that you mentioned?

Mr. LEAHY. Yes, sir; a reduction from the 3.8 billion dollars.

Senator TAFT. There would not be any great loss by imposing a total over-all 75 percent?

Mr. LEAHY. Probably not. That is just a rough guess.

Senator MILLIKIN. Give us a rule of thumb on the revenue which is yielded by 1 percent increase in the over-all corporate tax.

Mr. LEAHY. One percent increase in the over-all corporation tax—you mean surtax?

Senator MILLIKIN. All the way along the board.

Mr. LEAHY. About $380,000,000 gross.

Senator MILLIKIN. Per point?

Mr. LEAHY. Three hundred and eighty million.

Senator TAFT. But then you lose somewhere else.

Mr. LEAHY. There will be some loss from a reduction in dividends.

Senator MILLIKIN. $300,000,000?

Mr. LEAHY. I would say——

Senator MILLIKIN. You have thrown me off.

Mr. LEAHY. You take about $50,000,000 off the three eighty.

Senator TAFT. We were figuring 250 for 1 point and now we figure 5.

Mr. LEAHY. I cannot remember, sir, whether the 250 would be just a surtax or an increase all along the board. Many other rate increases, of course, are expressed only as an increase in the surtax rate on net income over $25,000.

Senator HOEY. If this bill was adopted and was retroactive to July 1 of this year, then you would realize in this fiscal year the full amount, would you not, just $2,000,000,000.

Secretary SNYDER. About $600,000,000.

Senator TAFT. You would not get the cash. You realize that you would not get the cash, because the tax is on the first half.

Secretary SNYDER. In fiscal 1951; yes.

Senator TAFT. The first half calendar 1951 would not be paid until 1952.

Secretary SNYDER. The tax on one-half of the calendar 1950 profits would be paid in part during this fiscal year. We estimate that our actual cash coming in from that would be about $600,000,000 in fiscal 1951.

The CHAIRMAN. A little more than half, because we changed that formula of payment.

Senator HOEY. The pay is faster.

Senator KERR. A little while ago in connection with your statement about the impact of the additional $4,000,000,000 would not be too great upon earnings which total $37,000,000,000, I asked you what part of the $37,000,000,000 would be earned by corporations that would be exempt from the provisions of this act, and I understood you to say that that question would be answered a little further on in the statement.

Secretary SNYDER. I thought it would. Mr. Leahy, will you answer that?

Mr. LEAHY. The net income of corporations with net incomes of less than $25,000?

Senator KERR. I did not ask that. You said it would be, approximately, 300,000 or approximately three-fourths.

Mr. LEAHY. Yes.

Senator KERR. Of all corporations exempt from the provisions of this act.

Mr. LEAHY. By the $25,000 specific exemption?

Senator KERR. By whatever it may be is immaterial so far as the information I want is concerned. They will be exempt?

Mr. LEAHY. Do you mean, sir, the total net income which is now subject to excess-profits tax?

Senator KERR. I thought I made myself very clear. I tried to ask what part of the $37,000,000,000, the total that you have estimated would be earned in 1950, would be earned by corporations who would not be affected by the provisions of this act.

Mr. LEAHY. The net income of corporations who will pay no excess profits tax we estimated will be $12,000,000,000.

Senator KERR. Then the impact of the $4,000,000,000 would be on corporations whose total earnings, according to your estimate, would be $25,000,000,000, and not upon corporations whose total earnings are $37,000,000,000.

Mr. LEAHY. These estimates are not based on the 37-, but on the 40-billion level. We do not have any——

Senator KERR. If you can answer my question I would appreciate it. If you cannot, I will quit asking.

Mr. LEAHY. We do not have any estimates at the $37,000,000,000 level.

Secretary SNYDER. We will see what we can furnish on that.

Senator KERR. You said it would be in the statement.

Secretary SNYDER. I was told that by the staff.

Senator KERR. That is fine. I was going on the basis of what you told me.

Secretary SNYDER. I was going on the basis of what one of my staff members told me. Now that we have traced it to its roots we will try to get the answer, if it is possible.

Senator KERR. The information will be furnished later?

Secretary SNYDER. We will try to get it for you.

Senator KERR. Thank you very much.

(The information is as follows:)

Distribution of net income, 1950,[1] by taxable status under H. R. 9827

[In billions of dollars]

Corporation profits, Department of Commerce basis	[2] 37.0
Income tax net income—all corporations	[3] 36.0
Taxable	23.2
Nontaxable	12.8
Excess profits net income—all corporations	34.5
Taxable	22.8
Nontaxable	11.7
Adjusted excess profits net income	8.0
Tax liability full year effect	2.4
Tax liability under H. R. 9827	1.2

[1] For corporations with taxable years ending after June 30, 1950 and before July 1951.

[2] The estimate of $37,000,000,000 of corporate profits contained in the Secretary's statement before the Senate Finance Committee represents an estimate of corporation profits on a Department of Commerce basis for the calendar year 1950.

[3] Surtax net income (excluding the credit under section 26 (i) relating to Western Hemisphere corporations) plus the amount of capital gains subject to the alternative tax rate.

Source: Office of the Secretary of the Treasury, Office of the Technical Staff. Dec. 8, 1950.

(The exhibit and Secretary Snyder's statement before the Ways and Means Committee follow:)

Exhibit to statement of Secretary Snyder—Comparison of House bill[1] with World War II tax under Revenue Act of 1942

A. MAJOR ITEMS

Subject	House bill	World War II treatment
1. Rate of tax	75 percent	95 percent (85.5 percent after postwar refund).
2. Over-all rate limitation on income and excess profits taxes.	67 percent	80 percent (72 percent after postwar refund).
3. Minimum credit or exemption	$25,000 minimum credit	$10,000 exemption.
4. Choice of earnings credit or invested capital credit, whichever produces lower tax.	Yes	Yes.
5. Base period	1946 through 1949	1936 through 1939.

[1] Including proposed Ways and Means Committee amendments.

Exhibit to statement of Secretary Snyder—Comparison of House bill[1] *with World War II tax under Revenue Act of 1942*—Continued

Subject	House bill	World War II treatment
6. Earnings credit—elimination of poor years in base period.	(*a*) Taxpayer may select best 3 out of 4 base period years. (*b*) Any deficits in 3 years chosen may be raised to zero.	No selection of years permitted. Taxpayer could raise the worst year to 75 percent of the average of the other 3 years, but could not adjust any remaining deficit year upward.
7. Earnings credit—adjustment in average base period earnings	Reduced to 85 percent	Reduced to 95 percent.
8. Invested capital credit—rate of return on equity capital and retained earnings.		
$0-$5 million	12 percent	8 percent.
$5-$10 million	10 percent	6 percent.
Over $10 million	8 percent	5 percent.
9. Invested capital credit—rate of return on borrowed capital:		
(*a*) Interest deduction	In full	Limited to ½.
(*b*) Additional allowance	⅓ of interest rate with a ceiling of 3 percent and, in the case of long-term obligations, a floor of 1 percent.	½ of above rates for equity capital.
(*c*) Total allowance	133 percent of interest payable (subject to floor and ceiling noted above).	From 2½ to 4 percent of borrowed capital, plus ½ the interest rate.
10. Earnings credit—additions to capital during base period.	(*a*) Upward adjustment in earnings credit permitted for any net additions to equity capital, retained earnings and borrowed capital in 1949 and for ½ of any such additions in 1948. (*b*) Rate of upward adjustment for such net additions to equity capital and retained earnings—12 percent. (*c*) Rate of upward adjustment for such net additions to borrowed capital—⅓ of the interest rate.	No adjustment in the earnings credit for such additions was allowed, except where taxpayer qualified for relief under sec. 722.
11. Earnings credit and invested capital credit—upward adjustment for net additions to equity capital and retained earnings after base period.	All taxpayers—allowance at rate of 12 percent on both new equity capital and new retained earnings.	(*a*) Taxpayers using earnings credit—allowance at rate of 8 percent on new equity capital but no allowance for new retained earnings. (*b*) Taxpayers using invested capital credit—allowance for new retained earnings at the applicable rates shown under item 6, and allowance for new equity capital at 125 percent of such rates.
12. Earnings credit—downward adjustment for net reductions in equity capital and retained earnings after base period.	At rate of 12 percent	At rate of 6 percent in case o equity capital; no downward adjustment for net reductions in retained earnings.
13. Earnings credit—additions or reductions in borrowed capital after base period.	Adjustment upward or downward equal to ⅓ of the interest rate.	No adjustment.
14. New corporations (organized after beginning of base period).	As an alternative to its usual credits, the taxpayer may apply to its invested capital after 3 years of growth (or at the end of the base period, if later) the average rate of return on invested capital for its industry in the base period.	(*a*) Taxpayers organized after the base period were required to use the invested capital credit unless they qualified for general relief. (*b*) Taxpayers organized in the base period could, in addition, compute an earnings credit; vacant years were filled in at 8 percent of invested capital at close of base period.
15. Substantial change during base period in product or services by corporation organized before 1946.	As an alternative credit, taxpayer may apply industry rates of return to its invested capital (as described under item 15).	Taxpayer could apply for general relief.
16. Smaller corporations (organized before beginning of base period) experiencing growth in the base period.	As an alternative credit, such a taxpayer meeting the following requirements may use 1949 earnings or the average of 1948 and 1949 earnings as its average base period earnings: (*a*) If in the last half of the base period its pay roll was 30	Taxpayers whose average earnings in the last half of the base period exceeded their average earnings in the first half of the base period could use, as an alternative credit, the sum of (*a*) their average earnings in the last half of the base period

[1] Including proposed Ways and Means Committee amendments.

Exhibit to statement of Secretary Snyder—Comparison of House bill[1] with World War II tax under Revenue Act of 1942—Continued

Subject	House bill	World War II treatment
	percent higher or its gross receipts were 50 percent higher than in the first half of the base period; and (b) Its assets do not exceed $20,000,000 (tax basis) as of the beginning of the base period.	and (b) one-half of the excess of that average over their average earnings in the first half of the base period. However, the credit so computed could in no event exceed their earnings in the best year of the base period.
17. Exclusion of nonrecurrent items of income and deductions in computing excess profits net income.	Yes, with several changes in World War II law.	Yes.
18. Excess profits credit of public utilities.	Minimum credit of 5 percent (after taxes) on both equity and borrowed capital in case of airlines and railroads and 6 percent in case of most other public utilities.	No special treatment.
19. Carry-backs and carry-overs:		
(a) Net operating loss	1-year carry-back and 5-year carry-over.	2-year carry-back and 2-year carry-over.
(b) Unused excess profits credit.	1-year carry-back and 5-year carry-over.	2-year carry-back and 2-year carry-over.
20. Relationship of income and excess profits taxes.	To be integrated into a single tax for administrative purposes, with excess profits subject to both (1) the 45 percent income tax and (2) a 30 percent surtax.	Two separate taxes.

B. MINOR ITEMS

Subject	House bill	World War II treatment
1. Option to file consolidated returns.	Yes	Yes.
2. Base period of fiscal year taxpayers.	Fiscal year taxpayers (other than those whose years end before April) would be required to use the 4 calendar years 1946–49 as their base period.	Since fiscal year taxpayers were not required to adjust to the 4 calendar years 1936–39, as much as 11 months of the first taxable year (1940) was sometimes included in the base period.
3. Exemption of personal service corporation whose stockholders elect to be taxable upon its income.	Yes	Yes.
4. Earnings credit-relief by disallowance of abnormal deductions in base period.	Yes	Yes.
5. Earnings credit-relief from abnormalities in base period.	Yes	Yes.
6. Earnings credit-relief from abnormalities in tax period.	Yes	Yes.
7. Earnings credit-allocation of earnings experience to successor corporations in case of corporate split-up.	Allocation permitted	Split-up corporations could not use prior earnings experience.
8. Exemption for strategic minerals (sec. 731).	Yes. (World War II list expanded to include uranium and others and Defense Minerals Administration authorized to expand further.)	Yes.
9. Special treatment for excess output of certain depletable resources (sec. 735).	Yes	Yes.
10. Relief for installment basis taxpayers.	Change to accrual basis permitted for both tax period and base period.	Change to accrual basis was permitted for tax period but not for base period.
11. Relief for taxpayers reporting income from long-term contracts upon the completed contract basis.	Yes	Yes.
12. Deferment of tax pament in case of abnormality.	Yes	Yes.
13. Railroad lessor-lessee corporations.	(a) Allocation of earnings credit permitted. (b) Payments by lessee of lessor's taxes excluded from lessor's income.	No special treatment.
14. Banks using reserve method of accounting for bad debts.	Permitted to abandon reserve method for excess profits tax purposes.	Banks did not use reserve method in 1940–45.
15. Invested capital credit-deficits in capital.	Recent deficits do not reduce invested capital.	Deficits did not reduce invested capital.

[1] Including proposed Ways and Means Committee amendments.

STATEMENT OF SECRETARY SNYDER BEFORE THE COMMITTEE ON WAYS AND MEANS, NOVEMBER 15, 1950

I am glad to accept your invitation to appear here today as your committee undertakes to carry out the congressional mandate that you prepare a profits tax bill as quickly as practicable. As you know, the President has recommended that you set the revenue objective of this legislation at $4 billion.

The task of preparing this legislation quickly is unusually difficult. Since time is short, I am particularly glad to have an opportunity at the beginning of your deliberations to offer you the technical facilities of the Treasury Department.

The world situation which compels us once again to make a defense effort is not one which any of us can face with equanimity. We are a peaceful people. Our only objective is an opportunity to join with others in a prosperity based on the association of free individuals and free nations.

That was our objective; that is our objective; that will remain our objective. But now we are faced with a grim reality. We are faced with a menace which can destroy the way of life we have built for ourselves, unless we make a determined effort to resist it. It could destroy the products of the magnificent direction of American management. It could destroy the vast contribution of labor to building up this Nation. And it could blot out, as if they had never existed, the free institutions which have made all of these things possible.

To meet this threat, we are building our defenses so that free peoples everywhere will not live in terror of unprovoked assaults, such as that in Korea.

This will be a costly process. It will require a significant part of the fruits of our managerial talent, our labor, our raw materials, and our technical resources. Moreover, this must be achieved without weakening our economy. We must blend together our defense needs and our domestic objective of maintaining a strong economic system, so that both will progress together.

This goal has an important bearing on our current fiscal policy. It has particular meaning to me as Secretary of the Treasury. The debt of the United States Government—one-half the debt of the entire country, both public and private—is interwoven throughout the financial fabric of the entire Nation. It represents an important part of the assets of our financial institutions, of our business concerns, and of the investment funds of individuals.

Under these circumstances, the first essential of a sound fiscal program is adequate tax revenue to give maximum protection to the financial position of the Government. This means enough revenue to pay for the Government's requirements.

There is no need to labor this point before your committee. The energetic and determined manner in which the chairman and members of this committee and the Senate Finance Committee responded this summer to the need for action on the first installment of the 1950 tax program necessitated by the aggression in Korea, is eloquent testimony of your appreciation of the problem before us.

It is in this spirit that the President recommended the prompt enactment of additional revenue legislation to complete the 1950 interim tax program. The President has a threefold objective: first, to contribute to meeting the increased cost of defense; second, to help check inflationary pressures and enable the Government to maintain a strong financial position; and third, to tax the high profits resulting from the defense program.

The uncertainty of the amount of national security expenditures makes it difficult to forecase the budgetary outlook for this fiscal year as a whole. A conservative estimate indicates that budget expenditures for this fiscal year will amount to about $45 billion. The present tax system, including the tax increases under the Revenue Act of 1950, is expected to produce $43 billion. This indicates a budgetary deficit for this fiscal year of about $2 billion.

As the President has stated, the amount of additional expenditures which will be required for military security is necessarily difficult to estimate. The direction of these expenditures, however, is clear.

Since commitments and obligations are now being made at a rate considerably greater than current expenditures, and since many items of military procurement have to be ordered long in advance of deliveries, expenditures for fiscal year 1952 and later years will be substantially above current levels. The magnitude of the revenues which will necessarily be needed to meet these expenditures on a pay-as-you-go basis is indeed sobering.

In considering the additional revenue required, we should not be misled by the fact that, temporarily, the budget deficit is moderate. Since an important

part of defense preparations entail production operations extending over two, three, or even more years, it is inevitable that obligations incurred now will be fully reflected in expenditures only at some time in the future.

The necessity for focusing attention on future rather than present expenditure levels is particularly important in connection with the President's objective of preventing inflation.

Under present conditions, expenditures for defense exert an inflationary pressure on the economy substantially in advance of the actual disbursement of funds. Demands for materials, for labor, and for capital outlays occur very soon after the Government contracts are let, well in advance of actual production, and consequently often far in advance of the time when the Government pays for that production. This explains in part why scarcities and inflationary pressures have developed even though a large portion of the increased defense funds appropriated by the Congress after Korea have not yet been reflected in Government expenditures.

The prevention of inflation is an essential element of our defense effort. A price and profits spiral would increase the cost of vitally needed defense materials, impose an inflationary burden on those earning relatively fixed incomes or depending upon past savings and, finally, divert the efforts of labor and management from the basic job of production. Private enterprise has much to preserve. The Government by prudent fiscal measures can encourage those who desire to concentrate on production.

To emphasize the importance of sound defense financing, I ask you gentlemen to consider my position as the official responsible for the credit of our Government. You know the gravity with which I view the responsibility entailed in managing a public debt which amounted to almost 270 billion dollars when I came to the Treasury more than 4 years ago. You know that it has not been possible to reduce this debt as much as would have been desirable. It is now approximately 257 billion dollars. I cannot emphasize too strongly my concern over the effect which the financing of the defense program will have on this problem.

The President's third objective, the prevention of profiteering from the defense program, is one about which there can be no disagreement. This goes to the very heart of the question of maintaining our free-enterprise system. It is well known that profits grow far more rapidly than other sources of income when production is forced to national capacity. An adequate tax policy can contribute to the prevention of profiteering, without interfering with the incentives which are essential to contained increases in production.

In this connection, it is important to distinguish between what may be called profits of the producers of defense materials and profits arising from the pressures of the defense program.

It is sometimes suggested that special profits taxation is unnecessary because the same objective can be obtained by renegotiation of Government contracts. Although renegotiation and profits taxation are interdependent and closely related, they are directed, of course, toward different objectives. One deals with fair pricing under Government contracts; the other with the taxation of corporate earnings during the defense period.

Renegotiation does not reduce the task of profits taxation in those segments of the economy where the defense program indirectly increases the demand for goods and services and thus increases profits. If, for example, the defense program absorbs the facilities of one manufacturer thereby increasing civilian demand for the products of another manufacturer of similar articles, it has contributed to the profits of the producer of civilian goods as certainly as to the profits of the producer of military supplies.

Accordingly, in devising taxes for dealing with profits arising from the defense program, it is necessary to consider the whole picture. Except in the case of individual defense contracts, it is impossible to determine the specific factors contributing to the changes in profits of a particular corporation or even of an industry. Future changes in the over-all level of profits, however, probably can be attributed largely to the impact of the defense program.

The rising trend of corporation earnings, particularly as reflected in recent financial reports, constitutes one of the bases of the President's recommendation that substantial additional revenue be obtained from profits taxation.

CORPORATION PROFITS

When this country responded to the Korean crisis with the only answer that was appropriate, the economy was nearing the record 1948 production level. Gross national product for the second quarter of 1950 was at an annual rate

of $270 billion compared with less than $254 billion in the fourth quarter of 1949. In the third quarter of this year, due to the impact of the defense effort, it jumped sharply to a level of $282 billion and is continuing to rise rapidly.

Although all segments of the economy are enjoying prosperity, the gains have been most striking in corporate profits. As you know, total corporate profits during the four years following World War II far exceeded any previous level. This enabled corporations to pay dividends at record rates and still reinvest substantial earnings. Corporation profits during the years 1946–49 averaged $29 billion before deduction of taxes. This was more than five times the 1936–39 average.

Chart 1 indicates that corporation profits for 1950 will establish a new record. It is now estimated that corporation profits before taxes for this year will total $37 billion, or $3 billion in excess of the peak year 1948.

Chart 2 shows the course of dividends and retained earnings. In the prewar period, dividends amounted to about $4 billion annually and retained earnings were very small. Dividends were fairly stable during the war, but in 1946 began to rise rapidly. This year they will reach 8.5 billion dollars—more than twice the prewar level. Despite the record dividend payments this year, retained earnings will equal the previous record in 1948.

Charts 3 and 4 present the trend of corporate profits in relation to the equity investment of corporations. The series in chart 3 ends in 1947, the latest year for which data from tax returns are available. The general trend, however, is clear. In 1947, the average rate of return on net worth of all corporations with net income was 19 percent before income taxes or more than double the prewar rate. After taxes, the 1947 rate of return was substantially higher than in any of the wartime years.

The information from tax returns shown in chart 3 is supplemented for more recent years for manufacturing corporations in chart 4. For the period 1947–49, profits of this group, after taxes, averaged 14.5 percent of net worth or almost two and one-half times the 1936–39 average.

The detailed record indicates that all corporations have not prospered to the same extent in recent years.

Chart 5 shows the rates of return on net worth before taxes for selected industries in 1947. The returns range from a high of 35 percent for the lumber industry to a low of 7 percent in the communications industry. With the principal exception of the transportation and communications industries, the rates of return were well above 10 percent.

Chart 6 shows the variations in the earnings experience of manufacturing firms of different sizes. For small- and medium-sized manufacturing corporations, rates of return on net worth decreased in 1948 and 1949. In contrast, the very largest manufacturing corporations maintained a very high rate of return throughout most of the postwar period. In 1950, the rates of return for corporations of all sizes apparently increased very substantially.

(The data underlying the charts are presented in the attached tables 1–6).

In view of this earnings record, there can be little doubt that, if properly distributed, $4 billion of additional taxes would leave corporations, in the aggregate, with high earnings and a high rate of return on investment.

ALTERNATIVE TAX METHODS

In appraising alternative tax methods, it is necessary to understand at the outset that defense financing calls for more than a tax on earnings considered excessive by recent high earning standards. It requires special regard both for the unusual profits that may develop under the defense program and for the high profit levels which have been prevailing. I encompass all of this in the taxation of defense profits.

We have given careful study to alternative ways of obtaining the President's revenue objective through the taxation of corporate profits. The alternatives explored range from a uniform percentage increase in the rate of the regular corporation income tax to various forms of war profits and excess-profits taxation, and combinations of these methods.

One conclusion which stands out clearly is the inadvisability of placing the burden of the President's revenue objective on the regular corporation income tax.

The basic issue is whether the additional tax should be distributed on all corporations regardless of their share in the present prosperity or whether taxation should be more selective. As was shown in chart 6, there is substantial variation in the increased profitability of small and large corporations. There

are equally important variations among industries and among firms within identical industries. As happened during the last war, these variations will undoubtedly increase under the abnormal conditions ahead of us.

In a year when corporation profits total about $40 billion, each 1 percentage point increase in the corporation rate produces about $340 million. In other words, to raise $4 billion from an increase in the corporation income tax rate would require boosting the present 45-percent rate to about 57 percent. The raising of $4 billion additional revenue from a flat increase in the corporation income tax would accentuate the uneven effects which the defense program will have throughout the business world. It would impose particular hardship on corporations whose profits are declining.

It will be said, of course, that the high profits of businesses which fare unusually well through direct participation in the defense program could be controlled by renegotiation of Government contracts. Undoubtedly this will do much to prevent profiteering, since it can be relied upon to skim off a large part of the excessive profits of firms directly connected with defense industries.

To say that renegotiation would level off profits among industries and corporations and thus justify omission of a defense-profits tax from the tax system, however, ignores most of the war-profits problem. High earnings are not necessarily concentrated in industries producing military materials. Moreover, the record of the last war shows that war contractors earned large excess profits even after renegotiation.

The extensive support given the principle of excess-profits taxation by this Congress when it considered the interim tax bill suggests that the need for a special tax is recognized by the Congress.

The taxation of profits, however, is not without its difficulties. The issue comes down to one of weighing these difficulties against the inequities involved in substantial increases in the taxes on the profits of all corporations. Many of the difficulties, however, can be tempered by benefiting from past experience to increase equity among taxpayers and to reduce the burden of tax administration.

In searching for the most satisfactory approach to this problem, the Department and the staff of the joint committee have examined a variety of possibilities. The Treasury staff has analyzed the experience of a large number of corporations under the last excess-profits tax and examined the impact of different approaches on various types of corporations.

These investigations suggest that in developing a basis for profits taxation it will be necessary to rely largely on the past earnings experience of corporations and to look to the rate of return on invested capital as a guide for taxation of those corporations with unsatisfactory earnings experience.

If this approach is adopted, consideration should be given to the fundamental changes in the World War II tax that seem most desirable, particularly from the point of view of its impact on specific firms and specific industries under current conditions.

WORLD WAR II EXCESS-PROFITS TAX

A brief review of the World War II excess-profits tax may be helpful as a setting for the discussion of the changes suggested for your consideration.

The wartime tax excluded most small corporations by providing a specific exemption of $10,000. This was in addition to the excess-profits credit allowed each corporation. Corporations had the choice of computing their credit on the basis of 95 percent of the average earnings for the base-period years 1936–39, or on the basis of a percentage of invested capital. The rates allowed on invested capital varied with the amount of capital. There were numerous exceptions to these general rules designed to relieve hardship.

During World War II, the maximum number of corporations subject to excess-profits tax was 68,000 in 1943, or about a quarter of all corporations subject to income tax for that year. Because of the relatively low rate of earnings on capital experienced in the base period years, little more than a third (35 percent) of the corporations subject to excess-profits tax elected the base period earnings credit in that year. However, the excess-profits tax of these corporations accounted for 54 percent of the total tax.

After 1943 the tax was imposed at a flat rate of 95 percent, but provision was made for a postwar credit of 10 percent which reduced the net tax rate to 85.5 percent. The over-all average effective rate, before the postwar credit, was 80 percent. The net yield, or the amount by which the receipts from this tax exceeded the amount that would have been raised from the corporation income-tax alone, was about $16 billion. (Detailed statistical data on the wartime tax are provided in exhibit 1.)

THE BASE PERIOD EARNINGS CREDIT

The recent profit experience of corporations shows that in the case of most corporations an earnings credit based on recent years would provide a reasonable method of arriving at defense profits. This represents an important change from the situation when the World War II law was formulated. In view of the relatively lower level of profits in the years 1936–39, the majority of corporations secured a higher excess-profits credit under the invested capital method than under the base-period earnings method.

In view of the dynamic expansion of the economy in recent times, only an up-to-date period will provide an adequate measure of defense profits. The 1936–39 base period of the previous law cannot be restored because it relates to a period when gross national product was only 25 percent of the present level and total profits only 13 percent. At least 45 percent of existing corporations have been organized since that time. Profit levels for the war years are also obsolete in view of the expansion in the economy. Moreover, the profits of different industries and corporations at that time reflected highly abnormal relationships.

The fact that most corporations would now rely upon a base-period earnings credit is an important consideration in selecting a base period which would achieve the greatest equity and minimize the need for special adjustments.

The years since the war, 1946–49, afford a broad and representative basis for appraising the earnings performance of individual corporations. It is well recognized, of course, that no one period provides for every business an entirely satisfactory measure of normal profits. However, these 4 years cover an exceptional period of sustained prosperity, giving an unusually large proportion of corporations an opportunity to earn high profits

The inclusion of the year 1950 in the base period should be rejected since it already reflects to an important degree the impact of defense expenditures. To a lesser degree, this objection is applicable to all recent years when governmental expenditures for defense and foreign aid have been substantial.

Although the profit experience of the years 1946–49 can serve as a general guide to normal earnings, irregularities did exist. The profits of some industries were depressed in 1946 because of reconversion from war to peacetime production. Other industries earned substantially higher profits in 1946 than later years (table 7). Omission of 1946 from the base period would penalize these firms and industries for their prompt fulfillment of consumer needs following the war.

The fairest method of recognizing these differences would be to allow the taxpayer to use the best 3 of the 4 years. This would be an improvement over the method used in World War II, which allowed a taxpayer with a bad year to substitute for his single lowest year, 75 percent of the average income of the remaining 3 years. The suggested exclusion of the poorest year would treat this type of case more generously.

The proposed treatment would increase the average base period earnings by 6¼ percent for those who, under the old law, would have qualified for an adjustment under the 75-percent rule. It would also be advantageous to a number of taxpayers whose income in the lowest year is more than 75 percent of the average of the remaining years and who obtained no relief under the wartime rule. For example, a corporation with earnings of $10 million in the lowest year and $20, $30, and $40 million in the other 3 years would use the average of the 3 highest years or $30 million. The wartime rule would have substituted 75 percent of this $30 million average, or 22.5 million, for the lowest year. This would result in a credit of $28.1 million or nearly $2 million less than under the proposal to average the best 3 years.

It should be noted that such a change would necessarily reduce the tax base since it would liberalize the credit for some corporations without reducing the credit for others. However, it would be more effective in minimizing possible grievances and relief claims.

Our studies also suggest the desirability of liberalizing the treatment of corporations with deficits in some of the base period years. This would be of considerable importance to some taxpayers, and would reduce the number of taxpayers seeking general relief.

Another provision the committee may wish to consider is the treatment of corporations which were increasing their capacity to earn during the base period and, in the normal course of events, might be expected to continue growing. In World War II this type of situation was handled by what is known as the growth

formula. With the elimination of the taxpayer's worst year under the proposed option to select the three best years, less need remains for this adjustment. However, it may be necessary to make some allowance for cases where substantial investment in the latter part of the base period is not adequately reflected in base period profits.

INVESTED CAPITAL CREDIT

Due to the large increase in the level of profits since the 1936–39 period an invested capital credit would be used less frequently in the present situation than during the last war. At that time this credit carried the burden of protecting many industries that had been operating under depressed conditions prior to the war.

Provision for an equitable invested capital credit is still essential as a relief measure. It would apply in three principal types of situations. First, certain industries may earn a low rate of return on capital which, though high in relation to preceding earnings, is low by generally accepted standards; second, there are industries or individual firms that failed to participate in the general prosperity during the proposed base period years; third, it is necessary to provide a basis for determining the tax status of new businesses.

To meet present requirements the invested capital credit requires substantial revision.

Rate on invested capital

No single rate of return on invested capital will allow for the varied conditions peculiar to different businesses. The statutory rates must aim at the best general level in the light of existing circumstances. When the World War II tax was initiated the invested capital credit was based on a flat allowance of 8 percent. It developed that this rate exempted all or most of the large corporations in a number of basic industries and therefore in subsequent acts the Congress reduced the allowance for larger corporations. The principle of varying the allowance according to size is believed to be sound and should be continued.

The invested capital allowances in the last version of the World War II tax appear to be low for present conditions. These allowances were:

	Percent
On the first $5,000,000 of invested capital	8
On the next $5,000,000	6
On the amount of invested capital above $10,000,000	5

Under these rates, few corporations would now find the invested capital option useful. Unless these rates are increased the alternative credit based on invested capital would not provide a significant measure of relief.

As indicated earlier in my statement, the average rate of return on equity capital for manufacturing corporations, before income tax, has more than doubled since the 1936–39 period. In 1939 nearly a third of the manufacturing companies had a return of less than 5 percent on equity capital. By 1947 the proportion of such firms had been reduced to about one-tenth (table 8). It is clear that the use of the statutory rates of return allowed at the termination of the World War II tax would discriminate against companies with low income in the base period because the bulk of corporations have enjoyed relatively much higher rates of return.

In revising the allowances under the invested capital credit, a balance must be found between two considerations which would lead to widely different rates. The first requires a rate sufficiently high to protect normal growth of new business and firms which normally earn relatively higher rates of return. If the invested capital credit is too low to be available to any substantial proportion of corporations falling in these categories, more corporations will be forced to have recourse to general relief in obtaining a reasonable minimum earnings base exempted from profits taxation. In the absence of an adequate invested capital credit, industries of great importance in the defense effort might be adversely affected.

At the same time it is also important to avoid invested capital allowances so high that industries characteristically having a relatively low rate of return might never become subject to defense profits taxation regardless of the expansion in their profits. Such a situation might arise in heavily capitalized industries. It may also affect those industries in which favorable treatment under the income tax law results in a rate of return computed for income tax much below the rate of return actually earned. Unless the invested capital credit is adjusted

to the realities of the situation, large windfalls might accrue to heavily capitalized industries.

Careful studies of the effect of different possible allowances under the invested capital credit suggest that the allowances provided at the end of World War II should be increased by about one-fourth to one-third. The principle of differentiation in allowances according to the size of the invested capital of a corporation should be retained. With this differentiation, an increased invested capital credit will afford effective relief for those industries and corporations that have lagged in the general expansion of earnings and will adequately protect existing investment in most cases.

Borrowed capital allowance

The World War II allowance for borrowed capital should be basically revised. That allowance provided for including 50 percent of borrowed capital in invested capital with a corresponding disallowance of 50 percent of the deduction for interest paid.

An allowance for borrowed capital gives recognition to the risk involved where the earnings on equity capital are subject to interest payments on debt. The amount of earnings remaining for equity capital under such conditions is subject to wider fluctuations than where borrowed capital is not employed. In the interest of equity, however, a revision of this statutory allowance is required.

The World War II allowance gave taxpayers the benefit of one-half the difference between the statutory rate on equity capital and the rate of interest on borrowed capital. This favored the larger corporations with well-established credit positions, able to borrow at the lowest interest rates. Under the World War II provision, for example, a large company having an equity capital allowance of 6 percent and borrowing at an interest rate of 3 percent would have its excess profits credit increased by one-half the difference between 6 percent and 3 percent, or 1½ percent of the amount of its borrowed capital. In contrast, a small corporation with a poor credit rating borrowing at 7 percent could have received a benefit equal to one-half the difference between this rate and the highest equity capital allowance of 8 percent, or only one-half of 1 percent on the borrowed capital. If its interest rate had been more than 8 percent it would have been penalized.

This inequity would be removed by adopting an allowance for borrowed capital proportionate to the interest rate. This would give recognition to the fact that high interest rates generally reflect greater risk. To provide reasonable protection in these cases, it is suggested that the invested capital credit be increased by about 25 to 35 percent of the amount of interest paid on borrowed capital, and no reduction be made in the interest deduction. To prevent abuse, the maximum allowance should be limited to 2 percent of the borrowed capital in addition to the interest deduction.

In general, this revision would make the invested capital credit more favorable to small corporations which must borrow at higher rates of interest than those which can borrow on very favorable terms.

Impaired capital

Under the World War II law, invested capital included capital and surplus paid in to the company regardless of whether such capital still existed or had previously been lost. It is well known that a number of large corporations have at some time in their history experienced large losses of capital. The former law, nevertheless, counted as existing capital much that had been lost in remote periods. This treatment created an inequity by giving such corporations an important tax advantage over competing concerns whose capital had not been impaired. This discrimination, often resting on accidental circumstances, might seriously affect new corporations attempting to compete with those receiving such a tax advantage.

It is possible to remove this discrimination and yet give proper recognition to temporary losses of capital by limiting the allowance to capital impairment attributable to recent years.

New capital

Under the World War II tax, corporations using the invested capital method were allowed a credit for new equity capital which was 25 percent larger than the credit allowed on old capital. Corporations using the average base period earnings credit were allowed a flat 8 percent on new capital. Increases in equity capital arising from the reinvestment of earnings were granted under the invested capital credit but not under the earnings credit.

The provisions of the World War II law are in need of revision. Otherwise most corporations, which will use the base period earnings credit, would obtain no allowance for the reinvestment of earnings. Such reinvestments have been at record levels in recent years. Wide discrepancies would result if this allowance depended upon the fortuitous shift of corporations from the earnings credit to the invested capital credit. The staff has assembled for your information data you will want to consider in the alinement of these credits. I would prefer to see recognition given to retained earnings in determining both the earnings and invested capital credits.

MINIMUM CREDIT IN LIEU OF SPECIFIC EXEMPTION

Experience suggests that it is desirable to limit the application of the type of profits tax under consideration to taxpayers with significant defense profits.

The World War II excess profits tax provided a $10,000 specific exemption for this purpose. Several advantages would be gained by replacing the specific exemption with a minimum credit and increasing the amount to $25,000.

Whereas a specific exemption is granted to all corporations, a minimum credit would apply only to those corporations with actual credits below the minimum. For example, under the specific exemption a corporation would not be subject to excess profits tax until its earnings exceeded its credit by $10,000. Under a minimum credit of $25,000 no corporation would be taxable unless its net income exceeded $25,000.

A minimum credit concentrates relief in the lower net income brackets, since it can be utilized only by those firms whose computed credits are less than $25,000. Thus, a $25,000 minimum credit would provide a larger favorable area for small and new businesses and the auditing of tax returns for these corporations would be greatly simplified. Moreover, the use of a minimum credit would also reduce substantially the number of claims for relief by small corporations. Such cases accounted for approximately a quarter or 13,000 of the 54,000 relief claims filed under the World War II tax, and for an even greater proportion of the litigation under the World War II relief provisions. The elimination of this administrative burden would be highly desirable.

RELIEF PROVISIONS

The generally prosperous condition of the country during the past 5 years and the type of revisions outlined here would enable taxpayers generally to establish a fair and reasonable base for the measurement of defense profits. Although the need for relief would be greatly reduced, abnormal cases would remain. Equitable treatment in these cases is one of the most troublesome problems encountered in the administration of a defense or excess profits tax.

General tax provisions must necessarily be drafted with the typical firm in mind. Whether primary use is made of an earnings standard or of an invested capital standard, cases will arise where the tax might occasion serious hardship in the absence of relief.

Although an earnings standard takes into account both differences in risk and differences in operating efficiency as reflected in past earnings, it is inadequate for the new or rapidly growing firm whose profit potentialities have not yet been demonstrated. A similar problem arises where base period earnings have been adversely affected by some abnormal or unusual occurrence beyond the taxpayer's control.

The general relief provisions of World War II specified in considerable detail the circumstances under which taxpayers would be entitled to relief. The law encouraged the filing of about 54,000 claims for relief and was difficult to administer. The corporation seeking relief became the rule rather than the exception.

The relief provisions should be revised to avoid extremes. The objective should be to provide a fair measure of relief which lends itself to reasonable administrative determination. New and growing firms confronted by risks which require a higher rate of return on invested capital than that allowed by the main provisions of the statute merit special attention. The records of the Bureau of Internal Revenue and the Excess Profits Tax Council provide guidance for the formulation of an appropriate general relief provision. The staff has assembled extensive materials on this subject for your consideration.

TAX RATE

The type of defense tax I have described must produce adequate revenue without involving very high marginal rates and without penalizing unduly corporations not sharing in the high level of profits. Excessively high rates tend to increase inflationary pressures because they induce waste and inefficiency.

In a situation short of total war and in the absence of comprehensive economic controls, it is necessary to retain the economic incentives of our private-enterprise economy. Nonetheless, a properly designed profits tax is essential for a balanced anti-inflation program since economic controls and higher taxes on individuals would be unfair unless high corporate profits carry their fair share of the tax load.

I believe you will agree that there would be little advantage, if any, in adopting this new tax if its rates were only a few percentage points higher than those of the regular corporation income tax. Such a tax would impose additional burdens by way of taxpayers' compliance and tax administration which would be warranted only if it produced significant amounts of revenue. At the same time, however, it is also desirable to avoid rates as high as the 85½-percent rate employed in the last wartime tax. If under present conditions and in the absence of wartime production motivation corporations were allowed to retain only a small part of any additional income they earn, they may not be left with sufficient incentive to maximize production. Under the present circumstances a rate of around 75 percent appears to be reasonable. This would mean a differential tax of 30 percent over the regular 45-percent corporation normal and surtax.

The World War II excess profits tax started with graduated rates. In 1942, however, graduation was eliminated and a flat over-all rate on all excess profits was substituted. It is our tentative conclusion that under present conditions graduation would not be necessary. It would tend to increase the top marginal rate, if the revenue objective is to be obtained, and is therefore likely to have less desirable incentive effects than a flat rate.

To achieve the President's revenue objective with a tax of the type I have described, and with a 75-percent tax rate, it would be necessary to reduce base period earnings by 25 percent for purposes of computing the credit. This cutback of the base period to 75 percent may be justified on grounds similar to those which underlay the cut-back to 95 percent in the World War II tax. It was the view of Congress then that firms in a position to use an earnings credit would, in effect, obtain an allowance equal to very high rates of return on their invested capital and would thus enjoy a big advantage over those restricted to the invested capital base. This advantage is even greater now than it was under the old law. The fact that some defense profits predated Korea also supports some reduction in the credit based on pre-1950 earnings.

It must be recognized that if the base period earnings credit is reduced, this tax will apply to some firms whose current profits are no higher than the average of their best three base-period years. For these firms the tax increase resulting from the 25 percent reduction in the credit will be equivalent to a 7½ percentage point increase in the corporate rate. However, the over-all distribution of tax burdens under this profits tax will differ from an equal general corporate income tax rate increase. Firms whose earnings had declined below 75 percent of the 3 year average would pay none of the increase. Firms with earnings between 75 and 100 percent of this average would pay only a small portion of a flat increase. Finally, firms whose earnings had actually increased over this average would pay more than 7½ percent additional tax on their entire income, depending on how much their profits increased.

I am limiting my comments to the more general features of the tax under consideration. The suggestions I have made for revision in the World War II tax, if that approach is adopted, are limited to the essentials underlying the concept of the tax. Since time during this session is short, you will doubtless want to confine this year's legislation to basic essentials, deferring consideration of provisions having more restricted application to next year.

As you know, the fair application of this type of tax requires a wide variety of detailed provisions. During the past several months the staff has assembled data bearing on the items I have mentioned and on many others. These investigations are going forward in the expectation that as your hearings and deliberations proceed you will have need for these materials. The staff will be prepared to present them at your convenience.

Mindful of this committee's immediate response to the need for interim tax legislation earlier this year, I am confident that despite the complexities of

profits taxation you will carry out the congressional mandate in the short time available. This will round out the 1950 interim tax program and bring the corporation-profits taxes into better alinement with the personal-income tax. It will combat profiteering and, by narrowing the gap between expenditures and revenues, will contribute to the soundness of the Government's finances and to the progress of the mobilization effort.

TABLE 1.—*Corporation profits before and after taxes, dividends, and undistributed profits, 1929–50*

[Millions of dollars]

Year and quarter	Profits before taxes	Taxes	Profits after taxes	Dividends	Undistributed profits
1929	9, 818	1, 398	8, 420	5, 823	2, 597
1930	3, 303	848	2, 455	5, 500	−3, 045
1931	−783	500	−1, 283	4, 098	−5, 381
1932	−3, 042	382	3, 424	2, 574	−5, 998
1933	162	524	−362	2, 066	−2, 428
1934	1, 723	746	977	2, 596	−1, 619
1935	3, 224	965	2, 259	2, 872	−613
1936	5, 684	1, 411	4, 273	4, 557	−284
1937	6, 197	1, 512	4, 685	4, 693	−8
1938	3, 329	1, 040	2, 289	3, 195	−906
1939	6, 467	1, 462	5, 005	3, 796	1, 209
1940	9, 325	2, 878	6, 447	4, 049	2, 398
1941	17, 232	7, 846	9, 386	4, 465	4, 921
1942	21, 098	11, 665	9, 433	4, 297	5, 136
1943	25, 052	14, 406	10, 646	4, 493	6, 153
1944	24, 333	13, 525	10, 808	4, 680	6, 128
1945	19, 717	11, 215	8, 502	4, 699	3, 803
1946	23, 464	9, 583	13, 881	5, 808	8, 073
1947	30, 489	11, 940	18, 549	6, 561	11, 988
1948	33, 880	12, 969	20, 911	7, 467	13, 444
1949	27, 625	10, 601	17, 024	7, 821	9, 203
1950 [1]	37, 000	15, 000	22, 000	8, 500	13, 500
1949—First quarter	28, 300	10, 900	17, 400	7, 900	9, 500
Second quarter	26, 400	10, 000	16, 400	7, 700	8, 700
Third quarter	28, 200	10, 800	17, 300	7, 400	9, 900
Fourth quarter	27, 600	10, 600	16, 900	8, 200	8, 700
1950—First quarter	29, 200	12, 000	17, 200	8, 100	9, 100
Second quarter	37, 400	15, 100	22, 200	8, 100	14, 100

[1] Estimated on the basis of incomplete data.

Source: U. S. Department of Commerce, Survey of Current Business.

TABLE 2.—*Rate of return on net worth, all corporations with net income, 1936–47*

[Dollar amounts in millions]

Year	Net income before tax	Net income after tax	Net worth	Net income as percent of net worth	
				Before tax	After tax
				Percent	*Percent*
1936	$9, 102	$7, 957	$105, 553	8. 6	7. 5
1937	9, 392	8, 146	112, 902	8. 3	7. 2
1938	6, 369	5, 525	99, 553	6. 4	5. 5
1939	8, 709	7, 492	110, 347	7. 9	6. 8
1936–39 average	8, 393	7, 280	107, 089	7. 8	6. 8
1940	11, 068	8, 543	116, 231	9. 5	7. 4
1941	17, 797	10, 733	127, 674	13. 9	8. 4
1942	23, 785	11, 647	131, 183	18. 1	8. 9
1943	28, 399	12, 647	139, 294	20. 4	9. 1
1944	26, 880	12, 111	144, 950	18. 5	8. 4
1945	21, 945	11, 243	144, 559	15. 2	7. 8
1946	26, 681	17, 971	148, 635	18. 0	12. 1
1947	32, 790	22, 003	169, 588	19. 3	13. 0

Source: Statistics of Income, pt. 2.

TABLE 3.—*Rate of return on net worth, all manufacturing corporations, 1936–50*

[Dollar amounts in millions]

Year	Net income before tax	Net income after tax	Net worth	Net income as percent of net worth	
				Before tax	After tax
Statistics of income data:				*Percent*	*Percent*
1936	$3,614	$3,027	$38,467	9.4	7.9
1937	3,669	3,028	41,239	8.9	7.3
1938	1,601	1,229	41,261	3.9	3.0
1939	3,559	2,930	42,438	8.4	6.9
1936–39 average	3,111	2,554	40,851	7.6	6.3
1940	5,302	3,758	44,162	12.0	8.5
1941	10,300	5,419	48,398	21.3	11.2
1942	13,544	5,386	55,072	24.6	9.8
1943	16,416	5,986	60,688	27.0	9.9
1944	14,740	5,422	63,071	23.4	8.6
1945	10,173	4,109	64,150	15.9	6.4
1946	11,501	6,958	67,589	17.0	10.3
1947	16,474	10,233	76,675	21.5	13.3
FTC—SEC data:					
1947	(1)	(1)	(1)	25.5	15.6
1948	(1)	(1)	(1)	25.6	16.1
1949	(1)	(1)	(1)	18.5	11.7
1950 (annual rate):					
First quarter	(1)	(1)	(1)	19.6	12.0
Second quarter	(1)	(1)	(1)	24.8	15.6

[1] Not available.

Sources: *Statistics of Income*, Part 2, and Federal Trade Commission and Securities and Exchange Commission, *Quarterly Industrial Financial Report Series for All United States Manufacturing Corporations.*

TABLE 4.—*Rates of return on net worth before taxes, by industrial groups, for selected years 1936–47, corporations with net income*

Industrial group	1936–39 average	1940	1944	1946	1947
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
All industrial groups	7.8	9.5	18.5	18.0	19.3
Total mining and quarrying	7.2	7.7	10.8	11.0	18.5
Total manufacturing	10.6	13.7	24.0	20.2	23.5
Food and kindred products	10.3	10.8	21.8	26.0	23.3
Beverages	21.5	20.3	32.5	32.8	31.6
Tobacco manufactures	15.3	16.7	17.2	16.4	17.3
Textile-mill products [1]	8.5	10.5	23.7	32.7	32.7
Apparel and products made from fabrics	10.0	11.7	30.1	37.9	31.0
Leather and products	8.9	10.2	20.4	27.7	25.2
Rubber products	7.6	10.4	35.7	30.2	21.2
Forest products	7.5	10.1	18.4	24.6	31.2
Lumber and timber basic products	[2] 5.2	9.1	15.9	23.5	34.8
Furniture and finished lumber products	[2] 9.0	11.3	21.6	26.0	26.5
Paper and allied products	8.5	13.0	20.2	23.8	32.2
Printing and publishing industries	11.0	11.6	27.5	28.4	25.1
Chemicals and allied products	13.6	17.1	21.5	24.0	25.3
Petroleum and coal products	4.6	4.7	7.3	7.7	11.5
Stone, clay, and glass products	11.0	14.3	18.6	20.4	22.7
Metal and its products	11.0	17.1	30.6	16.5	23.6
Iron, steel, and products	[2] 7.9	13.3	21.7	15.1	22.3
Nonferrous metal and products	[2] 9.9	17.2	22.1	16.3	22.5
Electrical machinery and equipment	[2] 11.0	22.2	37.6	16.6	28.4
Machinery, except transportation equipment and electrical	[2] 9.6	18.0	35.7	18.9	25.5
Transportation equipment except automobiles	[2] 12.6	23.5	44.5	15.0	13.8
Automobiles and equipment except electrical	15.7	20.1	27.9	7.9	26.6
Manufacturing not elsewhere classified	12.7	16.6	33.7	25.5	25.7
Other manufacturing	[2] 12.6	17.4	34.2	26.6	23.8
Manufacturing not allocable	[2] 9.2	13.7	32.8	23.7	29.6
Total public utilities	6.1	7.0	12.8	9.4	8.9
Transportation	[2] 5.0	5.8	15.8	8.2	8.7
Communication	[2] 7.8	9.2	12.2	9.3	7.3
Other public utilities	[2] 6.2	7.5	8.7	10.5	10.2
Total trade	10.6	12.1	23.7	30.5	29.2
Total wholesale	[2] 8.8	12.5	23.8	32.8	31.3
Total retail	[2] 9.6	11.6	24.6	29.7	28.2
General merchandise [3]	[2] 9.9	12.0	27.4	28.6	24.8
Food stores including milk	[2] 10.9	11.0	19.7	28.5	25.3
Apparel	[2] 10.5	12.7	32.1	32.0	25.0
Building materials, fuel, ice [4]	[2] 6.5	7.9	13.3	21.2	24.4
Total service	11.5	12.2	26.3	28.6	25.0
Hotels and lodging places	([5])	6.5	21.3	20.7	18.8
Business service	[2] 17.1	17.8	26.5	30.2	32.0
Motion pictures	([5])	11.9	29.0	32.0	25.1
Total finance, insurance, real estate, and lessors of real property	5.5	5.6	11.1	13.5	12.7
Total finance	[2] 4.5	5.5	7.3	9.9	8.2
Total insurance carriers, agents, etc	[2] 10.2	7.7	29.5	31.1	30.8
Real estate including lessors of buildings	[2] 4.1	4.5	8.6	14.1	13.4
Construction	12.8	18.0	22.9	27.4	30.5
Total agriculture, forestry and fishery	6.6	7.2	15.2	20.3	22.0

[1] Including cotton manufactures.
[2] Average for years 1938 and 1939 only.
[3] Including department, general merchandise, and dry goods stores, limited-price variety stores, and mail-order houses.
[4] Figures for 1936–39 include lumber and coal yards and exclude fuel and ice.
[5] Not available.

Source: Statistics of Income, p. 2.

TABLE 5.—*Rates of return on net worth after taxes, by industrial groups, for selected years 1936–47, corporations with net income*

Industrial group	1936–39 average	1940	1944	1946	1947
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
All industrial groups	6.8	7.3	8.4	12.1	13.0
Total mining and quarrying	6.2	6.1	6.2	7.3	12.2
Total manufacturing	8.9	9.9	9.0	12.8	15.0
Food and kindred products	8.7	8.4	9.0	16.3	14.8
Beverages	17.8	15.5	12.9	20.1	19.9
Tobacco manufactures	12.9	12.7	8.9	10.4	10.9
Textile mill products [1]	7.1	7.6	8.4	20.2	20.6
Apparel and products made from fabrics	8.4	9.1	11.7	24.0	19.9
Leather and products	7.5	8.1	8.6	17.1	16.0
Rubber products	6.5	8.2	10.5	18.8	13.8
Forest products	6.3	7.5	8.2	16.1	20.1
Lumber and timber basic products	[2] 4.3	6.8	7.6	15.5	22.5
Furniture and finished lumber products	[2] 7.6	8.5	8.9	16.7	17.0
Paper and allied products	7.1	9.4	7.6	15.0	20.2
Printing and publishing industries	9.4	9.0	10.9	18.3	16.3
Chemicals and allied products	11.6	12.5	9.2	15.3	16.3
Petroleum and coal products	4.1	3.8	4.4	5.3	7.8
Stone, clay, and glass products	9.3	10.4	7.7	13.0	14.4
Metal and its products	9.2	11.7	10.2	10.4	14.9
Iron, steel, and products	[2] 6.6	9.4	7.6	9.6	14.1
Nonferrous metal and products	[2] 8.3	11.9	8.4	10.4	14.4
Electrical machinery and equipment	[2] 9.2	15.2	12.0	10.5	17.9
Machinery, except transportation equipment and electrical	[2] 8.0	12.2	11.5	11.9	16.1
Transportation equipment except automobiles	[2] 10.3	15.3	14.5	9.7	8.7
Automobiles and equipment except electrical	13.3	13.9	9.0	5.1	16.8
Manufacturing not elsewhere classified	10.6	12.0	12.1	16.3	16.5
Other manufacturing	[2] 10.5	12.5	12.0	17.0	15.3
Manufacturing not allocable	[2] 7.6	10.3	12.3	15.1	19.0
Total public utilities	5.2	5.4	5.6	6.3	5.9
Transportation	[2] 4.2	4.5	6.0	5.4	5.6
Communication	[2] 6.9	7.0	6.5	6.8	5.4
Other public utilities	[2] 5.2	5.8	4.6	6.9	6.7
Total trade	8.9	9.3	10.0	19.7	19.0
Total wholesale	[2] 7.5	9.6	10.1	20.9	20.3
Total retail	[2] 8.1	8.9	10.0	19.2	18.4
General merchandise [3]	[2] 8.2	8.9	9.2	17.9	15.6
Food stores including milk	[2] 9.1	8.4	9.0	18.2	16.1
Apparel	[2] 8.7	10.0	13.3	20.7	16.7
Building materials, fuel, ice [4]	[2] 5.3	6.5	7.8	14.6	16.4
Total service	9.9	9.9	12.7	19.0	16.9
Hotels and lodging places	(5)	5.1	11.2	13.7	12.5
Business service	14.4	14.2	13.8	20.1	21.4
Motion pictures	(5)	9.9	13.1	20.8	16.9
Total finance, insurance, real estate, and lessors of real property	5.1	5.0	9.2	11.2	10.7
Total finance	[2] 4.2	5.1	5.7	7.7	6.5
Total insurance carriers, agents, etc	[2] 9.0	6.5	27.1	29.7	29.5
Real estate including lessors of buildings	[2] 3.5	3.7	5.9	10.3	9.7
Construction	10.6	13.9	10.9	18.9	20.6
Total agriculture, forestry and fishery	5.6	5.7	8.0	13.6	14.9

Source: Statistics of Income, pt. 2.

[1] Including cotton manufactures.
[2] Average for years 1938 and 1939 only.
[3] Including department, general merchandise, and dry-goods stores, limited-price variety stores, and mail-order houses.
[4] Figures for 1936–39 include lumber and coal yards and exclude fuel and ice.
[5] No average.

TABLE 6.—*Rate of return on net worth before and after taxes, by assets size classes, 1947–50*

MANUFACTURING CORPORATIONS

Total assets classes	1947	1948	1949	1950 [1]
Before taxes:	*Percent*	*Percent*	*Percent*	*Percent*
Under $250,000	23.8	15 5	9.8	15.2
$250,000, under $1,000,000	29.6	23 8	14.1	21.2
$1,000,000, under $5,000,000	31.2	24.8	15.5	21.6
$5,000,000, under $100,000,000	28.4	26 4	17.7	23.6
$100,000,000 and over	20.9	26.1	23.2	27.2
Total	25.5	25.6	18.5	24.8
After taxes:				
Under $250,000	14.3	8.8	4.9	9.6
$250,000, under $1,000,000	17.0	14.2	7.8	12 8
$1,000,000, under $5,000,000	18.5	14.8	9.0	13.2
$5,000,000, under $100,000,000	17.2	16.1	10.8	14.8
$100,000,000 and over	13.3	16.9	13.5	17.2
Total	15.6	16.1	11.7	15.6

[1] Second quarter at annual rates.

Source: Federal Trade Commission and Securities and Exchange Commission, Quarterly Industrial Financial Report for all United States Manufacturing Corporations.

TABLE 7.—*Corporate net income before taxes, by industrial groups, 1946–49*

Industrial group	1946	1947	1948	1949	Averages		
					1946–49	3 best years	3 best years as percent of 1946–49
	Mil. of dol.	*Mil. of dol.*	*Mil. of dol.*	*Mil. of dol.*	*Mil. of dol.*	*Mil. of dol.*	
All industries, total	$23,464	$30,489	$33,880	$27,625	$28,865	$30,665	106.2
Agriculture, forestry and fisheries	171	199	194	151	179	188	105.0
Mining	543	1,123	1,480	1,008	1,039	1,204	115.9
Contract construction	219	389	482	468	390	446	114.4
Manufacturing	12,046	17,355	19,081	14,663	15,786	17,033	107.9
Food	2,106	1,905	1,422	1,359	1,698	1,811	106.7
Tobacco	180	200	289	277	237	255	107.6
Textile mill products	1,462	1,593	1,745	762	1,391	1,600	115.0
Apparel	512	466	330	218	382	436	114.1
Lumber	273	534	516	254	394	441	111.9
Furniture	243	287	289	159	245	273	111.4
Paper	583	954	827	554	730	788	107.9
Printing, publishing	673	635	484	401	548	597	108.9
Chemicals	1,474	1,776	1,927	1,678	1,714	1,794	104.7
Products of petroleum and coal	964	1,708	2,746	1,727	1,786	2,060	115.3
Rubber products	317	208	190	124	210	238	113.3
Leather	244	226	169	102	185	213	115.1
Stone, clay and glass products	375	460	515	483	458	486	106.1
Iron and steel	1,059	1,972	2,434	1,878	1,836	2,095	114.1
Nonferrous metals	396	594	598	309	474	529	111.6
Machinery, except electrical	736	1,540	1,709	1,306	1,323	1,518	114.7
Electrical machinery	144	796	790	678	602	755	125.4
Transportation equipment except automobiles	−34	−7	147	117	56	86	153.6
Automobiles	103	1,259	1,710	2,112	1,296	1,694	130.7
Wholesale and retail trade	5,748	6,263	6,606	5,315	5,983	6,206	103.7
Finance, insurance, and real estate	1,723	1,675	1,948	2,155	1,875	1,942	103.6
Transportation	561	1,199	1,783	1,317	1,215	1,433	117.9
Railroads	123	751	1,134	656	666	847	127.2
Highway passenger transportation	148	86	80	51	91	105	115.4
Highway freight transportation	93	123	231	206	163	187	114.7
Water transportation	126	179	199	236	185	205	110.8
Air transportation	−23	−40	4	31	−7	4	....
Communication and public utilities	1,569	1,402	1,520	1,749	1,560	1,613	103.4
Telephone and telegraph	338	232	326	400	324	355	109.6
Radio, television	59	55	51	50	54	55	101.9
Utilities	1,172	1,115	1,143	1,299	1,182	1,205	101.9
Services	759	671	579	559	642	670	104.4
Hotels	125	115	118	108	117	119	101.7
Motion pictures	322	240	119	124	201	229	113.9
Amusements	95	64	63	61	71	74	104.2

Source: United States Department of Commerce, Survey of Current Business.

TABLE 8.—*Frequency distribution of returns on net worth before and after taxes of listed corporations, 1939 and 1947*

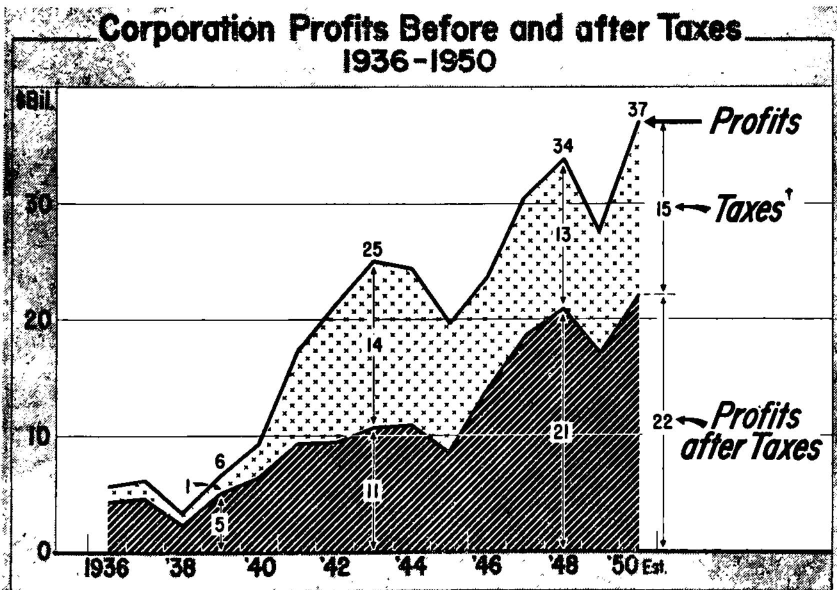
Percent of net profits to net worth [1]	1939		1947	
	Before tax	After tax	Before tax	After tax
	Number of corporations			
Under 5 percent	312	357	203	248
5 to 10 percent	206	253	86	227
10 to 15 percent	174	166	159	308
15 to 25 percent	192	171	371	486
25 to 50 percent	129	83	637	468
50 percent and over	30	13	374	93
Total	1,043	1,043	1,830	1,830
	Percent of total			
Under 5 percent	29.91	34.23	11.09	13.56
5 to 10 percent	19.75	24.26	4.70	12.47
10 to 15 percent	16.68	15.92	8.69	16.80
15 to 25 percent	18.41	16.40	20.27	26.52
25 to 50 percent	12.37	7.96	34.81	25.54
50 percent and over	2.88	1.25	20.44	5.11
Total	100.00	100.00	100.00	100.00

[1] Net worth taken as of beginning of year.

Source: Securities and Exchange Commission, Survey of American Listed Corporations.

CHARTS ACCOMPANYING THE STATEMENT OF SECRETARY OF THE TREASURY SNYDER

CHART 1



Source: Deparmtent of Commerce.

Office of the Secretary of the Treasury. Source: Department of Commerce.

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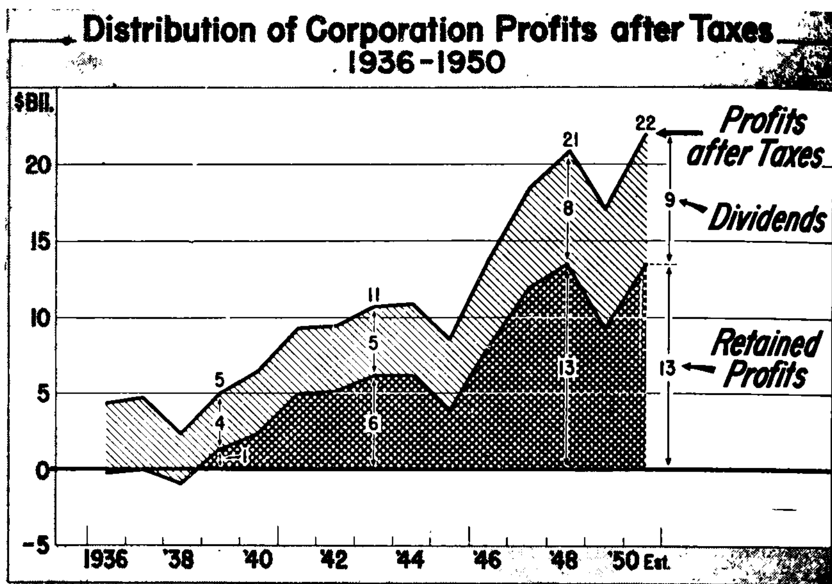
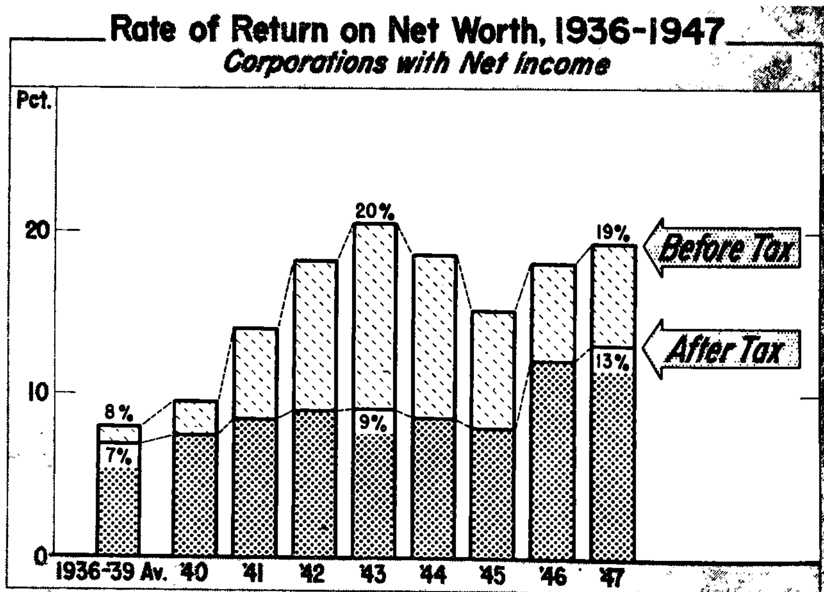
CHART 2



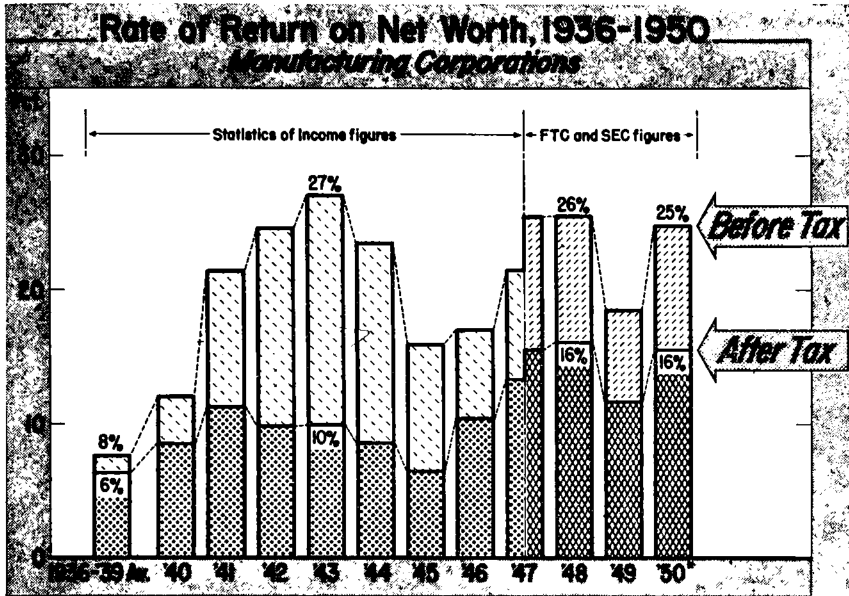
Office of the Secretary of the Treasury. Source: Department of Commerce.

CHART 3



Office of the Secretary of the Treasury. Source: Statistics of Income.

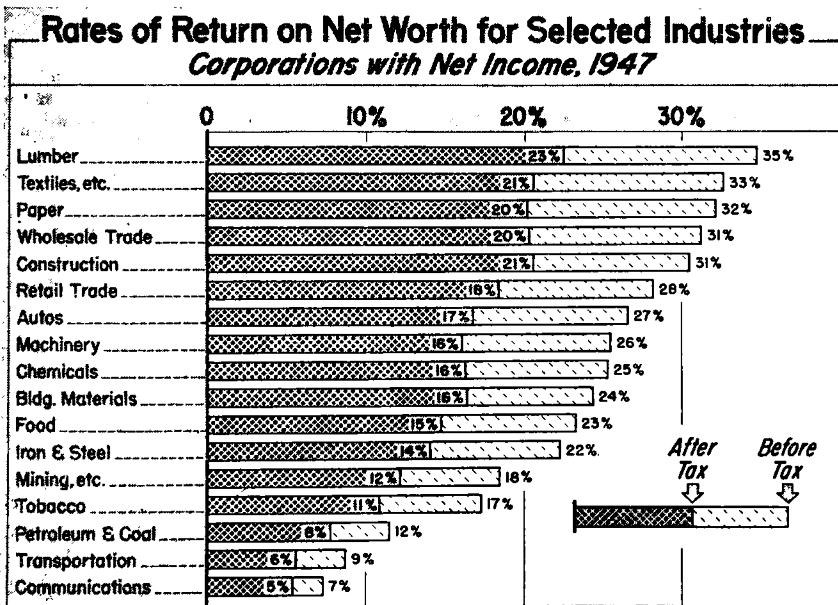
CHART 4



Office of the Secretary of the Treasury.

*Annual rate for second quarter.

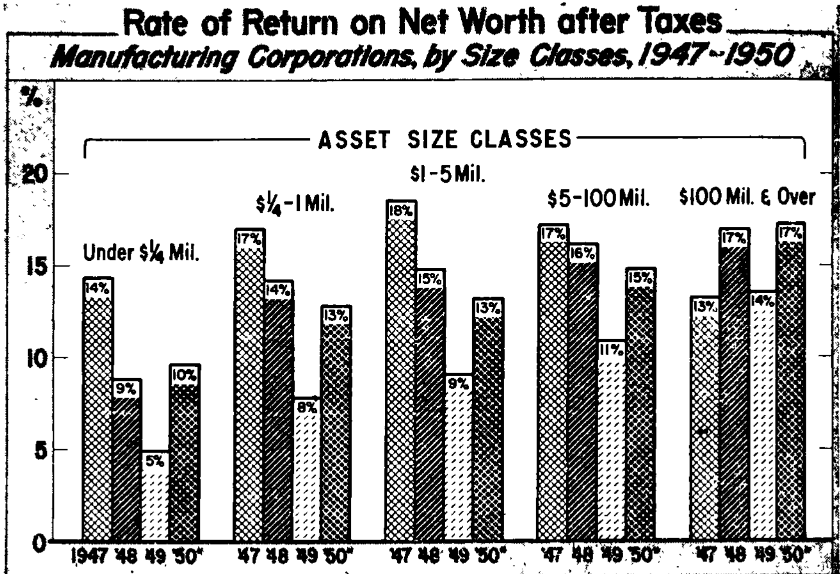
CHART 5



Office of the Secretary of the Treasury.

Source: Statistics of income.

CHART 6



Source: FTC and SEC.

Office of the Secretary of the Treasury.

*Annual rate for second quarter.

EXHIBIT 1

CORPORATION INCOME AND EXCESS PROFITS TAX LIABILITIES, 1940–45

This exhibit summarizes the statistical data on corporation income and excess profits tax liabilities in the period 1940–45, compiled from Statistics of Income. It includes (1) a summary of the adjustments to net income and tax liability due to renegotiation; (2) an estimate of the net yield of the World War II excess profits tax, after taking into account the effects of renegotiation, carrybacks of net operating losses and of unused excess profits credit, respread of special amortization deductions after the end of the war, and claims for relief; and (3) a brief discussion of the variations of the wartime income and excess profits tax among industries and assets size classes. The definitions of terms used in the text and appendix tables are given on page 12.

I. ADJUSTMENTS OF NET INCOME AND TAX LIABILITY DUE TO RENEGOTIATION

The net income originally reported by all corporations in the 4 years, 1942–45, totaled $98.2 billion.[2] As shown in table 1, this total was subsequently reduced by contract renegotiation to $91.6 billion or by a total of $6.7 billion.[3] Total tax liabilities[4] were reduced from $53.9 billion to $48.9 or by about $5 billion. Thus, while substantial amounts of profits were recaptured by the Government through renegotiation, taxes were also substantially reduced. As a result, the net effect of the renegotiation subsequent to the filing of tax returns, after allowing for the reductions in tax liabilities, was to increase the Government's receipts by about $1.7 billion. This figure understates the total effect of renegotiation, however, because it does not include renegotiation made currently and reflected on tax returns as filed.

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[2] Net income as reported in Statistics of Income has been reduced by the life insurance reserve credit for the years 1942–45.

[3] Figures do not include amounts of renegotiation which were reflected on the original tax returns as filed.

[4] In addition to income and excess profits taxes, total taxes include a small amount of declared-value excess profits tax which is not shown separately in the tables.

TABLE 1.—*Effects of renegotiation of war contracts upon reported income and taxes of corporations with net income, 1942–45*

[Dollar amounts in millions]

	Amount reported on tax returns	Amount after renegotiation	Reduction	
			Amount	Percent of original amounts
Total net income	$98,235	$91,559	$6,676	6.8
Net income subject to excess profits tax	45,820	39,208	6,611	14.4
Income tax	17,353	17,283	71	0.4
Excess profits tax	36,132	31,393	4,739	13.1
Total taxes	53,860	48,903	4,958	9.2

The adjustments made by renegotiation of war contracts were highly concentrated among a comparatively few taxpayers and the largest effects were in four groups of manufacturing concerns. The adjustment affected less than 2 percent of all corporations. Of the total reduction in net income through renegotiation in 1944, 71 percent was accounted for by manufacturers of electrical and other machinery, iron and steel products, and transportation equipment.[4a]

II. YIELD OF THE EXCESS PROFITS TAX

During the 6 years, 1940–45, when the excess profits tax was in effect, the total net income of all corporate taxpayers was approximately $121 billion, after allowance is made for the effect of renegotiation, and nearly half of this was paid in Federal income and excess profits taxes. Taxes ranged from 22.8 percent of net income in 1940 to 55.9 percent in 1944 (table 2).

TABLE 2.—*Net income and total taxes after renegotiation of all corporations with net income, 1940–45*

[Dollar amounts in millions]

Year	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
1940	$11,203	$2,144	$374	$2,549	22.8
1941	18,111	3,745	3,359	7,168	39.6
1942	21,462	4,298	6,601	10,941	51.0
1943	24,928	4,465	9,238	13,785	55.3
1944	24,660	4,335	9,374	13,778	55.9
1945	20,509	4,175	6,180	10,399	50.7
Total	120,873	23,172	35,126	58,620	48.5

In the peak years 1943 and 1944, the indicated yield of the ordinary income tax was roughly $4.4 billion and that of the excess profits tax was roughly $9.3 billion. However, these figures exaggerate the relative importance of the excess profits tax. Since excess profits were not subject to the ordinary income tax, a substantial portion of the reported excess profits tax merely replaced revenue that would otherwise have been collected through the regular corporation income tax.

The approximate amounts that the wartime corporation income tax would have yielded if it had applied to the entire net income, instead of only to the income not subject to the excess profits tax, are shown in table 3. These estimates were made by applying the top corporation income tax rate to the amount of taxable net income excluded from the income tax base and then adding the actual income taxes collected.

[4a] Statistics of Income for 1944, pt. 2.

TABLE 3.—*Estimated yield of the corporation income tax if it had applied to total corporate net income, 1940–45*

[Dollar amounts in millions]

Year	Income tax	Net income after renegotiation	Income tax as percent of net income
1940	$2,175	$11,203	19.4
1941	4,850	18,111	26.8
1942	7,758	21,462	36.1
1943	9,144	24,928	36.7
1944	8,951	24,660	36.3
1945	7,337	20,509	35.8
Total	40,218	120,873	33.3

Table 3 shows that for the 6-year period, 1940–45, the total income tax that would have been collected if the rates had applied to all corporate net income is over $40 billion. In the peak years 1943 and 1944, the yield would have been approximately $9 billion, or about two-thirds of the actual yield of combined income and excess profits taxes.[5]

The approximate differential effect of the excess profits tax is revealed by a comparison of the figures in tables 2 and 3. As shown in table 2, the total wartime tax yield in the period 1940–45 was $58.6 million after taking account of the effect of renegotiation. Since the corporation income tax alone would have produced $40.2 billion, the yield attributable to the excess profits tax on this basis was roughly $18.4 billion or $16.7 billion less than the original $35.1 billion paid as excess profits taxes (after renegotiation).

It is noted, however, that the $18.4 billion estimate does not take account of the tax-reducing effects of carry-back refunds, relief claims, and the special amortization deductions which were spread back after the war. Consequently, it still overstates the net yield of the excess-profits tax. It is estimated that these downward adjustments have amounted to, roughly, $2.2 billion up to June 30, 1950. If this amount is subtracted from the $18.4 billion figure computed above, the net yield of the excess profits tax becomes, roughly, $16.2 billion.[6] (Table 4.)

TABLE 4.—*Computation of the net yield of the wartime excess profits tax, 1940–45*

	Millions of dollars
1. Total excess profits taxes reported on tax returns afer renegotiation	35,126
2. Deduct portion of the yield attributable to the regular corporation income tax	—16,724
3. Equals yield of the excess profits tax before adjustments for subsequent refunds	18,402
4. Deduct refunds due to carry-backs, respread of special amortization, and relief claims [1]	—2,200
5. Equals estimated net yield of the excess profits tax [2]	16,212

[1] Through fiscal year ending June 30, 1950.
[2] Not including the additional tax collected as a result of audit.

Since the total net income after renegotiation for all corporations with net income amounted to $121 billion, the $16.2 billion net yield of the excess profits

[5] The effective rates of income taxes run 3 or 4 percentage points below the top combined normal and surtax rates in each year. There are several reasons for this apparent discrepancy. Probably the most important is that reported net income includes dividends received, while approximately 85 percent of these are deducted from net income before applying the tax rates. In addition, total net income includes incomes, such as partially exempt interest, capital gains, and income of small corporations, which are not subject to the top combined normal and surtax rates. Finally, for some corporations, the net income of the year is reduced, before the tax rate applies, by the amount of net operating losses carried over from other years. Each of these items tends to lower the ratio of total tax to report net income below the full statutory tax rate.

[6] The amounts of additional tax collected as a result of audit adjustments are not included.

tax amounted to an effective rate of 13.4 percentage points. However, a 13.4-point increase in the corporation income-tax rates would not have produced the equivalent of the net yield of the excess profits tax because net income overstates the actual tax base.[7] After adjustment for these differences, it is estimated that the net yield of the excess profits tax could have been raised by an increase of approximately 14.5 percentage points in the corporation income-tax rates. In the peak years 1943 and 1944 the additional percentage-point increase in corporate rates that would have been required was probably closer to 18 percent.[8]

III. DISTRIBUTION OF THE WARTIME TAXES

The excess profits tax concentrated much of the over-all burden of wartime corporation taxes on a relatively small proportion of corporations. As shown in table 5, the number of corporations paying excess profits tax was never as much as one-fourth the number of all corporation income taxpayers in any of the 6 years 1940–45. The share of total corporation net income which was treated as excess profits was, however, much larger. In 1943 and 1944, 46.1 percent of the net income of all corporations was subject to excess profits tax, and for the whole 6-year period, 38.4 percent of total net income fell within the statutory definition of "excess profits."

These figures indicate that the relatively few corporations with excess profits accounted for a very large portion of total corporation incomes. Partly as a result of this concentration of income and partly as a result of the high rate of tax on excess profits, corporations with excess profits paid, roughly, 85 percent of the total corporation taxes in the period 1940–45. (See appendix, tables 4 and 5.)

TABLE 5.—*Comparison of net income reported by all corporations and by corporations subject to the excess profits tax, 1940–45*

[Dollar amounts in millions]

Year	Corporations with net income			Net income after renegotiation			Income subject to excess profits tax	
	Total number	Subject to excess profits tax		All corporations with net income	Corporations subject to excess profits tax		Amount	Percent of total net income
		Number	Percent of total		Amount	Percent of total		
1940	220, 977	13, 440	6. 1	$11, 203	$3, 921	35. 0	$912	8. 1
1941	264, 628	42, 412	16. 0	18, 111	11, 632	64. 2	6, 335	35. 0
1942	269, 942	54, 002	20. 0	21, 462	15, 716	73. 2	8, 554	39. 8
1943	283, 735	68, 202	24. 0	24, 928	19, 877	79. 7	11, 493	46. 1
1944	288, 904	55, 912	19. 4	24, 660	19, 576	79. 4	11, 375	46. 1
1945	303, 019	52, 097	17. 2	20, 509	14, 132	68. 9	7, 796	38. 0
Total				120, 873	84, 854	70. 2	46, 455	38. 4

A. *Differences among industries*

Among the 8 principal industry divisions, the excess profits tax had greatest effect upon manufacturing concerns and least upon financial companies. As shown in table 6, 42.2 percent of the manufacturing companies were subject to the excess profits tax in 1944, and 54.8 percent of the net income of all manufacturing corporations was taxable as excess profits. At the other extreme, only 2.7 percent of finance corporations had excess profits tax liability. The relatively small impact of the excess profits tax on the finance group is explained by the fact that much of their income took the form of incomes not subject to excess profits tax.

[7] See footnote 1, p. 4.
[8] The estimate for an individual year cannot be made precisely because refunds cannot be allocated by tax years.

TABLE 6.—*Percent of corporations and of total net income subject to excess profits tax, by industrial groups, for returns with balance sheets only, 1944*

Industrial group	Percent of corporations subject to excess profits tax	Percent of net income subject to excess profits tax	Percent of net income accounted for by corporations subject to excess profits tax
Manufacturing	42.2	54.8	89.2
Public utilities	23.5	44.1	86.4
Trade	22.0	48.0	81.8
Service	18.3	38.9	72.0
Mining and quarrying	16.4	18.4	53.0
Agriculture, forestry, fisheries	16.4	29.8	65.6
Construction	15.3	39.4	66.9
Finance, insurance, real estate	2.7	2.1	8.1
All industrial groups	20.5	44.4	76.5

NOTE.—The percentages are based on net income after adjustment for renegotiation.

Table 7 indicates that the proportion of total net income that was paid in taxes varied widely among industries, ranging from 32.5 percent for finance companies to 61.3 percent for all manufacturing taxpayers in 1944. It also shows that the average effective rates of total taxes for firms which were subject to excess profits tax were substantially higher in each industry than the effective rates for the industry as a whole.

TABLE 7.—*Effective rates of total taxes, by industrial groups 1944*

Industrial group	All corporations with net income	Corporations subject to excess profits tax
	Percent	*Percent*
Manufacturing	61.3	64.5
Trade	57.4	63.7
Public utilities	55.8	59.1
Construction	51.2	62.6
Service	51.2	59.7
Agriculture, forestry, fisheries	47.0	57.0
Mining and quarrying	42.5	52.3
Finance, insurance, real estate [1]	32.5	50.0
All industrial groups	55.9	62.9

[1] The effective rates for the finance group were computed on the basis of net income after correction for both the life-insurance reserve credit and the dividends-received credit since these items are very large for this group.

NOTE.—The effective rates were computed on the basis of net income and tax liabilities after adjustment for renegotiation.

B. *Differences among corporations of different sizes*

Differences in the impact of the wartime taxes among corporations of different sizes are shown separately for nonfinancial corporations in tables 8 and 9.[9] The total wartime taxes were apparently largest as a percent of net income for corporations with assets of $500,000 to $100,000,000. Corporations with assets of more than $100,000,000 were affected somewhat less severely, and the burden on small corporations as a group was comparatively light.

[9] Financial corporations are not included because they paid relatively little excess-profits tax. (See tables 6 and 7.)

TABLE 8.—*Percent of nonfinancial corporations and of their total net income subject to excess profits tax, by assets size classes, returns with balance sheets only, 1944*

Total assets classes	Percent of corporations subject to excess profits tax	Percent of total net income subject to excess profits tax	Percent of net income accounted for by corporations subject to excess profits tax
Under $50,000	5.2	4.4	19 5
$50,000, under $100,000	24.1	18.3	49.5
$100,000 under $250,000	43.4	35.3	71.1
$250,000, under $500,000	59.6	48.5	82.5
$500,000, under $1,000,000	66.8	53 9	86.3
$1,000,000, under $5,000,000	71 7	57.4	88.5
$5,000,000, under $10,000,000	72.1	57.1	89.2
$10,000,000, under $50,000,000	73.2	55.9	87.8
$50,000,000, under $100,000,000	77.1	56.5	92.3
$100,000,000 and over	75.2	46.7	89.1
Total	27.3	50.4	86.2

NOTE.—The percentages are based on net income after adjustment for renegotiation.

Among nonfinancial corporations, with assets of $500,000 to $100,000,000, the average tax experience was fairly consistent. In 1944, excess profits taxes were paid by two-thirds or more of these corporations and from 54 to 57 percent of their net income was subject to excess profits tax. Total taxes amounted to about 62 percent or 63 percent of income in these classes; and for those paying excess profits taxes, the effective rate of total taxes was around 66 percent.

TABLE 9.—*Effective rates of total taxes for nonfinancial corporations, returns with balance sheets only, by assets size classes, 1944.*

Total assets classes	All corporations with net income	Corporations with excess profits tax
	Percent	*Percent*
Under $50,000	28.1	42.4
$50,000, under $100,000	37.2	49.2
$100,000, under $250,000	48.2	57.0
$250,000, under $500,000	57.2	62.9
$500,000, under $1,000,000	61.3	65.7
$1,000,000, under $5,000,000	63.1	66.6
$5,000,000, under $10,000,000	62.8	66.1
$10,000,000, under $50,000,000	62.4	66.0
$50,000,000, under $100,000,000	62.0	64.1
$100,000,000 and over	57.3	60.0
Total	59.0	63.1

NOTE.—The effective rates are based on net income and tax liabilities after adjustment for renegotiation.

While three-fourths of largest nonfinancial corporations paid excess profits tax in 1944, less than half of the total net income of these corporations was subject to that tax. This indicates that the wartime profits of this group rose less above their credit for normal earnings than was true of the middle groups.

A relatively small proportion of small nonfinancial corporations paid excess profits tax, and the proportions of total net income subject to that tax for these corporations were smaller yet. For example, only 5.2 percent of nonfinancial corporations with assets of less than $50,000 paid excess profits tax in 1944 and total tax applied only to 4.4 percent of the net income for the group. Among the smaller corporations, the average tax burden tended to vary directly with size; percentages of taxpayers and income subject to excess profits tax and the effective rates of total taxes all rose progressively with increased amounts of assets.

The appendix tables which follow present the information summarized above in greater detail.

DEFINITION OF TERMS

Net income is the amount of income reported by the corporation before statutory adjustments in arriving at income subject to normal and surtax. It includes the full amount of dividends received, Government interest subject to surtax only, and capital gains, but it does not allow for carry-overs of net operating loss deductions from other years. For the purpose of these tables, net income, as tabulated in Statistics of Income, part 2, has been adjusted for the years 1942–45 by subtracting the net life insurance reserve credits which were treated as deductions in 1940 and 1941.

Income subject to excess profits tax is the reported adjusted excess profits net income as defined in Statistics of Income, part 2.

Renegotiation adjustments of net income and taxes include only those war contract adjustments made after tax returns were filed. Since some adjustments made currently were reflected in the tax returns, the amounts shown here understate somewhat the total effects of renegotiation.

Excess profits tax is that imposed by section 710 of the Internal Revenue Code, as amended. For 1942, 1943, and 1944, the amount shown is the excess profits tax liability reported less the credit for debt retirement and the net postwar refund. For 1945, the substituted 10-percent credit was deducted. The amount for the years 1943 through 1945 is before the amount deferred under section 710 (a) (5) (relating to abnormalities under section 722) and after any adjustments reported on returns under other relief provisions. The amount for 1942 is after both the section 710 (a) (5) deferment and any other relief provisions.

Total taxes are the sum of corporation income and excess profits taxes and a small amount of declared-value excess profits tax which is not shown separately.

(NOTE.—Figures in the tables may not add to totals because of rounding.)

APPENDIX TABLE 1.—*Adjustments of net income and corporation taxes resulting from renegotiation, 1942–45*

[Dollar amounts in millions]

	Total	1942	1943	1944	1945
Total number of corporations with net income		269,942	283,735	288,904	303,019
Number of adjustments		6,471	5,355	4,167	2,077
Net income of all corporations with net income:					
Before renegotiation	$98,235	$23,245	$27,820	$26,139	$21,031
After renegotiation	91,559	21,462	24,928	24,660	20,509
Reduction	6,676	1,783	2,893	1,478	522
Income tax:					
Before renegotiation	17,353	4,338	4,479	4,353	4,183
After renegotiation	17,283	4,298	4,465	4,345	4,175
Reduction	71	40	14	9	8
Excess profits tax:					
Before renegotiation	36,132	7,852	11,291	10,432	6,557
After renegotiation	31,393	6,601	9,238	9,374	6,180
Reduction	4,739	1,251	2,053	1,058	377
Total taxes:					
Before renegotiation	53,860	12,256	15,925	14,884	10,795
After renegotiation	48,903	10,941	13,785	13,778	10,399
Reduction	4,958	1,316	2,141	1,106	[illegible]

Source: Statistics of Income, pt. 2.

APPENDIX TABLE 2.—*Number of returns and net income of all corporations with net income and of corporations subject to excess profits tax, 1940–45*

[Dollar amounts in millions]

ALL CORPORATIONS WITH NET INCOME

Year	Number of returns		Net income after renegotiation		Income subject to excess profits tax after renegotiation
	All corporations with net income	Corporations subject to excess profits tax	All corporations with net income	Corporations subject to excess profits tax	
1940	220,977	13,440	$11,203	$3,921	$912
1941	264,628	42,412	18,111	11,632	6,335
1942	269,942	54,002	21,462	15,716	8,544
1943	283,735	68,202	24,928	19,877	11,493
1944	288,904	55,912	24,660	19,576	11,375
1945	303,019	52,097	20,509	14,132	7,796
Total	1,631,205	286,065	120,873	84,854	46,455

NONFINANCIAL CORPORATIONS WITH NET INCOME

Year	All corporations with net income	Corporations subject to excess profits tax	All corporations with net income	Corporations subject to excess profits tax	Income subject to excess profits tax after renegotiation
1940	161,989	[1] 12,674	$9,172	(2)	[1] $777
1941	198,324	[3] 36,012	15,914	[3] $11,128	(2)
1942	201,453	(2)	19,743	(2)	8,486
1943	208,779	65,436	23,039	19,610	11,424
1944	206,067	53,848	22,446	19,318	11,307
1945	212,451	49,369	17,888	13,804	7,722

FINANCIAL CORPORATIONS WITH NET INCOME

Year	All corporations with net income	Corporations subject to excess profits tax	All corporations with net income	Corporations subject to excess profits tax	Income subject to excess profits tax after renegotiation
1940	58,988	[1] 659	$2,031	(2)	[1] $12
1941	66,304	[3] 2,042	2,197	[3] $369	(2)
1942	68,489	(2)	1,719	(2)	58
1943	74,956	2,766	1,889	267	69
1944	82,837	2,064	2,214	258	68
1945	90,568	2,728	2,621	328	74

[1] Excludes consolidated returns.
[2] Not available.
[3] Excludes returns which did not submit balance sheets, also fiscal year returns filed under the 1940 law.

Source: Statistics of Income, pt. 2.

APPENDIX TABLE 3.—*Percent of corporations and of total net income subject to excess profits tax, 1940–45*

[Dollar amounts in millions]

ALL CORPORATIONS WITH NET INCOME

Year	Percent of corporations subject to excess profits tax	Percent of net income subject to excess profits tax	Percent of net income accounted for by corporations subject to excess profits tax
1940	6.1	8.1	35.0
1941	16.0	35.0	64.2
1942	20.0	39.8	73.2
1943	24.0	46.1	79.7
1944	19.4	38.0	79.4
1945	17.2	38.4	68.9
NONFINANCIAL CORPORATIONS WITH NET INCOME			
1940	7.8	8.5	(1)
1941	18.2	(1)	69.9
1942	(1)	43.0	(1)
1943	31.3	49.6	85.1
1944	26.1	50.4	86.1
1945	23.2	43.2	77.2
FINANCIAL CORPORATIONS WITH NET INCOME			
1940	1.1	0.6	(1)
1941	3.1	(1)	16.0
1942	(1)	3.4	(1)
1943	3.7	3.7	14.1
1944	2.5	3.1	11.7
1945	3.0	2.8	12.5

[1] Not available.

Source: Appendix table 2.

APPENDIX TABLE 4.—*Effective rates of total taxes for all corporations with net income, 1940–45*

[Dollar amounts in millions]

Year	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess profits tax	Total taxes	
ALL CORPORATIONS WITH NET INCOME					
1940	$11, 203	$2, 144	$374	$2, 549	22. 8
1941	18, 111	3, 745	3, 359	7, 168	39. 6
1942	21, 462	4, 298	6, 601	10, 941	51. 0
1943	24, 928	4, 465	9, 238	13, 785	55. 3
1944	24, 660	4, 345	9, 374	13, 778	55. 9
1945	20, 509	4, 175	6, 180	10, 399	50. 7
NONFINANCIAL CORPORATIONS WITH NET INCOME					
1940	$9, 172	$1, 955	$366	$2, 351	25. 6
1941	15, 914	3, 463	3, 318	6, 844	43. 0
1942	19, 743	3, 949	6, 555	10, 545	53. 4
1943	23, 039	4, 060	9, 182	13, 321	57. 8
1944	22, 446	3, 852	9, 316	13, 224	58. 9
1945	17, 888	3, 572	6, 120	9, 733	54. 4
FINANCIAL CORPORATIONS WITH NET INCOME					
1940	$2, 031	$189	$7	$198	9. 7
1941	2, 197	282	41	324	14. 7
1942	1, 719	349	46	396	23. 0
1943	1, 889	405	56	464	24. 6
1944	2, 214	493	58	554	25. 0
1945	2, 621	603	60	666	25. 4

Source: Statistics of Income, pt. 2.

APPENDIX TABLE 5.—*Effective rates of total taxes for corporations subject to excess profits tax. 1940–45*

[Dollar amounts in millions]

ALL CORPORATIONS WITH NET INCOME

Year	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
1940	$3,921	$917	$374	$1,317	33.6
1941 [1]	11,632	2,424	3,224	5,703	49.0
1942	15,716	(2)	6,601	(2)	(2)
1943	19,877	3,001	9,238	12,302	61.9
1944	19,576	2,896	9,374	12,317	62.9
1945	14,132	2,348	6,180	8,560	60.6

NONFINANCIAL CORPORATIONS WITH NET INCOME

Year	Net income after renegotiation	Income tax	Excess-profits tax	Total taxes	Total taxes as percent of net income
1940	(2)	(2)	$366	(2)	(2)
1941 [1]	$11,128	$2,330	3,151	$5,534	49.7
1942	(2)	(2)	6,555	(2)	(2)
1943	19,610	2,932	9,182	12,177	62.1
1944	19,318	2,833	9,316	12,195	63.1
1945	13,804	2,267	6,120	8,418	61.0

FINANCIAL CORPORATIONS WITH NET INCOME

Year	Net income after renegotiation	Income tax	Excess-profits tax	Total taxes	Total taxes as percent of net income
1940	(2)	(2)	$7	(2)	(2)
1941 [1]	$369	$67	41	$107	29.0
1942	(2)	(2)	46	(2)	(2)
1943	267	69	56	125	46.8
1944	258	63	58	122	47.3
1945	328	81	60	142	43.3

[1] For 1941, data for fiscal year corporations filing in 1941 under the 1940 law are not available for corporations subject to excess-profits tax; however, the amounts of income and tax liability for these corporations are included in the totals for all corporations with net income, appendix table 4.
[2] Not available.

Source: Statistics of income, pt. 2.

APPENDIX TABLE 6.—*Effective rates of total taxes for all corporations with net income, by major industrial groups, 1944*

[Dollar amounts in millions]

Major industrial groups	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
All industrial groups	$24,660	$4,345	$9,374	$13,777	55.9
Nonfinancial groups	22,448	3,852	9,317	13,225	58.9
Manufacturing	13,585	2,193	6,101	8,326	61.3
Rubber products	296	31	176	208	70.3
Electrical machinery and equipment	859	93	485	579	67.4
Automobiles and equipment except electrical	300	36	165	202	67.3
Transportation equipment, except automobiles	1,826	216	992	1,213	66.4
Machinery, except transportation equipment and electrical	1,283	167	677	847	66.0
Cotton manufactures	259	38	131	169	65.3
Other manufacturing	306	43	152	196	64.1
Iron, steel, and products	1,880	284	904	1,192	63.4
Textile-mill products, except cotton	496	79	231	312	62.9
Paper and allied products	397	69	174	244	61.5
Apparel and products made from fabrics	250	37	112	152	60.8
Manufacturing not allocable	177	29	77	107	60.5
Beverages	386	70	162	233	60.4
Nonferrous metals and their products	426	70	186	257	60.3
Printing and publishing industries	575	95	248	345	60.0
Food and kindred products	1,109	219	427	649	58.5
Leather and products	139	27	53	80	57.6
Stone, clay, and glass products	244	52	87	140	57.4
Furniture and finished lumber products	158	30	59	90	57.0
Chemicals and allied products	1,244	238	459	699	56.2
Lumber and timber basic products	158	33	46	80	50.6
Tobacco manufactures	166	51	29	80	48.2
Petroleum and coal products	650	187	65	253	38.9
Trade	3,288	565	1,304	1,886	57.4
Retail	1,813	301	758	1,069	59.0
General merchandise	931	128	486	619	66.5
Apparel and accessories	234	34	102	137	58.5
Drug stores	53	9	20	29	54.7
Food stores, including market milk dealers	148	33	47	80	54.1
Other retail trade	87	16	27	44	50.6
Filling stations	12	3	3	6	(1)
Eating and drinking places	66	12	21	33	50.0
Furniture and house furnishings	86	21	19	41	47.7
Retail trade not allocable	40	9	7	17	42.5
Building materials, fuel, and ice	69	16	11	28	40.6
Automotive dealers	65	15	11	26	40.0
Hardware	14	3	2	5	35.7
Package liquor stores	7	1	1	2	28.6
Wholesale	1,218	208	479	692	56.8
Other wholesalers	1,125	192	449	646	57.4
Commission merchants	92	16	30	46	50.0
Trade not allocable	257	56	68	126	49.0
Public utilities	4,271	816	1,565	2,384	55.8
Transportation	2,565	423	1,162	1,587	61.9
Communication	731	132	211	343	46.9
Other public utilities	974	262	192	454	46.6
Construction	162	29	53	83	51.2
Service	621	117	199	318	51.2
Amusements, except motion pictures	51	7	23	31	60.8
Motion pictures	269	47	100	147	54.6
Miscellaneous repair services, hand trades	15	2	6	8	(1)
Other service, including schools	32	5	11	17	53.1
Business service	79	18	20	38	48.1
Hotel and other lodging places	104	23	26	49	47.1
Personal service	62	13	12	26	41.9
Automotive repair services and garages	9	2	1	3	(1)
Service not allocable	1	(2)	(2)	(2)	(1)

See footnotes at end of table.

APPENDIX TABLE 6.—*Effective rates of total taxes for all corporations with net income, by major industrial groups, 1944*—Continued

[Dollar amounts in millions]

Major industrial groups	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
Nonfinancial groups—Continued					
Agriculture, forestry, and fishery	$134	$29	$33	$63	47.0
Fishery	2	(2)	1	1	(1)
Agriculture and services	129	28	32	61	47.3
Forestry	3	1	(2)	1	(1)
Mining and quarrying	369	99	58	158	42.5
Non-metallic mining and quarrying	43	10	12	22	51.2
Bituminous coal, lignite, peat, etc	101	28	20	49	48.5
Crude petroleum, and natural gas production	98	27	11	38	38.8
Metal mining	110	28	14	42	38.2
Anthracite mining	16	5	1	6	(1)
Mining and quarrying not allocable	1	(2)	(2)	(2)	(1)
Nature of business not given	17	4	3	6	35.3
Financial groups	2,214	493	58	554	25.0
Lessors of real property, except buildings	110	34	12	47	42.7
Real estate, including lessors of buildings	335	85	17	103	30.7
Finance	1,358	281	11	293	21.6
Short-term credit agencies, except banks	55	18	3	21	38.2
Other finance companies	21	7	2	8	(1)
Long-term credit agencies, mortgage companies, except banks	6	2	(2)	2	(1)
Banks and trust companies	730	198	5	203	27.8
Finance not allocable	11	3	(2)	3	(1)
Security and commodity-exchange brokers and dealers	30	7	1	8	(1)
Other investment companies, including holding companies	309	36	(2)	36	11.7
Investment trusts and investment companies	197	11	(2)	11	5.6
Insurance carriers, agents, etc	411	92	18	110	26.8
Insurance agents, brokers, etc	32	8	4	12	37.5
Insurance carriers	379	85	13	98	25.9

[1] Percentages cannot be computed accurately from rounded figures.
[2] Less than $500,000.

Source: Statistics of Income for 1944, pt. 2.

APPENDIX TABLE 7.—*Effective rates of total taxes for corporations subject to excess profits tax, by major industrial groups, for returns with balance sheets only, 1944*

[Dollar amounts in millions]

Major industrial groups	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess profits tax	Total taxes	
All industrial groups	$19,441	$2.880	$9,306	$12,231	62.9
Nonfinancial groups	19,186	2,817	9,249	12,111	63.1
Manufacturing	12,013	1,681	6,050	7,760	64.5
Rubber products	289	28	176	205	70.9
Electrical machinery and equipment	824	85	483	569	69.1
Automobiles and equipment	285	32	161	194	68.1
Machinery, except transportation equipment and electrical	1,221	148	674	824	67.5
Nonferrous metals and their products	340	46	182	229	67.4
Other manufacturing	278	34	152	187	67.3
Cotton manufacturing	240	32	128	161	67.1
Iron, steel and products	1,634	192	901	1.096	67.1
Transportation equipment, except automobiles	1,778	206	980	1,190	66.9
Manufacturing not allocable	142	18	75	93	65.5
Textile-mill products, except cotton	451	64	230	295	65.4
Apparel and products made from fabrics	218	28	111	142	65.1
Printing and publishing industries	496	71	247	320	64.5
Paper and allied products	360	57	174	231	64.2
Beverages	335	53	160	214	63.9
Stone, clay and glass products	192	33	87	121	63.0
Furniture and finished lumber products	129	21	59	81	62.8
Food and kindred products	956	169	420	592	61.9
Leather and products	120	21	53	74	61.7
Chemicals and allied products	1,140	207	457	665	58.3
Lumber and timber products	116	20	46	66	56.9
Tobacco manufactures	118	33	29	61	51.7
Petroleum and coal products	351	84	64	148	42.2
Trade	2,663	387	1,297	1,696	63.7
Retail	1,530	224	755	986	64.4
General merchandise	904	120	485	610	67.5
Apparel and accessories	195	24	101	126	64.6
Drug stores	43	6	20	27	62.8
Eating and drinking places	44	7	20	27	61.4
Other retail trade	58	8	27	35	60.3
Food stores, including market milk dealers	124	26	46	73	58.9
Filling stations	9	2	3	5	(1)
Automotive dealers	29	5	10	16	55.2
Furniture and house furnishings	60	13	19	33	55.0
Building materials, fuel and ice	35	7	11	19	54.3
Hardware	6	1	2	3	(1)
Package liquor stores	2	(2)	1	1	(1)
Wholesale	974	136	476	616	63.2
Other wholesalers	906	126	446	577	63.7
Commission merchants	67	10	29	39	58.2
Trade not allocable	159	26	67	94	59.1
Public utilities	3,679	610	1,560	2,172	59.0
Transportation	2,273	320	1,160	1,482	65.2
Other public utilities	699	166	190	356	50.9
Communication	707	124	211	335	47.4
Construction	107	14	52	67	62.6
Service	439	65	197	262	59.7
Amusements, except motion pictures	40	4	23	27	67.5
Miscellaneous repair services, hand trades	11	1	6	7	(1)
Other service, including schools	21	2	11	13	61.9
Hotels and other lodging places	56	9	25	31	60.7
Motion pictures	227	34	99	133	58.6
Business service	48	9	19	28	58.3
Personal service	32	6	12	18	56.3
Automotive repair service and garages	3	(2)	1	1	(1)
Service not allocable	1	(2)	(2)	(2)	(1)

See footnotes at end of table.

APPENDIX TABLE 7.—*Effective rates of total taxes for corporations subject to excess profits tax, by major industrial groups, for returns with balance sheets only, 1944*—Continued

[Dollar amounts in millions]

Major industrial groups	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
Nonfinancial groups—Continued					
Agriculture, forestry and fishery	$86	$16	$33	$49	57.0
Agriculture and services	84	16	32	48	57.1
Forestry	(2)	(2)	(2)	(2)	(1)
Fishery	1	(2)	1	1	(1)
Mining and quarrying	193	43	57	101	52.3
Nonmetallic mining and quarrying	30	6	12	18	60.0
Bituminous coal, lignite, peat, etc	58	13	20	33	56.9
Crude petroleum and natural gas production	33	7	10	18	54.5
Anthracite mining	2	(1)	1	1	(1)
Metal mining	69	16	14	30	43.5
Mining and quarrying not allocable	(1)	(1)	(1)	(1)	(1)
Nature of business not given	6	1	2	4	(1)
Financial groups	256	63	57	121	47.3
Lessors of real property, except buildings	50	14	12	26	52.0
Real estate, including lessors of buildings	57	13	16	29	50.9
Finance	76	20	11	31	40.8
Other finance companies	6	1	2	3	(1)
Short-term credit agencies, except banks	19	6	3	9	(1)
Banks and trust companies	38	10	5	15	39.5
Security and commodity-exchange brokers and dealers	3	1	1	1	(1)
Other investment companies, including holding companies	8	1	(2)	1	12.5
Long-term credit agencies, mortgage companies, except banks	1	(2)	(2)	(2)	(1)
Finance not allocable	1	(2)	(2)	1	(1)
Insurance carriers, agents, etc	73	16	18	34	46.6
Insurance agents, brokers, etc	14	3	4	7	(1)
Insurance carriers	59	14	13	27	45.8

[1] Percentages cannot be computed accurately from rounded figures.
[2] Less than $500,000.

Source: Statistics of Income, for 1944, pt. 2.

APPENDIX TABLE 8.—*Effective rates of total taxes for all nonfinancial corporations with net income, by asset size classes, for returns with balance sheets only, 1944*

[Dollar amounts in millions]

Total asset classes	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
Under $50,000	$338	$76	$14	$95	28.1
$50,000, under $100,000	366	75	58	136	37.2
$100,000, under $250,000	840	144	255	405	48.2
$250,000, under $500,000	946	152	384	541	57.2
$500,000, under $1,000,000	1,186	194	528	727	61.3
$1,000,000, under $5,000,000	3,422	541	1,606	2,158	63.1
$5,000,000, under $10,000,000	1,733	277	808	1,089	62.8
$10,000,000, under $50,000,000	3,913	642	1,790	2,441	62.4
$50,000,000, under $100,000,000	1,710	274	785	1,061	62.0
$100,000 and over	7,804	1,446	3,023	4,472	57.3
Total	22,258	3,820	9,249	13,124	59.0

Source: Statistics of Income for 1944, pt. 2.

APPENDIX TABLE 9.—*Effective rates of total taxes for nonfinancial corporations subject to excess-profits tax, by asset size classes, for returns with balance sheets only, 1944*

[Dollar amounts in millions]

Total asset classes	Net income after renegotiation	Taxes after renegotiation			Total taxes as percent of net income
		Income tax	Excess-profits tax	Total taxes	
Under $50,000	$66	$13	$14	$28	42.4
$50,000, under $100,000	181	29	58	89	49.2
$100,000, under $250,000	597	81	255	340	57.0
$250,000, under $500,000	780	102	384	491	62.9
$500,000, under $1,000,000	1,023	139	528	672	65.7
$1,000,000, under $5,000,000	3,028	400	1,606	2,016	66.6
$5,000,000, under $10,000,000	1,545	210	808	1,021	66.1
$10,000,000, under $50,000,000	3,437	471	1,790	2,269	66.0
$50,000,000, under $100,000,000	1,578	226	785	1,012	64.1
$100,000,000 and over	6,951	1,146	3,023	4,172	60.0
Total	19,186	2,817	9,249	12,111	63.1

Source: Statistics of Income for 1944, pt. 2.

Senator MILLIKIN. May I ask you this end point question? What you want is $4,000,000,000, is that what you want?

Secretary SNYDER. We want, under the circumstances, all of the revenue that the Congress will give us, but at this particular time the President has suggested, to round out the tax program for fiscal 1951, and to put it somewhat in balance with the individual and the corporation and also to try to get at some of these abnormal taxes generated by the impact of the Korean situation, we would like to try to get $4,000,000,000.

The CHAIRMAN. As we understand it, that is simply providing a new springboard?

Secretary SNYDER. Yes.

The CHAIRMAN. For the final leap?

Secretary SNYDER. It has no bearing on the ultimate request for additional revenue.

Senator BYRD. Have you anything in mind now, Mr. Secretary, about asking for increased taxes above this?

Secretary SNYDER. No, sir; we have no definition of that yet, sir.

Senator KERR. You have the knowledge that it will definitely be asked for?

Secretary SNYDER. There is no question about that. There will be additional revenue requested.

The CHAIRMAN. Mr. Secretary, we appreciate your appearance here. Of course, the members of your staff will be here from time to time. The committee will not sit this afternoon because of so many unusual conditions that may arise in the Senate, but we will meet tomorrow morning at 10 o'clock.

Secretary SNYDER. Mr. Chairman, I appreciate the very, very wonderful courtesy your committee has shown and I want you to know that I will be available to come back on call any time you or your committee would like to have me. The staff will be here at all times.

The CHAIRMAN. We will feel free to call you at any time. I know you are very busy.

Secretary SNYDER. Yes, but this is important, and I will be glad to be here at any time.

The CHAIRMAN. We will recess until tomorrow at 10 o'clock.

(Whereupon, at 12:30 p. m., the committee adjourned to reconvene on Tuesday, December 5, 1950, at 10 a. m.

EXCESS PROFITS TAX ON CORPORATIONS, 1950

TUESDAY, DECEMBER 5, 1950

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

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

Present: Senators George, Connally, Hoey, Myers, Millikin, Taft, and Butler.

Also present: Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation; and Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will please come to order.

The first witness we have scheduled this morning is Mr. Beardsley Ruml of the Business Committee on Emergency Corporate Taxation. You may have a seat, please, sir. The committee will now be glad to hear you on this matter before us, which is the excess-profits-tax bill.

Will you please identify yourself for the record.

STATEMENT OF BEARDSLEY RUML, BUSINESS COMMITTEE ON EMERGENCY CORPORATE TAXATION, NEW YORK, N. Y.

Mr. RUML. Mr. Chairman and members of the committee, you have before you a printed copy of the testimony. The copy of what I shall present to you follows the text exactly, except for omissions. The omissions are made in the interest of saving time.

The CHAIRMAN. Very well, Mr. Ruml; you may hand your printed statement to the stenographer, if you wish it to go in in that form.

Mr. RUML. It is identical.

I am Beardsley Ruml of New York. I appear before you in behalf of the Business Committee on Emergency Corporate Taxation. This committee is made up of more than 100 of the leading business executives across the country. A number of them are present at this hearing today.

I am filing a letterhead of the committee which lists the membership, its officers and committees, and I believe you will agree that the membership is broadly representative of American industry and commerce. Each member is a principal of his own company. Each is personally active in this committee.

(The information referred to above appears at the end of Mr. Ruml's prepared statement.)

This committee does not speak for any single company or industry, but rather from the experience of businessmen who have lived with

the excess-profits tax through World War II, many through World War I as well.

We are here because we believe that the kind of defense-emergency taxes that are imposed now will have a profound effect on our national production for defense, as well as on our entire future productivity.

The deep seriousness of our national situation causes consideration of emergency taxation at this time. The very gravity of the situation demands that the amount of revenue raised should be adequate and that the method of raising it should be sound.

We know that any defense-emergency tax will be high. We also know that we must be prepared to live with high defense taxation for many years to come. Accordingly, it is imperative that the form of defense taxation be right, as right as wisdom and experience can make it.

Our business committee does not argue with the number of dollars. Whatever amount the Congress decides should come from taxes on corporate profits, that amount we do not dispute. Our recommendation here concerns method alone. We are concerned not with how much, but only with how.

We are certain that greater revenue can be obtained from a sound defense emergency tax on corporate earnings than will result from any excess-profits tax. We are equally certain that through effective procedures for negotiation and renegotiation any undue profits arising from direct defense expenditures can be recovered.

It is only necessary for me to mention the semantics which pervade the whole consideration of the excess-profits tax, and the hysteria which accompanies it. We have all been exposed to the catch phrases, and if there were merit and substance behind them, this business committee would not be opposing an excess-profits tax today.

There are those who honestly believe that we need an excess-profits tax for psychological or for political reasons. But are the people so swayed by the lure of words, that we may be forced to put a bad law on the statute books?

Must we let hysteria sweep us along to a wrong result? There can be no real or lasting advantage in haste for the sake of empty haste, or in rushing to the adoption of hurtful and mischievous legislation just because of its possible psychological appeal.

In this frame of reference our business committee recommends that the excess-profits-tax proposal and principle be rejected, and that in its place there be levied an across-the-board corporate-profit levy that will produce as much revenue as would the proposed excess-profits tax, and as much as it is deemed necessary and desirable to withdraw from the earnings of business corporations.

Let me set forth briefly the considerations that have led to this recommendation.

Analysis shows that basic defects exist, and that they are inherent in the tax.

Senator MILLIKIN. Or in any other kind of tax.

Mr. RUML. These basic defects are two:

1. It is impossible to select a basic level of earnings, above which additional profits will be defined as "excess" without wholesale inequities, damaging restraint on new and growing business, and on new and growing processes of production.

2. It is impossible to impose a high marginal rate on a portion of the earnings of a company without violent distortion of managerial judgment. What should be a disciplined effort to meet with efficiency the public's needs for products and services is transmuted into a skill in the avoidance of taxation and shrewdness and even carelessness in the manipulation of business expense. As I shall show later, the high marginal rate forces even the most prudent management to tax-begotten judgments which are individually sound, but which in the aggregate will destroy the free competitive enterprise system of production and distribution which has served this country so well and for so long.

These two basic defects have caused search to be made for methods of relief, sometimes by administrative relief provisions, sometimes by exclusions under the law itself. The record as it stands declares the failure of the relief provisions palliative.

These two basic defects already have forced liberalization of basic levels and the percentage marginal tax; but with this liberalization the revenue disappears, and all that is left is a tax structure still grossly inequitable and still perverse in its impact on managerial judgment.

Because of these defects, which are inherent in any excess profits tax, we must conclude that the problems of devising an acceptable excess profits tax is insoluble. Accordingly, any excess profits tax which involves a basic level of earnings and high marginal rates should be wholly rejected. Alternative methods of raising revenue from taxes on corporate earnings are readily at hand.

But first, I wish to show briefly the serious dangers (1) in creating a tax-oriented business management, (2) in imposing limitations on growth of investment, and (3) in legislating gross and conspicuous inequities in a tax system of any kind.

Tax orientation is the consequence of high marginal excess profits tax rates. Under such rates, to the extent a business is subject to excess profits taxes, management has two kinds of dollars to work with. It has cheap earned dollars and expensive earned dollars; cheap earned dollars are those which, if not spent, will be taxed at high marginal rates; expensive dollars are those which are taxed at ordinary rates.

Under the bill proposed by the Ways and Means Committee, the marginal rate is 75 percent, so the cheap earned dollar is worth 25 cents. The ordinary rate is 45 percent, so the expensive earned dollar is worth 55 cents, more than twice as much as the cheap dollar.

The creation by tax law of cheap dollars has resulted, and will result again, in carelessness, waste, and extravagance. The cheap dollar is demoralizing and breeds waste at every level of management.

Proposals to correct this weakness by a system of Federal inspection are entirely unrealistic. Such proposals would set up a post audit of all business expense and a Government agent would be required to judge after the fact whether an expenditure is to be allowed or disallowed for tax purposes. Since a business manager could only know the tax consequences of routine actions, risk and enterprise would be stopped before it began.

The inflationary consequences of Government-induced private spending have been fully discussed by others and are matters of common knowledge. What is less well understood is the fact that the

existence of cheap dollars makes prudent many business activities that would not be prudent except for the fact that the dollars expended are cheap.

The excess-profits tax is therefore not a burden, but a subsidy. It provides cheap dollars to the profitable and established company, dollars which can and must be used by a responsible management to safeguard and to extend the position of such a company against competition. If a competitor is not in excess profits, if it is weak in earnings, or young, or with inadequate capital—in other words, if it has only expensive dollars in its arsenal, it is a double disadvantage as against its entrenched rival with tax-created cheap dollars at its disposal.

The battle for markets, through better service, better coverage, better inventory stocks—yes, and through better advertising and promotion, too—will be a battle between the cheap expense dollars and expensive expense dollars—and the cheap dollars will win because they can extend farther and can take more risks.

Thus, by reason of the excess-profits tax, the Government will have created a double standard of dollars with favors going to those who are already strong. The excess-profits tax is a veritable engine of concentration, compelling prudent and aggressive business management to use wisely its cheap dollars to entrench and to expand. With Government excess-profits tax cheap dollars, the big will grow bigger and the small and weak will merge with them, or die.

If this is true, why then does even big business oppose the excess-profits tax? The reason is that all business wants to avoid putting tax considerations before market considerations; because when this happens, competitive enterprise based on efficiency and ingenuity in serving the public's demands will have been distorted by artificial and irrelevant factors which have nothing to do with skill in making and distributing the things and services that people want.

The second danger in an excess-profits tax is that of imposing limitations on the growth of investment. We must have constantly expanding productivity to serve the requirements of defense preparations, the needs of a growing population, and an increasing standard of living. Expanding production requires expanding investment—more machines, more buildings, more inventory, and all the rest.

The excess-profits tax put serious obstacles in the way of getting new investment from any of these sources. Additional debt money is more risky, and more difficult to pay off. Undistributed profits fade away. New investment of savings becomes unattractive to the people since the dangers of loss are not offset by commensurate opportunity for gain.

The excess-profits tax will hold back dangerously the expansion of American productivity, so needed both for the general welfare and the common defense.

The third danger, and the last that I shall mention, is that of legislating gross and conspicuous inequities into the tax system.

No tax system will work unless it is largely self-enforcing. The average taxpayer, individual or corporate, must feel that he is fairly treated. He must compute and pay his tax as a matter of conscience and duty, and must believe that by and large other taxpayers are not privileged as compared to himself.

The excess-profits tax is an evil brew of iniquity, exception, exemption, and privilege. It will poison the spirit of the taxpaying public. It will undermine the moral compulsions that make the tax system of the United States so successful. Even if an excess-profits tax with all its other defects were needed, which clearly it is not, it should be rejected in principle on this ground alone—that a tax that is conspicuously inequitable will destroy the moral compulsions that are needed to make any tax system work.

I have already given the recommendation of our committee, that an across-the-board rate increase should be susbstituted for the proposed excess-profits tax.

The reasons for such an across-the-board tax may be summarized as follows:

1. It will be equitable.
2. It will not produce a double standard of dollars, thereby corrupting managerial judgment.
3. It can be made to produce as much revenue now as an excess-profits tax, and, at the same rates, will produce more revenue as times goes by. The excess-profits tax will produce less revenue over the years because of increased managerial skill in the use of cheap dollars.
4. It will be less of a handicap to new investment.
5. And finally, no compelling substantive reason has been presented as to why an excess-profits tax should be adopted. Both experience and reason warn clearly against the adoption of this mischievous tax.

What arguments have been made in favor of the excess-profits tax? The substantive arguments are few and they do not stand up under examination.

1. Advocates of an excess-profits tax have been denied the inflationary nature of the formula. They insist that surely the incentive for raising prices is lowered if only 15 or 25 cents of the profit dollar can be kept.

Such reasoning, often proceeding from lack of managerial experience, completely ignores the place of costs in pricing. Business managers have kept unit costs down in the face of rising wage rates and other expenses by economical use of materials and services, and by investment in new machine tools and equipment which cut costs.

The excess-profits tax puts a premium on aggressive bidding for materials and services to maintain and extend markets. At the same time, since new investment is not an expense but a capital charge, it is better business judgment to spend the cheap dollars to maintain the old and less efficient machinery rather than to risk investment in cost-cutting new machinery.

2. The Treasury has urged an excess-profits tax in preference to a flat increase in the corporate rate, because the additional tax should be "more selective," and because it should be limited to "taxpayers with significant defense profits." To serve the latter purpose, the $25,000 minimum credit was proposed. This exemption of small business just as easily could be included in a flat tax increase measure.

The Treasury also seemed to feel that something should be done taxwise to level down the earnings of successful corporations. By introducing differential treatment through exemptions and graduated rates, it thereby proposes to put into effect indirectly the progressive taxation of corporate income—an issue of grave importance which has not been a subject of explicit discussion.

We have contended that the excess profits tax is not equitable. The Treasury's proposals and its supporting tables prove that the formula purposely discriminates in favor of some and against others—and that it is recommended just because it is so "selective." To the taxpayers, such selectivity becomes plain discrimination.

3. The public has been led to believe that the excess profits tax can recover unusual profits arising from the defense effort.

Few people understand the excess profits tax applies to only a small fraction of profitable enterprise. It does not apply to unincorporated business; it does not apply to rents and royalties, to personal services, nor to farmers.

The excess profits tax applies only to earnings which arise under the corporate form of doing business. Such a tax in World War II was paid by only 1 out of 60 business concerns.

Since economic activity is generally stimulated by expanded defense preparations, then obviously a tax which excludes individual earnings and reaches perhaps only 1 out of 60 business enterprises cannot claim to be either equitable or efficient in recovering a proper share of profits arising from defense.

Business principals with whom we have been in contact are overwhelmingly opposed to an excess profits tax in general and in detail. A substantial number of companies represented on our committee would be favored rather than hurt by an excess profits tax, at least in the few years ahead. But in the interest of the general public welfare, they still oppose the tax as being fundamentally unsound.

Even though the excess profits tax might improve their immediate current earnings as against an across-the-board tax increase, even though their bargaining position might be improved against lower-cost producers, nevertheless they reject this unsound tax measure that, over a period of years, would wreck our economy. They understand full well that the final answer in our conflict with those who would destroy our free institutions will be given in substantial measure by which way of life, which type of economy makes the greater, the sounder progress in the next decade.

These are the facts. On these facts the excess profits tax should be forever rejected as bad for America.

We all know the seriousness of the times. You, better than we, know the desire of the people to be dealt with in frankness and to be given wisdom and patience in leadership.

In this spirit, we submit our case to you, our elected representatives.

(The prepared statement submitted by Mr. Ruml reads, in full, as follows:)

STATEMENT OF BEARDSLEY RUML, IN BEHALF OF THE BUSINESS COMMITTEE ON EMERGENCY CORPORATE TAXATION

I am Beardsley Ruml of New York. I appear before you in behalf of the Business Committee on Emergency Corporate Taxation. This committee is made up of more than 100 of the leading business executives across the country. A number of them are present at this hearing today.

I am filing a letterhead of the committee which lists the membership, its officers and committees, and I believe you will agree that the membership is broadly representative of American industry and commerce. Each member is a principal of his own company. Each is personally active in this committee

This committee does not speak for any single company or industry, but rather from the experience of businessmen who have lived with the excess-profits tax through World War II, many through World War I as well.

We are here because we believe that the kind of defense emergency taxes that are imposed now will have a profound effect on our national production for defense, as well as on our entire future productivity.

The deep seriousness of our national situation causes consideration of emergency taxation at this time. The very gravity of the situation demands that the amount of revenue raised should be adequate and that the method of raising it should be sound.

We know that any defense emergency tax will be high. We also know that we must be prepared to live with high defense taxation for many years to come. Accordingly, it is imperative that the form of defense taxation be right, as right as wisdom and experience can make it.

Our Business Committee does not argue with the number of dollars. Whatever amount the Congress decides should come from taxes on corporate profits, that amount we do not dispute. Our recommendation here concerns method alone. We are concerned not with how much—but only with how.

We are certain that greater revenue can be obtained from a sound defense emergency tax on corporate earnings that will result from any excess-profits tax. We are equally certain that through effective procedures for negotiation and renegotiation any undue profits arising from direct defense expenditures can be recovered.

It is only necessary for me to mention the semantics which pervade the whole consideration of the excess-profits tax, and the hysteria which accompanies it, We have all been exposed to the catch phrases, and if there were merit and substance behind them, this Business Committee would not be opposing an excess-profits tax today.

There are those who honestly believe that we need an excess-profits tax for psychological or for political reasons. But are the people so swayed by the lure of words, that we may be forced to put a bad law on the statute books?

Must we let hysteria sweep us along to a wrong result? There can be no real or lasting advantage in haste for the sake of empty haste, or in rushing to the adoption of hurtful and mischievous legislation just because of its possible psychological appeal.

In this frame of reference, our Business Committee recommends that the excess profits tax proposal and principle be rejected, and that in its place there be levied an across-the-board corporate profit levy that will produce as much revenue as would the proposed excess profits tax, and as much as it is deemed necessary and desirable to withdraw from the earnings of business corporations.

Let me set forth briefly the considerations that have led to this recommendation.

Analysis shows that basic defects exist, and that they are inherent in the tax.

These basic defects are two:

1. It is impossible to select a basis level of earnings above which additional profits will be defined as "excess" without wholesale inequities, damaging restraint on new and growing business, and on new and growing processes of production.

2. It is impossible to impose a high marginal rate on a portion of the earnings of a company without violent distortion of managerial judgment. What should be a disciplined effort to meet with efficiency the public's needs for products and services is transmuted into skill in the avoidance of taxation and shrewdness and even carelessness in the manipulation of business expense. As I shall show later, the high marginal rate forces even the most prudent management to tax-begotten judgments which are individually sound, but which in the aggregate will destroy the free-competitive-enterprise system of production and distribution which has served this country so well and for so long.

These two basic defects have caused search to be made for methods of relief, sometimes by administrative relief provisions, sometimes by exclusions under the law itself. The record as it stands declares the failure of the relief provisions palliative.

These two basic defects already have forced liberalization of basis levels and the percentage marginal tax; but with this liberalization the revenue disappears, and all that is left is a tax structure still grossly inequitable and still perverse in its impact on managerial judgment.

Because of these defects, which are inherent in any excess-profits tax, we must conclude that the problems of devising an acceptable excess profits tax is insoluble. Accordingly, any excess profits tax which involves a basis level of

earnings and high marginal rates should be wholly rejected. Alternative methods of raising revenue from taxes on corporate earnings are readily at hand.

But first, I wish to show briefly the serious dangers, (1) in creating a tax-oriented business management, (2) in imposing limitations on growth of investment, and (3) in legislating gross and conspicuous inequities in a tax system of any kind.

Tax orientation is the consequence of high marginal excess-profits-tax rates. Under such rates, to the extent a business is subject to excess-profits taxes, management has two kinds of dollars to work with. It has cheap earned dollars and expensive earned dollars; cheap earned dollars are those which, if not spent, will be taxed at high marginal rates; expensive dollars are those which are taxed at ordinary rates.

Under the bill proposed by the Ways and Means Committee, the marginal rate is 75 percent, so the cheap earned dollar is worth twenty-five cents. The ordinary rate is 45 percent, so the expensive earned dollar is worth 55 percent, more than twice as much as the cheap dollar.

The creation by tax law of cheap dollars has resulted, and will result again, in carelessness, waste and extravagance. The cheap dollar is demoralizing and breeds waste at every level of management.

Proposals to correct this weakness by a system of Federal inspection are entirely unrealistic. Such proposals would set up a post audit of all business expense and a Government agent would be required to judge after the fact whether an expenditure is to be allowed or disallowed for tax purposes. Since a business manager could only know the tax consequences of routine actions, risk and enterprise would be stopped before it began.

The inflationary consequences of Government-induced private spending have been fully discussed by others and are matters of common knowledge. What is less well understood is the fact that the existence of cheap dollars makes prudent many business activities that would not be prudent except for the fact that the dollars expended are cheap.

The excess-profits tax is therefore not a burden, but a subsidy. It provides cheap dollars to the profitable and established company, dollars which can and must be used by a responsible management to safeguard and to extend the position of such a company against competition. If a competitor is not in excess profits, if it is weak in earnings, or young, or with inadequate capital—in other words, if it has only expensive dollars in its arsenal, it is at a double disadvantage as against its entrenched rival with tax-created cheap dollars at its disposal.

The battle for markets, through better service, better coverage, better inventory stocks—yes, and through better advertising and promotion, too—will be a battle between the cheap expense dollars and expensive expense dollars, and the cheap dollars will win because they can extend farther and can take more risks.

Thus, by reason of the excess-profits tax, the Government will have created a double standard of dollars with favors going to those who are already strong. The excess-profits tax is a veritable engine of concentration, compelling prudent and aggressive business management to use wisely its cheap dollars to entrench and to expand. With Government excess-profits-tax cheap dollars, the big will grow bigger and the small and weak will merge with them, or die.

If this is true, why then does even big business oppose the excess-profits tax? The reason is that all business wants to avoid putting tax considerations before market considerations; because when this happens, competitive enterprise based on efficiency and ingenuity in serving the public's demands will have been distorted by artificial and irrelevant factors which have nothing to do with skill in making and distributing the things and services that people want.

The second danger in an excess-profits tax is that of imposing limitations on the growth of investment. We must have constantly expanding productivity to serve the requirements of defense preparations, the needs of a growing population, and an increasing standard of living. Expanding production requires expanding investment—more machines, more buildings, more inventory, and all the rest.

The excess-profits tax puts serious obstacles in the way of getting new investment from any of these sources. Additional debt money is more risky, and more difficult to pay off. Undistributed profits fade away. New investment of savings becomes unattractive to the people since the dangers of loss are not offset by commensurate opportunity for gain.

The excess-profits tax will hold back dangerously the expansion of American productivity, so needed both for the general welfare and the common defense.

The third danger, and the last that I shall mention, is that of legislating gross and conspicuous inequities into the tax system.

No tax system will work unless it is largely self-enforcing. The average taxpayer, individual or corporate, must feel that he is fairly treated. He must compute and pay his tax as a matter of conscience and duty, and must believe that by and large other taxpayers are not privileged as compared to himself.

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Even though the excess profits tax might improve their immediate current earnings as against an across-the-board tax increase, even though their bargaining position might be improved against lower-cost producers, nevertheless they reject this unsound tax measure that, over a period of years, would wreck our economy. They understand full well that the final answer in our conflict with those who would destroy our free institutions will be given in substantial measure by which way of life, which type of economy makes the greater, the sounder progress in the next decade.

These are the facts. On these facts the excess profits tax should be forever rejected as bad for America.

We all know the seriousness of the times. You, better than we, know the desire of the people to be dealt with in frankness and to be given wisdom and patience in leadership.

In this spirit, we submit our case to you, our elected Representatives.

GENERAL PRINCIPLES

1. The defense program may last for a long time, and, accordingly defense expenditures may be expected to continue at a high level for a long time, perhaps 10 years, perhaps more, perhaps less.

2. The tax and fiscal program of the Federal Government must be geared to a long-time high level of defense expenditures. The objective is to provide adequate defense without inflation, to increase the level of taxation to meet the requirements of a realistic pay-as-you-go budget policy, and to derive the required revenue with fairness, and in a manner consistent with the system of political freedom and economic initiative which we are committed to defend. It is of particular importance that our tax and fiscal program should not handicap growth and innovation in the American productive system.

3. Business profits must bear their fair share of increased taxation.

4. The excess-profits tax as proposed is unfair and destructive. Any excess-profits tax that involves taxation, at high marginal rates, of profits over a defined base, whether it be allowed earnings on invested capital, or the income of a base period, is grossly inequitable as between taxpaying corporations; it is demoralizing to prudent managerial judgment and initiative, and it breeds inflationary waste and extravagance. Continued over a long period of time, the conventional excess-profits tax will transform managerial initiative in getting efficient production and distribution into a system where tax savings, and not earned profits, will be the test of business decisions. An excess-profits tax which involves high marginal tax rates over a so-called normal base should be completely rejected.

5. Undue profits arising out of defense contracts with the Government should be prevented by effective negotiation and renegotiation procedures.

6. A defense-profits tax should be adopted to produce such revenues as should be taken from corporation profits. It should not impose high marginal rates, nor should it be imposed above a basis point. Concrete suggestions for such a defense-profits tax have already been made and give clear evidence that sound alternatives to the excess-profits tax are available.

7. The committee is interested in the well-being of all business as a proved effective system of satisfying increasingly the requirements of the country for goods and services. The committee recognizes that special problems arise in particular industries and companies, and expects that those special problems will be presented outside the committee by the appropriate trade association or other specialized agency. The committee however addresses its attention to the general welfare of business for the national community as a whole.

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S. Abbot Smith, president, Thomas Strahan Co.
Edwin J. Spiegel, vice president, Gaylord Container Co.
Robert C. Sprague, president, Sprague Electric Co.
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Vernon Stouffer, president, Stouffer Corp.
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Harry W. Zinsmaster, president, Zinsmaster Bread Co.
Robert W. Johnson, Johnson & Johnson.
James S. Nowlson, Stewart-Warner Corp.

The CHAIRMAN. Thank you very much. Are there any questions? If not, we thank you very much, again, Mr. Ruml, for your appearance here, sir.

Mr. RUML. Thank you.

The CHAIRMAN. We will next hear from Mr. Leo Cherne of the Research Institute of America, Inc.

STATEMENT OF LEO CHERNE, EXECUTIVE SECRETARY, RESEARCH INSTITUTE OF AMERICA, INC., WASHINGTON, D. C.

Mr. CHERNE. Mr. Chairman and members of the committee, I am Leo Cherne, executive secretary of the Research Institute of America, Inc., whose Washington offices are at 1026 Seventeenth Street NW., Washington 6, with headquarters at 292 Madison Avenue, New York 17, N. Y.

The Research Institute of America has, for over 15 years, been an impartial, objective channel of communication to and from the American business community—over 30,000 businesses, labor unions, professional people, and Government agencies are in our membership.

I am here today not to argue for or against an excess-profits levy or the technical aspects of such a tax—but rather to analyze for your consideration the business response which a recent institute survey indicates on the question. It is our thought that these findings may

help show this committee what a reasonably typical cross section of the business community thinks of the various possibilities—and what the practical operating reactions would be to excess-profits taxation.

I file a copy of the Research Institute questionnaire, believing you will find it designed objectively and impartially. You will also note that it specifically takes account of businesses of different size, function, and taxable income.

(The questionnaire referred to is as follows:)

HOW DO YOU VOTE ON AN EXCESS-PROFITS TAX?

To make your opinion heard in Congress on the desirability and nature of any corporate excess-profits tax, please fill in and return the following questionnaire to the Research Institute of America, Inc., 292 Madison Avenue, New York 17, N. Y. The results of this survey will be presented by the institute to both the House Ways and Means Committee and the Senate Finance Committee.

1. Assuming that mobilization and the draft continue for years, all taxes will be raised. So far as corporate taxes are concerned, would you prefer to see the increase in the form of—

---- (a) Higher corporate rates?
---- (*b*) An excess-profits tax?
---- (*c*) A combination of more modest corporate tax and mild excess-profits tax producing the same yield as (*a*) or (*b*)?

If there will be an excess-profits tax—

2. Would you prefer the average earnings credit (the measure of normal profits) to be the average of earnings in:

---- (*a*) The 3 years 1947–49;
---- (*b*) The 4 years 1946–49;
---- (*c*) Any 2 of the 3 years 1947–49;
---- (*d*) Any 3 of the 4 years 1946–49;
---- (*e*) Any 4 of the 10 years 1940–49;
---- (*f*) The 4 years 1936–39;
---- (*g*) Any other?

3. Would you prefer an alternative credit under which normal profits are measured as a percentage return on invested capital?

(1) No. ----; (2) 4 percent ----; (3) 6 percent ----; (4) 8 percent ----; (5) 10 percent ----.

Should borrowed capital be taken into account—

---- (1) In full, like equity capital?
---- (2) To only half of its value?
---- (3) To only three-quarters its value?

Should earnings accumulated after the effective date of an excess-profits tax be permitted to increase invested capital?

Yes ----; no ----.

4. Do you think an additional credit should be allowed to corporations for new capital invested after the base period if they—

---- (*a*) Use the average earnings credit?
---- (*b*) Use an invested capital credit?

If so, should be the percentage allowed be—

(1) 6 percent ----; (2) 8 percent ----; (3) 10 percent ----; (4) 12 percent ----.

5. Should there be a special credit allowance for "growth" companies?

Yes ----; no ----.

6. Should there be a flat exemption from excess-profits tax?

(1) No ----; (2) $10,000 ----; (3) $15,000 ----; (4) $20,000 ----; (5) $25,000 ----.

7. Should there be a relief provision for hardship cases?

---- (1) No.
---- (2) The type of provision found in the World War II excess-profits tax?
---- (3) An alternative normal profits figured on a percentage of the highest year's earnings in last 10 years?
---- (4) An average rate of return on capital invested similar to that earned by the industry as a whole in the base period?

---- (5) A specified percentage of dollar turn-over of business during the taxable year?

8. If you were subject to excess-profits tax, at which tax rate would you be more inclined to make business expenditures for salaries, advertising, etc., on the basis of tax consequences rather than business policy?

(*a*) 50 percent ----; (*b*) 60 percent ----; (*c*) 70 percent ----; (*d*) 80 percent ----.

9. Should the income subject to excess-profits tax be the income reduced by normal and surtax with a corresponding reduction in base-period income?

Yes ----; no ----.

10. Should capital gains be included in income subject to excess-profits tax?

Yes ----; no ----.

11. Should the tax be made one with normal tax and surtax for administrative purposes, such as sending 90-day letters, limitations, credits and refunds, etc.?

Yes ----; no ----.

Please check the following information about your business before returning this questionnaire.

Corporation ----; partnership ----; individual proprietor ----.

Taxable income: To $25,000 ----; to $50,000 ----; to $100,000 ----; to $500,000 ----; over $500,000 ----.

Manufacturer ----; wholesaler ----; retailer ----; service ----; professional ----.

Name (optional)--------------------

Statistically we stopped tabulation after recording some 1,500 replies, since no significant variations in the pattern of response occurred as we approached that number.

You will be interested to know the composition of the businesses which responded to our survey. Ninety-five percent of the total group operate as corporations and the remaining 5 percent as partnerships and individual proprietorships. Among the corporations, 8 percent have a taxable income under $25,000; 39 percent have a taxable income under $100,000, and 53 percent over $100,000. The overwhelming percentage of those surveyed are in manufacturing—some 55 percent of the total group—10 percent are wholesalers, 7 percent retailers, 10 percent service, and 18 percent of the total group are professional people, particularly in the professions of law and accounting.

With this as the background may I now indicate the sentiment of these business and professional people on the question of whether there should be an excess-profits tax, and if so, what its characteristics should be.

1. Assuming that mobilization and the draft continue for years, all taxes will be raised. So far as corporate tax is concerned, would you prefer to see the increase, whatever the amount, in the form of:

50.50 percent (*a*) higher corporate rates?

19.00 percent (*b*) an excess-profits tax?

30.50 percent (*c*) a combination of more modest corporate tax and mild excess-profits tax producing the same yield as (*a*) or (*b*)?

If there will be an excess-profits tax—

2. Would you prefer the average earnings credit (the measure of normal profits) to be the average of earnings in:

13.16 percent (*a*) the 3 years 1947–49

11.73 percent (*b*) the 4 years 1946–49

21.95 percent (*c*) any 2 of the 3 years 1947–49

27.65 percent (*d*) any 3 of the 4 years 1946–49

18.78 percent (*e*) any 4 of the 10 years 1940–49

1.73 percent (*f*) the 4 years 1936–39

5.00 percent (*g*) any other?

3. Would you prefer an alternative credit under which normal profits are measured as a percentage return on invested capital?

(1) No 45.17 percent; (2) 4 percent, 0.63 percent; (3) 6 percent, 4.73 percent; (4) 2 percent, 17.33 percent; (5) 10 percent, 32.14 percent.

Should borrowed capital be taken into account?

80.15 percent (1) in full, like equity capital?
13.87 percent (2) to only half of its value?
5.98 percent (3) to only three-quarters of its value?

Should earnings accumulated after the effective date of an excess-profits tax be permitted to increase invested capital? Yes, 90.90 percent. No, 9.10 percent.

4. Do you think an additional credit should be allowed to corporations for new capital invested after the base period if they—

Yes by 55 percent of all answers (*a*) use the average earnings credit?
Yes by 63 percent of all answers (*b*) use an invested capital credit?

If so, should the percentage allowed be—

(1) 6 percent, 9.19 percent; (2) 8 percent, 26.24 percent; (3) 10 percent, 46.31 percent; (4) 12 percent, 18.26 percent.

5. Should there be a special credit allowance for "growth" companies?

Yes, 84.58 percent. No, 15.42 percent.

6. Should there be a flat exemption from excess profits tax?

(1) No, 16.35 percent; (2) $10,000, 5.13 percent; (3) $15,000, 2.28 percent; (4) $20,000, 1.90 percent; (5) $25,000, 74.33 percent.

7. Should there be a relief provision for hardship cases?

11.59 percent (1) No.

12.03 percent (2) Satisfied with the type of provision found in World War II express profits tax.

33.33 percent (3) Preferred an alternative normal profits figured on a percentage of the highest year's earnings in last 10 years.

25.28 percent (4) Preferred an average rate of return on capital invested similar to that earned by the industry as a whole in the base period.

17.77 percent (5) Preferred a specified percentage of dollar turn-over of business during the taxable year.

8. If you were subject to excess profits tax, at which tax rate would you be more inclined to make business expenditures for salaries, advertising, et cetera, on the basis of tax consequences rather than business policy?

(*a*) 50 percent, 16.85 percent; (*b*) 60 percent, 21.71 percent; (*c*) 70 percent, 24.95 percent; (*d*) 80 percent, 36.50 percent.

Senator MILLIKIN. What do you mean, "on the basis of tax consequences"? Do you mean pay more wages and salaries?

Mr. CHERNE. That is right. In other words, that there would be a greater tendency to free expenditure in many areas as a result of excess profits taxes as the rates rise. The tax consequences of the business action then takes precedence over normal business judgment in terms of the same type of expenditure.

And we conclude, incidentally, from that, that it is inescapable that increased taxation reduces corporate restraint against less essential expenditures. It is apparent from our survey that even the most modest excess profits tax will, in a minority of instances, stimulate corporate expenditure beyond levels otherwise considered prudent. And as the rate of excess profits tax increases, the volume of such expenditures will increase. However, it is not until a 70-percent rate that this inflationary effect becomes marked.

This is the result of the survey we conducted upon our 30,000 members.

I would like to point out in addition that the survey was conducted prior to the consideration of the revenue measure by the House Ways and Means Committee and, consequently, reflects sentiment prior to the military events of the last 2 weeks.

Senator MILLIKIN. Were your customers thoroughly advised that whatever might result in the way of an excess-profits tax bill would only be a drop in the bucket, so far as the entire corporate tax is concerned?

Mr. CHERNE. No; they were not.

Senator MILLIKIN. Would that not be a pertinent factor to be considered?

Mr. CHERNE. The first question asked of them in determining their preferences indicated to them that there would be additional need for substantial increase in taxation. The alternative presented to them, assuming a certain number of dollars, whatever the number of dollars required by the Government was, which way would you prefer to see those number of dollars raised, whatever the number of dollars?

Senator MILLIKIN. Assuming that the corporate excess profits tax takes but a fraction of the earnings of the corporations affected, would that not have some restraining effect on inflationary tendencies to which you refer?

Mr. CHERNE. Yes, if it takes only a fraction, that is true.

Senator MILLIKIN. The question is, how big is a fraction?

Mr. CHERNE. I think interestingly enough, both the business people and the professional people responding to the survey made that judgment themselves, since a fairly substantial portion of the group prefer a combination of a mild excess profits tax and an increase in corporate rates.

Senator MILLIKIN. Mr. Stam, how much corporate taxes do we expect to get without giving allowance to the excess profits during this fiscal year?

Mr. STAM. On the total taxes, you mean?

Senator MILLIKIN. That is what I am talking about.

Mr. STAM. The total figure of all corporate taxes, as to that, I do not have that figure offhand. I have the total over-all taxes.

Senator TAFT. $12,000,000,000.

Senator MILLIKIN. It is $12,000,000,000 to $15,000,000,000?

Mr. STAM. About that.

The CHAIRMAN. About one-fourth.

Senator MILLIKIN. Next year there will be a substantial increase under any kind of tax bill that will come up. Again, we will have to say, how much is substantial, but it will be plenty, so that out of the whole corporate structure you might have from 3 to 4 billion that might have the potentiality of this inflationary tendency to which you refer. That might be 3 or 4 billion out of maybe 20 billions, and it may be considerably more than 20 billion. Do you thing the corporate structure would be distorted because of that element in that whole picture?

Mr. CHERNE. You are asking me for my personal judgment rather than the judgment of those of the membership of the Research Institute?

Senator MILLIKIN. Yes. The reason I ask that is that it is not clear to me that you have brought it to the attention of your clients what the total amount of corporate taxes will be.

Mr. CHERNE. We did not. We placed the hypothesis before them.

Senator MILLIKIN. Which is an element of judgment before giving any answer to any kind of questions.

Mr. CHERNE. That was not available to us, and I am not sure that that is available to the Congress.

Senator MILLIKIN. It is not available to the committee, but we know there will be substantial increases of taxes of all kinds in legislation, probably next year.

Mr. CHERNE. If it is of aid to the committee, may I suggest that we will be happy to resurvey the entire group as soon as there is any determination of even the approximate amount of additional corporate taxation required, and ask them in more specific terms in the light of this amount of taxation which, in their judgment, would be the preferred means of raising that amount of required revenue. But in the absence of the precise figure which is not available to the committee, we were unable to do more than say, higher taxation, which would you prefer in order to raise this required revenue, whatever it is.

The CHAIRMAN. Are there any further questions by the members of the committee? If not, you may proceed.

Mr. CHERNE (reading):

9. Should the income subject to excess profits tax be the income reduced by normal and surtax with a corresponding reduction in base period income?

Yes, 73.70 percent. No, 26.30 percent.

10. Should capital gains be included in income subject to excess profits tax?

Yes, 17.11 percent. No, 82.89 percent.

11. Should the tax be made one with normal tax and surtax for administrative purposes, such as sending 90-day letters, limitations, credits, and refunds, et cetera?

Yes, 74.89 percent. No, 25.11 percent.

These points of interest should be noted:

1. In answer to question 1, the percentage of corporations favoring a straight corporate tax rise increased in proportion to the size of their income. Of corporations earning under $25,000, only 25 percent preferred higher corporate taxes exclusively. In the over-$100,000 bracket, 57 preferred the corporate increase with no excess-profits tax.

2. In question 2, there is no one base period for average earnings which is preferred by any substantial majority. The greatest percentage, 27.65 percent, chose any 3 of the 4 years 1946–49, which corresponds to the base period suggested by the Treasury. Once again there is a marked divergence in preference among corporations falling into different income brackets. While those earning over $100,000 prefer any 2 of the 3 years 1947–49, those earning between $25,000–$100,000 chose any 3 of the 4 years 1946–49 while those earning under $25,000 selected any 4 of the 10 years 1940–49.

3. In question 6, a larger proportion of corporations earning over $100,000 would be willing to waive any flat exemption, although even in this income category the majority favors a $25,000 exemption.

4. In question 7, dealing with a relief provision, it is important to note that all corporations, large and small, are pretty well in agreement on preferring something other than a repeat of section 722.

The CHAIRMAN. We thank you very much.

We will now hear from Mr. Harold V. Bozell, of the United States Independent Telephone Association.

You may identify yourself for the record.

STATEMENT OF HAROLD V. BOZELL, UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION, LARCHMONT, N. Y.

Mr. BOZELL. My name is Harold V. Bozell. I am a resident of Larchmont, N. Y. I am president of General Telephone Corp., parent company of the largest group of independent telephone companies, with headquarters in New York, and I am also chairman of the tax

committee and immediate past president of the United States Independent Telephone Association. This association speaks on behalf of the 5,700 independent telephone companies in the United States which serve nearly one-fifth of the Nation's telephones operating through nearly two-thirds of the 18,000 (approximate) telephone exchanges, and covering about 60 percent of the geographical area, of the United States. These companies range in size from small ones serving 50 or 100 telephones to the largest, having well over 400,000 telephones.

Naturally we appreciate as fully as anyone the necessity for increasing available revenues to the Government at this time. Just as naturally we feel it is highly essential that any increased taxes be levied in such a way as to maintain the maximum strength of American industry to do the enlarged job it will have to do and which, naturally, it desires to do. It looks as if it is going to be a long job, and that increases the necessity of being sure the tax imposition is done equitably.

It is our understanding that H. R. 9827 is designed specifically to impose an excess profits tax, that is, a tax which will skim off, so to speak, earnings which are considered excess earnings arising from the present accelerated industrial and economic program although I understand that this committee is properly considering a broader gage program as to what is the best and most equitable over-all method of increasing income to the Government under current conditions.

We are not attempting to speak to this broader program but discuss briefly the relation of the telephone industry, particularly the independent segment of that industry, to this particular plan proposed under H. R. 9827.

Because of the $25,000 exemption, this bill does not affect directly a large number of the smaller companies in the independent telephone industry.

Senator MILLIKIN. What percentage of the companies will be exempted?

Mr. BOZELL. I imagine close to 75 percent.

Senator MILLIKIN. How many companies did you say?

Mr. BOZELL. Fifty-seven hundred companies.

Senator MILLIKIN. Fifty-seven hundred?

Mr. BOZELL. That is in number of companies.

Senator MILLIKIN. So that, roughly, there are 4,000 of them?

Mr. BOZELL. That would, probably, come under the $25,000 class. That is correct.

Senator KERR. What percentage of the total volume does that represent?

Mr. BOZELL. That is less than half; in other words, as I say here, because they are all part of the Nation-wide organization.

But because they are all part of the Nation-wide interconnected and integrated telephone network, their ability to do their job is dependent on the health of the entire industry.

Senator MILLIKIN. Are they interstate or intrastate?

Mr. BOZELL. They are engaged in interstate communication. They are subject, however, to the States. They are subject to the regulations of the Federal Communications Commission only if they own lines that go across State lines or connect with companies under common ownership that go across State lines.

Senator MILLIKIN. Thank you very much for that explanation.

Mr. BOZELL. And their ability to get new capital along with the rest of the industry, which I will mention shortly, is affected by the public's attitude toward telephone securities as a class. At the other end of the scale in this group of independent telephone companies are over 250 which have annual gross revenues of over $100,000—the largest one having gross revenues of more than $20,000,000 with a plant investment of over $90,000,000—and collectively these 250 companies constitute well over half of the independent segment of the industry.

Senator MILLIKIN. How many are subject to interstate regulations of the large companies?

Mr. BOZELL. There are about 85.

Senator MILLIKIN. About 85 in number?

Mr. BOZELL. Yes.

In 1941 the telephone industry had a fair amount of cash on hand, it had substantial plant margins with which to render additional service and its demands for capital during the period of World War II were accordingly relatively small. Today while the telephone companies serve a much greater number of telephones and have a much larger toll network, their plant, because of the pent-up demand at the end of the war and the new demand since the war, still continuing, is overloaded—there is actually a plant shortage—and the continual demands for capital to construct additional plant are staggering.

Senator MILLIKIN. Are the materials available if you have the money?

Mr. BOZELL. They are available, quite extensively. There has only been 15 percent cutback in copper so far and, probably, some in aluminum.

Senator MILLIKIN. There will be a cutback in that as the mobilization proceeds, will there not?

Mr. BOZELL. Yes, sir.

Senator MILLIKIN. So you will have a real problem, even if you have the money, of getting the equipment; is that correct?

Mr. BOZELL. That is correct, but during the last war, the War Production Board saw the essential necessity of allowing those materials to go where it felt the economy would demand it, that there be communications services. And, of course, the defense, the Government, demands the services, and they must all be part of the same system.

These demands come not only from business and residential customers, but they also come and will come in an increasing amount from war industries and direct military and Government requirements.

Mr. CHERNE. One thing we know about is the radar screen around the United States which calls for a tremendous increase in telephone expense. We have to contact those. They are in out-of-the-way places.

Mr. BOZELL. This telephone plant must all be integrated into one system—it cannot be segregated into separate categories—because to be most useful every telephone must be able to connect with every other telephone.

And there is only one source from which the funds to meet this plant demand can be obtained and that is from the public by the sale of securities, in which there must be a substantial amount of common stock equity.

Senator KERR. What percent of the total of communications, speaking from the standpoint of telephone, is the group represented by you?

Mr. BOZELL. One-fifth of the entire telephone industry is independent—one-fifth in number of telephones, two-thirds in number of telephone exchanges, and over 60 percent of the area.

Senator KERR. All right, thank you.

Senator MILLIKIN. How do you measure the groups? By the number of calls, or by the size?

Mr. BOZELL. By the number of telephones installed. That is the unit used in the industry.

Senator KERR. Are the statements you are making to us with reference to your segment of the industry applicable, generally, to the entire industry?

Mr. BOZELL. Essentially, this is applicable to the entire telephone industry. We are all alike. We are all part of the integrated system. We are all connected. We live alike. Our characteristics between the independents and the Bell are almost identical.

Senator KERR. The demands for expansion apply both to you and to them about equally?

Mr. BOZELL. Yes; as a matter of fact, the telephone company which is growing fastest in the United States is this largest independent telephone company that I mentioned which encircles the city of Los Angeles. And all of the growth in Los Angeles, in that area, the larger proportion of it, grows in the environs and around those cities than it actually does in Los Angeles.

Senator KERR. You do not think that is any finer a city than a number of others that are served?

Mr. BOZELL. No, sir; it merely happens it is growing; it happens to be growing faster. For instance there is one place in our area where there are 17,400 houses being built in one tract simultaneously, and they all want telephones.

Any tax plan which would do other than result in sufficient earnings to attract this capital is bound to be a disservice to the country by the hobbling effect it would have on the industry to do its job.

Some people quesion why cannot regulated telephone companies finance their requirements as do many other industries, namely, by retained earnings. The answer is that the total annual earnings available to most telephone companies are but a small part of the annual capital requirements, and this will be true for some time to come, under any conditions we can foresee. For example, in the case of one large unit, the annual new cash requirements for the past 2 or 3 years have been about 10 times the total annual earnings accruing to its common stock. Therefore, as I have stated before, these companies must be able to continue to attract capital, and that is the basis on which they are regulated. The one significant feature of the Supreme Court's decision in the well-known Hope Natural Gas case is that regulated utilities must be allowed enough earnings, after all taxes, to attract purchasers of their securities on a fair and equitable basis to present holders as well as to the new purchasers.

Senator MILLIKIN. How are they usually financed? By equity financing, indebtedness, or how do they finance?

Mr. BOZELL. The usual capital is not to exceed 50 percent in bonds. That is too high. We ought to be below 40 percent in the telephone

industry. And the rest is equity. Sometimes preferred stock is used. Practically all of them have from 30 to 40 percent of common stock. We have had to go too far into debt during this time, that is, the whole industry has, because we have not been able to attract the equity capital necessary in this postwar period of increasingly high costs.

Senator KERR. Would you give us the increase in debt percentage as to that?

Mr. BOZELL. The Bell System statistics show something from 30 percent below to 50 percent.

Senator KERR. That 30 percent was in what year?

Mr. BOZELL. 1945.

Senator KERR. In 1945. What would you say would be the figures applicable to your segment?

Mr. BOZELL. In our particular system, the largest group of independents constituting about one-sixth of that, we were about 50 percent before the war, and we still are. That is as high as you can go. We have had to sell equity capital on a diluting basis, because that is the only way we have been able to get capital.

Senator KERR. You mean the market will not take the debt securities when the 50-percent factor is exceeded, as a general thing?

Mr. BOZELL. That is perfectly true. It would be dangerous to do so.

Senator KERR. Is there any of that brought about by reason of the rulings of regulatory bodies?

Mr. BOZELL. Yes, some commissions want to hold us to 40 percent. None of the commissions like to go over 50 percent. It just is not proper in this type of an industry to have that much. We are an industry of such heavy investment, with four or five dollars of investment per dollar of gross, that that investment has to be done on a conservative basis, because slight variations in the level of earnings would have distinctly negative effects on the whole earning situation.

Senator MILLIKIN. Is it not true that the higher your indebtedness, the more in jeopardy is your equity?

Mr. BOZELL. Yes.

Senator MILLIKIN. Therefore, you dry up the equity market while you increase your jeopardy through indebtedness?

Mr. BOZELL. That is exactly right. That is what we have been confronted with since the war, because of the lag in getting rate increases.

Senator MILLIKIN. Is there any figure you can give us on the amount of interest you pay on your fixed indebtedness, that is, your people?

Mr. BOZELL. We are paying around 3 to 3½ percent. Some of the smaller companies pay 4 percent.

Senator MILLIKIN. Are some of the smaller companies on a cooperative basis?

Mr. BOZELL. There are 60,000 of the little cooperatives in the rural districts, in addition to ours.

Senator MILLIKIN. You are not talking about them in your statistics?

Mr. BOZELL. I am not talking about them. You see, they bring their lines into the commercial telephone switchboard. They own their lines. We do the switching for them, and charge them the switching service. They do now own switchboards. They consist of anywhere from 10 to 30, or 40, or 50 members who build little toll lines in the farming communities, and bring them in to us.

Senator MILLIKIN. You finance your indebtedness on the basis of 3 and 3½ percent?

Mr. BOZELL. Three and three and one-half percent.

Senator MILLIKIN. Do you make general distribution of those bonds?

Mr. BOZELL. Yes.

Senator MILLIKIN. Do you sell them to a few purchasers?

Mr. BOZELL. Both methods are used. There are public offerings of bonds, and, also, the insurance companies are increasingly buying them. During the past 8 of 10 years the independent telephone securities have come into their own as senior securities in the institutional markets.

Senator MILLIKIN. How about your equities? Where do you distribute those?

Mr. BOZELL. They are distributed to the public through registration.

Senator MILLIKIN. Do you have any difficulty in distributing them?

Mr. BOZELL. Yes, these days, because the earnings have not been coming along fast enough.

Senator MILLIKIN. What is the scale of your dividends that are paid on your equities?

Mr. BOZELL. Those dividends are paid anywhere from 6 to 8 percent, but it takes, according to testimony even of adverse witnesses before our commissions, 12 or 13 percent earnings on this equity with this type of a capital structure to get people to buy these common stocks.

Senator MILLIKIN. Do you have difficulty in selling your common stocks when they pay 6 or 8 percent?

Mr. BOZELL. Yes, sir.

Senator MILLIKIN. I would be very much interested in having a little more information on the distribution of the equities.

Mr. BOZELL. Many of these companies are small, and the distribution is local, I mean, regional. My own company, the General Telephone Corp., is listed on the New York Stock Exchange with some 17,000 stockholders scattered all over the country. When we offer common stock, it is through registration statements, the same thing with the Peninsula Co., serving Tampa and St. Petersburg, Fla. Likewise with the Lincoln Telephone & Telegraph Co.

Senator MILLIKIN. Is it widespread distribution, somewhat similar to the larger companies?

Mr. BOZELL. Yes; as wide as you can get. It is Nation-wide. It is underwritten by the usual banking groups. The Rochester Telephone Co. is the largest city served by an independent, and that is marketed that way.

Senator TAFT. How far is it financed by rights to stockholders who buy?

Mr. BOZELL. A good deal. All of our common stock financing has been handled by rights to stockholders.

Senator TAFT. They take up most of it?

Mr. BOZELL. It has been taken about 75 percent of it recently, but we have had to offer stock which has a book value of $35 at $25 because of the earnings situation being not enough to bring it up. It has had to be a bargain to get them to take it.

Senator MILLIKIN. Later on you will tell us how you think an excess profits tax can be constructed so that it will protect; may I assume that?

Mr. BOZELL. That is my purpose here.

I might emphasize at this point that so far as the independent segment of the industry goes, we can well anticipate even greater migration of industry and its accompanying population to the more scattered and smaller communities, the large majority of which, as I have said before, are served by independent telephone companies. And this will place even greater demand on them for telephone plant and, therefore, capital.

Now all telephone companies are regulated so that there earnings are limited to the minimum requirements necessary to attract this additional capital. Telephone companies do not expect large earnings, but they do expect and need and must have a continuation of the level of earnings necessary to attract this capital. Since World War II, because of the rapid increases in operating costs and in cost of equipment and because of the necessary time consumed in the procedure of obtaining regulatory authority to increase rates, there has been a time lag on increasing their prices to maintain their earnings. Their rate of return has therefore been abnormally low during this period.

Now what has this to do with the proposed tax bill H. R. 9827? The House Ways and Means Committee has properly recognized that regulated industry has special characteristics, and in section 446 it has tried to meet these. But just as I predicted to the members of that committee on November 15, they have found it a difficult if not an impossible task to write provisions which can practically measure those earnings of a regulated telephone company above which additional earnings, if any, would be excess. We have conscientiously worked on this thing for years, and every avenue of approach, to try to find an answer leads to the inevitable conclusion that there are no excess earnings since the companies are all regulated to earn no more than their minimum requirements of obtaining additional capital. Any way one tries to define base earnings for determining any excess earnings leads inevitably to those earnings not by regulatory authorities as a minimum.

Secretary Snyder in his statement yesterday seemed to think that such a position as this, even such a position as taken by the House Ways and Means Committee itself, was fully improper. We believe he is in error and feel certain that he does not understand the peculiar characteristics involved. We feel just as certain that, if he would take the time to study this situation with us, we could convince him that any other answer than to recognize that these companies do not have excess profits and should, therefore, be included in the act as exempt corporations in section 452, is bound to impose on some of these regulated telephone companies a tax on at least part of what their regulatory commissions and what sound economy must consider normal earnings. The excess-profits tax of World War II, while it used different percentages, was much like this proposal without section 446, and there were many cases in which it did just that thing, namely, to tax, as excess profits, part of the normal profits of regulated companies. As a matter of fact, during World War II,

and in response to a letter from the California Public Utilities Commission to this committee, in the fall of 1942, we, the independent industry, developed a third alternative method, which embodied the principle that there could be no measure of excess earnings until after normal tax and surtax, and the then staff of the Treasury Department expressed agreement with the principle and said that had been their own philosophy when they started on the problem in 1940. Had the war not ended, and likewise the excess-profits law, I believe some such third alternative method would have been adopted. This principle is now properly included in section 446.

We sincerely feel that the position taken by the National Association of Railroad and Utilities Commissioners, composed of both the National and State regulating commissions, before the House Ways and Means Committee on November 15 is a sound one, namely, that regulated industry should be exempted because the State and Federal regulatory machinery keeps these earnings, as I have said before, at the absolute minimum necessary for them to do the job they have to do.

If, however, Congress decides to impose a so-called excess-profits tax on regulated telephone companies if it does so on other corporations, then the effort must be made to draft provisions which are equitable. The present section 446 does not do this for at least two reasons.

Senator MILLIKIN. Are there exceptions?

Mr. BOZELL. Exceptions to what?

Senator MILLIKIN. Do any of these companies have abnormal large profits that are not caught by the regulating machinery?

Mr. BOZELL. We believe not. We have not been able to find any at all. We do not conceive how they can happen. If people use the telephone more, what that causes us to do is to have to make more investment in our central office equipment, because it takes more switches to do the job. Commissioner Hesse, chairman of the Maryland Public Service Commission, and former dean of the law school of the University of Maryland, is, I understand, to appear as your first witness on Thursday, and he looks at the thing from the standpoint of the regulating authorities. He can speak with more authority than I can on that. But so far as we can find out, we cannot conceive of any, because the regulating commissions always are in the position to make any adjustment that is necessary.

The CHAIRMAN. Do all of the regulating commissions fix a rate, or do some of them simply say that you proceed until objections are raised, either that your rate that you are fixing is confiscatory or unreasonably high?

Mr. BOZELL. The procedure is different at different States. In some States you file a rate and you collect it, if the commission does not object, as you say. Normally, they do. And, therefore, they go through the machinery of discussing it. Sometimes in the smaller companies, they may look at the thing and find that it is not out of reason, so far as they can estimate it, and there is no objection from the community. And they let them go into effect. In other States you have to apply to be able to earn a certain amount of money. The various State laws differ on that.

The CHAIRMAN. You do not have an absolute, uniform earning rate recognized by all of the commissions in all cases?

Mr. BOZELL. No.

The CHAIRMAN. But the House bill does give you 6 percent?

Mr. BOZELL. Yes, sir.

The CHAIRMAN. How is that done? Let me ask you practically, have you looked at that bill?

Mr. BOZELL. Yes, sir.

The CHAIRMAN. Have you looked at it carefully enough to know what that is, on the basis of your book assets?

Mr. BOZELL. That is not, as I point out here, on the basis of the adjusted basis of the Treasury Department.

The CHAIRMAN. The tax report.

Mr. BOZELL. The tax report, absolutely.

The CHAIRMAN. It would make a big difference?

Mr. BOZELL. That was the punitive thing that the California Commission called to your attention in 1942 when they pointed out that 16 of the largest companies in California were being punished. The Pacific Gas & Electric and the California Southern Edison Co., to them were two identical companies in size and rate of return and so forth, but the Southern California Edison, because of its adjusted basis——

The CHAIRMAN. I did not know you were coming to that. I was curious to know from reading the act just how it was going to work.

Mr. BOZELL. That is what we question, sir.

Senator MILLIKIN. Was there not a difference under the earlier act; you only get 50 percent on your borrowed capital?

Mr. BOZELL. That is correct. Section 446 corrects that, sir.

Senator MILLIKIN. In a word, you are not satified with the provision as it is now in the House bill?

Mr. BOZELL. No, sir.

Senator MILLIKIN. You will make suggestions for its improvement?

Mr. BOZELL. Yes, sir.

In the first place, the basis upon which the earnings are measured before taxes is not realistic as it is entirely different from the basis on which the regulatory commissions themselves reach their conclusions. Quite generally the minimum basis used by the commissions in judging their results, although they may follow differing procedures to conform to the various Federal and State laws, is the total capital investment—borrowed capital, equity capital, and retained earnings—as shown on the books of the companies.

One of the leading accountants thinks all commissions ought to regulate it so that you earn your carrying charges on your senior securities, enough to keep the common stock selling 15 to 20 percent above par in the market, so that the stockholders will take up their rights, as Senator Taft suggested.

Senator MILLIKIN. May I ask Mr. Stam a question, please?

The CHAIRMAN. Yes.

Senator MILLIKIN. How much revenue do they expect to get from the telephone companies under the proposed bill?

Mr. STAM. I think they feel that this present 6 percent minimum exemption will reduce the revenue to a very small figure.

Senator MILLIKIN. To what?

Mr. STAM. I do not know that we have that. I do not have the exact figure, but they do not expect to get very much out of the whole utility group with the 6-percent credit which they allow after normal surtax.

Mr. BOZELL. They recognize that one whole day was devoted before the House Ways and Means Committee with about 15 or 20 different witnesses for the industry to that subject. And, I think, they were convinced that it does not occur, and they are trying to adopt this law to recognize that fact thoroughly. I just think they have missed the point technically on how to do it.

All of these books are kept according to Standard Classifications of Accounts required by the commissions, both State and Federal. On the other hand, the provisions of section 446 of H. R. 9827 would require the use of the "adjusted basis" of the utility's assets minus its liabilities, and such "adjusted basis," of the Treasury, for most regulated utility companies is——

Senator MILLIKIN. Is there any showing of any excess profits, as far as this utility field is concerned?

Mr. STAM. You mean in World War II?

Senator MILLIKIN. Right now.

The CHAIRMAN. Before the House committee, he means.

Mr. STAM. The figures that were presented would indicate that in many cases, as this gentleman just pointed out, where the later return would be more than 6 percent, running around, say, up to 7, and I think you said 8, you have seen cases where it was around 7, and I believe the average was supposed to be about 6½ or somewhere in that neighborhood, so that that little excess over the 6 percent, 6 being the usual rate fixed by many of the commissions, the excess over that would be the excess profits that we are talking about.

Senator MILLIKIN. What they are really trying to reach is what the commissions do beyond a certain point?

Mr. STAM. That is right.

Senator MILLIKIN. Did anybody regard it as an important problem, something that had to be dealt with in this kind of a law?

Mr. STAM. The only point was that they felt that in view of the fact that all of the business corporations in the country were going to be subject to an excess-profits tax on a certain amount in excess of their return, that the average rate that is fixed by the utilities ought to be, at least, the guiding post, so far as the law is concerned, and that was the theory back of it.

Senator MILLIKIN. No one claimed that it would involve a great, substantial sum of revenue, one way or the other?

Mr. STAM. No, indeed.

Mr. BOZELL. As Commissioner Hesse will point out to you, I am sure, as he did to the House committee, one objection to the 6 percent is that there is actually a variation in the amount of return, necessary variables being geological, and the size of company, and so forth. The Supreme Court of Vermont, for example, recently handed down an opinion. A certain water company contended they had to have an 8-percent return on the basis that they were using at that point.

The difficulty is that this percentage of return is upon different bases in different jurisdictions. Sometimes it is fair value, as in Michigan; reproduction cost in Ohio; original cost to the Federal Power Commission, and so forth. And those percentages set forth in the order are not, therefore, the actual percentages which result upon the company's own investment.

Senator MILLIKIN. Do you claim there is any difference in the principles involved between your type of utility and other types of utilities?

Mr. BOZELL. Yes, sir. I think you will find universal acceptance of the fact that the telephone industry is a more volatile industry than the power or light or water companies, or the railroads.

Senator MILLIKIN. But the basic principles?

Mr. BOZELL. The basic principle is the same. It is purely a question as to what is necessary, what is the relative risk. We have a very much larger labor cost element in our operations, somewhere around 60, as against some of the others. You can easily stop long-distance calls. And people will take out telephones, where they will not stop power and water, as was found out in the last depression.

Continuing with my statement: On the other hand, the provisions of section 446 of H. R. 9827 would require the use of the "adjusted basis" of the utility's assets, minus its liabilities, and such "adjusted basis," of the Treasury, for most regulated utility companies is, because of the nature of origin of that basis, lower than the capital of the company as shown on their books of accounts. This, in itself, as pointed out to you by the California Utilities Commission in 1942, penalizes certain companies and is destructive of their credit, and is certainly no basis for a true measure of what are necessary and normal earnings, to use as a basis of determining excess earnings. We feel definitely that the base should be redefined.

To use section 446 as now written or to use the alternate sections 435 or 436 would mean that a great many companies would pay excess-profits taxes for the years 1950 and 1951 even though during those years the regulatory commissions are finding that the companies do not have sufficient earnings to maintain financial stability and are granting increases in rates.

For example, the largest independent telephone company in Illinois, whose rates are such that it will earn only 5 percent on its capital for 1950, and which has on file with the Illinois Commerce Commission at this time an application for additional rates, would have to pay a so-called excess-profits tax on its earnings for 1950, even though it has done financing and declared dividends and had other financial operations based upon those earnings which are thus retroactively taken away.

With respect to retroactivity, by the way, if any telephone company is thus penalized, because that is what it would be, there is no way it can recover. Incidentally, in 1943 or 1944, this committee adopted and proposed an appropriate amendment to the Internal Revenue Code, and in wording it, the Treasury Department inserted a retroactive clause. As I recall it, Senator Lucas and Vice President—then Senator—Barkley, spoke forcefully about the inequity of such retro-

activity, and spoke so effectively that the Senate killed the retroactive feature.

In addition to this "adjusted basis" being an improper base, we feel definitely that experience shows that in the telephone industry, to obtain the amounts of equity capital which it is continuingly necessary for us to obtain, the 6 percent upon this capital is demonstrably too low. As I said to the House Ways and Means Committee, we believe that it should be 7½ percent, and we think we can prove that to you. We have to compete in the open financial markets for this new capital, and that market determines what earnings we require to sell our securities.

If excess-profits taxes in line with the formula proposed were enacted, even with a redefinition of the invested capital base, many telephone companies would have to pay excess-profits taxes on earnings which their commissions consider either normal or subnormal—the latter demonstrated by the commissions' granting increases in rates—and these taxes would have to be included in still further rate increases in rations which are rather startling. For each additional $1 of necessary net income to the telephone company, there will have to be an increase of $4 to the telephone user and this would still further increase the amount of the excise tax.

The telephone user is already almost the most highly taxed customer of any business—certainly of any business as essential as a utility service. Of the dollar he pays for telephone service, from 25 to 30 percent goes to direct corporate and excise taxes. To have to increase this tax upon telephone service still further, and particularly to the degree which would be necessary, is a demonstrably large inequity.

Senator MILLIKIN. What does the average fellow pay for his telephone service?

Mr. BOZELL. It runs anywhere—well, in our system, around $70 a year, up to $100 a year.

Senaor MILLIKIN. What would be a fair average?

Mr. BOZELL. That includes toll service, as well, business, and everything, and that also includes this tax.

Senator MILLIKIN. How much would the proposed bill increase the telephone charge?

Mr. BOZELL. Mr. Hesse testified before the House Ways and Means Committee that to use a sort of measure and to limit telephone and other utilities to 6 percent would probably increase the utility bill of the country over a billion dollars without any excise taxes. You will find that that is the testimony before the House Ways and Means Committee on November 15.

Senator TAFT. You mean that was the application of the whole bill without this exemption?

Mr. BOZELL. Yes, that was, if you used the proposal without section 446.

Senator TAFT. That is, to public utilities in general?

Mr. BOZELL. Yes. As was pointed out in some recent cases here, even with the present just corporate tax of the old 38-percent variety, every time we had to have an extra $500,000, the customer had to pay $800,000, and he had to pay 15 or 20 percent on top of that for the excise tax. The thing snowballs in a tremendous volume.

In enacting legislation to increase national revenues, we do not believe that the way to do it is to enact an excess-profits tax law which would tax the normal earnings of regulated industry. We believe the only safe way to prevent this inequity, which would materially hobble these companies in doing the job they have to do——

Senator MILLIKIN. Under the proposed bill, how much would the telephone bill of the user be increased?

Mr. BOZELL. It has been impossible for us to measure that quickly, sir.

Senator MILLIKIN. Do you have a rough figure?

Senator TAFT. Some companies would be entirely exempt, would they not?

Mr. BOZELL. Some companies would not have to pay any tax under this. It all depends upon the adjusted basis that will be in the Treasury Department.

Senator MILLIKIN. You have no estimate?

Mr. BOZELL. I do not have one, I am sorry. I do not know whether the Bell System has one or not.

Senator MILLIKIN. The telephone user, unless he is in business, does not get a reduction for his telephone expense?

Mr. BOZELL. No; nor for the excise tax he pays on it.

Senator MILLIKIN. Unless he is in business?

Mr. BOZELL. Unless he is in business; correct.

Continuing with my statement: We believe the only safe way to prevent this inequity, which would materially hobble these companies in doing the job they have to do, is to recognize that they do not have excess profits, and so draft the act. But if these companies are to be included as corporations subject to the excess-profits tax, then we believe that the retroactive feature should be dropped and that section 446 should be written more realistically.

I understand that today we have the opportunity to submit to you certain further information to support this with specifics.

The CHAIRMAN. We will be glad to have it for the record. You may do so.

Are there any further questions? If not, thank you very much, Mr. Bozell. You may furnish additional information and statistics for the record.

Mr. BOZELL. Thank you.

(The supplemental information, when received, will be placed in the committee files.)

The CHAIRMAN. We will next hear from Mr. Royal Little, of Textron, Inc. You may proceed, Mr. Little.

STATEMENT OF ROYAL LITTLE, TEXTRON, INC., NEW YORK, N. Y.

Mr. LITTLE. In order to save time I have filed with the committee a statement which I will not read. I will speak from the charts, instead, if I may, please.

The CHAIRMAN. Yes, sir. You filed the statement with the committee?

Mr. LITTLE. I filed the statement with the committee.

I would like to make this summary of the recommendations, which I am going to make.

In the first place, I would like to go on record as saying that I am against an excess profits tax in principle. However, being a practical businessman, I realize that we probably are going to get an excess profits tax, and I would like to bring before you for consideration a type of excise profits tax which I feel would be fair.

This is entitled: "Plan for a Fair Excise Profits Tax To Become Effective January 1, 1951."

1. The taxpayer should be granted an option, at the time of filing the return, to calculate the excess profits tax credit, in either of these ways:

(*a*) Invested capital: A flat 12 percent of invested capital, with all indebtedness with a maturity exceeding 1 year included as invested capital.

(*b*) Base period earnings: 100 percent of average earnings for the best three of the four years 1946–49.

All earnings in excess of the credit to be taxed at 75 percent rate.

2. Complete exemption of the first $100,000 of earnings for all corporations regardless of size, with a provision to prevent duplication of exemptions by corporations under common control.

3. Basic normal and surtax rates to remain as they are, but taxpayer electing either invested capital or base period earnings method of figuring excess profits tax credit should be subject to a minimum over-all tax rate of 52½ percent.

4. The 2 percent penalty for filing consolidated returns should be eliminated.

5. An adequate renegotiation law should be passed to take excess war profits out of business.

6. Relief provisions such as sections 721 and 722 should be eliminated, thus relieving the Bureau of complicated administrative detail and possible future refunds.

7. Include a simple automatic relief provision for hardship cases. The taxpayer should have the privilege, to be exercised 1 year before the date for filing his return, of waiving his right to calculate his excess profits tax credit under 1 (*a*) or 1 (*b*), and of agreeing instead to pay an excess profits tax equal to 20 percent of his total normal and surtax for the year, or an over-all relief rate of approximately 54 percent.

Under the above proposal all taxpayers will fall into one of the following categories:

1. Complete exemption under the $100,000 exemption.

2. Minimum 52½-percent over-all rate under either invested capital or base period earnings method of computing excess-profits tax credit.

3. Up to a maximum 75-percent rate under invested capital or base period earnings method of computing excess-profits tax credit, for taxpayers not electing special relief rate.

4. Special relief rate of approximately 54 percent over-all.

This plan will permit every taxpayer with any known type of hardship situation to obtain a special relief rate of only 1½ percent above the minimum rate by a declaration of intent 1 year in advance of the tax return filing date.

Any taxpayer who fails to take advantage of this special relief rate will have no one but himself to blame should his earnings for the year exceed expectations and his over-all tax rate exceed 54 percent.

In order to show some background I would like to speak for a few minutes from the charts, if I may.

Senator KERR. Will it be shown what this proposal of yours would produce?

Mr. LITTLE. That will be shown in the charts.

Senator MILLIKIN. Would your opinion of the subject be the same if we knew there would be a substantial increase in the regular corporate rates, say, next year?

Mr. LITTLE. Yes, sir, it would, because this plan could be adjusted merely by changing the minimum rate under the excess-profits tax, and the other rate, and the whole thing could be moved up without disturbing the basic principle.

Senator MILLIKIN. You would contemplate doing that in the event that you had a substantial increase?

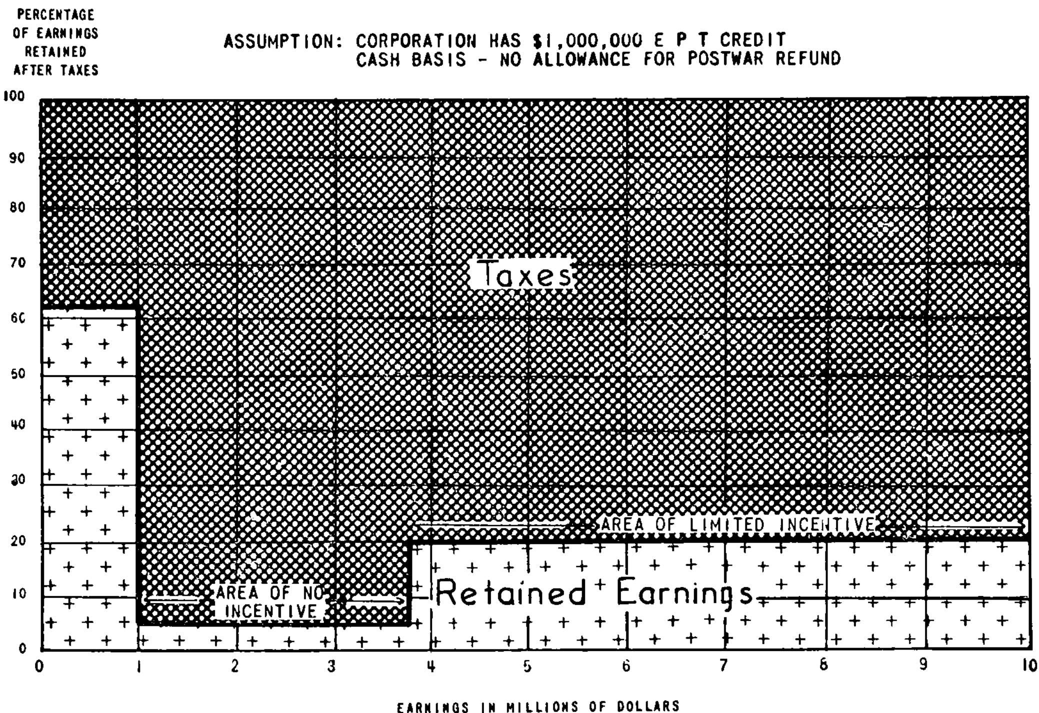
Mr. LITTLE. That is correct. The provision is made, so that just those percentages would have to be changed within this framework.

Here is a chart which I do not think anyone else has ever prepared.

(Chart 1 is as follows:)

CHART I

EFFECT OF WORLD WAR II EXCESS PROFITS TAX ON RETAINED EARNINGS



Mr. LITTLE. This shows very graphically the disadvantage of the excess-profits tax theory. This is under World War II rates. The assumption is that a corporation has $1,000,000 excess-profits-tax credit, and this is figured on a cash basis with no allowance for postwar refund.

Here you have the percentage of earnings retained after taxes, charted against the number of millions of dollars of earnings for the corporation. You see, under that provision all of this area is taxes and this is retained earnings, and here is what happens: On your first million, the corporation retained 62 percent, but just as soon as you got to the edge of this precipice and you had the problem of would you expand your operations, you were faced with this dreadful drop here where the retained earnings immediately dropped from 62 to 5 percent on the cash basis. You could not pay for plant expansion with your postwar refund.

Therefore, I have reduced this strictly to a cash basis. And it meant that you had what I called an area of no incentive, which goes up some 3.8 million dollars, if you have a million dollars before you get up to a plateau where you would retain 20 percent again.

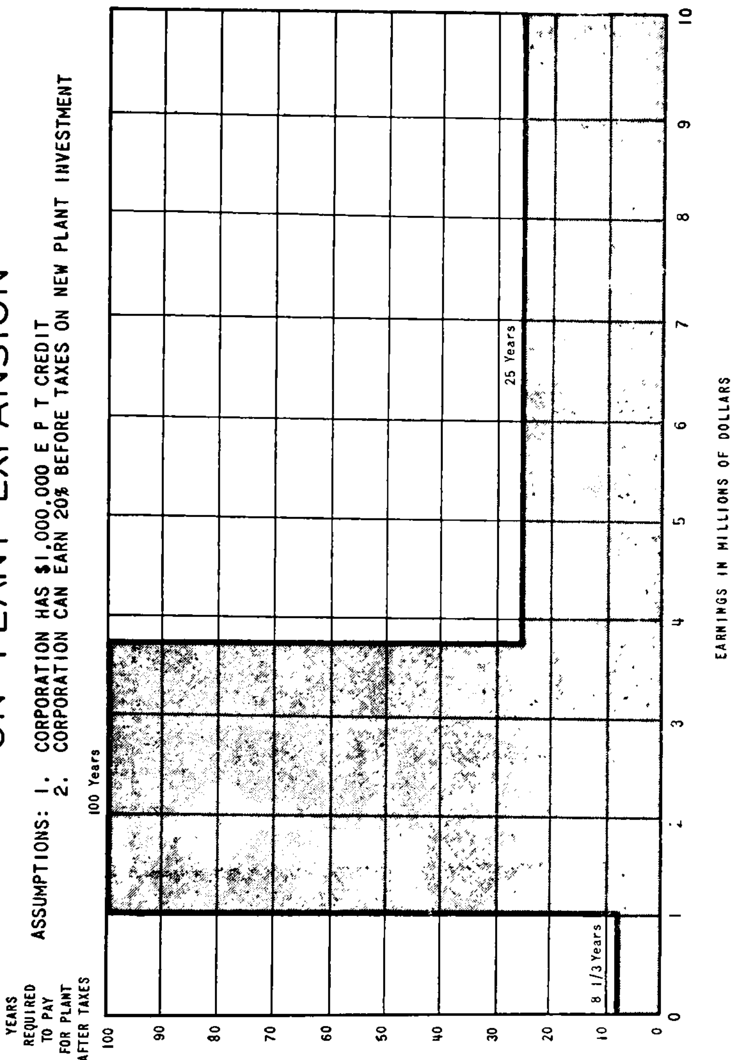
This I call the "area of limited incentive," but that jog in the tax law, as it was passed before, caused many, many corporations to stop short of the precipice, because if they spent another nickel on plant expansion they dropped off the cliff and could not possibly get their money back.

Now, I will show you how long it would take to pay back after taxes for plant expansion under that tax law.

I next refer to chart 2.

(Chart 2 is as follows:)

CHART II



Mr. LITTLE. Here is the same corporation with a million dollars excess-profits-tax credit. We will assume that a corporation on new plant could earn 20 percent before taxes on this new plant and new machinery. If they are in the fortunate position of being within their first million dollars, they get the money back after taxes of 8⅓ years, but the minute they get beyond that point it would take them 100 years to get that money back after taxes. And that is even with 20-percent earnings before taxes.

Then after you go up here to 3.8 million, you then get your money back after 25 years.

That shows the fallacy of excess-profits taxes.

Senator TAFT. What was the figure that affected that 3.8, the over-all limit, or something?

Mr. LITTLE. That is your over-all limit of 80 percent. You see, you run into the over-all limit of 80 percent and then you get in this area, but in this area, which is 3.8 times your base, you are just in this morass of hopelessness where you cannot afford to spend a nickel for plant expansion.

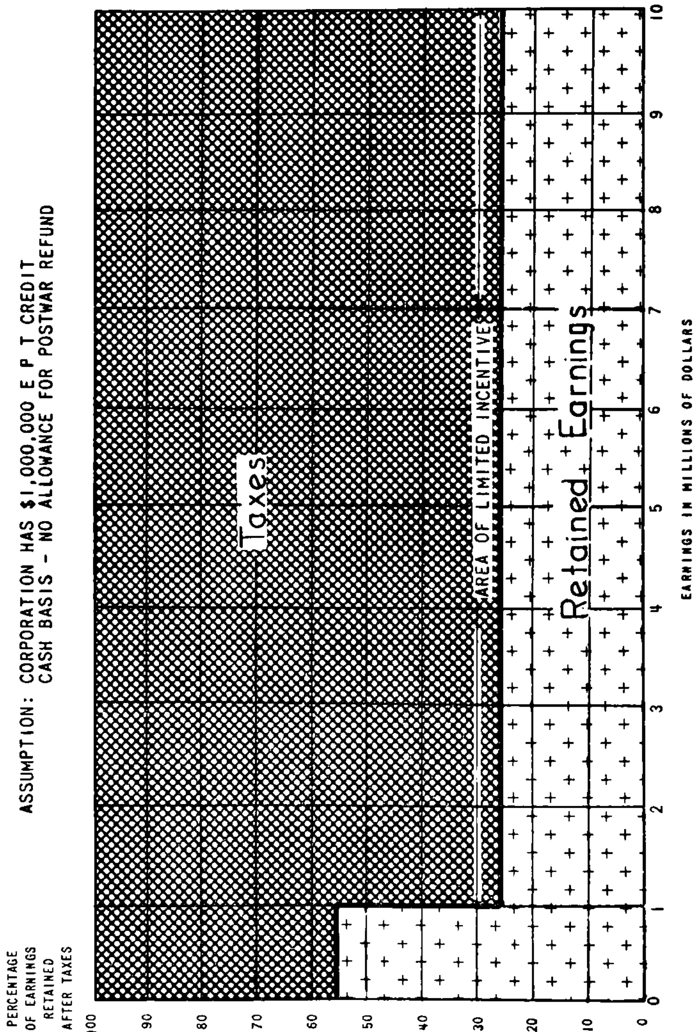
Senator KERR. That was with reference to World War II?

Mr. LITTLE. Yes. I have the charts on the present law.

Next I shall refer to chart 3.

(Chart 3 is as follows:)

CHART III



Mr. LITTLE. Under the House of Representatives plan you keep 55 percent.

Senator MILLIKIN. Does that preceding chart work merely on excess profits, or does it take the whole corporate picture into account?

Mr. LITTLE. It takes the entire tax.

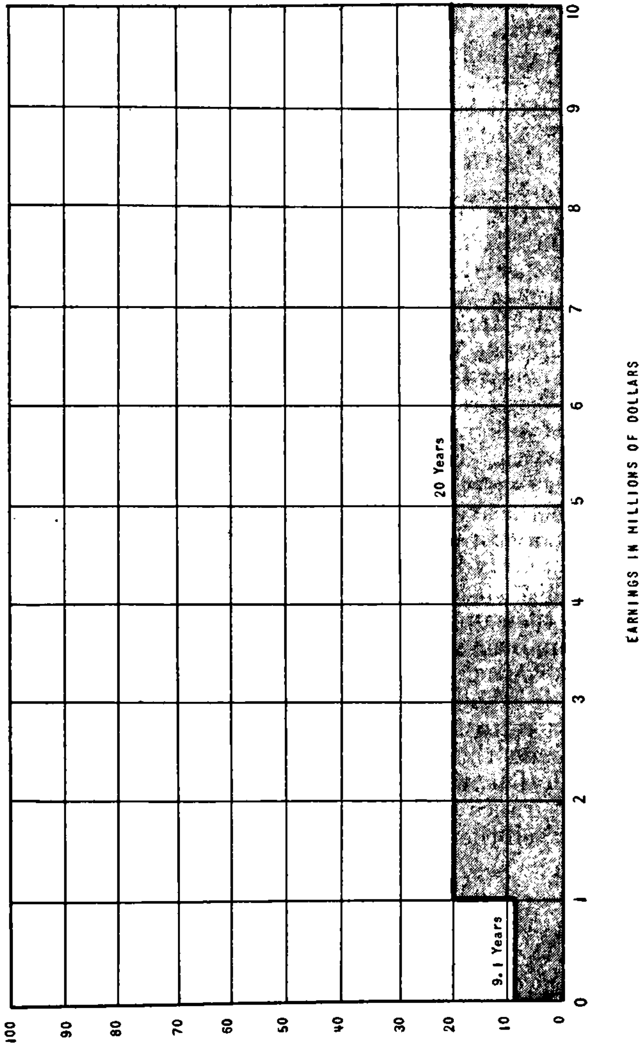
Under the present plan, on this chart 3, you keep 55 percent. Then you drop here to keeping 25 percent. I have not figured the point at which you keep 33 percent as a result of the 67 percent over-all rate. That takes a little complicated algebraic formula. When this line comes up again, this will come up under the new tax, under the 67-percent over-all rate. So you then keep 33 percent, but there again will be one of those gaps of no incentive and then back up.

I will show you how that works again on new plant expansion.

I will next refer to chart 4.

(Chart 4 is as follows:)

CHART IV



Mr. LITTLE. Here again the corporation earns a million dollars a year. It has a million a year tax base and can earn, say, 20 percent before taxes.

On the first million, as long as its expansion is within its first million-dollar base, you get your money back in 9 1/10 years, but the minute you go over this it will take 20 years, today, under this bill, to get your money back. And unless you can qualify for a certificate of necessity I think you will find that it would be very difficult to get corporations to expand and produce more goods, to knock down this inflationary trend, if they have to wait 20 years after taxes to get that money back on any plant expansion. That is a very important point. There will be a jog here again.

Senator MILLIKIN. Would your point be modified if we had general controls?

Mr. LITTLE. Again you have the same problem if you have general controls. And they want more production in certain industries where they cannot get the certificate of necessity. The company that is at this point would still be faced with having to wait 20 years to get the money back on this new machinery.

Senator MILLIKIN. When you get to the point of general controls, part of the theory is to repress certain types of production and expansion?

Mr. LITTLE. Yes.

Senator MILLIKIN. And in theory you overcome the area of need with the special certificates?

Mr. LITTLE. Yes.

Senator MILLIKIN. That you are talking about?

Mr. LITTLE. My answer to that would be that we should do that through control regulations and not through the tax law.

I shall next refer to chart 5.

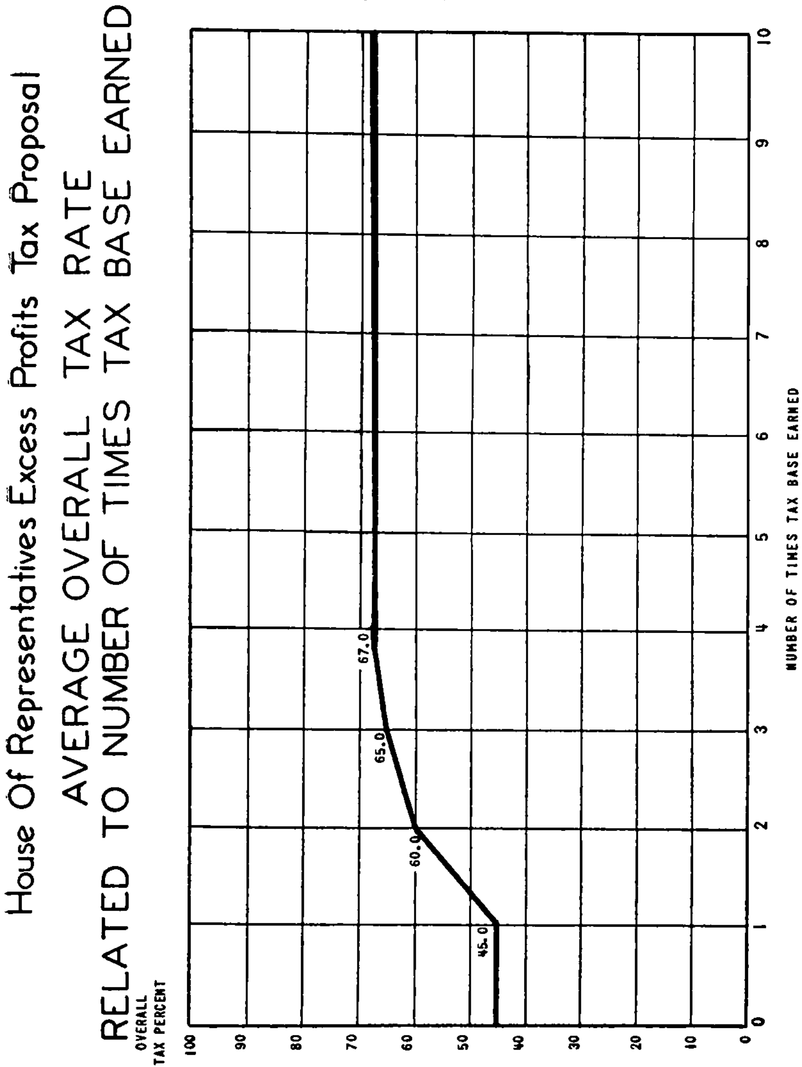
(Chart 5 is on p. 147.)

Mr. LITTLE. This shows the over-all effective rate that corporations will have to pay under the new law.

This is the average over-all rate related to the number of times your tax base, again percentage over-all tax, and here is once, twice, three times your tax base. You start off with 45 percent. If you double the tax base of earnings your average over-all goes to 60, three times 65, and then up to four times where you level out at the 67 percent maximum over-all rate.

Senator MILLIKIN. If there is a fallacy in your chart, you are assuming that it is "business as usual." When you get into over-all controls and start in to full mobilization, you will not have business as usual, and business that is not connected with the defense effort; in connection with that, will there be that same incentive to expand when there is no assurance that they can either get the material to produce the goods or sell them after they produce them?

Chart V

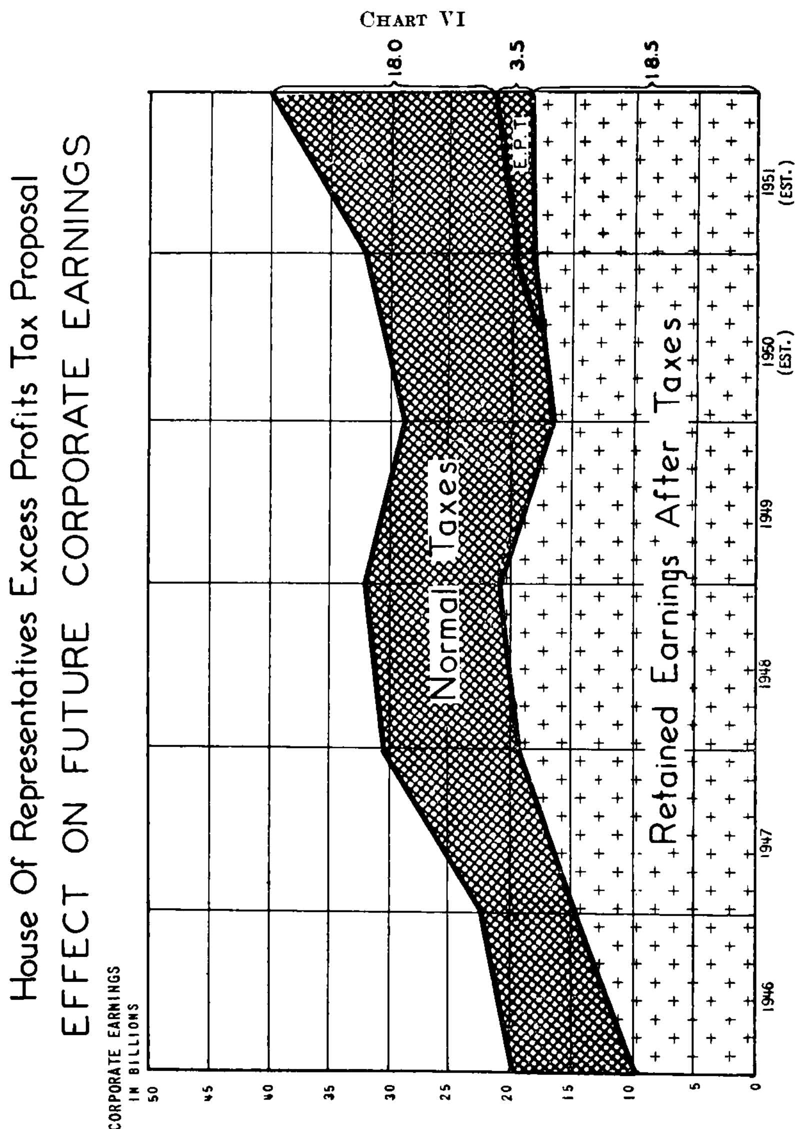


Mr. Little. In the last war there was considerable expansion in industries over than war industries. There are many industries that expand, and I think you will find that the administration's incentive will be to cause many of the essential industries of the country to expand, and to produce more goods rather than letting the inflationary pressures press against your controls and cause black markets, and so forth.

I shall next refer to chart 6.

(Chart 6 is as follows:)

CHART VI



Mr. LITTLE. Under the House of Representatives' proposal this chart shows, going back to 1946 and 1947 and 1948, and estimated next year, about where your corporate dollar goes in the earnings before taxes.

This is the area that goes to normal taxes and surtaxes and retained earnings are in this area. This is in billions of dollars.

I have estimated 40 billions for 1951, and if you get 3½ billions in excess-profits taxes here you will get $18,000,000,000 in normal taxes at your 45 percent rate.

That shows that actually the excess-profits tax is a small portion of the total and, therefore, it might readily be changed to some other form of taxation.

Senator MILLIKIN. I was suggesting a while ago that perhaps we introduce a certain exaggeration into the whole case when we consider the relation of this particular tax to the whole corporate tax picture which we are coming in to.

Mr. LITTLE. Yes. My chief objection to the excess-profits tax theory is that it is most unfair to many small and growing concerns, and no matter how carefully those hardship provisions are drawn for relief, the way they are in the present bill you cannot possibly conceivably take care of every single case. That is why I have come up with this simple, automatic provision.

I shall next refer to chart 7.

(Chart 7 is as follows:)

CHART VII.—*Comparison of additional net corporate tax revenue under House of Representatives excess profits tax proposal and alternate proposal*

HOUSE OF REPRESENTATIVES EXCESS PROFITS TAX PROPOSAL

Additional gross taxes to be received	$3,400,000,000
Less: 10 percent for estimated furuture relief refunds	340,000,000
Additional net taxes to be received	3,060,000,000

ALTERNATE PROPOSAL BASED UPON $40 BILLIONS TOTAL CORPORATE NET INCOME IN 1951

Estimated earnings subject to tax	Tax rate	Taxes
(1) $10,000,000,000	52½ percent (minimum excess profits tax rate)	$5,250,000,000
(2) $20,000,000,000 [1]	54 percent (relief rate)	10,800,000,000
(3) $10,000,000,000	58 percent (estimated average rate for nonminimum corporations electing either invested capital or base period earnings).	5,800,000,000
Total tax under new excess profits tax		21,850,000,000
Less: tax on $40,000,000,000 at 45 percent		18,000,000,000
Additional gross taxes to be received		3,850,000,000
Less: Estimated future relief refunds		
Additional net taxes to be received		3,850,000,000

[1] Since relief rate must be declared by taxpayer 1 year before filing date, real hardship cases only will elect this method. Most borderline corporations would take regular excess profits tax options upon filing and pay an average of more than 54 percent if earned rather than commititng themselves 1 year in advance to the 54-percent relief rate.

Mr. LITTLE. This shows the comparison of what the House of Representatives' bill would do, and what the proposal I am making would do.

Incidentally, I am figuring here about three billion four. I am putting in, which I think you will have to consider, 10 percent for estimated possible relief funds. Of course, it may be that you will finally pass a bill without 722 or 721. So there is no possibility of refunds.

Under the present act I notice there are some possibilities that you will have to make refunds. So I put this in to show that this may only net, after refunds, $3,000,000,000. Then, taking the proposal that I have made, I have estimated that $10,000,000,000 of corporate earnings would be subject to the 52½ minimum rate, which would bring in 5¼ billion. That 20 billion of earnings would apply for the 54 percent special relief rate.

And, really, to lay it on the line 1 year in advance that they will pay that 54 percent rate which would bring in ten billion eight, and then there would be many corporations who would be borderline cases who would say, "But we would rather pay more than 54 percent, if we earn it, rather than to declare 1 year in advance that we will pay 54 percent. So many of them would pay substantially more than 54. I have estimated possibly 58 percent that would bring in five billion eight.

That brings in $21,850,000,000 total taxes less $18,000,000,000 from normal and surtaxes, leaving $3,850,000,000 from excess profits taxes.

So this plan, in my opinion, would bring in more revenue than the House bill and would eliminate every single form of hardship that you can think of.

The only fellow who would be hurt would be the one who did not take advantage of the relief provision of advising the Internal Revenue Department 1 year in advance of tax filing date that he would pay 54 percent and waive irrevocably for that year his rights to elect either the invested capital or base period earnings credit.

Senator TAFT. About the first item of 52½ percent, is that on the theory that everybody pays 52½ percent? You have a general increase of 7½ percent.

Mr. LITTLE. That is on the theory that everybody pays 52½ percent.

Senator TAFT. So it is a combination of an increase in corporate tax and an excess profits tax that you are proposing?

Mr. LITTLE. Exactly. In other words, I started my statement by saying that I was against excess profits tax in principle, but here is the combination of the two which, I think, would be fair. One reason I am against excess profits tax the way it has been worked in the past, is that too many large companies get a free ride and do not pay 1 cent extra tax toward this defense program. That cannot be permitted the next time.

I shall next refer to chart 8.

(Chart 8 is as follows:)

CHART VIII.—*Examples of hardship cases resulting from House of Representatives excess profits tax proposal*

Company	Estimated income			Total tax	Percent of earnings payable in taxes
	Total	Excess profits tax credit	Subject to excess-profits tax		
Blousemaker Inc	$200,000	$59,700	$140,300	$132,090	66
Competitor	200,000	170,000	30,000	99,000	49.5
Evelyn Pearson Inc	200,000	46,950	153,050	134,000	67
Competitor	200,000	170,000	30,000	99,000	49.5
Nashua Textile Co	500,000	46,200	453,800	335,000	67
Competitor	500,000	425,000	75,000	247,500	49
Lonsdale Co	2,000,000	377,800	1,622,000	1,340,000	67
Lonsdale Co. (using base of predecessor company)	2,000,000	2,056,588	0	900,000	45

Mr. LITTLE. We have several situations where we have helped people set up businesses to take over divisions of our company that we formerly operated.

Textron last spring decided to go out of the apparel business and confine itself to the manufacture of fabrics. In that spring period the directors authorized us to set up several of the division managers in business, if they put in $100,000 or $150,000 of equity capital. So we now find ourselves in the position where we have taken back notes for over $2,000,000 from these small concerns against their inventories and plant, when we had no thought of excess-profits tax then in mind.

We now find that Textron has over $2,000,000 tied up in notes receivable. These small companies which have been set up and in which we have no further interest, except as a creditor, it now looks to us under the present tax laws as though it will be almost impossible for them to pay off those obligations when they become due.

We have a situation like this: Blousemaker, Inc., which should make $200,000, and under the new tax law set-up they will have to pay 66 percent of their earnings in taxes, but the fellow across the street who makes exactly the same kind of blouses, with the same sales force, the same styles, and the same sized plant, because he has base-period earnings, that is, a good tax base, will pay 49.5 percent. Blousemaker is not profiteering. They are charging exactly the same price for the same service. Why should they pay that tax premium over their competitor?

The same is true in this loungewear company where they have been set up and started in business. They will pay 67 against 49.5.

Then there is the case of the Nashua Textile Co. Textron purchased the Nashua Manufacturing Co. some years ago. Two years ago when we curtailed our operation we set up, by giving credit to these people, a company which would take over some of the looms and make some of the fabrics which we no longer wanted to make. That preserved jobs for some 400 people in the community. We backed them to the extent of some $480,000 in notes for plant and inventory. They put up $100,000, which they raised in their community. We have no equity interest whatsoever. That company still owes us a lot of money. Under this provision they would pay 67 percent against 49 percent for their principal competitor. They are performing the same service, in the same kind of plant, selling at the same price. Why should they have to pay almost 50 percent more in taxes than their competitors?

Here is another interesting case: The Lonsdale Co., which was set up on June 30, 1948. They purchased the assets of the predecessor company, which had a terrific tax base. They did not purchase the stock of that corporation. If those new shareholders had purchased the stock of that corporation they would have only paid 45 percent taxes, but because they purchased assets instead of stock, just a legal technicality, they end up paying 67 percent.

You have these unusual cases like that. These are the ones that I know of, because Textron has been involved. There must be thousands and thousands of other hardship cases that cannot possibly be cured by technical language in the act. You cannot possibly write enough provisions in the act to cover all of the hardship situations that will be created.

That is why I urge you to try to put in some simple, automatic relief provision whereby these people can come 1 year prior to filing date to the Internal Revenue Department and say, "We will pay a 54 percent rate;" in other words, 20 percent over the normal and surtax rate, "and we will waive for the next year our right to file under either

invested capital or base period earnings method." Let's make it simple.

Senator BUTLER. What does your plan do with reference to utilities that we have been hearing about this morning?

Mr. LITTLE. Well, the utilities would get taxed 52.5 percent under my plan. It is my theory that everybody has got to pay something more. If 52.5 percent is too high for the minimum rate, you can make it 50. I have given you a formula that is completely flexible. You can change the percentages and get the result.

I shall next refer to charts 8 (*a*), 8 (*b*), 8 (*c*), and 8 (*d*).

(Charts 8 (*a*) to 8 (*d*), inclusive, are as follows:)

CHART VIII (*a*).—BLOUSEMAKERS, INC.

Balance sheet, Sept. 30, 1950

ASSETS		LIABILITIES	
Current assets:		Current liabilities	$596, 715. 04
Cash	$151, 197. 71	Long-term liabilities	534, 638. 76
Accounts receivables	393, 773. 90	Reserve for estimated income taxes	29, 529. 25
Other receivables	3, 095. 89	Total value of capital stock (net worth)	62, 369. 23
Finished goods inventory	579, 811. 25		
Total current assets	1, 127, 878. 75		
Fixed assets	85, 630. 43		
Prepaid expenses and deferred charges	9, 743. 10		
Total assets	1, 223, 252. 28	Total liabilities and capital	1, 223, 252. 28

Computation of excess profits tax

[Assumptions: (1) Net earnings of $200,000; (2) industry rate of return 10 percent]

Net worth and borrowed capital	$597, 000
Excess profits tax credit	59, 700
Normal tax (on $59,700)	26, 865
Excess profits tax (on $140,300)	105, 225
Total tax	132, 090=66%

CHART VIII (*b*).—EVELYN PEARSON, INC.

Balance sheet, July 31, 1950

ASSETS		LIABILITIES	
Current assets:		Current liabilities	$801, 182. 24
Cash	$118, 277. 05	Notes payable for fixed assets	47, 310. 48
Accounts receivable	152, 948. 86	Notes payable, offices	100, 000. 00
Other receivables	304. 31	Total liabilities	948, 492. 72
Merchandise inventory	686, 923. 21	Capital stock	50, 000. 00
Total current assets	958, 453. 23	Surplus	22, 515. 84
Fixed assets	59, 365. 63		
Other assets	3, 189. 50		
Total assets	1, 021, 008. 56	Total liabilities, capital stock, and surplus	1, 021, 008. 56

Computation of excess profits tax

[Assumptions: (1) Net earnings of $200,000; (2) industry rate of return 10 percent]

Net worth and borrowed capital	$469, 500
Excess profits tax credit	46, 950
Normal tax (on $46,950)	21, 127
Excess profits tax (on $153,050)	114, 787
Total tax	135, 914=68%
Maximum tax payable (at 67-percent rate)	134, 000

CHART VIII (c).—*Nashua Textile Co.*

Balance sheet, Oct. 1, 1949

ASSETS		LIABILITIES AND CAPITAL	
Current assets:		Current liabilities:	
Cash	$39, 266. 25	Notes payable	$50, 861. 73
Accounts receivable	57, 818. 80	Accounts payable	49, 577. 77
Merchandise inventories	308, 451. 55	Accrued liabilities	38, 158. 85
Supplies and other current assets	6, 495. 92	Provision for estimated taxes	38, 374. 25
Total current assets	412, 032. 52	Total current liabilities	176, 972. 60
Property, plant, and equipment	267, 751. 93	Notes payable (due after 1 year)	333, 804. 74
Prepaid expenses and deferred charges	9, 484. 53	Deferred accounts payable	28, 391. 64
		Capital stock and surplus:	
		Preferred stock	96, 100. 00
		Common stock	3, 922. 00
		Earned surplus	50, 078. 00
		Total capital stock and surplus	150, 100. 00
Total assets	689, 268. 98	Total liabilities and capital	689, 268. 98

Computation of excess profits tax

[Assumptions: (1) Net earnings of $500,000; (2) industry rate of return, 10 percent]

Net worth and borrowed capital	$462, 000
Excess profits tax credit	46, 200
Normal tax (on $46,200)	20, 790
Excess profits tax (on $435,800)	340, 350
Total tax	361, 140=72%
Maximum tax payable (at 67% rate)	335, 000

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CHART VIII (*d*).—LONSDALE CO.

Balance sheet, Sept. 30, 1950

ASSETS		LIABILITIES CAPITAL, AND SURPLUS	
Current assets:		Current liabilities:	
Cash	$46,019.46	Notes payable	$1,000,000.00
Accounts receivable	1,270,421.22	Equipment loans	86,737.38
Inventories	3,558,745.31	Accounts payable	178,062.55
		Accrued liabilities	387,123.86
Total current assets	4,875,185.99	Provisions for Federal income taxes	84,452.99
Investment in wholly owned subsidiaries	1,500.00	Employee deposits	48,787.96
New plant, property and equipment	891,848.86	Total current liabilities	1,785,164.74
Deferred charges	62,588.24	Equipment loans (long term)	13,005.22
Premium deposits	67,833.68	Deferred liability arising from sale of leased property	37,578.95
Total assets	5,898,956.77	Deferred credit resulting from temporary reduction in LIFO inventory	298,005.82
		Capital and surplus	3,765,202.04
		Total liabilities, capital and surplus	5,898,956.77

Computation of excess profits tax

[Assumptions: (1) Net earnings of $2,000,000; (2) industry rate of return, 10 percent]

Net worth and borrowed capital	$3,778,000
Excess profits tax credit	377,800
Normal tax (on $377,800)	170,000
Excess profits tax (on $1,622,200)	1,216,650
Total tax (69 percent rate)	1,386,650=69%
Maximum tax payable (at 67 percent rate)	1,340,000

Calculation of excess profits tax credit based on profits of predecessor company as indicated on Federal income-tax returns

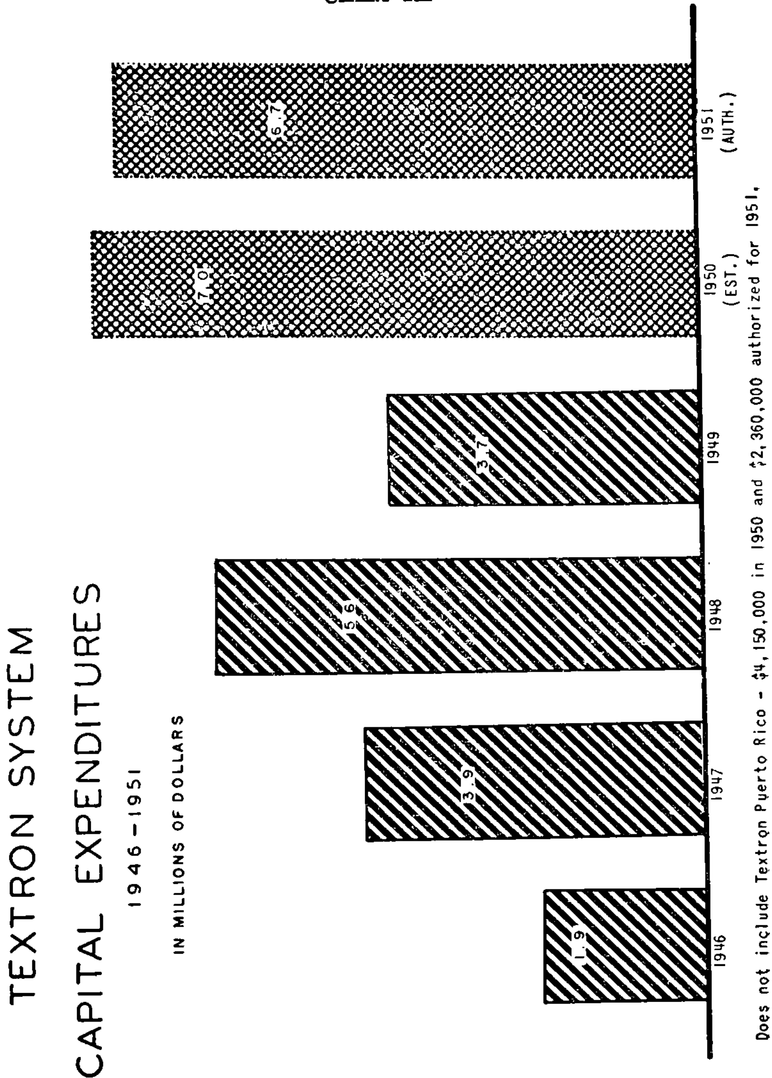
	Profit
1946	$3,000,924
1947	2,512,918
1948	1,744,703
3-year total	7,258,548
Average	2,419,516
Excess profits tax credit (85 percent of average)	2,056,588

Mr. LITTLE. These show the balance sheets which you have there, showing the financial condition of these small companies. I will save time by just turning over to the case of Textron itself.

I shall next refer to chart 9.

(Chart 9 is as follows:)

CHART IX



Mr. LITTLE. Textron has spent $28,000,000 in the last several years for new plants and on new equipment. That is in the States of New Hampshire, Massachusetts, Rhode Island, Connecticut, North Carolina, South Carolina, Georgia, and Alabama.

When you build a new textile plant it takes at least a year or so to bring it up to an earning basis.

These expenditures are now starting to produce results. The result is that Textron has doubled its productive capacity now over what it had in the base period, and has doubled its potential earnings. But we got this money largely from transferring inventories that were tied up in our apparel divisions into new plants. So the result is that

we have not increased our net equity in our business, but we have doubled our earning capacity. There is an interesting hardship case that is not covered at all.

The cases that are covered in this House bill are the ones where you get more capital in, or retain earnings, and you get credit for that extra retained earnings. Here we have taken the assets we had in the company and put them to better use. We get no benefit whatsoever for this enormous increase in capacity, which I claim is going to come in very handy in the next few years in producing more essential textile products and holding down this inflationary trend. But we are going to get tremendously penalized because we have put all of that money into plants, which is now starting to produce earnings.

In closing, I spent 4 hours last night reading the House tax bill. I have always considered that I was able to understand the tax laws, but, gentlemen, I throw my hands up on this one. My analysis of this is that in a period where every man-hour we have should be used to produce something, this tax bill is going to cause hundreds of millions of man-hours to be diverted into litigation and diverted from productive effort.

I also predict that this tax bill will divert hundreds of millions of dollars that should be going to the Treasury and that are badly needed, into the pockets of the accountants and the lawyers. This bill is a bonanza for the country's accountants and lawyers.

I thank you, gentlemen.

The CHAIRMAN. We shall include your prepared paper as a part of the record.

(The prepared statement submitted by Mr. Little reads, in full, as follows:)

STATEMENT OF ROYAL LITTLE, PRESIDENT OF TEXTRON, INC.

My name is Royal Little. I am president of Textron, Inc. I am appearing for the purpose of urging upon this committee the necessity of adopting an excess profits tax law which will not foster monopolies, discourage the creation of new enterprises, or prevent the normal growth of established businesses. The bill which has been introduced in the House of Representatives will, in my opinion, seriously disrupt the economy and will be particularly harmful to new and growing enterprises.

The proposed law fosters waste and inefficiency. It encourages extravagances in operational costs, whereas the tax program should encourage economies in operation by permitting corporations to retain the earnings resulting from such economies. This type of law tends to discourage expansion and to further entrench old, well-established companies.

Chart I, attached, illustrates graphically that under the World War II type of excess profits tax, corporations were placed in the position of having no incentive to make greater profits. Also, under the World War II type of excess profits tax, capital investment in new business or in expansion was discouraged. Chart II shows that under the old type of excess profits tax it would take 100 years for an investor to recover the money he has invested, if his earnings are subject to the tax.

The same situation exists, though to a lesser extent, under the House of Representatives' proposal. Chart III shows that incentive for further earnings is lost when a corporation is, in effect, dealing with 25 cents on the dollar. Chart IV illustrates the effect of the proposed new law on possible plant expansion. Obviously, expansion will be discouraged when an investor must wait 20 years to get his money back. For most new enterprises, which are rarely overcapitalized, the effective tax rate will be the proposed maximum of 67 percent (see chart V). Such new businesses will be at a serious competitive disadvantage, taxwise, with their financially well established competitors.

Chart VI illustrates the effect of the proposed excess profits tax on future corporate earnings.

I cite you the following hardship cases, with which I am familiar (see chart VIII):

Blousemaker, Inc.—This corporation was formed on August 5, 1950, to take over and operate Textron's blouse division. Textron assisted the new owners to get established by taking back notes aggregating $848,000 for plant and inventory. Under the proposed law this new and struggling company will pay in taxes 66 percent of its earnings whereas a well-established competitor will pay only 49½ percent (see chart VIII (*a*)).

Evelyn Pearson, Inc.—This company was organized in June 1950 and purchased Textron's lounge-wear division. Textron helped the new owners to get started by taking notes aggregating $694,000 for the plant and inventories sold to the new company. Under the proposed law this company will pay the maximum of 67 percent in taxes as against a 49½ percent effective rate for established competitors. This small company, heavily in debt, will be paying 35 percent more of its earnings in taxes than its financially well established competitors (see chart VIII (*b*)).

Nashua Textile Co., Inc.—This corporation was organized on November 4, 1948, with equity capital of $100,000. Textron sold the new company certain machinery and inventories and took long-term notes for the purchase price. This company has a large indebtedness and under its present financial set-up will be forced to pay the maximum of 67 percent of earnings whereas its established competitors will be paying at a rate of about 49 percent (see chart VIII (*c*)).

Lonsdale Co.—This company was formed on June 30, 1948, to purchase the assets of an old New England textile firm. Because the new company purchased assets, its excess profits tax credit under the proposed legislation will be only $377,800, whereas if the new owners had purchased the stock of the old company instead of assets, its excess profits tax credit would be $2,056,588. The result is that this new company will be paying an effective tax rate of 67 percent whereas the effective rate would have been 45 percent had the purchase been handled in a different way (see chart VIII (*d*)). The Lonsdale case differs from the three hardship cases previously mentioned, because Lonsdale is not undercapitalized. Lonsdale's principal competitor sells products similar to Lonsdale's at approximately the same open-market prices. Both companies have approximately the same working capital per employee, per spindle, and per dollar of sales. The competitor is nearly 10 times larger than Lonsdale, but it is obviously unfair that Lonsdale should, by a technicality in the law, be forced to pay 67 percent of its earnings in taxes when its competitor will pay less than 50 percent of its earnings in taxes.

Textron itself will be severely discriminated against under the proposed law. At the end of 1949, Textron's total plant investment was approximately $13,000,000. Since that time approximately $15,000,000 has been expended or committed for expenditure for new plants and modernization of existing plants in New Hampshire, Rhode Island, Massachusetts, Connecticut, North Carolina, South Carolina, Georgia, and Alabama (see chart IX). As a result of this expansion program Textron has more than doubled its productive and earning capacity with no increase in net worth. This enormous increase in capacity has been financed through the liquidation of apparel inventories and through 5-year term loans of approximately $10,000,000. Why shouldn't Textron be allowed at least twice its base period earnings credit in view of its doubled plant capacity and doubled potential earnings? Why should Textron be penalized because it has expanded while less progressive competitors who have maintained the status quo will gain a substantial tax advantage?

In my opinion the relief provisions of the proposed law for new and growing businesses are inadequate. The cases I have cited demonstrate this.

I believe that a fair excess profits tax bill should include the following:

(1) An excess profits tax credit of 100 percent of average earnings for the best 3 years in the period 1946–49. The 85-percent figure in the House bill means, in effect, that the tax is not only on profits deemed excessive, but on 15 percent of profits which are considered normal.

(2) An excess profits tax credit of 12 percent of all invested capital, instead of the sliding scale provided in the House bill. This method of equal treatment for all corporations is obviously fair. Also, all indebtedness with a maturity in excess of 1 year should be included as invested capital.

(3) A minimum excess profits tax credit of $100,000 for all corporations, rather than the $25,000 minimum of the House bill. The House bill minimum is so low

that relatively few small corporations would benefit by it. A provision should be included to prohibit duplication of exemption for corporations under common control.

(4) An over-all minimum of total taxes of 52½ percent for corporations computing the excess-profits tax on either the base period earnings formula or on the invested-capital formula.

(5) The effective date of the new tax should be January 1, 1951. Admittedly this is a "defense" tax, calculated to give the Government that portion of profits which are excessive because of the defense program. The operation of the program has just begun and its impact on corporate profits will certainly not be felt until 1951.

(6) A simple automatic relief provision for all hardship cases. The relief provisions in the World War II excess profits tax law are unsound and unworkable. I have a proposal which I feel will afford relief in all hardship cases and which can be applied simply and automatically.

My proposal is that all corporate taxpayers be permitted the option, prior to March 15 of the current tax year, of electing to pay an excess-profits tax amounting to 20 percent of the total normal and surtax payable on such current year's earnings. This would, in effect, result in a special relief rate of approximately 54 percent. Having made the election to pay the special relief rate, the taxpayer would thereby waive the right to adopt either the invested-capital method or the base period earnings method of computing the excess-profits tax for that year. It would, of course, be necessary under this proposal to give the taxpayer a further option to review his situation if the normal or surtax rate applicable to the taxable year should be changed by legislation.

I believe that more revenue would be raised under this proposal than under the bill which has been introduced in the House of Representatives. Chart VII sets forth a comparison of the additional revenue to be received under the House bill and under the alternative proposal I have made.

Under such a provision new businesses and growing businesses will be protected and hardship cases will be effectively eliminated.

I urge this committee to adopt this alternative plan in conjunction with the proposed invested capital and base period earnings credits provisions.

The CHAIRMAN. Does anyone have any questions of Mr. Little?

Senator MILLIKIN. I think it should be said that when the gentleman said that he can understand the tax law, I think that is an understatement.

Mr. LITTLE. I give up now.

The CHAIRMAN. We thank you.

Mr. LITTLE. Thank you, Mr. Chairman.

The CHAIRMAN. We will next hear from Dr. Allen B. Du Mont.

STATEMENT OF DR. ALLEN B. DU MONT, PRESIDENT, ALLEN B. DU MONT LABORATORIES, INC., CLIFTON, N. J., AND CHAIRMAN, NATIONAL CONFERENCE OF GROWTH COMPANIES

Dr. DU MONT. My name is Allen B. Du Mont, and I am president of the Allen B. Du Mont Laboratories, Inc., of Clifton, N. J.

I am here today as the authorized spokesman for a group of companies in diversified businesses and industries. I am filing with your committee a list of those companies which have organized informally in the National Conference of Growth Companies and which have expressly approved recommendations which I shall submit to you.

We are acutely aware of the gravity of the world situation and the necessity for committing our Nation to such constructive defense action as may be necessary.

We are conscious of an outlook which pictures many sacrifices not only for individuals but for every unit and segment of our social and economic community.

We recognize that this is no time for the injection of selfishness or selfish attitudes and we are not here as selfish pleaders.

We are here because such awareness, such consciousness, and such recognition of realities demand that every action taken to meet our grave problems be the result of decisions based on the soundest and most constructive foundations.

What price sacrifice today, if in the sacrificing we destroy our national ability to produce for further sacrifices in what may be graver times ahead?

Does the Government need more revenue to meet increased defense spending? The answer clearly is "Yes." Then why not raise that revenue in the most efficient manner?

Virtually every national business and industrial organization in the country, and many individual corporations, have told our Government, directly or indirectly, that they are ready and willing to pay more taxes and in the amounts specified by the administration as needed at this time. They also have been unanimous in their condemnation of the so-called excess profits tax as the most inefficient and most damaging means of producing revenue. It is also the most unfair.

According to announcements made in connection with action by the House Ways and Means Committee on its excess profits tax bill, 70,000 corporations will be subject to its levy. That means that only about 1 in 8 will be taxed. Such selectivity cannot possibly be justified and should not be condoned.

Every company in the group I represent joins with all of the others in condemning and opposing the so-called excess profits tax. We are hopeful that this committee will follow recommendations for an emergency profits tax in the form of a flat rate levy on corporate income.

However, should you find the political and emotional pressures too great, and a so-called excess-profits tax is inevitable, we are confident you will recognize the importance of seeing that companies who represent the dynamic segment of industry are not disastrously affected.

By dynamic segment, I mean those companies whose growing and expanding productivity are adding to the strength of our Nation.

That dynamic segment can be better protected, can have its incentives preserved to a greater extent, and will be accorded more equitable treatment if the so-called excess-profits tax bill is amended to incorporate recommendations which I am pleased to outline here. A more detailed presentation of the recommendations is provided in a supplemental brief to be filed.

Senator MILLIKIN. I notice that you are speaking for the National Conference of Growth Companies. May we assume that what you have to say here are their recommendations? Are there any exceptions, so far as the growth companies are concerned?

Dr. DU MONT. You were supposed to get a list of the companies that had approved the recommendations in this memorandum.

Senator MILLIKIN. Do you know of any companies that do not approve of the recommendations?

Dr. DU MONT. No.

Senator TAFT. They appear in the longer memorandum at the end?

Dr. DU MONT. That is correct.

1. No discrimination should be made in the computation of the excess profits tax credit as between corporation on an invested capital basis and those on an average earnings basis with respect to new venture capital, undistributed profits, and increased borrowed capital in the years following the base period.

This was originally in our proposal. This has been pretty well taken care of in the House bill. That is pretty well handled.

2. Full allowance instead of 85 percent should be made for base period net income in the determination of excess profits tax credit.

3. Broaden relief provisions so that the expenses incurred in pioneering or developing a new product or service and creating a market therefore are not used to reduce the base period earnings.

4. Broaden relief provisions with respect to abnormalities in income in the excess profits tax years. This is designed to exclude from excess profits tax such profits resulting in the taxable period from development and research carried on in the base period.

5. Revise policies in connection with administration of special relief provision. This is directed to the alleviation of hardship situations, the recommendation being that the administration of the law be more intelligently and sympathetically dealt with.

6. Revise and liberalize so-called growth formula applied to average earnings in base period to arrive at excess profits tax credit for true growth companies. A true growth company is defined as one that meets any one of the four requirements outlined in the supplemental brief and it is recommended that the taxpayer be accorded option of four alternative methods of applying the growth formula to the end that the excess profits tax credit so developed could exceed the base year in the base period.

Senator MILLIKIN. What, roughly, are those?

Dr. DU MONT. It should be under 6 in the brief.

The CHAIRMAN. That is in the supplemental brief attached.

Senator TAFT. I have a copy of it.

Dr. DU MONT. The pages are not numbered, but it is about the fifth or sixth page. It is headed figure 6 at the top here.

Senator TAFT. Is there any possibility of taking into account increase in production, or possibly increase in productivity of the number of men employed as a means of increasing the excess profits base?

Dr. DU MONT. We have considered that.

Senator TAFT. After all, what the country is interested in is increase in production.

Dr. DU MONT. That is right.

Senator TAFT. And it seems that if a man makes more profit because he has increased his production or the productivity of his men that it is somewhat harsh to tax that as an excess profit.

Dr. DU MONT. That is right. It happens to be that most of these recommendations do not go along that particular line.

Senator TAFT. Maybe it is too complicated.

Dr. DU MONT. I do not know that it is impossible. In view of the fact that it is a tax on earnings we try to define it more or less in terms of earnings. It could very well be increase in production or increase in the number of people employed. I think it would be possible to do that.

Senator TAFT. A man who makes twice as much money because he has increased the production of his plant by two, it would seem to me,

would be entitled to better treatment than the man who has increased his prices.

Dr. Du Mont. That is right.

7. Use the experience formula to provide relief for growth occurring after base period for reasons largely unrelated to defense economy. This pertains to new companies and companies experiencing sharp growth at the end of and after the base period.

The recommendations on which this outline was based are the product of extended discussion by numerous growth company executives and tax experts.

We submit them with the firm conviction that even if they are incorporated into a so-called excess profits tax bill you will not have the right kind of legislation but they will relieve some of the inequities of the current measure and will help to preserve incentives to growth and expansion.

I have said before, and I repeat to you, that excess profits tax is a masquerade. Its label is false. It implies that every corporation subject to the tax is profiteering from war. It places a stigma on the corporate management and makes it appear as an unpatriotic element of our country which must pay penalties for success in building to keep America strong. And then—it fails to live up to its implied promise of taxing excess profits.

The avowed intent of authors of excess profits tax proposals is to tax profits directly or indirectly acquired as the result of war or defense spending. There is no quarrel with that intent or objective. But excess profits tax does not do that. It imposes tax penalties on normal profits by arbitrarily calling them excessive.

The worst single feature of the bill as applied to growth companies is that which attempts to distinguish between normal and excess profits. In doing so, it assumes that no growth company would have continued to grow in 1950 except for the war.

My company is an example of such fallacy. It shows continuous, substantial uninterrupted growth each year over the previous year in the base period by any standard. Yet under the House bill, any profits in excess of 85 percent of 1949 earnings are labeled excessive.

Senator Millikin. What percentage of your product goes into the Military Establishment?

Dr. Du Mont. In normal times?

Senator Millikin. Prior to July of this year.

Dr. Du Mont. Well, prior to July of this year I would say somewhere around 10 percent of our product went into the Military Establishment. There has been no appreciable change in that since July of this year.

Senator Millikin. Are they accelerating the amount of orders they are giving to you?

Dr. Du Mont. No. In our industry there has been very little in the way of orders. We anticipate that sometime around January or February of next year that it will be very, very heavy, but it is not ready yet to award the bids, which are not ready.

Senator Millikin. So your industry has not felt the impetus to business due to the war?

Dr. Du Mont. No, we have not felt any impetus. As a matter of fact, most manufacturers have cut production from 10 to 30 percent

because of the scarcity of materials. So we are still producing at a high rate, but we are not producing what we anticipated.

Senator MILLIKIN. Assuming that a formula could be worked out for growth companies, is there any reason why the first half of 1950 should not be included in the formula?

Dr. DU MONT. No; that would help very much. If you used the first half of 1950 that would help in the formula.

I would just like to point out some things on these charts that we have here. The first one is on "Sales." This curve shows the sales growth of the company from 1946 to 1950. You see, we start off with around $2,000,000 in 1946, and end up with around $80,000,000 this year.

Senator MILLIKIN. Do you manufacture or do you assemble, or both?

Dr. DU MONT. We manufacture cathode tubes. We were the first manufacturer of those tubes. We developed them for the industry. We manufacture television receivers. We manufacture television transmitters, and also transmitters for the Government. We manufacture cathode ray oscillographs, which are instruments used largely in laboratories in the Government. And then we own three television stations and have a television network. So we are in all phases of the television business. We are the only company that is in all phases of the televsion business exclusively. There are others that are in all phases, but they are in refrigerators and washing machines and everything else, too.

The point which is perfectly obvious from this chart is that by definition progress is supposed to stop in 1949; in other words, no company is supposed to grow after 1949. You can see from the curve that obviously that should not cut off at 1949. It has nothing to do with the war.

I would like to have the next chart on "Profits." This is the profits curve, and shows about the same growth as the sales curve. It happens that the abscissa on this one is a little squeezed up. If you spread that out over the whole chart you will find it is at about the same rate.

Outside of the loss year in the first year, our profits run between 7 and 9 percent of sales, somewhere around that amount.

It is interesting to note that shows the net income before taxes, but if you take the net income after taxes, we have made approximately 12.5 million in that period of time.

What did we do with that 12½ million? A good portion of that would be considered excess profits. We spent 8 million for new plants and equipment. We put in 10 million into the business for additional inventory and 4 million for additional accounts receivable. So we made 12½ million over that period, but we put 22 million in the business during that period.

Where did we get the $22,000,000 to put into it? We had three stock issues of $12,000,000. So 12 plus 12 is 24, and we put 24 into the business. In other words, when you show these profits like that, they look high.

What are we doing? We are essentially creating services and work for people.

I would like to have this chart here which shows the number of people that we have put on in our plant. We start off in 1946 with 998, and you can see that the growth in the number of employees is

pretty much proportional to the increase in sales. And I think, Senator Taft, you just referred to that. It is not a question of raising prices to increase the profits. It is a question of keeping the profits. Maybe the percentage goes down a little as you get bigger, but it is essentially the same.

This is another chart which I will touch on for a second. It shows the three companies, A, B, and C, that made the same amount of money from 1947 to 1949; in other words, company A made half a million dollars in 1947, a million dollars in 1948, a million and a half in 1949, and 2 million in 1950, but all three companies made a total of $3,000,000 between the base years. The growth company pays 64-percent tax. Company B, that has not changed at all, still pays an excess-profits tax. He pays the tax of 52.6 percent or that 7.6-percent excess-profits tax, whereas the company C that went from a million and a half to half a million just pays the normal tax of 45 percent.

That is simply gotten up to show the effect of the excess-profits tax on the growth companies.

Continuing with my statement: Our profits exceeded that amount in the first half of 1950, before Korea. We have continued to grow and earn profits since Korea even though we have been adversely affected, not helped by the war.

Even if we had operated at some loss from July 1 to the end of 1950 we would still be said to have "excess" profits for the year, under the House bill. Is it logical to say that our growth stopped in 1949?

Other growth companies' situations will parallel our case. We cannot urge you too strongly to give favorable consideration to those steps which will relieve the present bill of its many features damaging to our economy. For as it now stands—

1. It is the most inefficient way of producing revenue, that is, the excess-profits tax.
2. It is unfair and inequitable.
3. It is inflationary.
4. It will be an administrative nightmare.
5. It will penalize and stop industrial growth.

In conclusion, we urge, first, an emergency profits tax—a flat rate levy on corporate income sufficient to meet defense needs, or, secondly, amendment of the proposed bill to preserve incentives to growth and expansion so that we may keep America strong.

The CHAIRMAN. Your supplemental brief will be incorporated in the record.

(The supplemental brief of Dr. Du Mont is as follows:)

SUPPLEMENTAL BRIEF SUBMITTED BY DR. ALLEN B. DU MONT, CHAIRMAN, NATIONAL CONFERENCE OF GROWTH COMPANIES

SUMMARY OF RECOMMENDATIONS AGREED UPON BY COMMITTEE

1. No discrimination in the computation of the excess profits tax credit as between corporations on an invested capital basis and those on an average earnings basis with respect to new venture capital, undistributed profits and increased borrowed capital in the years following the base period.
2. Full allowance for average base period net income in the determination of excess profits tax credit (Treasury Department recommends only 75 percent and in World War II limited to 95 percent.)
3. Broaden relief provisions with respect to elimination of abnormal deductions in base period. This relates more particularly to the definition as an

abnormal deduction of expenses or net losses incurred during the base period in pioneering or developing a new product or service and creating a market therefor.

4. Broaden relief provision with respect to abnormalities in income in the excess profits tax years. This is designed to exclude from excess profits tax such profits resulting in the taxable period from development and research carried on in the base period.

5. Revision of policies in connection with administration of special relief provision. This is directed to the alleviation of hardship situations, the recommendation being that the administration of the law be more intelligently and sympathetically dealt with.

6. Revision and liberalization of so-called growth formula applied to average earnings in base period to arrive at excess profits tax credit for true growth companies. A true growth company is defined as one that meets any one of four requirements outlined and it is recommended that the taxpayer be accorded option of four alternative methods of applying the growth formula to the end that the excess profits tax credit so developed could exceed the base year in the base period.

7. Use the experience formula to provide relief for growth occurring after base period for reasons largely unrelated to defense economy. This pertains to new companies and companies experiencing sharp growth at the end of and after the base period.

COMPANIES JOINING IN RECOMMENDATIONS OF NATIONAL CONFERENCE OF GROWTH COMPANIES

Admiral Corp., Chicago, Ill.
American Airlines, Inc., New York, N. Y.
American Home Products Corp., New York, N. Y.
Aerovox Corp., New Bedford, Mass.
Austin-Western Co., Aurora, Ill.
Cochran Foil Co., Inc., Louisville, Ky.
Corning Glass Works, Corning, N. Y.
Deep Rock Oil Corp., Tulsa, Okla.
Diamond Portland Cement Co., Middle Branch, Ohio.
The Dow Chemical Co., Midland, Mich.
Elastic Stop Nut Corp., Union, N. J.
Ex-Cell-O Corp., Detroit, Mich.
Fram Corp., Providence, R. I.
Frontier Refining Co., Denver 2, Colo.
General Portland Cement Co., Chicago, Ill.
Gerber Products Co., Fremont, Mich.
Goebel Brewing Co., Detroit, Mich.
Granite City Steel Co., Granite City, Ill.
The Hallicrafters Co., Chicago, Ill.
The Haloid Co., Rochester, N. Y.
Hytron Radio & Electronics Corp., Salem, Mass.
Hood Chemical Co., Inc., Philadelphia, Pa.
Indiana Limestone Co., Inc., Bedford, Ind.
Interstate Bakeries Corp., Kansas City, Mo.
Kennametal, Inc., Latrobe, Pa.
Kirsch Co., Sturgis, Mich.
LeBlanc Corp., Lafayette, La.
Lily-Tulip Cup Corp., New York, N. Y.
Medusa Portland Cement Co., Cleveland, Ohio.
Merck & Co., Inc., Rahway, N. J.
Micromatic Hone Corp., Detroit, Mich.
National Research Corp., Cambridge, Mass.
Olympic Radio & Television, Inc., Long Island City, N. Y.
Pfeiffer Brewing Co., Detroit, Mich.
Pittsburgh Metallurgical Co., Inc., Niagara Falls, N. Y.
Reda Pump, Bartlesville, Okla.
Riley Stoker Corp., Worcester, Mass.
Rulane Gas Co., Charlotte, N. C.
Southland Paper Mills, Inc., Lufkin, Tex.
Sperry Corp., New York, N. Y.
Standard Products Co., Cleveland, Ohio.
Steel Products Engineering Co., Springfield, Ohio.
Sylvania Electric Products, Inc., Salem, Mass.
Tennessee Products & Chemical Corp., Nashville, Tenn.
Toklan Royalty Corp., Tulsa, Okla.
Tung-Sol Lamp Works, Inc., Newark, N. J.
Willys Overland Motors, Inc., Toledo, Ohio.

BRIEF

The following pages contain amplification of recommendations for improving the so-called excess-profits tax bill as presented to the Senate Finance Committee on December 5, 1950.

1. Identical treatment of new venture capital and retained earnings to corporations whether on income or invested capital basis

The so-called excess-profits tax laws in effect during both wars took into account as a measure of normal earnings—crude though they were the results for a prior period. That feature is incorporated in the Treasury's suggestions submitted to you on November 15. It is assumed, therefore, that whatever excess profits tax law is enacted it will accord to corporations the option of computing an excess profits tax credit on an invested capital basis or on a so-called average base period net income basis.

Obviously if a taxpayer is on the invested capital basis his credit rises or falls as his invested capital increases or decreases. The increase may be attributable to either the bringing in of new venture capital or by the plowing back into the business of undistributed profits. In either event the corporation on an invested capital basis benefits from year to year from the resultant increase in invested capital.

This is not so, however, with respect to the corporation on an average earnings basis. Its credit becomes fixed except for an increase resulting from the introduction of new venture capital. In other words, he receives no benefit in the form of an increased credit because of either undistributed profits or increased borrowed capital. It is only equitable that corporations on an average earnings basis receive the same treatment in this respect as those on an invested capital basis.

2. Elimination of any percentage reduction of base period earnings in the determination of the so-called excess profits tax credit

The Treasury Department's proposal recently submitted to you suggests that the credit be based on 75 percent of the average income of the best 3 years out of the 4-year period 1946 to 1949, inclusive. During World War II the credit was based on 95 percent of the average earnings during the 4-year period 1936 to 1939, inclusive.

Secretary of the Treasury Snyder, in submitting the Treasury Department outline of the so-called excess profits tax bill, attempted to defend his suggestions for the inclusion of only 75 percent of prior period earnings by simply stating that such a provision would be necessary to raise the revenue requested by President Truman. Nevertheless, he did defend an excess profits tax law as such, and that it should be applied to what he termed "defense profit." Certainly the application of an arbitrary 25 percent discount to prior period earnings is a naive approach to the determination of defense profits. It is features like this in an excess profits tax law that make it all the more inequitable, and particularly to growth and expanding companies.

If the only basis for it is, as Secretary Snyder testified, to raise the required revenue, then an excess profits tax law should still not have such a feature, and whatever additional revenue is then required should be raised by some other means, such as for instance, an increase in the regular corporation income tax rates.

It may be argued—and in fact it already has been—that some discount is justified by the increase in aggregate corporate earnings. However, none of these arguments ever take into account the fact that all income has increased—wages and farm income as well as profits from industry. The inflation factor—that is, the depreciated purchasing value of the dollar seems always to be ignored when corporate profits are referred to

3. Broaden relief provisions with respect to abnormal deductions in base period

Secretary Snyder in testifying before this committee on November 15 did not spell out suggestions for the relief of hardship cases, leaving such details for the Treasury to propound later. He did say, however, that the wartime relief provisions should be revised to avoid extremes.

The so-called excess profits tax laws in effect during World War II did provide for the elimination of abnormal deductions in the base period in section 711. The intentions of Congress were quite admirable in this respect. However, the administration of this section placed an intolerable burden of proof by the invocation of section 711 (b) (1) (K). There is urgent need for the broadening of any section dealing with this subject matter.

The law should clearly define as an abnormal deduction the expense or net loss incurred during the base period in pioneering or developing a new product or service and creating a market therefor.

4. Broaden relief provisions with respect to abnormalities in income in taxable period

Abnormal situations of this type were dealt with in World War II in section 721. A similar section in a new bill should also provide for a liberalization of these provisions, designed to exclude from excess profits tax, such profits resulting in the taxable period from development and research carried on in the base period.

5. Revision of policies in connection with administration of special relief provision

This pertains to relief provisions similar to those incorporated in section 722 of the so-called excess profits tax laws in effect during World War II. In this respect again Congress devoted a great deal of time and attention in an effort to alleviate hardship situations by incorporating section 722. It was pointed out by Secretary Snyder in his appearance before this committee on November 15 that that section of the law brought about the filing of 54,000 claims, many of which are still pending. The fault to be found with this section is not so much with the law itself as it is the lack of intelligent and sympathetic administration by the Treasury Department. Perhaps to a certain extent that is inevitable, and if so, steps should be taken in drafting a similar section to couch it in such terms as to improve and accelerate its administration.

6. Revision and liberalization of so-called growth formula applied to average earnings in base period to arrive at excess profits tax credit for true growth companies

Congress in the enactment of the so-called excess profits tax laws during World War II was well aware that the merely averaging of earnings during the so-called base period wrought a grave injustice to companies with growth and expansion An effort was made to cope with this, but it fell woefully short of its objective insofar as true growth companies were concerned.

It might well be at this time to define what we consider to be a true growth company. It should meet one of the following four requirements:

(*a*) The earnings in the second half of the base period are at least double those of the first half of the base period.

(*b*) Earnings show a constant increase throughout the base period of at least 15 percent in each succeeding year over the preceding year.

(*c*) There is a 10-percent increase in each year in the base period in (1) net earnings, and (2) payroll as reflected in social-security tax returns.

(*d*) A consistent and substantial expansion in earnings, net worth, or sales as compared with the average of all corporate business.

We hold no brief for the figures used. These criteria of a true growth company are illustrative only, and the result of the deliberations of our group over a relatively short period of time. Undoubtedly they could be expanded or improved upon, but at any rate companies of this type are entitled to a special relief provision and that can best be incorporated in connection with the growth formula.

During World War II the application of the growth formula was limited to the best year in the base period. It is recommended that this be liberalized. It is too restrictive in that it presupposes a growth company has reached full maturity by the end of the base period. Perhaps some limitation is necessary, and accordingly it is suggested that companies qualifying as outlined above be permitted to avail themselves of the following alternative or similar computations of a growth formula adjustment.

First the application of the growth formula cannot result in a larger credit than the larger of the best year in the base period or the year immediately following the base period, if the best year in the base period is the last one. This meets an argument that if the best year in the base period is not the last year there is a presumption that the company is not a growing and expanding one.

As a second alternative before computing the growth formula, the worst year in the base period could be eliminated and substituted therefor 75 percent of the average of the remaining 3 years, and then applying the growth formula without limitation. This has the effect of reducing the extent of the growth formula adjustment so computed but would then permit its application without a ceiling.

The third alternative might be to adjust the computation of the growth formula itself. In the law effective during World War II it was computed by determining

the excess of the aggregate income during the last half of the base period over the first half of the base period—dividing that excess by two—and adding that result to the aggregate income for the last half of the base period—and then dividing that total by two. This result, of course, was then subject to the limitation of the best year in the base period. It is suggested that the ceiling limitation be removed if the computation were revised by dividing the excess of the aggregate of the last 2 years of the base period over the aggregate of the first 2 years of the base period by four instead of two.

As a final alternative it is suggested to eliminate 1946 earnings in the computation of the growth formula and change the base period to the 4 years, 1947 to 1950, inclusive, with the present growth formula limitation, and use 1950 earnings to be determined by annualizing the earnings of the first half of 1950, that is, the earnings before the Korean invasion. The annualization could be at the same ratio as total earnings in the base period years 1946 to 1949 bear to the total first half earnings in those years in order to provide for any seasonal factor. If deemed advisable the annualization could then be limited to not more than double the first 6 months earnings in 1950, so as to further limit the resultant credit from the employment of 1950 first half results.

7. Use of experience formula to provide relief for growth occurring after base period for reasons largely unrelated to defense economy

Recommendation.—In the case of new companies and companies experiencing sharp growth at the end of, and after, the base period for reasons largely unrelated to the war or defense economy, determine the average base period net income by reference to earnings after the base period after normalizing such earnings by the application of known and public indexes.

Example.—With respect to any particular year (1952 for example), a ratio would be determined between the income of all corporations for that year and the average of income for all corporations for the base period years. Assume this ratio is 150 percent. The average base period income for a new or growing company would be determined by dividing its 1952 income by 150 percent. This would have the effect of subjecting to excess profits tax that portion of the company's 1952 income which was attributable to business factors resulting from the war economy without subjecting to excess profits taxes that portion of the company's 1952 income attributable to its own inherent growth.

Reasons for recommendation.—The most difficult and important problem in drafting an excess profits tax law is to recapture war profits without stifling new and growing companies. The constant development of new products, processes, and methods by old and new companies has been largely responsible for this country's industrial growth. It would be a tragedy to enact a tax law which would penalize the new companies and the dynamic companies. In the World War II excess profits tax laws an attempt was made to alleviate hardship of this kind by means of the so-called push-back rule in section 722 (b) (4). This provision failed to accomplish its purpose mainly because of the statutory provision against the consideration of events and conditions occurring or existing after 1939, and because of the lack of any definite standards or methods for measuring the extent to which relief should be accorded in cases covered by the push-back rule. It is essential that some simple, well-known, and easily administered formula be set forth in the statute itself to cover these situations if inequity is to be avoided.

The formula suggested, while not perfect, will accomplish this purpose in the vast majority of cases.

If a method such as outlined above would be deemed to be too complicated, then a quite simple though admittedly arbitrary method could be evolved, and probably arrive at approximately the same net result—namely, that the net income subject to excess profits tax of such a company be limited to 35 percent of its total net income.

Senator MILLIKIN. How do you propose to execute the second part of your recommenations? What do we do about it, in other words? I think there is great sympathy for your general proposition that growth corporations should have special treatment, but what special treatment, assuming that you are going to have an excess profits tax?

Dr. DU MONT. I think probably the most important one, so far as the growth companies are concerned, is the recognition of the fact

that 1949 is not the end of progress in America; in other words, some provision should be made so that the expansion can take place in our country past 1949.

We have suggestions in here of ways and means to accomplish that, in recommendation 6. I think that is one of the most important items involved here.

I think another important item is No. 3. The way it is now, if a company spends money developing and pioneering over a long time and it has results from that pioneering and development, the effect on his tax picture all occurs in 1 year. If some method could be arrived at so that he received some relief from that, it would be of considerable help. In other words, a company develops for a long, long period of time and then suddenly it becomes commercially practical and he is immediately hit with a terrific tax.

In our case, we worked from 1931, where we had $70 worth of business, until 1946—we built the business from $70 up to $2,500,000. At that time television started, and we went right up like that [indicating]. As soon as we really get going on it, then your taxes are so high it is very difficult to get back the money that you invested in the business.

Senator MILLIKIN. Has anyone prepared any language, drafted any language for the bill?

Dr. DU MONT. I think there is some language drafted on it, yes.

The CHAIRMAN. You have your supplemental statement which has been incorporated in the record.

Dr. DU MONT. That is correct.

The CHAIRMAN. Is there language suggested there for these growth companies? That is, growth formulas?

Dr. DU MONT. It is really a further explanation, rather than an attempt to put in language in legislative form.

Senator MILLIKIN. You could put in the language. Do you not think so, Mr. Chairman?

The CHAIRMAN. You can furnish us with language and we can make more progress with it in that way.

Dr. DU MONT. We can do that.

(The information is as follows:)

DECEMBER 8, 1950.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR GEORGE: As requested, we are pleased to hand you herewith a draft in legislative form of proposals relating to growth companies to be considered for incorporation in the pending excess profits law.

Section 435 (e) of the House bill on this subject proceeds on the assumption that growth ceased in 1949. However, it was demonstrated before you and your committee that accelerated growth in many companies was common in the 6 months of 1950 before the Korean War.

Accordingly, the enclosed legislative suggestions attempt to give proper weight to the continuing growth factor. This is done by an almost literal repetition of the World War II excess profits tax provisions concerning growth companies (sec. 713 (f)), omitting limitations and adding certain provisions to permit the growth company taxpayer an average base period net income, reasonably in excess of its best year during the base period to reflect the continued growth factor. Four such alternative elective computations are submitted for your consideration. It is not proposed that all be used, but only such as you deem best meets the situation, giving due consideration to administrative difficulties.

We have approached this problem from the viewpoint only of true growth companies by limiting protection or relief to that category. We have gone further in this limitation than the House bill by providing four alternative tests of a more stringent nature. The net result will be fewer companies which can qualify but those which meet the test will be true growth companies meriting more equitable treatment with little effect on total revenue to be derived from the tax.

We are also transmitting a suggestion for a new paragraph 13 to be added to section 433 (b) of the House bill which would provide for the exclusion of losses incurred by companies in pioneering and developing new products, service and industries. For instance, television broadcasting has developed during the base period a great loss in building for the future. Unless such expenses are eliminated, the base period net income corporations engaged in pioneering enterprises are subject to double discrimination. Not only are their base period earnings reduced by these costs, but profits anticipated from these expenses would be derived in years after the base period and they would be taxed as excess profits.

The draft which we are submitting covers the matters on which we were requested to make legislative suggestions in accordance with our testimony before you. Since no mention was made in that testimony of limitations dependent upon the size of the company claiming growth, we have incorporated none in our proposal. Many true growth companies would be affected by the House bill's limitations which would admit as growth companies only those having total assets of $20,000,000 or less at the beginning of the base period. Probably some limitation is necessary, but we question whether the House bill method is the correct one or whether it should be so exclusive. We shall be glad to express our views further if you so desire.

Finally, although this also is no part of our testimony, we would like to call to your attention that in the House bill section 435 (a) (1) (B), the base period capital additions computed under subsection (F) are not allowed to growth companies as they are to other companies. This, we think, is an unjustified discrimination, since the fruits of capital acquired late in the base period will be reflected only in years following the base period for growth companies in precisely the same way as in all other companies. Perhaps you will want to correct this discrepancy.

We are most grateful to you and the committee for your courtesy and time in the hearing, and your quick comprehension of the special problems of the growth companies.

Respectfully submitted.

NATIONAL CONFERENCE OF GROWTH COMPANIES,
By B. L. GRAHAM, *Vice Chairman,*
Care of Allen B. Du Mont Laboratories, Inc., Clifton, N. J.

GROWTH COMPANY CONFERENCE DRAFT

At end of section 433 (H. R. 9827) a new paragraph No. 13 should be inserted, reading as follows:

"(13) Pioneering and development expenditures: In the cases of taxpayers engaged during the base period in pioneering and development of new products or services, or television broadcasting and the creation of markets therefor, in which efforts substantial sums have been expended by the taxpayer, there shall be excluded, net losses sustained in connection with such activities after allocating thereto, a fair portion of general overhead expenses. A product or service shall be deemed to be new if it has not been developed to a profitable basis by the beginning of the base period. The secretary shall prescribe such regulations as he may deem necessary for the application of this subparagraph."

Section 435 (e) shall be amended as follows:

"Strike out all of section 435 (e) following 435 (e) (1) (A) and substitute in lieu thereof the following:

"'(B) (i). The excess profits net income of the taxpayer for the last half of its base period in 200 percent or more of its excess profits net income for the first half of its base period; or

"'(ii). The excess profits net income of the taxpayer in each successive 12 months period during the base period is 115 percent or more of its excess profits net income in the last preceding 12-month period · or

"'(iii). The excess profits net income of the taxpayer and the payroll of the taxpayer as reported in its social-security tax returns for each successive 12-

month period during the base period are, respectively, 110 percent or more, of its excess profits net income and such payroll for the last preceding 12-month period; or

"'(iv). Upon making application therefor in accordance with regulations prescribed by the secretary, the secretary shall find such a consistent and substantial expansion in net income, net worth, or sales or a combination thereof during the base period, as compared with the average of all corporate businesses during the same period, that in the opinion of the secretary, the taxpayer should have the benefits of this subsection.'"

NOTE TO THE COMMITTEE.—The following four alternative methods of computation are suggested for insertion at this point. It is requested that the committee choose the one or more which it prefers and discard the remainder.

(Alternative 1)

(2) COMPUTATION.—Average base period net income determined under this subsection, shall be determined as follows:

(A) By computing for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

(B) By computing for each half of the base period, the aggregate of the excess profits net income for each of the taxable years in such half, reduced if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purpose of such computation, if any taxable year is partly within each half of the base period, there shall be allocated to the first half, an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(C) If the amount ascertained under paragraph (B) for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

(D) By adding the amount ascertained under paragraph (C) to the amount ascertained under paragraph (B) for the second half of the base period;

(E) By dividing the amount found under paragraph (D) by the number of months in the second half of the base period, and by multiplying the result by 12;

(F) The amount ascertained under paragraph (E) shall be the average base period net income determined under this subsection, except that the—

(i) average base period net income determined under this subsection, shall in no case be greater than the highest excess profits net income for any taxable year in the base period unless the highest excess profits net income in the base period is for the last year, in which case—

(ii) the average base period net income determined under this subsection shall be no greater than the higher of the excess profits net income for such year or the next succeeding year. For the purpose of such limitation, if any taxable year is less than 12 months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by 12 and dividing by the number of months included in such taxable year.

(Alternative 2)

(2) COMPUTATION.—Average base period net income determined under this subsection, shall be determined as follows:

(A) By computing for each of the taxable years of the taxpayer in its base period which, for purposes hereof shall begin January 1, 1947, the excess profits net income for such year, or the deficit in excess profits net income for such year, except that the excess profits net income for the first 6 months of 1950 shall be annualized and for the full year of 1950 shall not exceed twice the excess profits net income for the said first 6 months.

(B) By computing for each half of the base period, the aggregate of the excess profits net income for each of the taxable years in such half, reduced if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purpose of such computation, if any taxable year is partly within each half of the base period, there shall be allocated to the first half, an amount of the excess profits net income, or

deficit in excess profits net income, as the case may be, for such taxable year which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(C) If the amount ascertained under paragraph (B) for the second half, is greater than the amount ascertained for the first half, by dividing the difference by two;

(D) By adding the amount ascertained under paragraph (C) to the amount ascertained under paragraph (B) for the second half of the base period;

(E) By dividing the amount found under paragraph (D) by the number of months in the second half of the base period, and by multiplying the result by 12. and the amount ascertained under this paragraph (E) shall be the average base period net income determined under this subsection.

(Alternative 3)

(2) COMPUTATION.—Average base period net income determined under this subsection, shall be determined as follows:

(A) By computing for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year and by then substituting for the excess profits net income or deficit for the lower of the first 2 years an amount equal to 75 percent of the average excess profits net income for the other 3 years in the base period;

(B) After such substitution by computing for each half of the base period, the aggregate of the excess profits net income for each of the taxable years in such half, reduced if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purpose of such computation, if any taxable year is partly within each half of the base period, there shall be allocated to the first half, an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(C) If the amount ascertained under paragraph (B) for the second half is greater than the amount ascertained for the first half, by dividing the difference by 2;

(D) By adding the amount ascertained under paragraph (C) to the amount ascertained under paragraph (B) for the second half of the base period;

(E) By dividing the amount found under paragraph (D) by the number of months in the second half of the base period, and by multiplying the result by 12; and the amount ascertained under this paragraph (E) shall be the average base period net income determined under this subsection.

(Alternative 4)

(2) COMPUTATION.—Average base period net income determined under this subsection shall be determined as follows:

(A) By computing for each of the taxable years of the taxpayer in its base period the excess profits net income for such year, or the deficit in excess profits net income for such year;

(B) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purpose of such computation, if any taxable year is partly within each half of the base period, there shall be allocated to the first half an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(C) If the amount ascertained under paragraph (B) for the second half is greater than the amount ascertained for the first half, by dividing the difference by 4;

(D) By adding the amount ascertained under paragraph (C) to the amount ascertained under paragraph (B) for the second half of the base period;

(E) By dividing the amount found under paragraph (D) by the number of months in the second half of the base period, and by multiplying the result by 12; and the amount ascertained under this paragraph (E) shall be the average base period net income determined under this subsection.

The CHAIRMAN. Are there any further questions? If not, thank you, Dr. Du Mont, very much for your appearance here.

Dr. DU MONT. Thank you.

The CHAIRMAN. The committee will recess until 2 o'clock.

(Whereupon, at 12:05 p. m., a recess was taken, to reconvene at 2 p. m., this same day.)

AFTERNOON SESSION

(The committee reconvened at 2 p. m., upon the expiration of the recess.)

Senator HOEY (presiding). The committee will come to order, please. I shall preside for a few minutes in the absence of the chairman who has been detained at a very important Foreign Relations meeting.

Mr. Heer is our first witness.

Mr. HEER. How do you do, sir.

Senator HOEY. Have a seat.

STATEMENT OF LEO J. HEER, VICE PRESIDENT, NATIONAL RETAIL FURNITURE ASSOCIATION, CHICAGO, ILL.

Mr. HEER. Thank you.

Mr. Chairman and Senators, I am Leo J. Heer, vice president of the National Retail Furniture Association. I appear on behalf of approximately 9,000 furniture stores of all sales volume categories located in all sections of the Nation.

The problem of providing equitable treatment for installment-basis taxpayers in an excess profits tax law is the subject of my comment.

Under an excess profits tax, inequity for the installment basis taxpayer stems primarily from two causes: (1) The installment basis of accounting is designed to tax income in the year it is collected, rather than in the year it is earned; and (2) Government regulation of installment credit, such as Regulation W of the Federal Reserve Board, create abnormalities.

The varied distortions that create inequities and the justice of providing equitable adjustment in an excess-profits tax law has been explored by the House Ways and Means Committee, by Mr. Colin Stam and the staff of the Joint Committee on Internal Revenue Taxation, by Mr. Vance Kirby and technicians of the Treasury and representatives of the Bureau of Internal Revenue.

As a result of consideration given the problem, section 453, Relief for Installment Basis Taxpayers, has been included in H. R. 9827, with cross references to certain other sections on certain facets of the problem.

Section 453 with its cross references, by providing to the installment basis taxpayer an election to report for excess-profits tax on the accrual basis, and likewise compute the base period years on the accrual basis, essentially corrects the inequity.

We wish to commend the action taken by the House Ways and Means Committee in the interest of equity. We desire also to compliment the painstaking efforts of the joint committee staff, the Treasury staff, and the Bureau of Internal Revenue representatives. Under most trying circumstances with so little time available, they extended themselves to consider the position of installment basis taxpayers, justifications for relief and the technical means of providing it.

Section 453 apparently recognizes and corrects shortcomings of old section 736 (a) that sought to provide equity under the previous excess-profits tax law. The very speed necessary in the legislative consideration and drafting may have resulted in an omission that may be significant. If time is available, we propose to explore this with the experts of the joint committee staff, the Treasury, or the Bureau.

I should like to observe at this point that our further action in connection with the request I am now about to make will be predicated in the main upon the results of those further conversations if they can be had.

We ask, therefore, your indulgence and the privilege of filing for the record before the conclusions of these hearings such perfecting recommendations as may develop to be warranted for your consideration in connection with section 453, and related sections having to do with installment basis taxpayers.

With only the reservation as to possible suggestions that may evolve from further study, and these further consultations, we respectfully suggest that section 453, with its cross references, be adopted by your committee.

Senator HOEY. You may file that additional statement if you desire to do so.

Mr. HEER. Thank you very much, Mr. Chairman.

(The supplemental statement is as follows:)

SUPPLEMENTAL STATEMENT OF NATIONAL RETAIL FURNITURE ASSOCIATION WITH SPECIFIC SUGGESTIONS FOR PERFECTING EQUITY PROVISIONS APPLICABLE TO INSTALLMENT BASIS TAXPAYERS IN H. R. 9827, DECEMBER 8, 1950

In accordance with permission granted on December 5, 1950, the National Retail Furniture Association files, herewith, a supplemental statement. The suggestions herein are on three points which have developed to be needed as a result of further study of the position of installment basis taxpayers under the excess profits tax bill, H. R. 9827.

These points and the reasons for their consideration, are—

1. Need to amend section 430 (a) (2) dealing with the application of the 67 percent limitation to section 453 in the interest of precluding litigation and for purposes of clarity.

2. Relief section 453, so vitally needed now in the interest of equity, will have the peculiar effect of provoking hardship at the time in the future when governmental regulation of installment credit reverses from stringency to relaxation. There should be permission to abandon the election at such time. This peculiarity was recognized in a similar relief provision (736 (a)) in the old excess profits tax law, but the permission to abandon the relief when it becomes a hardship was omitted from section 453.

3. The reserve method of accounting for bad debts was permitted for installment basis taxpayers commencing in 1949, following upon its allowance to banks in 1947. There is a parallel inequitable result for banks and installment basis taxpayers in both the base period and the excess profits tax years. Proper relief was afforded the banks but omitted for installment basis taxpayers.

The foregoing points are elaborated on in the following paragraphs:

1. In the interest of clarification, it is suggested that an explicit provision be inserted dealing with the application of the 67-percent limitation to taxpayers computing their excess profits tax net income under section 453.

The language now contained in section 430 (a) (2) is similar to the language in section 710 (a) (1) (B) of the previous excess profits tax law. The Treasury regulations dealing with 736 (a) required the limitation to be computed on the accrual basis. However, there has been two conflicting circuit court decisions on this point. (See Basalt Rock and Sokol Furniture Co. cases.)

The National Retail Furniture Association suggests that in order to follow the rule of the applicable Treasury regulations under the previous excess profits tax law new and explicit language be added to section 430.

2. The proposed legislation makes no provision for a second election to return to the installment basis for the purpose of the excess profits tax when relief becomes hardship.

The influence of governmental regulation of consumer installment credit in the future makes it imperative that a second election be granted in order to avoid turning relief into grave hardship. It will be noted that the condition which will create this unusual abnormality is the direct result of governmental control and entirely beyond the influence of the taxpayer.

The need for this second election was recognized in old section 736 (a), for the reasons set forth above. It is contemplated that this proposed second election to abandon relief would be final and irrevocable.

The National Retail Furniture Association realizes that the problem of the second election is not one which is now serious. It appreciates that the pressure of making adequate provision for existing problems may preclude immediate consideration by the experts of the Treasury and the joint committee. It does urge, however, that the matter be considered at the earliest opportune moment and if at all possible be done now. This can be accomplished by adding to section 453 a few sentences similar to the old section 736 (a) language.

3. With respect to the reserve method of accounting for bad debts, the installment basis taxpayer is situated similarly to banks whose problem was recognized in section 433 (a) (1) (L) and in section 433 (b) (12) of H. R. 9827.

The exact parallel exists by reason of the timing of permission to use the reserve method which previously had been denied to both banks and installment basis taxpayers.

Installment basis taxpayers, previously denied the use of the reserve method, were permitted by the Bureau of Internal Revenue to begin its use in 1949.

Thus two effects take place:

(*a*) One of the base period years is distorted.

(*b*) By virtue of the timing over which installment basis taxpayers had no control, the excess profits tax years are affected. The limit of the reserve has probably been reached by most stores, at the very time when governmental control of consumer credit (regulation W) acts to increase down payments and collections. The reserve, having already been established in preexcess profits tax years for normal purposes, this results in denying to installment basis taxpayers the actual bad debt loss experienced in excess profits tax years for excess profits tax purposes.

In equity, therefore, it is submitted that installment basis taxpayers should be accorded the treatment for excess profits tax provided in sections 433 (a) (1) (L) and 433 (b) (12) of H. R. 9827 by the simple device of making these sections applicable also to installment basis taxpayers.

Senator HOEY. Mr. Miles Pennybacker.

Come around, Mr. Pennybacker.

STATEMENT OF MILES PENNYBACKER, PRESIDENT, VOLTARC TUBES, INC., NORWALK, CONN.

Mr. PENNYBACKER. Mr. Chairman and Senators, I am Miles Pennybacker, president, Voltarc Tubes, Inc., 44 Cross Street, Norwalk, Conn. We are a manufacturing concern, a small one, with about 75 employees. We are also in a growth industry of the type comparable to some of those that have previously been discussed.

I am appearing here this morning to testify on behalf of Americans for Democratic Action, an independent, progressive, political organization dedicated to the achievement of economic security for all people within a framework of universal political freedom.

I welcome this opportunity to appear before this committee on the question of excess profits taxes.

ADA believes that your committee should recommend excess profits tax legislation. We believe that it is possible to have a sound excess profits tax that will raise at least the $4,000,000,000 revenue, and also not place undue or unjust hardship on any segment of business.

Everyone, including most conservative businessmen, recognizes the necessity for higher taxes on corporate incomes. Therefore the question is simply how much revenue should be raised by new taxes on corporate profits, and what form these higher taxes on corporations should take. Regardless of the manner in which the Congress handles the question of increased corporate taxes, it is clear that in the very near future you will be called upon to impose new and higher taxes all along the line. The answer to the corporate profits taxation problem with which this committee is now concerned, will have a good deal of influence on the spirit with which laborers, farmers, white-collar workers, and other low-income groups respond to congressional demands for higher contributions from their incomes.

The seriousness of the international situation demands that the Congress face up to the needs of the Federal Treasury, and answer these needs in equitable taxes based on ability to pay. We in the ADA view an excess profits tax as a necessary complement to the tax measure enacted in September of this year which did not place a fair share of the burden on large corporate incomes, which have greatly increased because of the war situation.

We believe that your committee in the face of soaring profits and the dire need for increaesd Federal revenues should legislate to take most of the excess profits out of war.

I need not recount to this committee the corporate profit figures for 1950. For most large corporations profits after taxes are far higher than they have ever been in history. Therefore, it appears obvious to me that in the face of a mounting budget deficit, the Government should tap these profits.

I would like to interpolate here, if I may, that the base on which excess-profits taxes will be figured is much more favorable to large corporations than to small independent businesses, because during a period of rising prices such as we have had, and are likely to continue to have, large corporations have profited to a much greater degree in terms of percentage of their sales than have small businesses.

I favor an excess-profits tax for the following reasons:

1. This tax is fair and equitable.
2. This tax is anti-inflationary.
3. This tax is a link in our over-all mobilization program.
4. And most importantly, this tax will raise considerable revenue.

Let me, as a businessman who will have to live under such a tax if you pass it, explain my position on these four points.

Fair and equitable: Under the excess-profits tax, by far the largest share of the additional revenue will come from the relatively small number of corporations whose earnings have increased very substantially as a result of the mobilization effort.

I think during the presentations this morning, it was said that probably only one out of seven or one out of eight corporations would be paying excess-profits taxes. My concern is with the other seven, and the effect of alternative taxes on those larger number of corporations.

The major portion of excess profits made as a result of the emergency cannot be tapped in any other way. Contract renegotiations can recapture only excess profits made on direct Government contracts and cannot affect profits made indirectly.

The alternative tax method, that is, increasing the normal tax rate on corporations is not equitable because it hits those less able to pay.

Secondly, anti-inflationary: Many businessmen have stated that the excess-profits tax is inflationary and leads to extravagance in corporate spending. The extravagance argument has been overdone. As a businessman let me tell you that I know when the emergency is over, I will have to meet tough competition again, and I simply cannot afford to permit large extravagances to enter into my costs. Also, there is no question in my mind that it would be easier to pass higher flat-rate increases in corporate taxes onto the consumer in the form of higher prices than would be the case with an excess-profits tax.

I would like to elaborate on those two points slightly, if I may.

On this question of increasing extravagance we have not merely a theory on this but we have experience in the recent war, and during that time excess profits taxes paid a much higher percentage of the total corporate tax than is now contemplated, and yet during the war we did not have inefficiency over-all as a result.

We gained in efficiency so that the relatively small percentage which would now be raised by the proposed bill would certainly not increase extravagance or inefficiency greater than it was during the past war.

Senator TAFT. Is there any evidence of that at all, Mr. Pennybacker? I can just guess the opposite. There was no increase in efficiency during the war. All the increase in the productivity has occurred since the war.

Labor was generally more inefficient at the end of the war than it was at the beginning—I mean the productivity of labor—and certainly the general testimony of everybody you met was that they did not care about expense accounts or anything, what they were spending. I don't know. I mean, my evidence is no more than yours, but I wonder what evidence you have of your statement here.

Mr. PENNYBACKER. I managed a war plant with about 700 employees during the war. We made radar tubes, and the corporation for which I was working then was in the excess profits tax category, and while it is true that you do not have quite the same feeling about the dollar, nevertheless you cannot afford as a businessman to deliberately introduce inefficiencies into your organization simply because it does not cost you a great deal.

Senator TAFT. But things like expense accounts and advertising are things that can be stopped when the war is over. I agree with you you would not want to make your machinery operations different, certainly.

Mr. PENNYBACKER. You have a tendency to increase minor items, and those are peanuts. You also have a tendency to increase research for example, things that tend to increase productivity in the long run, and I think those two things tend to equalize.

You tend to spend more money for things that are long term, such as research, which aids the economy, and those more than offset the increase in expenditures for travel expenses and the minor items.

Senator Taft, I think you said something this morning that I am completely in accord with. That is on the question of minimizing the penalty on those who do not increase prices. In general, independent business is not in a position to increase prices, whereas semimonopolies, or those large businesses are in a better position to increase prices, so that a general increase in the normal corporate tax can be passed on readily to the consumer, and any increase in the excess profits tax cannot be so readily passed on.

Senator TAFT. That might be so up to a limited point. I think if you got up to 100 percent——

Mr. PENNYBACKER. Even if it were 100 percent——

Senator TAFT. It seems to me it is a question of how high you can go.

Mr. PENNYBACKER. Let us assume it is 100 percent, and it applies to only one-seventh or one-eighth of your corporations. They are in competition with the other seven-eighths who do not have that extra tax, and who are accordingly not in a position to pass it on.

Senator TAFT. Mr. Stam, what is your estimate of active corporations that are going to pay this tax, or those who are now paying income taxes? Have you made any estimate as to a percentage of corporations who will pay the excess profits tax? Why won't practically all of them pay it if it is based on 85 percent of normal earnings?

Mr. STAM. I think the minimum exemption of $25,000 was supposed to exempt all but about 77,000 out of a total of 400,000.

Senator TAFT. That does not exempt any corporation of any size. Earnings of $25,000 does not exempt anybody that is playing an important part in the war effort.

Mr. STAM. That is right.

Mr. PENNYBACKER. But those small corporations play a very important part in determining prices, because they are competing with the large corporations, and I think that is a point.

Senator TAFT. $25,000 and under?

Mr. PENNYBACKER. Yes, indeed. My company competes with the General Electric Co. on fluorescent lighting, and we have an effect on the entire price structure of that industry, even though our percentages of it is extremely small, and an increase in the normal tax or the present excise tax, for that matter, has a direct effect of being passed on in prices to the consumer. An excess profits tax would not, and I am speaking here from direct experience of my own company. In fact, Senator, I think in 1948 when you were chairman of the Committee on the Joint Econmic Report, in reporting on the President's proposal at that time for an increase in corporate taxes in your majority report, you said that you thought an increase in corporate taxes and normal income tax could readily be passed on to consumers.

Senator TAFT. It is passed on all right in prosperous times. I do not think it is in hard times, because then a lot of companies are not making profit, and are not affected.

Mr. PENNYBACKER. Exactly so. We are talking now about these times and the next few years, which are prosperous, and probably will be for the large corporations.

My third point relates to the over-all mobilization program.

Many hope that short of total war the economy can be stabilized on a high-production, fully employed basis without rigid direct controls. If such stability is to be achieved an excess profits levy is a necessary ingredient of it. However, if indirect controls are pro-

vided inadequate to meet the tide of inflation, then an excess profits tax becomes even more important if we are to secure sound economic functioning. It becomes not only a matter of economic balance but one of equating the sacrifices of all elements of society. It can be said, therefore, that an excess profits tax is peculiarly designed to play an important role in an antiflation stabilization program built upon direct or indirect controls.

Fourth, revenue producing: An excess profits tax will go directly to the basic problem of all taxation in that it seeks out tremendously large amounts of relatively untaxed moneys. Therefore, by simply studying the increase in profits in the past 6 months we must recognize that profits are much greater than they were prior to the Korean invasion.

Before closing my remarks I want to say that I do not believe that an excess profits tax is a tax without inequities. I think those inequities can be taken care of by provisions, some of which have already been provided, and possibly with the addition of an appeals board to check and administer it.

I approve of an excess profits tax at this time as the most equitable answer to our Government's need for more revenue. The alternative proposal presented thus far by many groups, which would increase normal corporate taxes, is much more inequitable than an excess profits tax because it would place an added burden on earnings which do not increase as a result of the emergency.

In fact, the earnings of a great many small businesses will decrease as a result of the emergency.

I would like to mention also that as I understand it, an increase in the normal tax, which would provide the same amount of revenue, let us say $4,000,000,000, would be an increase of approximately 12 percentage points. In other words, from 45 to 57 percent. That is an increase of a particular amount of income of 25 percent in the tax that would be paid if this revenue is raised by an increase in the normal, rather than an excess profits tax.

If you bear in mind that you are increasing that tax rate on companies whose revenue is declining during this period, you can see how inequitable such an increase in the normal tax rate would be.

I urge this committee to report an excess profits tax. I further urge that such a tax be retroactive to June 30. Common justice demands that increased profits made out of a situation which has brought tragedy and hardship to many people, be taxed.

Senator HOEY. Thank you, Mr. Pennybacker.

The next witness is Mrs. Jessie R. Muni.

STATEMENT OF MRS. JESSIE R. MUNI, TREASURER AND DIRECTOR, INVESTORS LEAGUE, INC., NEW YORK CITY, N. Y.

Mrs. MUNI. Mr. Chairman and Senators, I am Mrs. Jessie R. Muni, treasurer and a director of the Investors League, Inc., with headquarters at 175 Fifth Avenue, New York 10, N. Y.

The league which I represent is the oldest and most successful organization of investors in the United States, with thousands of members residing in every State of the Union. It is an organization of investors, both small and large, and made up of women as well

as men, who constitute the backbone of our private enterprise system which is, in turn, the backbone of our national economy.

As the recognized representative of an official spokesman for investors of the United States, the Investors League respectfully submits this statement to the Senate Finance Committee for its consideration in connection with section 701 of the Revenue Act of 1950.

It is the firm conviction of the Investors League that the United States is at the crossroads of its history in attempting at this time to levy enough taxes to pay for the rearmament program proposed by our Government.

We face one of two things—inflation or socialism—and possibly both.

If Government controls are not placed over our economy to keep prices from advancing too rapidly, and to keep vital materials moving into essential channels, we run the risk of dangerous price inflation. With the serious labor shortage, labor will demand and get additional wages with which to pay increased taxes. With shortages of materials, industry will demand and get higher prices with which to pay its taxes. The result in either case obviously is inflation.

If we place Government controls over industry and over labor, and these controls are allowed to stand for the duration—which may be 10 years or more—we run the risk of having them become permanent. In that event we would have socialism patterned after that which existed in Italy during the reign of Mussolini. Italy had a one-man dictatorship. We might have a bureau dictatorship.

Investors throughout the country would be hurt seriously by inflation but they would be hurt even worse by socialism.

Whether increased taxes are levied primarily on American individuals or on corporations the effect is the same. They will be passed on to consumers. To that extent they are the equivalent of a sales tax.

The Investors League believes that it is time for Americans to be realistic. It believes that it is time to stop hiding behind political dodges. It believes the only sound and practical way to raise a large portion of the funds which will be needed to finance rearmament at this time is through a sales tax, to apply on all goods with the exception of food.

I think it is high time we people of the United States began to face the fact that people ought to know what is going on. They ought to feel it, they ought to take a part in it, and if we are going to have any kind of a tax that goes across the population generally and takes the spending power out of its hands, the excess spending which they have and will have, we have got to get down to the common level.

With a direct sales tax the people of this country will stand the best chance of avoiding inflation and of avoiding socialism. At the same time they will know precisely what they are paying and why.

The Investors League is very much opposed to a so-called excess profits tax for the following reasons: (*a*) No excess profits tax formula could be devised which would be even reasonably fair to all. Any such tax would harm the so-called growth companies and would deter new enterprises; (*b*) an excess profit tax encourages inefficiency in management; and (*c*) it is difficult and costly to administer—many tax cases arising from the complex law of World War II are still in litigation.

The position of the Investors League is that in lieu of an excess profits tax, based on the World War II concepts, it recommends that the following tax measures be employed:

1. A uniform increase in the corporation rate in the form of a temporary war profits tax or emergency defense tax, with the explicit proviso for its repeal when the rearmament period terminates. As an illustration, current taxable corporate earnings are at an annual rate of $40,000,000,000; an increase in the corporation tax from 45 to 55 percent would produce $4,000,000,000 in additional revenue. Such a temporary increase is more desirable for business in general and the national welfare than an excess profits tax. It is pertinent to note that in World War II similar increases would have raised as much revenue as was obtained from excess profits and corporation normal and surtaxes. In the highest revenue year, a rate of 55 percent would have sufficed and in 1941 a rate of only 39 percent would have been necessary.

2. A broad excise tax at either the manufacturing or retail level. Such a tax accompanying a corporate increase would be a substantial revenue raiser. It is estimated that a 5-percent excise tax on all products, except food, would yield $9,000,000,000, which is $4,000,000,000 more than results from current excises.

3. A reduction in the holding period on securities would produce, we believe, increased revenues for the Government in capital gains tax, and would enhance the flow of venture capital needed to expand our country's productive facilities.

4. In addition, some further increase in personal income tax rates probably will be necessary. But in that event suitable credit or other relief should be given stockholders to compensate them for the unfair double taxation; namely; first on their corporation profits and secondly on the same profits when paid to them in the form of dividends.

Several of these points I have come into contact with very intimately. As a profession, I am an investment counselor. I handle the funds of many, many people, and many of them are women. I have had to, of course, watch out in these recent years that their income is kept in line with our inflationary elements, so that they do not have to move out of the house they are in, and many other things, so that I can keep them living in as decent circumstances as they have been accustomed to.

Also it gives me an opportunity to learn from these investor groups and individuals just how the idea of the tax question affects each, and how they feel about it.

Also I have had to do a great deal of research, as you can imagine, in the years I have been counseling, and I found all during World War II that the excess profits tax was apparently a very unfair thing, and these very points we bring out here. It tended to encourage laxity in expenses: "Well, the Government is going to pay 75 percent of that anyway."

It was all the easier for labor to put across its demands, instead of keeping labor in line as well as other people. I find that the common man in the street hasn't any realization of the taxes that he should pay, or what his taxes are used for. He complains about this or that in a small way of taxes, and yet he hasn't any conception of all the things he gets for his taxes.

We have got to get down to the grass-roots level so the Investors League has gone out, and written many letters, and used these replies and interviews to find out what the general feeling is, and we have incorporated in this statement here what we have learned from these contacts.

The Investors League firmly believes that the type of tax program it recommends should be adopted in lieu of an excess profits tax. Whatever the name of the tax, it must have its true meaning and name. Let us get down to honest facts. We recommend it be called a war profits tax.

The people know that they are being taxed for war purposes.

Senator HOEY. Thank you very much.

The next witness is Mr. Willford King.

STATEMENT OF WILLFORD I. KING, CHAIRMAN, COMMITTEE FOR CONSTITUTIONAL GOVERNMENT, NEW YORK, N.Y.

Mr. KING. Mr. Chairman and members of the committee, I appreciate being invited down here. I represent the Committee for Constitutional Government, 205 East Forty-second Street, New York City.

Our organization attempts to educate the public in what we believe to be sound economics. I shall begin by listing a few fundamental premises which I believe each member of your committee will endorse:

1. We are now battling against a foe having manpower far in excess of ours.

2. Our chance of victory depends primarily upon our superior ability to produce war matériel; hence it is essential that we avoid hampering such production in any way.

3. Neither compulsion nor patriotism can be depended upon to keep individuals working diligently day after day, month after month, and year after year. The only known force which has ever brought forth long-continued persistent effort is hope of gain.

4. A tax on excess profits obviously weakens the incentive just mentioned, leads to indifference, carelessness, and waste, and hence reduces production—thus benefiting the enemy.

5. Our war expenses promise to be very heavy. Deficit financing commonly results in inflation, confiscation of the savings of the thrifty, and futile attempts at price control. The eventual outcome is curtailment of production. Therefore, it is imperative to balance the Federal budget every year. I cannot emphasize that too much.

6. The maximum amount which it is feasible to raise by means of an excess profits tax is only a small fraction of the additional revenue now required to balance the budget. Moreover, excess profits cannot be computed until the end of an accounting period. Hence the excess profits tax does not respond quickly to revenue needs.

7. A far simpler, and more effective revenue producer is available—namely the excise tax. It is ideally suited for purposes of war finance, for it brings in revenue promptly, utilizes the services of corporations as tax collectors, and permits vast sums to be raised inexpensively with the minimum amount of irritation to the public.

As a peacetime tax, the excise tax is not good for the reason just mentioned. It is a hidden tax, but as a wartime tax when you have to raise immense amounts, I think it is a good thing not to impress the people too much with the burden.

Moreover, since it bears with equal weight upon the products of all concerns in an industry, it, unlike a tax on profits, has no tendency whatever to penalize efficiency.

I was talking to a gentleman yesterday, who said that if we wanted to encourage efficiency, we ought to tax losses, not profits. Of course, that is not feasible from a revenue standpoint, but it certainly is in the right line. The last thing that you ought to do is to penalize the efficient corporations, so that the notion of increasing taxes on all corporate profits is not as sound from an economic standpoint as is the levying of excise taxes.

By exempting bare necessities, levying moderate taxes on most products, heavy duties on nonnecessities and luxuries, and very heavy imposts on goods used mainly for display—keeping up with the Joneses—a system of excise taxes can be built up which will divert labor and capital to war industries while at the same time producing all the revenue needed to pay for a major war, thus avoiding inflation with its disastrous effects. By applying judiciously a well-planned system of excise taxes, any need for an excess-profits tax as a revenue raiser can be obviated.

You can use excise taxes that way and avoid the necessity for any direct controls. Just put the pressure on subsequently with the tax, and the labor and capital will flow to the point where they are most needed.

Senator TAFT. Don't you think that the moment the workingman has to pay more for so-called luxuries, when his cost of living is increased 5 to 10 percent, he would be right in with a wage demand of 5- to 10-percent increase in wages? It seems to me an excise tax is inflationary, like all taxes. I do not quite see why most of them are not.

Mr. KING. I do not believe that taxes in general are inflationary. I think that inflation consists solely in increasing the amount of money or money substitutes in proportion to the volume of trade.

Senator TAFT. The ordinary housewife regards inflation as an increase in her prices, and an excise tax increases the prices, and then the workingman immediately wants higher wages. That increases costs and prices go up again. It seems to me it starts a spiral of inflation.

Mr. KING. I am inclined to believe that there is not such a thing as a wage-price spiral leading to inflation, if you do not inflate the currency. If you keep the currency supply constant——

Senator TAFT. I do not know about theory, but in practice what the people regard as inflation is higher prices.

Mr. KING. Yes; which I think is a very serious error and leads to all kinds of wrong conclusions. Where you have strong unions, they will do, of course, exactly what you say, but if the total spending power in the hands of the public is not increased, then there will be less to spend for other things, and the prices there will be held down so that the total effect on the price level, one down and the other up, will be nil.

Senator TAFT. You say here "without controls." It seems to me that if you put in a general increase in excise taxes, which really is intended to enforce a kind of economy, a kind of a reduction in standard of living, to go for war purposes, you are going to have to back it up with price controls, I am afraid, if you do not want to have it nullified by wage increases.

Mr. KING. Of course, I think that we are extremely foolish to allow a lot of labor monopolies to dominate our economy. I do not think you can ever have a sound economy as long as you have a bunch of labor monopolies that are responsible to no one except their own interests and push up prices, any more than I think it would be just as bad to have other monopolies increase prices.

I think that we ought to crush monopoly and put it out of business. I would agree that as long as you have powerful monopolies, that control either wages or prices, you are always going to be in trouble.

So that in my opinion by having a carefully planned, judicious system of excise taxes, any need for an excess-profits tax as a revenue raiser can be obviated. I think you can raise 10 times as much revenue by excise taxes as you can by any excess-profits tax, and you may need to.

I think that the excise taxes are much superior to retail sales taxes in time of war, because the retail sales taxes cost much more to collect and are resisted much more by the public. In time of peace I would say I prefer a retail sales tax. I think it is a much better tax than the excise tax in time of peace.

Now, there are some weaknesses of the excess-profits tax. The notion that the burden of an excess-profits tax is borne by some "soulless corporation" is, of course, absurd. I think that is a very common opinion, the strongest argument in favor of it, probably. Every cent of it eventually comes out of the pockets of stockholders and other consumers. And, almost all persons familiar with the excess-profits tax agree that it (1) penalizes efficiency, (2) encourages extravagance and waste, (3) is very difficult to administer, (4) is often grossly unfair because it taxes imaginary profits representing nothing more than an inflation-induced shrinkage in the value of the dollar.

During World War II prices went up and gave corporations profits which are purely imaginary because they would not buy the replacements that the dollars would buy before, but they had to pay excess-profits taxes on these imaginary profits.

Practically the sole argument advanced in favor of the excess-profits tax is that "it takes the profits out of war." This slogan appeals to sentimentalists, but has no logic whatever behind it. Probably, it was invented by enemies of our Republic anxious to weaken our defenses. It is utilized largely by labor union leaders who believe the imposition of an excess-profits tax will make it easier for them to get concessions such as wage increases and pensions. It is pertinent to note that it is always the other fellow who is asked to make the sacrifice. No one ever wishes to reduce his own gains from war. Farmers want higher farm prices. Wage workers demand higher pay. Government officials and employees seek higher salaries. They are all human, and want to penalize the other fellow.

And remember that yielding to the demand to "take the profits out of war," thus reducing efficiency and productivity, is likely to cause many thousands of our brave boys to lose their lives on the battlefield and may possibly take the victory out of war.

Apparently, the only argument in favor of an excess profits tax that has any logic behind it is that concerns manufacturing for the Government products of new design—for example, airplanes—often get huge windfall profits; and, admittedly, neither cost-plus contracts nor renegotiation has proved satisfactory as a method of protecting

the intrests of the taxpayers under such circumstances. This does not mean, however, that the excess profits tax furnishes the best solution of this problem. As a matter of fact, a far better one is available—namely, the sliding-scale-of-profit contract. It, unlike the excess profits tax, does not put a premium on waste. Instead, it penalizes inefficiency and rewards efficiency and economy. The operation of this device is illustrated by the following hypothetical example:

Suppose that the XYZ Corp. is negotiating for a contract for the manufacture of a new type of jet plane. The Government engineers figure that the planes will cost around $400,000 each. The company engineers consider this estimate reasonable, but, in view of the uncertainties involved, warn the corporation officials against placing a bid below $500,000.

Next, let us suppose that, in making bids, the company usually allows for a 10-percent net profit. And, let us assume further that, instead of agreeing to make the planes for $500,000 each with the understanding that, if profits turn out to be unduly large, they will be renegotiated or taxed away, the contract is made to read as follows:

1. All expenditures are to be recorded and verified.
2. If the cost per plane conforms to the joint estimate of the Government and company engineers—namely, $400,000—the company will be paid the standard profit of 10 percent; in other words, $40,000.
3. For every additional $5 of expenditure, the profit will be cut $1. Hence, if the cost per plane runs up to $500,000—that is, $100,000 more than expected—the profit will be reduced by $20,000—leaving a net gain of only $20,000. (The 1-to-5 ratio suggested above is merely illustrative. In cases in which cost estimation proved very difficult, the profit-reduction raito would be reduced—perhaps even to 1 in 10.)
4. On the other hand, if the cost per plane is reduced below the estimated $400,000, the profit allowed will be increased $1 for every $3 saved. Thus, if the total cost per plane is cut to $340,000—that is, $60,000 less than the anticipated amount—the profit allowance will rise by $20,000, and the company will receive a total profit of $60,000 per plane—50 percent more than the standard figure. But the cost reduction will save $40,000 for the Government.

Senator MILLIKIN. That is on the basis of your original estimates?

Mr. KING. Yes; that is right.

Senator MILLIKIN. Which proved very faulty in World War II.

Mr. KING. It is very hard to estimate those things, I know.

Senator TAFT. We used to make those kinds of building contracts in the twenties. They did just exactly this for contractors on buildings who were given a fixed fee, to be increased if the cost were——

Mr. KING. I know it has been used successfully.

Senator TAFT. What are you going to do with it?

Mr. KING. Clearly, this sliding-scale-of-profit arrangement, if adopted, would act as a powerful incentive to the manufacturing concern to reduce costs to the minimum. However, the corporation would be protected against loss if forces beyond its control required outlays materially greater than expected.

Furthermore, the contracting concern would not have its operations hampered by having part of its working capital tied up for months, or perhaps for years; the heavy expense involved in the renegotiation

proceedings would be avoided; and the feeling of being cheated by the renegotiators would never arise.

It seems to me that a sliding-scale-of-profit arrangement such as the one outlined above is relatively simple, encourages efficiency and economy, expedites settlements, and prevents annoyance and dissatisfaction, and, if used in all contracts involving sizable costs not susceptible of accurate determination in advance, would eliminate any necessity either for renegotiation or for the levying of excess profits taxes.

Senator MILLIKIN. What part of the economy do you reach?

Mr. KING. The buying by the Government of all kinds of new things, like planes and radio equipment, and so on.

Senator MILLIKIN. Only the contracts with the Government?

Mr. KING. Yes.

Senator MILLIKIN. You have a mass economy that circulates outside of that.

Mr. KING. It would be a very good thing for people to adopt it in the other fields, but I do not think you can compel that by law.

Senator MILLIKIN. You are leaving out an enormous field that revolves outside of the orbit of Government contracts, but is affected by Government contracts.

Mr. KING. Yes. It would not affect subcontractors, I think, unless——

Senator MILLIKIN. Would it not affect the suppliers?

Mr. KING. Yes, but the suppliers, of course, of standard materials are usually in keen competition. They do not have much chance to make any unfair profits.

It is the people that manufacture these things that they cannot figure on, that may get unreasonable profits. If you are buying lumber or iron, copper, anything of that sort, you have keen competition, and if you sometimes get very big profits, you can get very big losses if you figure wrong.

Unless the thing is monopolized, as I see it, there is no chance of any sure profit in any standard article; but, if you are building something like a plane that has never been built before, of course you may make an enormous margin on it.

Senator TAFT. The method of dealing with cost-plus contracts seems to be a good method, but I cannot see how it meets our excess profits tax requirements.

Mr. KING. That is all, I believe, I have to present. Thank you very much.

Senator HOEY. Thank you very much.

The next witness is Mr. Elden McFarland.

STATEMENT OF ELDEN McFARLAND, WASHINGTON, D. C., ON BEHALF OF THE RUDOLPH WURLITZER CO.

Mr. McFARLAND. Mr. Chairman and members of the committee, the Rudolph Wurlitzer Co. is engaged in the manufacture and sale of spinette and grand pianos and accordions at De Kalb, Ill., and electronic organs, coin-operated phonographs and television cabinets at North Tonawanda, N. Y. It also operates retail music stores in New York, Philadelphia, Chicago, Buffalo, Detroit, and Cincinnati.

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Senator MILLIKIN. Did you not manufacture in Cincinnati?

Mr. McFARLAND. Yes, some time ago.

Senator TAFT. The whole company started there.

Mr. McFARLAND. Yes. It originated in Cincinnati many years ago.

During World War II this company's manufacturing facilities were completely converted to war production. Early in World War II it received both the Army and Navy E awards, and these awards were repeated at intervals throughout the war. It is contemplated that a substantial part of its facilities may be used in defense production during the present emergency.

The company is interested in presenting its particular problems to this committee because these problems are not only of vital concern to it but also undoubtedly are common to many other corporations.

1. Section 435 of the bill provides for an excess profits credit of 85 percent of the average base period net income. This means that the remaining 15 percent of a taxpayer's normal earnings is to be subjected to excess profits taxes. We respectfully suggest that the credit should allow the full 100-percent average—otherwise, normal income would be taxed at excess profits tax rates.

Senator MILLIKIN. There seems to be no defense for that except that it will raise money. I do not want to try to justify it as a logical part of wartime excess-profits tax system.

Mr. McFARLAND. The second point is as follows: Section 442 of the bill provides for relief in the case of two classes of abnormalities which correspond respectively to section 722 (b) (1) and the first sentence of section 722 (b) (2) of the present Internal Revenue Code.

Senator MILLIKIN. Another objection to it is that it is in substance a retroactive imposition of a regular tax on corporations, and, not having had any notice of that kind of a tax, it is a very unfair thing. I am talking about your No. 1 point.

Mr. McFARLAND. Yes. We have mentioned in our third point a suggestion with respect to minimization of the retroactivity. These two provisions that I have just referred to, section 442 contains in two parts of that section the same provisions that were contained in section 722 (b) (1) of the World War II Act, present Internal Revenue Code, and the first sentence of section 722 (b) (2) of the present code.

In theory, these two provisions should afford some measure of relief, but as a matter of practical experience we know that very little relief will actually be granted, administratively, under these provisions. Section 722 (b) (2) has been construed very strictly by the Excess Profits Council with the result that practically all 722 (b) (2) claims have been denied.

Senator MILLIKIN. Do you have any pending claims from World War II?

Mr. McFARLAND. I do not believe this company has any pending claims at all, but I have a general practice specializing in taxation, and I have had a great deal of contact with other attorneys, because of my bar-association work and my general acquaintance with attorneys throughout the United States.

I have been very closely in touch with the work, with the progress and the results of the Excess Profits Council, with the condition of

the calendar of the Board of Tax Appeals which now includes some 600 cases before the Board on excess taxes alone which have been turned down by the Excess Profits Council, so, a good many of the remarks which I make are not remarks which are based upon the experience of this particular company but are based upon facts which are within my personal knowledge and my professional experience.

I just stated that 722 (b) (2) has been construed very strictly by the Council. Let me give you a specific example. The majority report of the Ways and Means Committee on this bill, at page 53, illustrates section 442 (a) (2) as being applicable in a case "such as a severe price war." The same illustration was used in the committee report on section 722 (b) (2) back in 1942. The Regulations of the Commissioner of Internal Revenue (sec. 35.722-3(b)), however, specifically refer to a "ruinous price war" as one in which sales are made "below cost." So, unless the taxpayer can show that the price war resulted in sales "below cost," he is very likely to be denied administrative relief. Thus, if a taxpayer with normal profits of $500,000 actually realizes a profit of but $50,000 due to a ruinous price war, he does not qualify for relief under the regulations as administered, because he did not sell "at less than cost," but actually made a small profit.

The foregoing illustration is not hypothetical, nor is it just one isolated case. It represents not only an actual case rejected by the Excess Profits Council and now pending before the Tax Court but also, we think, is a fair illustration of a general bureau policy of extremely unsympathetic administration of this particular relief provision.

We respectfully suggest a further clarification in the report of this committee, if this provision is to provide any measure of relief whatever.

Undoubtedly, a great deal of the difficulty in the application of the relief provisions would be eliminated if an automatic qualification for relief were inserted in the statute—by this, I am referring to section 442—such, as for example, if the net income for the third largest base period year or 12-month period were less than, say, 50 percent of the average of its other two better years, it would automatically qualify for relief, the amount, if any, to be determined as provided in section 442. Such a provision would elimiante a tremendous amount of administrative difficulty and expense in presenting and passing upon claims.

I have noticed in reading over section 442 that there is in that more or less of an automatic provision for qualification under that relief provision; and it seems to me that if some qualification as I have suggested here be placed in section 442 it would eliminate a lot of uncertainty and a great deal of administrative time and expense, as well as time and expense of taxpayers to even find out whether they are going to be permitted to qualify.

The third and the last suggestion has already been more or less referred to. We also respectfully suggest that the act be not made retroactive beyond October 1, 1950, the date when the tax increase on individuals was made effective.

In conclusion, may I suggest, as I have stated, I am in that class referred to by Mr. Little of Textron, a class of either lawyers or accountants, and I believe he said that he thought that this was more or

less of a bonanza that would accrue to such persons as I and the associates that I have in various cities.

I would be very glad, indeed, to waive all benefits that might result from the passage of an excess profits tax if the Congress would pass a suitable tax as has been suggested, not in the present form of the excess profits tax but rather as an increase in rates.

Senator MILLIKIN. We will tax you for more income tax.

Mr. MCFARLAND. I am fully cognizant that I am going to be stuck, but what I am doing is talking for the corporations, and in the interest of the public economy I have seen the extreme difficulty that results from the attempt to apply the relief provisions of the excess profits tax, and although an admirable effort has been made in the drafting of this bill, I still definitely am of the opinion that it is going to be absolutely impossible to not only draft a fair excess profits tax, but I also have a very deep-seated feeling that it is not in the interest of the economy, of the public economy, it is not in the interests of the revenues, and it is not in the interests of good business administration for such a tax to be passed.

I thank you.

Senator BUTLER. I take it, that you were rather favorable to the proposal made, then, this morning by Mr. Little?

Mr. MCFARLAND. His was a fourfold proposal and something that involves a lot of things that I have not had a chance to study, and I would hesitate to express an opinion of the details of his proposal, but it does seem to me that somewhere either between that suggestion or a suggestion of a flat increase in rates to be called a defense tax, would make toward a more simple administration, and not something which has such fuzzy edges as any excess profits tax such as that which we have in the present bill is bound to have.

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

Mr. MAURICE FRIDLUND.

STATEMENT OF H. MAURICE FRIDLUND, SPECIAL COUNSEL FOR THE NATIONAL FEDERATION OF AMERICAN SHIPPING, INC., NEW YORK, N. Y.

Mr. FRIDLUND. I am H. Maurice Fridlund, of New York City, appearing as special counsel for the National Federation of American Shipping, Inc., an organization representing most of the companies engaged in foreign and domestic shipping by sea.

Let me interpolate at this point, that I have had 28 years of experience with the taxation of shipping companies. That includes the excess profits taxes that we had during World War I and World War II, and for that reason I hope that I can be helpful to this committee in its present problems.

The general position of the National Federation of American Shipping is this: We suggest at the outset that the imposition of corporate taxation should be proportional to increases imposed on other tax sources.

Senator MILLIKIN. May I ask, what do you mean by that? Give me an example, please.

Mr. FRIDLUND. We have made certain increases in taxes on individual incomes, and little or none in the other sources, whether they be in the form of excise taxes or otherwise.

Senator MILLIKIN. You mean that if we increase personal tax 10 percent, we should increase corporate income taxes 10 percent?

Mr. FRIDLUND. Something of that sort, so that the entire burden of the extra taxes required will not rest on corporate profits in any form.

Senator TAFT. I think we can agree on that, that the bill which passed last summer was a bill which probably would maintain about the same proportion of corporate and individual income taxes. Your suggestion is that you ought not just increase corporate income taxes. If you are going to increase, you ought to increase everything at once?

Mr. FRIDLUND. Yes, Senator Taft, to the extent, of course, that this burden has equalized among other sources, why, my remarks here have no application.

Secondly, we suggest that any extra tax should be definitely labeled as a defense tax, and to expire by its terms when the extra defense needs are ended.

We do not advocate the adoption of an excess profits tax. If, however, such tax is to be imposed, we point out that H. R. 9827 will require major amendments; if it is not to bear inequitably upon the American shipping industry. We are not asking for any special favors, but only that the American merchant marine be not penalized by reason of its unique contribution to national defense.

In other words, insofar as the law already places that industry on a subpar basis, that that should not be made the basis for taxing it more than the level which would apply to others. I think I can make that clear. Consider, if you will, the relation of shipping to national defense.

In the brief time available, it is impossible to stress adequately the vital position which the shipping industry occupies as an adjunct to our Armed Forces. The American merchant marine is aptly called the "fourth arm" of our national defense. The facts speak for themselves when we realize that privately operated American ships have delivered more than 80 percent of all cargoes and military supplies to the United Nations forces fighting in Korea. The shipping industry is the first to feel the impact of a war emergency; and it is the last to be released from wartime requisitions.

In addition, shipping is a highly regulated public utility, whose rates in domestic commerce are fixed by the Interstate Commerce Commission, and in foreign commerce governed by regulations of the Federal Maritime Board. In wartime, our ships are requisitioned by the Government and diverted to war purposes at compensations fixed by the Government under the law—section 902 of Merchant Marine Act—which prohibits any "enhancement due to the causes which necessitated the taking." As a result, any opportunity to earn "excess profits" are almost nonexistent.

Because a strong and efficient merchant marine is indispensable to national welfare and defense, Congress enacted the Merchant Marine Act of 1936. In sections 511 and 607 thereof, it ordained the establishment of certain statutory funds, into which the shipping companies were required or encouraged to deposit proceeds from the disposition of ships and/or the ship earnings on a tax-deferred basis. These deposited funds are dedicated primarily to build new and better ships.

Herein lies the problem. Under the proposed bill, these deposited profits will count neither as "base period income" nor as "invested

capital." Since these plowed-back earnings of prior years are so disregarded, any normal earnings of the new ships will be practically confiscated by the excess profits tax. We think this would be a strange hardship and a great injustice to visit on an industry for having cooperated so loyally in the Government's policy to build up speedily the necessary merchant marine.

Senator TAFT. Does this position about profits go right on into the war period?

Mr. FRIDLUND. It did not in the last war.

Senator TAFT. Supposing it does, are those profits counted?

Mr. FRIDLUND. No; they are not counted.

Senator TAFT. They would have to be deducted also, then, in determining what your normal account was in 1951?

Mr. FRIDLUND. Yes; that is true, but usually in a wartime period when a company's ships are requisitioned and they are no longer operated on a commercial berth, those profits cannot be deposited, and therefore would be included in the excess profits income even though they have no reflection in either the invested capital base or in the base period earnings.

Senator MILLIKIN. What was the reaction of the House Ways and Means Committee to this same argument?

Mr. FRIDLUND. We presented that argument, but we have searched the bill and are unable to find any relief granted on that score.

Senator MILLIKIN. Have you had any discussion with the House staff?

Mr. FRIDLUND. We had a brief discussion, but they were in preparation for the House hearings at the time, and had very little time to give to it.

I think perhaps I can illustrate this by an example, if I may. It points up the particular hardship which would thus be imposed. I am going to take a simplified example, which admittedly is extreme, but otherwise applicable.

Suppose that a shipping company has normal profits of $100,000 per year for 10 years, namely 1940 to 1949, and they are deposited in the statutory funds.

Senator TAFT. All of them?

Mr. FRIDLUND. I am assuming for the sake of simplicity all of them; yes.

Senator TAFT. Are you required to deposit them?

Mr. FRIDLUND. Some companies are, Senator, and to other it is optional.

Senator MILLIKIN. Does that not fall under presumably advantageous terms?

Mr. FRIDLUND. I think that is reflected in an entirely different aspect, namely, that when the Government in wartime requisitions that ship, it gets it at a very much reduced rate, having little or no relation to its current earning power or even normal earning power, but solely on a cost-allowance basis.

In the example, let us assume that this $1,000,000 accumulated for 10 years is in 1950 used to build a ship which comes into service for the first time on January 1, 1951. Having been built with tax-deferred funds, that ship has no cost basis, no depreciation, its current earnings have no reflection in any base period income or even in invested capital.

This means that the current recovery of prior years' earnings would be subject to that tax now of 75 percent instead of the old 25, in case of a capital gain, or 38 percent in case of ordinary earnings, and the balance of the current earnings, even no more than the $100,000 normal earnings,would be fully subject to the excess profits tax.

We submit that the shipping companies that have faithfully carried out the Government's maritime policy should not be so penalized.

Senator MILLIKIN. What does the Government say is the equity of this? It seems to me that there is missing some factor here that might lend a little more equity to this than appears on the surface.

Mr. FRIDLUND. I think we have much the same situation, Senator, that we have in dealing with long-term contracts or installment basis. So long as we are on a purely income tax basis, why, it makes very little difference whether these things are taxed now or a little later, but when we come to an excess profits tax which sharply increases that rate, then it makes a great deal of difference whether the earnings in this case deposited and dedicated to a particular purpose, are included or excluded from the base period earnings, and likewise, of course, from the invested capital.

Senator MILLIKIN. Since those profits had been taken out of the business and are dedicated in this way, the Government has gotten no revenue in the same sense that it would have had, had an ordinary corporation distributed those profits to the individuals who are taxpayers. There has been an exemption there from normal taxation through individual income tax.

Mr. FRIDLUND. Perhaps I did not make myself clear on this. This has been interpreted by the Treasury not to be an exemption but merely a deferment of the tax. The deposited funds when reinvested in a ship, of course that ship having had lower cost basis and with eanings currently therefore higher for the lack of that extra depreciation, it is deferred only temporarily, but that makes a great difference when we come to an excess profits tax year whether the earnings actually earned in 1940 to 1949 are not counted though actually earned, though temporarily tax-deferred, are not counted for purposes of invested capital and base period income.

The CHAIRMAN. Did you notice the House statement on this point? They said in their report:

> Under section 505 of the Merchant Marine Act of 1936 as amended, if any contracting party in its taxable year completes one or more contracts or subcontracts for the construction of a vessel——

are you speaking about the earnings?

Mr. FRIDLUND. Yes, Mr. Chairman. That section refers only to the companies engaged in shipbuilding.

The CHAIRMAN (reading):

> under such act, such party is required to pay to the Maritime Board any profit in excess of 10 percent of the total contract price of such contract and subcontract. The excess profit so paid to the Maritime Board together with all other receipts of the Board are placed in a revolving construction fund and available for further ship construction.

You are talking about the earnings of the ship?

Mr. FRIDLUND. Yes.

The CHAIRMAN. Is operation as contrasted with profits made upon a ship that you are constructing?

Mr. FRIDLUND. That section as I understand it is limited to those companies that are engaged in shipbuilding.

The CHAIRMAN. It says that, yes:

> The treatment accorded such profits by section 726 of the World War II law is continued by your committee's bill.

They say this:

> As a general rule, the amount received by the contracting party and recaptured by the Maritime Board would be excluded in computing the excess profits tax under section 430 of the bill. In computing the alternative tax provided by section 455 of the bill, the taxpayer will be required to increase its excess profits net income and its normal tax net income by the amount of the payment to the Maritime Board. The law computed upon this basis is then reduced by the amount of such payments and the remainder constitutes a tax which is to be paid if it is less than the tax computed under section 430.

Mr. FRIDLUND. Yes, Mr. Chairman, but that relates only to shipbuilding contracts and has nothing to do with the companies that own and operate the ships.

The CHAIRMAN. Do you have to pay to the Maritime Board a portion of your earnings on your ships in operation?

Mr. FRIDLUND. That is true of the subsidized companies whose subsidy is subject to recapture, even though it is currently included in taxable income.

There are many special treatments that place us in an inferior position, which I would like to have time to deal with, but we have picked out the two that I believe are the most unjust, and with a strong conviction that Congress will rectify such threatened injustice, we merely urge this: that the profits for 1946 to 1949, that is, the base period years which had been required or permitted by the Merchant Marine Act to be deposited in statutory funds, should be recognized in computing base period income. Similarly, such deposited profits of prior years should be recognized for invested-capital purposes, after being reduced by the taxes that have been temporarily deferred.

This is in line with the recommendations made by, I believe, a completely unbiased section, namely, the section of taxation of the American Bar Association in its bulletin for October, 1950, page 11, item a, where it is recommended that special consideration should be given "where circumstances require the correction of inequities grown out of tax-free transactions." Likewise such solution is consonant with the relief given by section 453 for relief in the analogous cases of "installment bases and long-term contracts."

Section 455 of the bill, which as the Chairman has just pointed out, deals with other problems that are peculiar under the Merchant Marine Act should be broadened by the addition of a new subsection substantially to the following effect:

> (c) Earnings and profits required or permitted to be deposited under sections 511 or 607 of the Merchant Marine Act, reduced by deferred taxes otherwise applicable, shall be includible in equity invested capital under section 437 (c); and such earnings and profits for the base period without reduction shall be included in base-period income under section 435 (b).

Senator MILLIKIN. May I ask Mr. Stam a question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator MILLIKIN. What is the argument against that, Mr. Stam?

Mr. STAM. I do not recall that this problem was raised before the House committee, and it was not gone into in the committee itself in executive session, so the matter is still open.

Senator TAFT. I think we should request the staff to make a study of it.

Mr. STAM. I will be glad to do that.

Mr. FRIDLUND. I have dealt with a problem which is probably the most threatening to the shipping industry, which would in effect result in taxation at excess profits rate of those things which are either the deferred collection of income from prior years or perfectly normal earnings.

Let me very briefly deal here with problems which are common to all industries, although they happen to bear with aggravated force on the shipping industry.

1. Borrowed capital credit is recognized under section 439 only to the extent of one-third of the interest rate. Thus if the interest rate is 3 percent the deduction is 3 percent and the credit is 1 percent, a total effective allowances of only 4 percent for borrowed capital. I believe if we were to seek a policy deliberately designed to stifle production, we could think of no better way to do it. This restriction on borrowed capital credit is particularly vicious in the case of the shipping industry, which finds it so difficult to borrow its requirements commercially that in order to get ships built the Government, by statute, offers to lend 75 percent of the cost at 3½ percent.

We submit to you that the only fair solution as to borrowed capital credit is this: to give credit for borrowed capital at the same rates as equity capital, namely 8 percent to 12 percent, but reduced by the interest allowed as a deduction.

2. Base-period income credit, provided under section 435, fails to allow any income credit for expansion after 1949.

That is particularly serious in a shipping industry which the Government has been urging to build new ships, and some of which during the year 1950, some of them before the inception of the Korean war, and some of them after, have complied with that policy to expand during the year 1950. In other words, if we are to tax "excess" profits, we must find a fair "normal" base which for existing facilities may be the normal base-period income. Restricting the allowance for expansion, first, to the years prior to 1950, and secondly, to a capital percentage, which is what the bill does, is particularly unfair to an industry which operates with high risks. Therefore, if we are to allow for vital expansion, we must allow for an increase in normal income credit that is proportionate to the expansion. A company that had normal earnings of $100,000 per year with one 10,000-ton ship should be allowed to double its base-period income credit if it doubles its fleet by adding a second 10,000-ton ship in the taxable year. Such increase in base-period income, proportionate to increase in production facilities, should be stated as a rebuttable presumption.

Obviously no two assets are exactly alike, and if one is better than the other, why proportionate adjustment should be allowed.

An increase in productive facilities should likewise result in a percentage increase in the normal base-period income allowance, and we believe that the denial of any such proportionate increase would be so unfair that it would result in putting the brakes on expansion at the very time when we need it most.

Senator TAFT. Mr. Stam, is there not some allowance for an additional capital investment?

Mr. STAM. They allow 12 percent, a flat 12 percent rate for additional capital.

The CHAIRMAN. Invested in the excess profits year?

Mr. STAM. In the excess profits tax year or in the last year of the base period, or some adjustment in 1948.

The CHAIRMAN. We are speaking now of an increase in the excess profits year, an increase of facilities. What is that?

Mr. STAM. For the new ship, for the addition to capital he would get 12 percent on that. That is this flat rate he is talking about.

Mr. FRIDLUND. That is as to new capital, but suppose a company which has conservatively invested——

Senator TAFT. Suppose it has kept its money to put into a new ship.

Mr. FRIDLUND. To take the very simplest illustration of all, suppose that it had kept its earnings in cash, unproductive, awaiting the time when it could afford to expand the large capital sum required to build a ship nowadays, and it takes that risk, and it is a highly important risk. There has been no increase in capital except as to the 75 percent mortgage which is usually put on by the Government, for which I have pointed out a pitifully small 4 percent allowance is given in the——

The CHAIRMAN. That is the case of borrowed money.

Mr. FRIDLUND. Yes, but there has been no increase in equity capital, and yet it has doubled its productive facilities.

The CHAIRMAN. If you had plowed back or held back the earnings of the company, you would be entitled to credit under the House bill.

Mr. FRIDLUND. Oh, yes; but here there is no new capital except as to borrowed capital. In other words, when we are mixing, as this bill does, pumpkins with apples, we are comparing on the one hand base period earnings of productive facilities and then we are talking on the other hand about a capital increase.

We have got to compare like things with like, and when we talk about a base-period income, if we double our productive facilities, there should presumptively be a corresponding increase in the base period income.

Senator TAFT. In other words, you might turn to the capital income, you might get some advantage.

Mr. FRIDLUND. Oh, yes; particularly in a risky business like shipping. You cannot begin to compare a capital allowance on the one hand with an income allowance on the other, and where we try to mix the two, then we are certain to get unjust results.

Mr. STAM. The bill allows 12 percent on retained earnings and equity capital, that is new capital both for the invested capital credit and for the earnings credit. That was the change under the old law. The old law made no allowance for retained earnings under the income credit.

Senator TAFT. We had the same case this morning. We had another man here on the same matter. It just occurred to me that you might gear it somehow to the tax on increased production or increased productivity or something like that.

Mr. FRIDLUND. I think that is the point, Senator.

Mr. Chairman, may I have the permission of this committee to file before the conclusion of these hearings some further comments directed particularly to sections 442, 443, and 444, the relief provisions so-called, particularly as affecting growth companies.

The CHAIRMAN. Yes, sir, you may do so.

Mr. FRIDLUND. Thank you, sir.

(The following material was later submitted by Mr. Fridlund:)

[The Journal of Commerce and Commercial, Friday December 8, 1950]

THE SHIPPING OUTLOOK

THE EXCESS PROFITS TAX BILL

(By Edward P. Tastrom)

It is quite generally recognized by the shipping industry as well as by other segments of the economy that the huge defense outlays found necessary at this late hour must be met by sharply increased taxation.

However, there are equitable and inequitable ways of imposing taxes due not to any intent upon the part of legislative officers to effect particular hardships, but simply because certain situations do not quite fit into any general formula.

This is the position that the shipping industry currently finds itself in as Congress sits down to write a new excess profits tax bill. Representatives of the shipping industry have emphasized this in testimony before the House and Senate committees considering the new bill.

It is important to get clearly in mind at the outset that shipping men realize the need for more taxation at this time, that they do not suggest methods of raising revenue other than provided in the current bill and that the sole purpose of their plea is to prevent an injustice, that would work grave hardship, from being incorporated into law.

Now let us take a look at the proposed new excess profits law and how its application severely penalizes shipping.

Under the bill there are two ways you can establish your base for excess profits tax computation. One way is by average earnings for the 1946–49 period; the other is on the basis of current capital investment.

The object of either approach is to take off by way of taxes any extraordinary profits above a normal rate of performance, which profits are viewed by the taxing authorities as arising in large part from defense and emergency spending.

The bill as now written penalizes shipping, however, because it does not allow inclusion in determination of the normal rate of performance of those earnings or capital gains which have been set aside by operators in certain statutory funds established primarily to provide a capital pool to build new ships.

This means that inability to include these earnings or capital gains, which in some instances have amounted to a shipping company's entire net during some of the base period years, cuts by the amount of such exclusion current revenue that is taxable at the normal rate and makes applicable, instead, the full 75 percent excess profits tax rate.

It should be borne in mind that these statutory funds which shipping men have been encouraged to set aside for fleet rebuilding never have been tax-exempt, but only tax-deferred until used and that, furthermore, substantial amounts of these funds have been or are being used in new vessel acquisition or construction. Since the tax liability has always existed, and since the earnings and gains are real, it is difficult to see why they should not now be included in determining the base for excess profits tax purposes.

How their exclusion would work is given in a simplified example cited before the Senate Finance Committee this week by H. Maurice Fridlund, attorney appearing on behalf of the National Federation of Shipping.

"Suppose," said Mr. Fridlund, "a shipping company has profits of $100,000 per year for 10 years (1940–49), which are deposited in statutory funds. In 1950, an accumulated $1,000,000 is used to build a ship which comes into service January 1, 1951. Having been built with tax-deferred funds, the ship has no cost basis, no depreciation, and its current earnings have no reflection in any base period income or any invested capital. This would mean that current recovery of prior years' earnings (1940–49) would be subject to tax at the new 75 percent instead of the old 25 or 38 percent rate (depending on whether

capital gains or profits). The balance of the current earnings, even though no more than the $100,000 normal earnings, would be fully taxed as excess profits."

This points up the need for recognition by Congress in the new tax law that an exceptional situation exists with regard to these funds which shipping concerns have set aside, under Government encourgagement, and which now are threatened with a tax liability that borders on confiscation and is entirely contrary to the original concept of capital accumulation.

What can be done in a situation of this kind? Well, Congress can do precisely what it has done in other instances where the peculiarities of an industry's financial set-up have warranted exceptions, for the purpose of tax calculation, in income and capital treatment. It has provided in section 453 of the new bill for installment sellers and long-term contractors by allowing them to recompute their contracts on a percentage of completion basis and be subject to excess levies only on the uncompleted portion of the installment purchase or long-term contract.

This is a realistic approach that takes recognition of the basis on which the transactions were made. And this is all that the shipping companies are asking in requesting inclusion of these special capital funds in the base period calculation.

We must recognize that the new bill, as it presently stands, constitutes a change of signals on the shipping industry. Accumulation of these construction funds was encouraged to assure continuous modernization of our merchant marine. Operators had the right to assume that this money, when it became taxable, would be levied against at normal rates. Otherwise, there would have been no point in their building up these funds. They would have paid the capital gains or profits tax immediately when due and gone on about their business even though this might have meant no new ships and a downhill slide for our merchant marine such as happens in any business where replacement and expansion funds are lacking.

There are other phases of the tax bill which penalize shipping, such as the allowance made for earnings on borrowed capital and failure to allow any income credit for expansion after 1949. Both provisions will tend to discourage any future expansion.

This makes rather fatuous the exception provided in the bill for shipbuilders since there isn't likely to be much new building in the face of these limitations. This exception, incidentally, was made because shipbuilders are subject to recapture of certain construction earnings. However, lines having an operating-differential subsidy also are subject to recapture of earnings above 10 percent of average capital employed.

We have tried to point out both the injustices and the inconsistencies in the present bill which, it is recognized, was drafted hastily to meet increased military budget needs.

The Senate Finance Committee is now considering the measure and it is hoped that this body will give due weight to all the factors involved in this admittedly complex shipping situation and make the exception needed in the law to prevent an unwarranted tax burden from being imposed on ship operators.

STATEMENT OF H. MAURICE FRIDLUND, ON BEHALF OF SEATRAIN LINES, INC., RE NEEDED RELIEF FOR "INCREASED CAPACITY" UNDER EXCESS PROFITS TAX BILL (H. R. 9827)

Introduction

I am H. Maurice Fridlund, of New York City, appearing as counsel for Seatrain Lines, Inc., of 15 Broad Street, New York City. The company is engaged in operating Seatrain-type ships in interstate and foreign commerce.

General position

We join in the recommendations made by the National Federation of Shipping before your committee on Tuesday, December 5, 1950. In particular, we agree with the theme of the statements heretofore made before your committee by Dr. Allen B. DuMont, chairman of the National Conference of Growth Companies, and by Mr. Royal Little, president of Textron, Inc.: "H. R. 9827 does not provide proper relief for increased capacity." We are concerned, however, not with a gradual or steady yearly growth, like a store's sales increasing annually, but with major increases in productive capacity like a factory adding a new wing or a steamship company adding a new ship.

Defects in relief provisions

The bill properly discards the old section 722 as unworkable, but, in doing so, no real relief has been substituted in its place. As "increased capacity," the bill has the following serious defects:

(1) It assumes that all normal-income growth stopped at December 31, 1949.

(2) It allows no increase of base-period income for increase of productive capacity effected in 1950 or thereafter.

(3) It assumes that after 1949 any increase in productive capacity is adequately measured by new capital credit.

(4) It provides no real relief for expansion.

(5) As result, expansion is not rewarded, but is penalized.

Seatrain's situation

These defects are well illustrated by this company's situation. It has a relatively small invested capital, but the earning power of its unique type of ships is substantial. The following may be taken as illustrative of its situation in a much simplified form: At present it has in operation a fleet of four ships, which have had a combined annual earning power of over $3,000,000 (before taxes) or "normal earnings" of (say) $750,000 per ship since 1946. Since the last war the company has been conserving its earnings to build two more identical ships, to furnish increased capacity that has long been needed in its normal peacetime services. Plans and other arrangements for this expansion were made in 1949 and early 1950, before the Korean war began, and the contract was let last summer. Note carefully that these are not war facilities, but represent a long-planned peacetime expansion. These new ships will be paid for largely by conserved cash. When delivered in 1951, each of the two new ships are expected to earn at least as much as each of the four identical older ships.

Section 435 does not allow an adjustment of the base-period income credit unless new capital has been added. Section 443 does not apply to expansion subsequent to 1949. Thus, Seatrain will be allowed as credit only the base-period earnings of the four old ships, without any allowance whatsoever for the 50-percent increase in the productive capacity to be added by the two new ships. In other words, the company will be given no credit for conversion of its cash into two large productive assets. If we were deliberately seeking to devise a scheme that would stifle expansion of our privately owned merchant marine, we can think of no better way to do it.

To make matters worse, in wartime, the Government conscripts all seagoing ships for military use. As Seatrain-type ships are particularly desirable for such war use, we may expect that all the company's ships will be requisitioned (as they were in World War II), including the two new ships as soon as they are completed in 1951. Under section 902 of the Merchant Marine Act, the requisition hire is the normal hire "not enhanced by the causes necessitating the taking," and will be determined on 1949 rates. The requisition hire for each of the six ships, under facts assumed in the illustration, would be $750,000 plus depreciation, thus yielding the company a net "normal income" of $4,500,000. Under sections 435 and 442, however, the company's base-period credit would still be only $3,000,000, the actual normal earnings of the four old ships. Since no new stock was issued, the entire normal requisition hire of the two new ships would be deemed "excess profits" taxable at 75 percent. Thus, Seatrain will pay a penalty of $450,000 per year for having built (at its own expense and without Government aid) two urgently needed ships.

This is not a fantastic or imagined situation, for it is a repetition of what happened in 1940–45, in connection with the two new ships contracted for in 1939 and delivered in 1940. The question is: Shall the sorry history of section 722 be allowed to repeat itself because of defects in sections 435 and 442? If the intended relief under section 722 had been obtained, these two ships now under construction would have been built in 1946 or 1947, and thus their added earnings would have become a part of the income for 1947–49. We cannot believe that your committee will deny justice again, but will provide proper adjustments to reflect the "normal earnings" of the two new ships.

Normal earnings

H. R. 9827 fails to adjust the "income credit" for newly acquired production facilities. Obviously, this defect must be remedied, if the bill is not to impose intolerable hardships on expanding companies. Why should not the base-period income credit be increased by 50 percent when the productive facilities are increased by 50 percent? This should be allowed and regardless of whether the

cost of the new facilities was financed from the company's own surplus or by obtaining new capital from the outside.

We must never forget that we are seeking the "normal income" for the taxable year, not for some prior year. For old facilities, such normal income is what they actually earned during a normal year, such as the proper base-period years. New facilities which, in the taxable year, earn as much as do the old facilities, should be assigned the same normal earnings as the old facilities. That is common sense. Since the test is what are "normal earnings" for the taxable year, it makes no difference when the new facilities were added, whether during or after the base period. (Adjustments may be required if the new facilities are allowed war amortization.) For identical new facilities added after 1949, their normal earning power must be measured by the actual earning power of the comparable old facilities. Any denial of this principle will result in penalizing increased production at the very time when we need it most.

New capital allowance

A mere adjustment for new capital will not achieve a just result, for the following reasons: (*a*) Expansion is not always financed by new capital, either risk capital or borrowed capital; (*b*) expansion is sometimes financed by company's surplus changed from low-risk investment to high-risk productive facility; (*c*) a uniform allowance for new capital is not a fair measure of income basis; (*d*) mixing income allowance with capital allowance is not consistent.

Industry index

For the same reasons, relief based on an industry index is not adequate. Section 443 makes a restricted attempt at base-period income adjustment based on industry averages. This is at best a crude and inadequate relief for companies with base-period experience. The reason a company uses a "normal earning" method in the first place is that its efficiency entitles it to a higher return than an arbitrary capital percentage or an industry index. When it has proved what it can earn on one unit in the base-years and later adds a second identical unit, why should that company be arbitrarily deprived of its own earning index? This is both simpler and fairer than any artificial or average index that can be contrived. It is also common sense.

Solution

In the case of a company using the "base-period income" method, we cannot fairly compel it to measure "growth" by an allowance only for "new capital." To do justice, we must find a solution which will measure "growth" allowance by a simple and direct formula for adjusting the "income credit" itself. The virtues of section 722 must be retained, but its unworkable features must be eliminated. This can be achieved by the following formula:

It should be presumed that the newly acquired facility has the same rate of "normal earnings" as did the identical or similar old facilities in the base period. Note that this is stated as a presumption so that any advantages or disadvantages of the new facilities over the old can be properly adjusted. This will furnish a fair, simple, direct and workable means of adjusting the base-period income credit in proportion as the new productive facilities are added. If some such provision is not made, the rankest kind of injustice will be wrought on the companies that have responded to the Government's demand for more production. Otherwise, needed expansion will be penalized, and a tax premium will be given to those companies that maintain the status quo.

Summary

Amendments needed to give proper relief to growth companies for "increased capacity" are:

I. Sections 435 and 443 should be broadened to allow for expansion subsequent to December 31, 1949.

II. Such expansion cannot adequately be measured in all cases by increase in capital.

III. Base period income credit should be presumed to increase proportionately as productive capacity is increased, whether this occurs during or subsequent to the base period.

IV. If any cut-off date or "commitment rule" should be required, it should be not earlier than the date of enactment of the bill. Retroactive penalty for expansion would be particularly reprehensible.

The CHAIRMAN. We will be glad to have you do so. Mr. Schweitzer, will you please identify yourself for the record.

STATEMENT OF M. PETER SCHWEITZER, TREASURER, PETER J. SCHWEITZER, INC., NEW YORK CITY

Mr. SCHWEITZER. My name is M. Peter Schweitzer and I am the treasurer of Peter J. Schweitzer, Inc., a New York corporation with mills in New Jersey, Pennsylvania, Massachusetts, and Minnesota. We manufacture fine papers, including cigarette paper, carbonizing paper, and electrical papers. I want to speak on just one point which affects my company and which concerns a rather technical provision which was contained in the last excess profits tax law, in section 742 (f) of the Internal Revenue Code. A comparable provision is contained in section 462 (f) of H. R. 9827 as reported to the House by the Ways and Means Committee.

Peter J. Schweitzer, Inc., at the end of 1949 purchased for cash and notes all the stock of the Smith Paper Co. of Lee, Mass. In June of this year it liquidated the company and thereafter operated all of the former Smith plants as a division of Peter J. Schweitzer, Inc. This liquidation was not, however, contemplated at the time the stock was purchased. The Smith Paper Co., now a part of Peter J. Schweitzer, Inc., provides employment for approximately 700 people, the greater part of the working community at Lee, Mass., and during 1946 to 1949 had substantial average earnings. There is every reason to expect that these earnings will continue. Under H. R. 9827 as reported to the House, the Smith Paper Co. as a separate corporation would have had an average earnings credit of approximately $300,000. However, if a provision comparable to section 742 (f) is contained in the new excess profits tax law (as it now is contained in section 462 (f) of H. R. 9827), practically the entire credit of Smith will be lost to Peter J. Schweitzer, Inc. That is because under section 742 (f) the earnings of the liquidated company for the period prior to the stock acquisition cannot be used in computing the excess profits credit when the stock was purchased for cash and notes. As a result Schweitzer's credit would be based solely on Schweitzer's earnings during 1946–49, when it was not operating the Smith plants, although Schweitzer's income would be increased by the income previously earned by Smith.

As I said before, when the stock of Smith was purchased Schweitzer did not plan to liquidate the company. If Schweitzer had not liquidated the Smith Co., Schweitzer and Smith would each have continued to use its own base period experience in computing its excess profits tax credit. However, under section 742 (f) of the old law and section 462 (f) of H. R. 9827, by the mere fact of liquidation Smith's excess profits tax credit of approximately $300,000 is lost, and virtually all of the earnings allocable to the Smith plants and not just the excess earnings would be subject to excess profits tax.

Section 742 (f) of the Internal Revenue Code is part of supplement A which contains the provisions relating to the determination of the excess profits credit based on income when a corporation has acquired the properties of another corporation in a tax-free reorganization or liquidation. The general rule of supplement A (and also the general rule under H. R. 9827) is that the acquiring corporation can add the base period earnings of the acquired corporation to its own

base-period earnings in determining its excess profits credit on the income method. However, this general rule is limited by the provision of section 742 (f) of the old law and section 462 (f) of H. R. 9827, so that when a corporation first acquires the stock of another corporation and later liquidates the acquired corporation, if the stock was acquired with cash (or any property other than stock), the acquiring corporation cannot use any of the base-period earnings of the acquired corporation for the period prior to the stock acquisition.

I understand that section 742 (f) was included in the old law to eliminate a possible duplication of credit. The theory was that, when a corporation acquired the stock of another for cash (or any property other than its own stock), the cash or property had previously been producing income; and that there would be a duplication of credit if the corporation was allowed to use both that income and also the earnings of the liquidated corporation. I believe it would have been equitable, in cases where there was a duplication of credit, to have provided for the elimiantion of any income previously produced by the assets used to purchase the stock. But eliminating the earnings of the liquidated corporation produces extremely unfair results as is exemplified by the position Peter J. Schweitzer, Inc., will be in if section 462 (f) remains unchanged in the proposed new excess profits tax law. In the case of Schweitzer, the stock of Smith was purchased largely for notes and not with assets that had previously been income-producing.

I am sure that this is not an isolated problem peculiar to the Schweitzer Co.—it affects every company computing its credit on the income method, and there must be many, that purchased another company's stock for cash and then liquidated the company. I urge this committee to give this problem careful attention in the bill being drafted in order to elimiante a severe inequity that I do not think was ever intended by the Congress.

Thank you for your attention and for giving me the opportunity to make this statement.

The CHAIRMAN. Thank you, sir.

(The following matter was later received for the record:)

LORD, DAY & LORD,
New York, December 7, 1950.

Hon. WATER F. GEORGE,
United States Senate,
Washington 25, D. C.

DEAR SENATOR GEORGE: My firm is counsel for the firm of Peter J. Schweitzer, Inc., and at the request of that company, I am writing you with respect to one of the provisions contained in H. R. 9827 which is now being considered by the Senate Finance Committee. The provision with which the company is concerned is section 462 (f) (1) of H. R. 9827. Mr. Peter Schweitzer, the treasurer of the company, testified before your committee on this provision on Tuesday of this week, December 5, and I am enclosing a copy of his statement.

I believe that section 462 (f) (1) as it is now drafted will cause undue hardship to many corporations and that the recommended change in the proposed statute is equitable both to the corporations that would come within its coverage and to the Government. I am taking the liberty of enclosing, in duplicate, a draft of a suggested revision of section 462 (f) (1), which revision puts into statutory language the recommendation made by Mr. Schweitzer in his statement before your committee.

Respectfully yours,

HARRY J. RUDDICK.

PROPOSED REVISION OF SECTION 462 (F) (1) OF H. R. 9827 AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS TO THE HOUSE OF REPRESENTATIVES

(The material in brackets is material now contained in H. R. 9827 which would be deleted by this revision: and the material underlined is new material)

"SEC. 462. RECOMPUTATION OF EXCESS PROFITS NET INCOME.

* * * * * * *

"(f) (1) If, after December 31, 1945—

"(A) the taxpayer acquired stock in another corporation, and thereafter such other corporation became a component corporation of the taxpayer, or

"(B) a corporation (hereinafter called 'first corporation') acquired stock in another corporation (hereinafter called 'second corporation'), and thereafter the first and second corporations became component corporations of the taxpayer,

then to the extent that the consideration for such acquisition was not the issuance of the taxpayer's or first corporation's, as the case may be, own stock, the average base period net income of the taxpayer shall be reduced [, and the transferred capital addition and reduction adjusted, in respect of the income and capital addition and reduction of the corporation whose stock was so acquired and in respect of the income and capital addition and reduction of any other corporation which at the time of such acquisition was connected directly or indirectly through stock ownership with the corporation whose stock was so acquired and which thereafter became a component corporation of the taxpayer,] *in respect of any income of the taxpayer or of the first corporation, as the case may be, attributable to assets of the taxpayer or of the first corporation, as the case may be, used to acquire such stock* in such amounts and in such manner as shall be determined in accordance with regulations prescribed by the Secretary. For the purposes of this paragraph, stock which has, in the hands of the taxpayer or first corporation, as the case may be, a basis determined with reference to the basis of stock previously acquired by the issuance of the taxpayer's or first corporation's, as the case may be, own stock, shall be considered as having been acquired in consideration of the issuance of the taxpayer's or first corporation's, as the case may be, own stock."

The CHAIRMAN. Mr. William Balderston.

STATEMENT OF WILLIAM BALDERSTON, PRESIDENT, PHILCO CORP., PHILADELPHIA, PA.

Mr. BALDERSTON. My name, Mr. Chairman, is William Balderston, and I am president of the Philco Corp. of Philadelphia. My purpose in appearing before your committee is to suggest means of imposing an excess profits tax, if this is deemed necessary—and believe me we do not believe in an excess profits tax——

Senator CONNALLY. Do you want to throw that in, that you are against it?

Mr. BALDERSTON. Yes, sir.

Senator CONNALLY. Being against it, you want it dehydrated as much as you can?

Mr. BALDERSTON. Yes, sir, I think that is a good idea. I would like to do that, without undue discrimination against growth companies, such as the Philco Corp.

The House excess profits bill will impose an unbearable burden on the Philco Corp., which has really only gotten under way in the past few years, after many years of costly research and development. The House bill will impose an unfair and discriminatory tax on this industry, unless it is substantially modified to make provisions for growth industries.

As I understand the philosophy of the excess profits tax, it is to tax only those profits which have been generated as a result of the defense

program. Actually, the television business has been hampered in the year 1950 by the defense program through serious shortages of material.

Senator CONNALLY. Do you think that if the defense program hinders the television business, you ought to stop the defense program?

Mr. BALDERSTON. No, sir, I do not believe that.

Senator CONNALLY. Is that your atitude?

Mr. BALDERSTON. No, sir, I would not do that; no. I mean by that, Senator, that 1950 is not a complete performance for the television industry. If the defense program had not come along——

Senator CONNALLY. I have got one of your televisions and I am surprised at the attitude of your company in making profits and then coming down here to kill the taxes.

Mr. BALDERSTON. We are not down here to kill the taxes, sir. I assure you of that.

Senator CONNALLY. All right, go ahead.

Mr. BALDERSTON. In the case of our own company, our production of television sets will fall short of the schedules established in May of this year by over 100,000 units because of material shortages. 1950 is really the first year that the television business has been able to hit its stride and demonstrate its profit-making potentialities. We sincerely believe that the proposed tax legislation should take full account of these facts, and the best practical solution that occurs to us is to use 1950 earnings as the normal base for the television industry.

For the information of the committee, we have prepared a tabulation showing Philco's profit before income taxes compared to the entire television industry and to all industries generally. You will note from this tabulation that on the basis of estimated 1950 profits, all industries generally will be expected to pay excess profits tax on about 30 percent of their estimated earnings, whereas the television industry will be expected to pay excess profits taxes on 66 percent of their estimated earnings and Philco will be required to pay excess profits taxes on 58 percent of its estimated earnings.

The House bill purports to grant relief to growth companies, such as Philco Corp., by permitting such companies to use as their earnings credit, either the average of the years 1940 to 1949, or the year 1949. We wish to point out that neither of these proposals would afford any relief to Philco Corp. because of an adverse earnings experience during the year 1949. A special combination of factors, together with certain unexpected and highly abnormal production difficulties, caused a very low level of television production in our plants during the first 6 months of 1949.

As a result of these difficulties our pretax operating earnings fell from $22,000,000 in 1948 to $4,000,000 in 1949. By the end of the year these obstacles had been overcome and the results for 1950 reflect normal level of operations attained after this period of readjustment.

In view of the fact that the television industry had grown from an output of 6,000 sets a year in 1946 to about 6,500,000 sets in 1950, no growth formula predicated upon historical earnings for any period prior to 1950 can give adequate recognition to the problem of our industry. Since 1950 is the first normal year of operations for the television industry, it follows that the only fair and equitable treatment of the industry can be attained by giving recognition to 1950

earnings. The Radio and Television Manufacturers Association has developed and will present before your committee a formula based upon 1950 earnings which would accord fair treatment, both to the industry and to Philco Corp.

We further urge that you give your careful consideration to the enactment of more liberal general relief provisions patterned after those employed under the prior law. It is unlikely that any formula can give adequate relief under all combinations of circumstances to specific problems of individual companies.

As you gentlemen undoubtedly know, the Philco Corp. was one of the large electronic suppliers to the Armed Forces in the last World War for which we received some 21 Army-Navy "E" awards and special recognition from the President. We are now being called upon to make a special effort in the production of electronic equipment in the present defense program. Anticipating this demand on our facilities, Philco Corp. has already authorized an expansion program over the next 18 months in excess of $12,000,000. If other important defense projects which are now under consideration materialize, substantial additional investments will have to be made in buildings and equipment to carry out our part of these programs. If a large proportion of our earnings are siphoned off through a discriminatory excess profits tax, it may greatly hamper our expansion program for the defense effort.

Gentlemen, while I am not in a position to speak for the entire industry, I am sure that their problems are very parallel to ours, and I would certainly recommend that the committee give careful consideration to the impact of the proposed House bill on the ability of the entire electronic industry to carry out its important assignment in the defense program.

The CHAIRMAN. Are there any questions? If not, thank you very much, Balderston, for your statement.

Mr. Frederick G. Weisser. Have a seat, please, sir. Will you please identify yourself for the record.

STATEMENT OF FREDERICK G. WEISSER, ATTORNEY FOR COLLINS & AIKMAN CORP., NEW YORK, N. Y.

Mr. WEISSER. My name is Frederick G. Weisser, and I represent the Collins & Aikman Corp.

I would like to say preliminarily also that my statement relates solely to section 442 of the proposed bill, which is one of the relief provisions.

Under the provisions of H. R. 9827, the base period for the computation of the average earnings credit is the 4-year period 1946 to 1949, and the poorest year may be eliminated. For most corporations, that 4-year period was one of unusual prosperity and for that reason the House Ways and Means Committee deemed it advisable to adjust the average base period income by a 15 percent cutback (House Ways and Means Committee report, p. 5).

The House committee realized, however, that the years 1946 to 1949 were not uniformly prosperous for all corporations and the bill, therefore, attempts to provide relief in certain hardship cases by the use of a formula for the determination of the exact amount of relief (House report, p. 16).

This, the House report says:

will avoid in large measure the difficulties of proof and the subjective determinations which characterized the administration of section 722 and will eliminate the delays which attended the provision of relief for hardship cases under the World War II law.

It is further stated that the bill provides relief where the taxpayer's income during the base years was abnormal because of a physical interruption to production or because of a depression in the business of the taxpayer resulting from temporary economic circumstances such as a severe price war (House report, pp. 17 and 18).

Section 442 of the bill (p. 57) provides that:

If for any taxable year within * * * the base period a taxpayer which commenced business prior to January 1, 1946, establishes—

and I would like to emphasize that word "establishes"—

(2) The business of the taxpayer was depressed because of temporary economic circumstances unusual in the case of such taxpayer, * * * the taxpayer's average base period net income shall be the amount determined in accordance with the provisions of this section or section 435, whichever is higher.

It is submitted that this phraseology presents enormous difficulties. In the first place, what are "temporary economic circumstances unusual in the case of such taxpayer"? It is visualized that the courts will struggle with the interpretation of that provision for many years at great expense to the Government and to the taxpayer, again resulting in extended delays in the settlement of relief claims and discrimination against taxpayers who have neither the time nor the financial resources necessary for the establishment of their cases.

Furthermore, there appears to be no sound reason for limiting relief to taxpayers whose business was depressed because of economic circumstances. There should be no discrimination against the corporation whose earnings were depressed because of poor management or for any other reason. It ought to be sufficient, for the determination of excess profits, that the earnings in any base year were subnormal.

In order to avoid such litigation and discrimination and to simplify administrative procedure, it is suggested that a provision be inserted at the end of section 442 (a) substantially as follows:

It shall be conclusively presumed that an abnormality exists under this subsection whenever the excess profits net income or the deficit in excess profits net income in any taxable year within, or beginning or ending within, the base period of a taxpayer which commenced business prior to January 1, 1946, shall be less than 15 percent of the excess profits net income of any other taxable year within the base period.

May I interpolate here. In some cases the earnings in some of these base period years are way down below normal, and there ought to be some percentage figure where it becomes conclusive that those years are abnormal years without any showing of economic situations, which may be pretty hard to prove.

May I continue. As an alternative, the relief provisions of the bill might include a clause reading somewhat as follows——

Senator TAFT. You already take care of 1 year.

Mr. WEISSER. I beg your pardon.

Senator TAFT. I say you already permit the elimination of 1 year.

Mr. WEISSER. Yes, we do.

Senator TAFT. What is the normal thing? Suppose you have 1 very good year and 3 years that are not good. How do you determine it? Haven't we already gone pretty far in eliminating 1 year?

Mr. WEISSER. I do not know. We have got a peculiar situation, as I will point out a little later on when I go into our specific case where we had in those 4 years 1 good year. We had 3 bad years, which were perhaps not due to any economic situation at all, but rather to peculiar circumstances.

Senator TAFT. You say because 1 year was high, therefore there is going to be a conclusive presumption that the other three years——

Mr. WEISSER. The other two years. Two of the other three are abnormal years.

Senator TAFT. I do not see how you can do that. It seems to me that is an impossible suggestion. Conceivably, you might give some weight to a second bad year in the four years, not perhaps elimination, but some weight to a second bad year, but I do not see how because of one good year in four, you can use that as a normal, and say that everything else is abnormal.

Mr. WEISSER. Well, I think under our peculiar circumstances that is just about the way it works out. I think our normal earnings would be up around $4,000,000. We had 1 year where they were $6,000,000. The other 3 years were about $500,000 in each of 2 years, and about $250,000 in the third year, and that was 3 years in a row.

Senator TAFT. You knock 250 out?

Mr. WEISSER. The 250 would be out. We are awfully low on the other 2 years, with only half a million, when our normal earnings would be up around $4,000,000.

Senator TAFT. How do you determine what normal earnings are? This is a standard which is even more difficult to guess at than the one you object to in the present law.

Mr. WEISSER. I think that is the difficulty, if I may say so, with an excess profits tax in itself. It is almost impossible to determine——

Senator TAFT. I do not see that you are improving it any by your suggestion.

Mr. WEISSER. I think you are.

The CHAIRMAN. You would not be dragged down because you did not make any profits——

Mr. WEISSNER. Of course, you appreciate that we can show that 2 years are abnormal years despite the fact that we throw one out, provided that we come within the provision which requires us to show that the business of the taxpayer was depressed because of temporary economic circumstances, unusual in the case of a taxpayer.

Senator MYERS. What was the amount earned in the good years?

Mr. WEISSER. Six million dollars.

Senator MYERS. Did you have any other years in which you approached $6,000,000?

Mr. WEISSER. Yes, we did.

Senator MYERS. When were they?

Mr. WEISSER. They were prewar years.

Senator MYERS. How many years of prewar did you approach $6,000,000?

Mr. WEISSER. Not many, but they were up around $4,000,000, and in through that area.

The CHAIRMAN. You did business in the prewar period?

Mr. WEISSER. Oh, yes. I cover that.

The CHAIRMAN. Is there anything in the bill which prevents an established company from falling below its average earnings in the base period of World War II Act?

Mr. STAM. The committee over in the Ways and Means considered the problem of giving them alternative credit based on the old period, but they decided not to do that, it was so far away, and so they did not adopt that in their provision.

Mr. WEISSER. I am making that same suggestion in this memorandum.

The CHAIRMAN. Suppose you go ahead now, and tell us your company's actual condition. You might have had three normal years and one abnormally good year. That is where the difficulty comes, unless there was some peculiar circumstance.

Senator TAFT. You say here anything 15 percent less that very exceptionally good year should be considered abnormal?

Mr. WEISSER. That is a possibility on the surface. I am skipping a small part here which relates to going back to the old 1936 to 1939 base period. I have a suggestion in here that there be a clause in the law permitting us to go back to that.

Collins & Aikman Corp., manufactures upholstery materials for automobiles, furniture, busses, airplanes, and railway cars and men's and women's wear fabrics such as suiting and cloaking materials. In addition, it manufactures and sells worsted cotton and blended yarns.

It operates seven plants, three of which are located in Rhode Island, two in Pennsylvania, and two in North Carolina. Its executive offices are at No. 200 Madison Avenue, New York City. It has 4,500 employees, a capital investment in excess of $22,000,000, and total assets in excess of $32,000,000. Through predecessor companies, it has been in business for over 100 years.

Prior to World War II, the company's largest outlet was in the automobile field.

May I interpolate there and say that about 70 percent of the company's product prior to World War II was to the automobile industry for upholstery fabrics in automobiles.

During the war, its civilian business was in furniture fabrics, men's and women's cloth, fabrics for cold-weather garments, and yarns for defense orders.

In 1947, the style trend in automobile fabrics was away from the type of fabrics manufactured by this company to a type of woolen fabric which it was not equipped to make. This was due in part to the use of seat covers which did away with the necessity of having a high-grade durable upholstery. Gradually the demand for style fabrics in automobile upholstery returned, and, with the introduction of the 1950 models, the company recaptured a large part of this business.

Although the company did not show a loss in any fiscal year in the base period, its profits were abnormally low for the fiscal years ended February 28, 1948, 1949, and 1950. Starting with September 1949 earnings increased and by June 1950, they had returned to a normal prewar pattern.

The company's excess profits credit on an income basis for the fiscal year ended February 28, 1946, the last year under the World War II excess profits tax, was $3,689,711.

Under H. R. 9827, section 435, the company's excess profits credit on an income basis would be approximately $2,000,000. On an equity capital basis, section 437, the company's credit would be approximately $2,100,000.

I think we are entitled to relief, but there can be no certainty that this company would obtain relief as a hardship case under section 442. It would undoubtedly take years of litigation before it would know the answer and during that time its income tax liability would remain uncertain. Under present-day conditions, it is essential that every corporation should be in a position where it can intelligently and with confidence arrive at day-to-day decisions involving employee and stockholder interests with the assurance that the tax concequences of their actions have been determined on an accurate basis.

The CHAIRMAN. Thank you, sir.

Mr. WEISSER. Thank you.

Senator TAFT. You would contend, under section 442, that you were entitled to relief?

Mr. WEISSER. We would attempt to do that.

Senator TAFT. You would contend that your business was depressed, because of temporary economic circumstances?

Mr. WEISSER. That is right.

Senator TAFT. And unusual in the case of such a taxpayer?

Mr. WEISSER. Yes, but I am afraid it would be a very difficult situation to prove, because of the fact that the automobile companies, after the war, when they first started to make automobiles again, found out there was a tremendous demand for cars. The purchasing public was not interested in examining into the upholstery. They wanted the cars. The automobile dealer was loading down the cars with everything that he could think of, and he put on seat covers which hid the upholstery, so that the buyer never even looked at the upholstery fabrics in the car, with the result the automobile companies were using a cheaper fabric; they did not have to use our better grade fabrics, and we lost a good deal of business because of that. And it kept us down during this period when there was a great demand for cars.

Senator TAFT. It seems to me that is a temporary economic circumstance.

Mr. WEISSER. That is right.

Senator TAFT. I do not think you are going to be successful in substituting any automatic 15 percent abnormality.

Mr. WEISSER. Well, we might be successful, ultimately. It is one of those things which will run through the courts for year on end, and be a burden to those who are called upon to administer the act. I think there ought to be some simple formula.

Senator TAFT. There is no simple formula on an excess profits tax.

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

Mr. WEISSER. Thank you again.

The CHAIRMAN. We will next hear from Mr. Jerry Johnson, of the National Association of Refrigerated Warehouses.

Identify yourself for the record.

STATEMENT OF JERRY P. JOHNSON, VICE PRESIDENT, NATIONAL ASSOCIATION OF REFRIGERATED WAREHOUSES, WASHINGTON, D. C.

Mr. JOHNSON. My name is Jerry P. Johnson. I am vice president and general manager of the Terminal Refrigerating & Warehousing Corp. of Washington, D. C., and vice president of the National Association of Refrigerated Warehouses with headquarters in Washington.

I am neither a tax expert nor an economist. I am a refrigerated warehouseman appearing on behalf of the National Association of Refrigerated Warehouses by unanimous vote of their executive committee, and represent the refrigerating warehousing industry with a combined capacity of more than 413,000,000 cubic feet of public refrigerated space; or in other words, storage space for 4,000,000,000 pounds of perishable foods—the storehouse of the Nation. This industry has voluntarily, in the interest of the American people, sponsored the Refrigeration Research Foundation, which has spent to date more than $500,000 in furtherance of the development of sound refrigerating practice in the handling, protection and conservation of the Nation's perishable food supply. The industry has a total investment of approximately $270,000,000, and replacement cost of approximately $630,000,000. Statistics show that it pays $1 in taxes for every $3 paid in wages.

Refrigerated warehouses, unlike the large manufacturing industries, are not concentrated in single locations, but operate nationally serving individual communities. We are strictly small business performing the most exacting and essential service to the physical well-being of the American people—the protection and distribution of their perishable food supply.

In expressing our opposition to an excess profits tax, we feel that there are basic fundamentals which should be considered by the Congress, namely:

Equity in taxation: The President in a recent address stressed that everybody must carry a share of the burden in this emergency, and the emergency is greater today than at that time. The refrigerated warehouse industry is willing and anxious to stand its fair and just share, but we do not believe that large or small corporations should be expected to bear the brunt. It is a load all should bear, and by all, we mean every person and organization, corporation, or otherwise, in this country making a profit in the normal conduct of competitive enterprise.

We particularly refer to the fast growing army of so-called nonprofit organizations which have taken steps or are preparing to do so to take advantage of increasing their income by tax exemption through operation of business enterprises in competition with fully taxed businesses. It has been conservatively estimated that the Treasury is losing a billion dollars in revenue annually through the income tax loopholes favoring such organizations. This is revenue sorely needed in this emergency.

Taxpaying businesses, particularly small enterprises, are being hampered and slowly throttled by the unfair competitive situation in which they are placed by these tax-free operations. There are

many forms of beneficiaries of these Federal income tax subsidies which are justly entitled to exemption. I specifically refer to the truly farm cooperative and nonprofit industrial research and educational organizations; but we submit that any tax-free organization making a profit in competition with free enterprise should be taxed. The existing loopholes which permit this should be closed and all organizations required to pay full income taxes on their earnings from business operations in the competitive market to end the unfair competition that now exists and share the burden of the taxed. In other words, the untaxed should be taxed.

The excess profits tax law passed during World War II provided exemption for these tax-exempt organizations. As a result, they were able to use for the promotion and expansion of their business very considerable sums of money which, in the case of regular corporations, went to the Treasury in taxes. The consequence was, of course, that cooperative businesses grew at a greater speed, which was wholly unjustified under war conditions.

This should not be permitted to happen again.

Cooperatives and other tax-exempts should be taxed just like other businesses on whatever profits they realize during the defense emergency, and it is respectfully urged that in whatever excess profits tax bill you write that cooperatives and other tax-exempt groups which are engaged in competitive business activities be made subject to this excess profits tax.

Just so long as such exemptions are included in any excess profits tax legislation, there can be no equity in taxation.

Economy in the use of funds derived from taxes: Long ago Cicero stated that "Economy is in itself a great revenue." Government, which in itself produces nothing but survives on the taxes taken from the people, should take careful heed of this admonition. Public utterances to date would indicate the misconception that our only salvation is to make taxes sufficiently high to pay for the war as we go, and to continue spending as usual. With the Nation on notice that increased military expenditures face us not only this year, but for several years, pay as we go is our only salvation, but we submit that there is a vast saving to be effected without impairing any essential wartime service or curtailing the rearmament program through a drastic pruning of nonmilitary spending. It is the first duty of the Government to cut to the bone every nonmilitary expenditure and to reduce the budget in such manner that funds now slated for use on the home front can be diverted to the defense program. Extravagances and ill-considered expenses of Government should receive first consideration for elimination. While this will not eliminate the need for additional taxes, it is the first step in the share-the-burden program stressed by the President—the Government's share.

Simplicity and consistancy in tax administration: The complexity of the application of the excess profits tax leads to costly administration expense and compliance costs and will undoubtedly result, as before, in considerable litigation working hardship alike on businessmen and Government. A sound and just tax policy should be developed with simplicity in operation and compliance, and economy in administration.

Allowance for retention of earnings for specific purposes: Small business, such as our industry, plays a vital part in the economy of our

country and could not be aided more than in this matter of taxation. A large proportion of small business has its back to the wall with respect to financing needed replacements, improvements and expansion, or being able to maintain a sound ratio of working capital.

Existing laws do not make this possible.

Government loans or financing is not the answer.

The proposed excess profits tax law does not make it possible.

We submit that there should be sound provisions in any tax law that will enable small businessmen to retain a larger proportion of their earnings for business maintenance, improvements, and expansion, as well as working capital. They should not be drained dry. An economy which tends to drain business enterprise of the means for normal maintenance and repair, and prevents improvements and expansion as required in the national interest, will eventually drain itself into exhaustion.

Repeal of the World War II excess profits tax: When the Revenue bill of 1945, which repealed the former excess profits tax, was being considered and reported upon by this committee, the primary reason for advocating repeal was the expressed belief that the tax was a major obstacle in the way of reconversion and expansion of business which was essential for the attainment of a high level of employment and income. It was stated: "The tax takes such a large portion of corporate profits that most businesses are not willing to take the risk of expanding their business while this tax is in operation." Nothing has happened since to basically change this sound reasoning.

Summing up our opposition to the excess profits tax, we submit:

First, the excess profits tax works hardship on small business by placing a serious limitation on the maintenance of property and equipment and sound working capital, and on capacity to expand through retention and investiment of earnings. This comes at a time when expansion by Government request is the order of the day.

Second, the excess profits tax stimulates waste and inefficiency in business, and in Government. With the Government a partner in business, and business on the short end, there is no urge to make higher profits, but rather to spend and avoid paying the higher taxes. This is human nature.

Third, the excess profits tax stifles incentive and promotes inflation.

Fourth, penalization of high profits is against the primary objective of private enterprise. While the excess profits tax is ostensibly designed to cut into the profits of corporations claimed to be making abnormal profits as a result of the defense effort, it fails to accomplish this purpose; and destroys the very foundation of the free competitive enterprise system.

You know and I know that the growth in production and resultant improvement in the American way has been constantly affected by the existence, or absence, of profits. The redeposit of profits in new equipment for better quality and greater man-hour production has been the outstanding factor in the growth of our economy; and, consequently, in the growth of America.

You, as American lawmakers and your associates in Government, are undoubtedly going to call on American industry for new records of production. You will find American industry ready and willing to retool, remodel, and rebuild after an almost devastating drain on buildings and equipment as a result of the unbelievable record of

production during World War II. The money to do this with has to come either from profits, new venture capital, or an increasingly benevolent Government. We, as small-business men, prefer not to resort to the latter means.

An excess profits tax would seriously hamper both the availability of those tools and our ability to purchase them.

Therefore, it is our firm belief that every revenue objective of an excess profits tax can be achieved with a minimum of additional expense and delay for both the Government and the taxpayers by making appropriate adjustment in the rate of the ordinary corporation income tax, with sound provision for retention of a larger proportion of earnings for business maintenance, improvements, and expansion, as well as working capital. We heartily support the proposal that the tax contribution from corporations toward the pay-as-we-go tax program should be made through an addition to the corporation income tax to be known as the corporation defense tax. To effect a clear distinction between the income tax and the corporation defense tax, and to avoid imposing too heavy a burden on small business, the standard corporation income tax rate should be set at 38 percent, by changing the normal tax rate in the Revenue Act of 1950 from 25 percent to 18 percent, while leaving the surtax rate at 20 percent The corporation defense tax should be imposed as a flat percentage of the amount of the corporation income tax, such impost to be placed at a figure estimated to produce the required yield.

The CHAIRMAN. Thank you very much.

Senator CONNALLY. You are against any kind of an excess-profits tax?

Mr. JOHNSON. We feel it is not to the interest of the country, yes, sir.

Senator CONNALLY. I say, you are against it?

Mr. JOHNSON. Yes, sir.

The CHAIRMAN. Thank you.

Mr. JOHNSON. Thank you.

The CHAIRMAN. We will next hear from Mr. J. Keith Mann.

Please identify yourself for the record. I believe you are the last witness scheduled today. If there are any other witnesses who will not be able to appear tomorrow, you may file a brief by handing it to the clerk of the committee.

STATEMENT OF J. KEITH MANN, ATTORNEY, WASHINGTON, D. C., APPEARING FOR NORTHCUTT ELY, REPRESENTING WESTGATE-SUN HARBOR CO., SAN DIEGO, CALIF.

Mr. MANN. Mr. Chairman and members of the committee, my name is J. Keith Mann, and I am an attorney in the law offices of Northcutt Ely, Tower Building, Washington, D. C., and we represent the Westgate-Sun Harbor Co. of San Diego, Calif.

First, we wish to thank the committee for the privilege of this opportunity to present our views. Although we represent but a single company, we feel that Westgate-Sun Harbor's situation is not unique, and that numerous companies organized during the postwar period of business expansion will be faced with a similar disadvantageous competitive position if certain deficiencies in the World War II act

are not remedied. It is with this broader context in mind that we have prepared our statement.

Concretely, this is what our company is up against: The Westgate Sea Products Co. and the Sun Harbor Packing Co. were engaged in the canning of tuna fish. The one company lost its lease and the other did not have a recognized trade name, but did have a lease on a plant site. Dictated by these urgent business considerations, the two companies went through a tax-free reorganization, and formed a new corporation, the Westgate-Sun Harbor Co. The new company took over the entire business of the predecessor companies so far as their packing and merchandising functions were concerned. The packing plants, trade names, and good wills, together with certain inventories, were transferred. The predecessor companies were not liquidated, chiefly because they were of disproportionate size, and it was necessary that they retain assets if they were to contribute equally, and thus owned jointly, the new company. The old companies are largely dormant, and their income-producing assets are in the hands of the new company.

Under the World War II act, where less than "substantially all"—those were the critical words—of the partnership or corporate assets were transferred, the new company was not entitled to use the base-period earnings experience of the transferor. This resulted in an inequality with respect to companies which acquired only a part as distinguished from substantially all of the assets of a transferor. Moreover, this restriction was inconsistent with the generally understood policy of supplement A, which was to allow earnings to accompany transferred assets, and to treat the acquiring corporation as standing in the shoes of a transferring corporation where there is continuity of interest.

In drafting H. R. 9827, the Committee on Ways and Means, the Joint Committee, Treasury and Bureau officials have given thoughtful and sympathetic attention to this problem. Section 461 (a) (1) (E), found at page 107 of the bill, in particular seems designed to alleviate the previous inequality. We have two specific comments concerning the clarity and adequacy of section 461 (a) (1) (E) and section 462 (e), page 123 of the bill, which implements the new provision.

First, though we have had only a short time to study the bill, we take the liberty to suggest to you that as presently drafted, there is a potential unwarranted limitation on the scope of section 461 (a) (1) (E).

I am happy to see Mr. Stam here, because from his fund of experience, he can clear up our analysis of this.

We feel confident that it has crept in through the pressure of reporting the bill so quickly. For as presently written, the provision speaks only in terms of section 112 (b) (5) transactions. While it may be doubtful whether there are any transactions which are solely 112 (b) (4) or 112 (b) (5), as we understand it, section 112 (b) (5) has been thought to apply in the main to the formation of a corporation through the contribution of partnership or individual assets. Section 112 (b) (4) is involved in the effecting of many reorganizations.

I called our people on the west coast last night, and they were unable to determine from their documents whether we had a " (b) (4)" or "(b) (5)" transaction.

There are differences in the requirement of subsequent control in the two sections, which might result in some 112 (b) (4) transactions not being covered. No reason occurs why both situations should not be treated in the same manner. The whole tone of the report conveys the idea that this was the intention.

Indeed, it is stated expressly that, "In general the reorganizations dealt with in part II are the type with respect to which gain or loss is not recognized"; page 29 of the committee report, that part II is "directed essentially at the problem of providing for a proper determination of the average base period net income of a taxpayer which is a continuing corporation in a reorganization"; page 63, and again that "transactions must satisfy the requirements of section 112," page 64. Without differentiating between the two sections.

The language of section 461 (a) (1) (E) is to the effect that an acquiring corporation is one which receives "properties either from one or more corporations or from one or more partnerships * * * in an exchange," so that it may already reflect the evident intention expressed in the report to cover all "split-ups" and to give such new corporations the benefit of the earnings experience attributable to the assets in the hands of a predecessor or predecessors. Nevertheless, in view of the independent body of precedent which surrounds the reorganization provisions of section 112 (b) (5), to which (E) is in terms restricted, we urge that that which is implicit be made explicit by amending section 461 (a) (1) (E) to read specifically in the fifth line, "* * * to which section 112 (b) (4), section 112 (b) (5), or" et cetera.

Secondly, we wish to comment briefly on section 462 (e) which specifies the rule for allocating the amount of income which shall go over in those transactions in which a corporation transfers only a part of its properties. In general, section 462 (e) provides that the income is to be allocated according to the proportion which the fair market value of the assets transferred bears to the fair market value of the total assets of the transferring corporation. In addition, it is provided that pursuant to appropriate regulations, the parties to the transaction may agree on the amount to be apportioned, "provided the Secretary consents thereto."

Now we think it is agreed that the actual earnings of the transferred assets is the most logical portion of income to place in the new corporation, and the only deterrent to such a provision was the very real administrative difficulty thought to be involved in identifying the prior earnings with the assets which have been transferred. But we suggest that this identification is at least practicable in those instances where a particular department or a segregable part of the business is put into a new enterprise. In our case, reputable certified public accountants assure us that the books and the tax returns of these predecessor companies give an accurate and readily ascertainable picture of the earnings actually earned by and identifiable with the assets transferred to Westgate-Sun Harbor.

We assume that it was in such instances that the draftsmen anticipated the Secretary would consent to allocation by agreement. But

we respectfully request that you consider whether such consent should be left to the sole discretion of the Secretary without standards in the statute or the legislative history to indicate that consent is obtainable as a matter of right if the requirements of proof are met.

We are grateful that those responsible for the preparation of this legislation have been objective in approach, and displayed constructive and creative draftsmanship. It seems to us that the solution to a distributing problem can be completed by making the two revisions suggested above. Particularly the one clarifying (a) (1) (E). Such clarification will effectuate the desirable policy of equality of treatment for new as compared with established companies expressed in the current bill, and thus make essential contributions toward a healthy economy.

We thank you for your courtesy.

The CHAIRMAN. Are there any questions? If not, we thank you, sir, for your appearance.

Mr. MANN. Thank you, sir.

The CHAIRMAN. Are there any other witnesses who wish to offer any brief for the record, rather than to appear tomorrow?

(No response.)

The CHAIRMAN. We will now recess until 10 o'clock tomorrow morning.

(Whereupon, at 4:25 p. m., a recess was taken until 10 a. m., Wednesday, December 6, 1950.)

EXCESS PROFITS TAX ON CORPORATIONS, 1950

WEDNESDAY, DECEMBER 6, 1950

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

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

Present: Senators George, Connally, Byrd, Lucas, Hoey, Kerr, Myers, Millikin, Taft, and Butler.

Also present: Colin F. Stam, chief of staff, Joint Committee on Internal revenue Taxation; and Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will please come to order. Mr. Dumas, you are our first witness.

STATEMENT OF HAL S. DUMAS, PRESIDENT, SOUTHERN BELL TELEPHONE & TELEGRAPH CO., ATLANTA, GA.

The CHAIRMAN. You are the president of the Southern Bell Telephone & Telegraph Co., are you?

Mr. DUMAS. Yes, sir.

The CHAIRMAN. At Atlanta, Ga?

Mr. DUMAS. Yes, sir.

The CHAIRMAN. You are here speaking for your industry?

Mr. DUMAS. Yes, sir; the Bell System.

The CHAIRMAN. We had yesterday a gentleman from New York, I believe, who was speaking for the independents.

Mr. DUMAS. Mr. Bozell. Yes, indeed, sir; a very splendid gentleman.

The CHAIRMAN. You may proceed now. Would you wish to present your brief before you yield for any questions?

Mr. DUMAS. If I could, sir, because I have a very short statement.

The CHAIRMAN. You go ahead and we will ask you questions afterwards. Some of our other members of the committee may be in before you have finished.

Mr. DUMAS. My name is Hal S. Dumas. I am a resident of Atlanta, Ga., and I am president of the Southern Bell Telephone & Telegraph Co.

My company, which operates in the 9 Southeastern States is one of the 20 operating companies of the Bell Telephone System which provides telephone service to about 35,000,000 telephones, employs over 600,000 people, and its capital investments represent the savings of well over a million people. In the interest of time I have been asked by these Bell System companies to speak to you in their behalf.

In appearing before you today I am deeply conscious of the fact that our country is in, perhaps, the greatest danger it has ever been since its foundation. It is the gladly accepted duty of every citizen and every company to make any sacrifice which may be required to carry this country through this ordeal which may very well last through most of the years which we here today may live. In planning our actions I firmly believe, to be successful, it must be for the long pull which is ahead of us.

In presenting my views it is done with the purpose of attempting, in the short time I have before you, to outline our convictions as to how the war tax program should be set up with regard to telephone companies so they may do the most effective possible job for our country.

In my judgment our first job is to provide emergency defense communications. In this connection we already have plans under way to provide alternate means of communication for the large and vital centers of production in this country in case of total destruction of central communication facilities by bomb attack. I might for instance point out that your own city here in Washington may very well be a primary objective for bomb attack and that the provision of duplicate and alternate telephone communications facilities, which by the way is already under way, is of very obvious vital necessity to our nation. It is, also a very expensive project which must be repeated in all of the great cities which are adjudged to be primary targets for attack. All of you no doubt have knowledge of the giant radar screen project, costing the telephone companies from 15 to 20 million dollars for communication facilities alone, which will effectively alert all of our defense forces in case of attack. In addition, there will no doubt be thousands of military and war production facilities which must be provided with complete communication plants without delay. I am thinking of such facilities as the new H–bomb project in South Carolina which has just been announced, as well as the many military facilities which are being reactivated so rapidly at present. In the last war there were 320 such establishments in the territory which my company serves in the Southeast alone. We must also have ready and adequate communication networks to speed the enormous troop movements which must take place.

Just as important is our job to provide adequate and speedy communications so that national production can be expanded to meet the tremendously increased demands of our war situation. Effective communications are the nerve force of our Nation and are an absolute necessity if production is to be maintained and increased. At all costs the telephone companies must keep at a high level of readiness to serve if our country is to meet this situation successfully.

We must, also, as far as national policy indicates, meet the telephone requirements of the civilian population, including those in the rural areas of this country, so as to help maintain their morale in the all-out effort which everyone must make to reach the highest possible peak of production.

These must be our objectives and we are asking that the taxes on our industry be imposed in such a way that we can meet them.

In stating our views as to how these objectives can be met let me make it clear that the communications industry does not want undue earnings and that, as a matter of fact, since the war, our earnings

have been at just about the lowest ebb in the history of the business. This has been caused by the fact that our labor and material costs have increased by about 50 percent in this period. During this same time the over-all increase in the prices we charge for our service has been only 17 percent.

Our industry is regulated by the Federal Communications Commission for interstate service and by State regulatory bodies and the District of Columbia for intrastate. As rising costs have made our earnings inadequate and we have been forced to apply for increases in our prices, those regulatory bodies have held lengthy hearings so that the facts might be fully developed and generally months and sometimes a year or more have elapsed before we were given permission to make the necessary price adjustments. Because of this procedure the increases in our prices have always lagged far behind our increase in costs and our return on investment has been far below the level which these commissions themselves have recognized we need.

I want to make it absolutely clear that the communications industry wants to carry its full share of whatever tax burden is required. Already taxes including excise taxes average $2.50 per month per telephone, which is equivalent to more than 25 percent of the amounts collected from customers.

Since we are already carrying just about the highest tax burden of any industry and since our earnings are so low compared both with our own past earnings and also with the current earnings of other industries it is obvious that any additional taxes must be applied with great caution if we are to raise the huge sums of capital money which are necessary to meet the tremendous communication requirements of the period ahead of us.

I do not want to burden you with statistics, but for a thorough understanding of this matter there are a few fundamental facts you should have. Since the last war we have had an explosive demand for telephone service. Our number of telephones has grown from 23,000,000 to 35,000,000 in the short period of 5 years' time. Each of the telephones added since the war has cost an average of $335 as compared to $250 up until this period. Since in a regulated industry earnings cannot provide funds for new construction, to do this job we have had to get investors to let us have tremendous sums of new money. During this period our total capital has grown from about $4,000,000,000 to $8,000,000,000 which is an expansion rate unequaled in the industrial history of our country.

As you know, the communications industry has no choice as to when it will expand. It is our obligation to serve everyone who wants service in the areas we serve and to give them the type of service they want as nearly as we can with the money, manpower, and material which we can command.

During this period of great expansion and low earnings we have been able to finance our program because of the splendid credit which we had established in better earning years and because of investors' confidence that the fairness and good sense of the regulatory and taxing bodies would, in the long run, allow us earnings that were adequate and reasonable.

A very satisfactory feature of this financing was that to raise the money we were obliged to increase the proportion of debt for the system from 30 percent to 55 percent. During this year, fortunately,

we have been able to reduce this proportion to 50 percent. It is our considered belief that the successful operation of our business for the long pull in the interests of the telephone user and the telephone investor depends upon further substantial reduction in the debt ratio, and that we cannot do this unless our earnings are at least 7 to 7½ percent on total investment which, after all, is less than 6 percent on the actual value of our plant. We are also convinced that unless we can have earnings in this order we cannot expect to raise the billions of new money we will need in the next few years to do our job effectively.

There are 975,000 stockholders of the Bell System. The average number of shares they own is about 30 and to most of them the return on their stock is a very important item in their livelihood and their security. The greater part of these stockholders made their investment with us before the onset of the present inflation and they find that the over-all purchasing power of their incomes has already been sadly reduced. Any tax which might threaten a reduction in the dividend which they receive would be indeed a major catastrophe to most of them.

H. R. 9827 provides for 6 percent earnings in the telephone industry before excess profits taxes apply. It has been estimated that manufacturing industry in general will earn 12 percent after excess profits taxes provided for in H. R. 9827 are paid. We must convince the public that it is to their advantage to invest billions of dollars in our industry over the next few years if we are to do our job. With a prospective return of under 6 percent in our industry, it is hard to see how the job can be done and yet it must be done.

During the past 5 years we have raised $4,000,000,000 in new money which is more than any other integrated industry has ever raised in a similar length of time. In the process of raising these tremendous sums we have had every opportunity to fully examine the public's financial judgment as to what return is required in our business if capital is to be obtained quickly when needed and on terms which will protect the interests of those who have already invested their money in our securities. This experience has brought us to the firm conviction that for the telephone industry we must have a return of at least 7 to 7½ percent if this is to be done.

Since telephone companies are strictly regulated they are not permitted to make excess profits. From a strictly logical standpoint an excess profits tax should not apply to telephone companies. If, however, the exigencies of war make such a tax necessarily all inclusive in the opinion of Congress, it should be applied to our business with great caution to avoid damage to the effectiveness of the communications service at a time when the country must have the best service of its history. If our industry is to be subject to an excess profits tax, it is our earnest recommendation that H. R. 9827 be revised so that we will be allowed earnings of 7½ percent on our capital before the tax is applied.

The military and industrial might of America has as one of its firm foundation stones the best telephone service in the world. The telephone people of this country are intensely proud of their ability to serve this country as no other country is served.

They are depending upon the wise leadership of this committee to pass tax legislation which will not make their job impossible.

Senator BUTLER. I know that we are working against time, but I think this is really one of the very important industry statements that we will receive. I wonder if Mr. Dumas could tell us if the situation that you face now, the beginning of the crisis that we face, is different than it was at the beginning of the last war.

Mr. DUMAS. Senator, it is exceedingly different. When our company went into the last war, in the first place we had normal margins in our telephone plant; that is, we have to carry margins, ordinarily, so that we can take care of the demand when it is made. Of course, during the war we used up all of those margins, very properly so.

Another thing that is very different from the situation that existed at the beginning of that war, we had at that time in the Bell System, the normal debt ratio in the business. It was about 30 percent. And as I said in my statement, it is now 50 percent.

I hope you will pardon this kind of a common allusion, but we are somewhat in the shape of the man down in my country who has a good, strong mule, and he uses that mule to plant the crop in the spring of the year. And by the end of the time he gets the crop in, the mule is worn down to just about a bag of bones. He is looking forward to the time when he can get him built up again, but all of a sudden, the levee bursts and his crop is flooded out, and he has to make another crop and make it now or he will starve to death.

So we are in that shape We are not in anything like the shape we were when we went into the last war.

Senator BUTLER. You made the statement two or three times in your formal statement that you thought 6 percent, I think that is allowed by the controlling agencies, is not sufficient to cover your requirements. Is that the reason you have asked for this 7½ percent?

Mr. DUMAS. Yes, indeed, it is.

Senator BUTLER. In the statement you have given us?

Mr. DUMAS. Yes, indeed. I might say this, sir, that the 6 percent mentioned in this bill, in the judgment of everybody in this telephone industry, because we are regulated, will turn out to be a ceiling on our earnings, and not a floor. That would be a maximum that we will not be allowed to earn beyond.

The CHAIRMAN. You mean all of the regulatory bodies will consider the action of the Congress as fixing it as a ceiling?

Mr. DUMAS. I rather think so, Senator. Let me make this clear. Down in our territory we operate in nine States, and in eight of the nine States we have been allowed earnings by the regulatory bodies of 6 percent or better. And yet through the action of this lag that I am talking about, in getting rates increased, the actual earnings for our company during this past 1950 will be about 5½ percent. The average allowed us by the commissions would be well in excess of 6 percent, 6½, 6.6.

The CHAIRMAN. But the increased cost, between the application and the actual order of the commission is responsible for that?

Mr. DUMAS. The commissions in our part of the country proceed very cautiously about ratings, which they very well should do, but in a time like this, when costs are moving up so fast, for instance, if we applied for a rate increase, as we did last February, we may get that increase the first of January this year. The rates will go back. If we had them last February, they would make us whole, but we do not get them until 11 months later. In the meantime costs have gone up.

We build a lot of this high-cost plant. And the arnings will be very much lower than the commission itself says it is giving us.

So this 6 percent, if adopted as the top allowance by the commissions, it is very likely that it would certainly prevent us from earning anything like we are doing at the present time.

Senator TAFT. I have heard the suggestion made that base varies in different places, that the 6 percent is calculated on a different base from what various State commissions use. Do you know about that, as to the cost of reproduction new, against the investment? This 6 percent is based on the valuation, based on investment, is it not?

Mr. DUMAS. Yes, sir.

Senator TAFT. The cash invested?

Mr. DUMAS. On net cash invested; yes, sir. I believe in your State, sir, the regulatory law is a little different than in our part of the country, but in most States they are basing rates on the same thing that this bill mentions, that is, the net investment.

Senaor TAFT. In Ohio, I take it, they allow a larger base. They allow a return—I do not know what the return is—6 percent or something—on the cost of reproduction new which is, of course, a good deal higher than the investment basis.

Mr. DUMAS. Yes. If we were allowed—if we ever got to 7½ percent which, of course, we could not, even though it was mentioned in this bill, but if we ever got that as actual earnings, on the actual value of our plant, such as you use in Ohio, it would well be under 6 percent.

Senator TAFT. Because of the difference of type of base, a much greater difference between 6 and 7½ percent.

Mr. DUMAS. It is a good deal more than that; yes, sir.

Senator MILLIKIN. I believe it should be pointed out that there may be a lot of public misconception about the 6 or the 7½ percent. You have no guarantee of 6 or 7½ percent. You have a ceiling, and you have the opportunity to make 6 or 7½ percent, or whatever it may be, if and when you can make it, is that not true?

Mr. DUMAS. That is exactly right.

Senator MILLIKIN. I think quite a few members of the public feel that the utilities operate under some kind of a guaranty. That is completely false, as I understand it.

Mr. DUMAS. That is.

Senator MILLIKIN. It is if you can make it and when you make it.

Mr. DUMAS. That, certainly, is true.

Senator MILLIKIN. You mentioned this backward lag. Is there not also a forward lag, I mean, if you were to know today that one of your companies could get another percent, it would take you some time to get that other percent, would it not?

Mr. DUMAS. Certainly it would. If you do not mind, sir, I would like to give you the earnings in my own company during these war years or since the war, because it illustrates just what you have in mind, sir.

Our earnings in 1946—and this is invested capital, a sound dollar in our business for every dollar accounted for—was 3.28. In 1947 it was 2.51, in 1948 it was 4.03, in 1949 it was 4.86, and this year it will be about 5.52 or 5.53.

During that time the commissions have wanted to help us, but with this thing moving as it is doing, we can never earn what is stated as the earning rate.

The CHAIRMAN. You never catch up with it?

Mr. DUMAS. No sir; we certainly do not.

Senator KERR. I have some questions. You say you are now earning about 5½?

Mr. DUMAS. Yes, sir; in my company.

Senator KERR. And did I understand you, also, to say that the imposition of the tax on the earnings that you made above 6 percent would put you in worse shape than you are now?

Mr. DUMAS. It was not exactly the imposition of the tax as such. It was the fact that, I believe, these regulatory commissions will be very reluctant to ever grant us any rate increase that would bring this thing to 6 percent or above 6 percent. They would use that as a sort of a ceiling. As I tried to say, we have never been able to get our earnings up to what the commissions say we ought to earn. It has set 6 percent as a ceiling. And if they did that I doubt if we will ever be able to earn much more than 5¼ percent, you see.

Senator KERR. If you do not earn the 6 percent, or more, and if you are exempt up to 6 percent, the tax on what you earn above 6 percent does not get any money out of you, does it?

Mr. DUMAS. No, sir; they are not going to get much money out of the communications industry on this tax.

Senator KERR. You said a while ago, as I understood it, that you realized there would have to be more taxes paid.

Mr. DUMAS. Yes.

Senator KERR. And the communications industry wanted to do its part.

Mr. DUMAS. Yes.

Senator KERR. I wonder if you would tell the committee how you think you could do that.

Mr. DUMAS. Well, Senator, I believe that at the present time we are just about the heaviest-taxed industry in the country. The total taxes which we must of necessity collect from the telephone users amounts now to about $2.50 a month.

Senator KERR. I understand that. I was trying to find out if there was any practical significance to the statement you made.

Mr. DUMAS. I have this feeling, that we have to serve this country. You cannot get along without effective communications. That is our first duty. If our earnings ever get up to the place that they can even come close to what other industries are making, then tax us and tax us 100 percent of that, but until we get to the place where we can do an effective job I think that this Congress better go cautiously about the taxes they impose on us.

Senator KERR. I understand the significance of what you are now saying. I was just trying to find some significance to the statement that you made that you realized there would have to be more taxes paid and that your industry wanted to do its full part.

Mr. DUMAS. We certainly do.

Senator KERR. I do not see any suggestion that you have given us whereby they would have any part in it.

Mr. DUMAS. My very real suggestion is that our taxes not be increased right at the moment until we can catch up on our earning rate so that we can do this job effectively.

Senator KERR. Then what you are saying is that your industry has a more important job to do than to pay taxes.

Mr. DUMAS. I certainly think so.

Senator KERR. And the statement that you made that you wanted to do your full part of paying the increased load would have to be understood to mean that you would be doing it in the field of service and not in the field of taxes?

Mr. DUMAS. That is exactly right, with this exception, if you will, sir, that is, if we ever get up to an earning ratio that is anything like other people get, then for God's sake tax us and tax us just as heavily as you wish.

Senator KERR. We will not have to do that for God's sake; they will get around to it before they have that justification. I was just trying to see if I had misunderstood you, or if we would have to have some other significance to the statement about the communications industry paying some part of this increased tax load.

Senator MILLIKIN. Would this be a fair statement of it, that you want to contribute as much as you are able to contribute without impairing your service and that in view of the fact that you are a regulated industry, that of itself puts a ceiling on your ability to contribute?

Mr. DUMAS. It most certainly does.

Senator MILLIKIN. If that ceiling is impaired, lowered on you, you will not only not be able to contribute in the way of money, but not be able to contribute what you should contribute in the way of service, it that true?

Mr. DUMAS. Exactly.

Senator MILLIKIN. Let me ask you about how you finance yourself; what is your stock selling for on the market?

Mr. DUMAS. Our stock is selling for about $150 a share.

Senator MILLIKIN. What is the return to the purchaser?

Mr. DUMAS. It is paying $9 to the stockholders at 6 percent.

Senator MILLIKIN. And that, of course, is subject at least in many cases to income tax, that is, personal income tax?

Mr. DUMAS. It certainly is, sir.

Senator MILLIKIN. So there is another nick out of that 6 percent, is that correct?

Mr. DUMAS. Yes.

Senator MILLIKIN. Do you have a formula that you would suggest we put into this act that would give you 7½ percent?

Mr. DUMAS. I have not prepared any such thing, because I only got to see this bill last night.

Senator MILLIKIN. This bill does not satisfy you?

Mr. DUMAS. The bill is a very great improvement over the original proposal of Mr. Snyder, of course, and we very greatly appreciate that. This 6 percent just does not go quite far enough to do the job for us.

Senator MILLIKIN. Let me suggest that you submit to our staff a draft of what you think ought to be in there to cover the telephone situation.

Mr. DUMAS. Thank you, Senator.

(The information is as follows:)

The principal change we urge in the House bill is that section 446 (c) be amended to allow companies providing telephone and telegraph service a credit of 7½ percent on total capital before excess profits tax becomes applicable.

Our most important concern is that the allowance of 6 percent provided for in section 446 (p. 73 of the House bill) is inadequate for telephone companies. Our judgment, based on experience in raising about $4,000,000,000 of new capital in the last 5 years, is that a return of 7½ percent after taxes is necessary to permit us to raise further large sums of new capital needed to provide the necessary service for both defense and civilian purposes.

Certain other changes of a technical nature will be suggested to the committee's staff.

Senator MILLIKIN. You raise money when you want to by adding either to your indebtedness, which you have been doing on rather a substantial scale, and I assume you sell those bonds to insurance companies and other outfits of that kind; is that correct?

Mr. DUMAS. We have been doing financing by selling convertible debentures.

Senator MILLIKIN. Debentures?

Mr. DUMAS. Yes, sir.

Senator TAFT. Could I ask a question there?

Senator MILLIKIN. Yes.

Senator TAFT. What is your average interest on half of the capital that is borrowed?

Mr. DUMAS. It will run about 3 percent on the borrowed capital.

Senator MILLIKIN. Around 3 percent?

Mr. DUMAS. Yes. The last issue was 3⅛.

Senator MILLIKIN. I notice you said you retired some of those bonds. Did you retire them out of earnings?

Mr. DUMAS. No sir; we do not have the earnings. What actually happens on that, Senator, is this: These convertible bonds are converted—we do not retire the bonds—they are converted to stock at various prices which the stockholders have to pay, or the holders of the debentures have to pay.

Senator MILLIKIN. Do you have public sales of your stocks?

Mr. DUMAS. Yes, sir. Not of stocks. We sell debentures through bids, competitive bids.

Senator MILLIKIN. Then the debentures, in turn, have the right to exchange those for stock?

Mr. DUMAS. The debenture holder has the right to do so.

Senator MILLIKIN. That is what I mean.

Mr. DUMAS. Yes. One right interesting feature about that. I do not want to take up too much time of this committee. We have an issue of debentures outstanding that can be converted at 146; that is, a man can turn in his debenture for which he paid $100 and pay $46 in cash and get a share of stock. That debenture at the present time pays the debenture holder $2.75 a year. By paying in $46 he can get a share of stock which at the present time pays him $9 a year. In other words, his income, by paying in $46, goes up $6.25. I was figuring it out in my own mind. That is about 13 or 14 percent that he would get on his money. And yet, up to date, only about a fifth of the debenture holders have been willing to convert those debentures.

Senator LUCAS. Why is that?

Mr. DUMAS. I think it is because the earnings on the stock are quite low. We are just barely meeting our dividend requirements. And I think that the debenture holders feel like they do not want to convert on that basis.

Senator MILLIKIN. What is the average? You have about a million stockholders?

Mr. DUMAS. Yes, sir; 975,000.

Senator MILLIKIN. What is the average holding per person?

Mr. DUMAS. Less than 30 shares. I believe the last average was about 29 shares per person. And I think one of the interesting things about it is that there are well over 400,000 stockholders who own 10 shares or less.

Senator MILIKIN. Your answer goes to the whole system?

Mr. DUMAS. Yes, sir.

Senator MILLIKIN. And not to your particular part of it. It is as to the whole system?

Mr. DUMAS. Yes, sir.

The CHAIRMAN. Are there any further questions?

Senator KERR. What is the book value of that stock?

Mr. DUMAS. The book value of it is $138 per share of stock.

Senator KERR. And you are permitted to earn 6 percent above in all of the States you operate on that book value; that is, they do not guarantee it, but they permit it?

Mr. DUMAS. We earn in our State on the actual investment in that particular State in intrastate properties.

Senator KERR. I presume that the over-all valuation of all of your properties is what goes to make up the book value?

Mr. DUMAS. That is it, exactly, yes.

Senator KERR. And you are permitted to earn a minimum of 6 percent, I suppose, and from that greater amounts on the book value, in the final analysis?

Mr. DUMAS. That is what they try to do, but the actual earnings always turn out to be less than that.

Senator KERR. I did not ask you if they guaranteed it.

Mr. DUMAS. They do not guarantee it.

Senator KERR. I know they do not, but they do permit it?

Mr. DUMAS. Yes.

Senator KERR. The rulings are based on their conclusions on the evidence you give them as to what is required to permit that?

Mr. DUMAS. Yes, sir.

Senator KERR. You are permitted to earn that above all expenses?

Mr. DUMAS. Yes, sir.

Senator KERR. Including interest on debentures?

Mr. DUMAS. Yes, sir.

Senator KERR. What part of your capital structure is represented by debentures or other evidences of indebtedness?

Mr. DUMAS. Our total debt now for the Bell System runs 50 percent.

Senator KERR. Then about 50 percent of your total investment has been provided from your borrowings through debentures or other forms of indebtedness?

Mr. DUMAS. Yes, sir.

Senator KERR. And that investment is a part of your rate base?

Mr. DUMAS. Yes, indeed.

Senator KERR. And you are permitted to earn whatever amount they give you on the investment that you have from moneys secured in that manner, the same as on investments from moneys secured by the sale of stock?

Mr. DUMAS. Yes, sir.

Senator KERR. So that at this time, about half of your over-all investment is from moneys derived from the sale of stock?

Mr. DUMAS. Yes, sir. Most of those sales were made, of course, years ago, and not lately.

Senator KERR. I understand. Are you not paying your stockholders not only more money than your earnings on the investment which the money you receive from them represents, but are you not paying them more returns than the average of what the State regulatory bodies permits you to pay on stock, or rather, to earn on investments in their jurisdictions?

Mr. DUMAS. Well, of course, the regulatory bodies look on our investment as one whole.

Senator KERR. I understand that.

Mr. DUMAS. And they allow generally better than 6 percent on the total investment.

Senator KERR. What is the average?

Mr. DUMAS. Well, the average in my company—I could not tell you for the United States—but in my company it would be about 6½, 6.7 percent that they set up as allowances.

Senator KERR. If the book value of that stock is $138—Is that what you said?

Mr. DUMAS. That is the book value, of coure, of the American Co. stock, and that represents the money which the stockholders have in the business for each share of stock they own.

Senator KERR. If that is the book value, you are paying the owner of that share of stock more returns than you are permitted to make on your over-all investment?

Mr. DUMAS. Senator, that is generally necessary to get——

Senator KERR. I am not asking you why.

Mr. DUMAS. Yes; it is true.

Senator KERR. I am asking if you are.

Mr. DUMAS. Yes, indeed; sure, we are. We have to do it.

Senator TAFT. May I say this: If half of your capital is debt and you pay 3 percent, and the other half is stock, and you pay 6 percent, you are paying 4½ percent, roughly speaking. Is that a correct analysis—4½ percent to your security holders. And that leaves you, if you earn 5½ percent, 1 percent for possible reinvestment in the business. Is that a correct statement for the moment?

Mr. DUMAS. That is not exactly correct.

Senator TAFT. You have not earned 4½ percent in the last 5 years, you say?

Mr. DUMAS. Actually, on the book value, that is, the value that the stockholders own in the business, they are getting $9, and when you figure that out that is about 7 percent that they are getting on their actual investment, the money that they turned over to us. If you average it out on that sort of basis, it comes out.

Senator TAFT. It would be about 5 percent. Then you are paying out 5 perecent to your security holders. You are paying more than you actually are earning?

Mr. DUMAS. That is right.

Senator MILLIKIN. You have increased your indebtedness because of the difficulties of financing equity capital.

Mr. DUMAS. We could not sell equity capital.

Senator MILLIKIN. For how many years past have you been paying roughly the same amount of dividends to your stockholders?

Mr. DUMAS. About 40 years.

Senator MILLIKIN. Roughly the same amount?

Mr. DUMAS. Thirty years, I beg your pardon.

Senator MILLIKIN. Roughly the same amount of return?

Mr. DUMAS. Yes, sir.

Senator MILLIKIN. So that your returns have not at all reflected the general inflation that affects your stockholders; is that correct?

Mr. DUMAS. That is right. Stockholders feel like the purchasing power of their dividends is very much lower now than it was when they bought their stock.

Senator MILLIKEN. Roughly speaking, it is about 3 percent, if you are paying them 6 percent today as compared with, say 10 years ago—you are paying 3 today?

Mr. DUMAS. Yes, sir.

Senator MILLIKIN. In other words, the earnings of the stockholders have not kept up with the earnings of many other industries?

Mr. DUMAS. Not nearly so, and many wage workers. Most other industries have been able to increase their earnings and dividends to their stockholders.

Senator MILLIKIN. How much money out of your revenue do you keep for plant expansion?

Mr. DUMAS. At the present time it would be only about—well, I cannot figure it right quickly—it is 5 percent of our total earnings which are kept, and out of the gross revenue, that would be much less than 1 percent, I believe.

Senator MILLIKIN. Out of your net available for dividends and interest payments, how much do you set aside for plant expansion?

Mr. DUMAS. We set aside very little, indeed. Over the last years the average additions to surplus—and that is what you have in mind—have been about 30 cents a share, over the last 10 years; practically nothing.

Senator MILLIKIN. And you pay how much per share in dividends?

Mr. DUMAS. Nine dollars. So, you see we have to get every cent of money that we put in the plant from new money financing.

Senator MILLIKIN. Your equity is not very well protected?

Mr. DUMAS. Certainly not.

Senator MILLIKIN. Unless you up your income; is that correct?

Mr. DUMAS. That is correct. To keep this dividend paid we have had to reduce the surplus which we had over the years. Twenty years ago it was something like $40 a share, and now it is down to about $14 a share.

Senator MILLIKIN. Is not 30 percent considered by rule of thumb perhaps the limit that a company should permit itself for indebtedness?

Mr. DUMAS. We feel very much that 30 percent is just as high as we ought to go.

Senator MILLIKIN. Is that not the rule in industry?

Mr. DUMAS. It certainly ought to be a rule in the kind of business we are in.

Senator MILLIKIN. Is it not correct that the higher you increase your indebtedness the less protection you have for your equity holders?

Mr. DUMAS. That is exactly true. And it is so evident that that is true, because we have had so much trouble selling the equity stock.

Senator MILLIKIN. In other words, you reach a point where the equity holder does not own the company, the company is owned by the holder of the indebtedness; is that not correct?

Mr. DUMAS. Yes, sir. As you go up on the proportion of debt you have to pay more for your debt capital.

Senator MILLIKIN. That is unwholesome in a corporate structure.

Mr. DUMAS. It is. Certainly, in a time like we are getting into.

Senator LUCAS. This may have been answered, Mr. Chairman, but this question is frequently asked. How can a utility whose rates of earnings are subject to regulation by public utility commissions have excess profits? And you probably have answered that, but would you answer it again for the record, because a lot of people do not understand how a utility that is regulated can have excess profits.

Mr. DUMAS. Well, as a general thing, they will not have excess profits, because the regulatory commissions will see to it that they do not pay such taxes. That certainly would be true in a period like this, where because of rising costs the utilities have had to ask for increases in their rates. And it is not a question of just leaving earnings as they are now. We are continually being pressed by the rising cost of everything we use. We are continually having to go before commissions and ask for rate increases. That means that although in the State of Georgia our earnings might today be fairly reasonable, they will not be 4 or 5 months from now. At that time, when we ask for an increase in rates, undoubtedly the commission will bear this particular thing in mind as to what they do to us, as to what they allow us.

Senator LUCAS. I agree with you on that. The bill that was introduced originally by the Treasury Department had no special credits of any kind for utility companies. That is true?

Mr. DUMAS. Yes.

Senator LUCAS. And the House, as I understand it, put a 6-percent provision in there for utilities.

Mr. DUMAS. Which we greatly appreciate.

Senator LUCAS. You still contend that that does not take care of the utility situation?

Mr. DUMAS. It just is not enough, sir, to do that job.

Senator LUCAS. How much additional percentage would you say that it would be necessary to have to take care of that?

Mr. DUMAS. I think we ought to have 7½ percent allowed, because just in the nature of things, as I tried to explain here, we will never get to any such figure as 7½.

Senator LUCAS. In other words, once this figure of 6 percent is set by Congress, the utility commissions will say that that is the ceiling and not a floor?

Mr. DUMAS. We are very much afraid that would be the reaction. I think it would be very natural for them to feel that way.

Senator LUCAS. I notice, Mr. Dumas, that you are representing the operating companies of the Bell System in Atlanta, Ga., representing the Southern Bell Telephone & Telegraph Co. Are you representing or are you familiar with the operations of the Bell Telephone Co. in the State of Illinois?

Mr. DUMAS. Only rather in a very general way, sir. I know Mr. McCorkle quite well, who is the president of that company.

Senator LUCAS. I do not know whether any of those gentlemen are going to testify.

Mr. DUMAS. I think not.

Senator LUCAS. Before this committee or not.

Mr. DUMAS. I think not.

Senator LUCAS. But I have information from those who represent that company in my State that in the event the original bill as submitted by the Secretary of the Treasury became law that it would be necessary in Illinois to increase the rate to the extent of receiving $30,000,000 in that State in order to restore the present level of earnings. Do you know anything about that, whether that is correct or not?

Mr. DUMAS. Yes, offhand, I would say that that estimate would appear to me to be approximately all right. If you remember, Senator, I believe that there has just been adjudged in Illinois an increase in the rates which will for the time being at any rate place their earnings on a reasonable basis.

Senator LUCAS. That is right.

Mr. DUMAS. They earn a great deal more than my company does. And, undoubtedly, it would be necessary to maintain their present level of earnings to increase rates very materially under this bill.

Senator LUCAS. They further state that in the event that the 6 percent is allowed they would have to increase the rates to the consumers of utility businesses to the extent of about $4,000,000, as I understand it.

Mr. DUMAS. That would be the effect of the present House bill; yes, sir. I think that is about right. That would sound just about what it would proportionately work in my own company.

Senator LUCAS. They have the same fear that you expressed a moment ago, that when they asked for this increased rate, that the commerce commission of the State may not grant it.

Mr. DUMAS. I think that would be very logical, sir.

Senator LUCAS. And do you think the 7½ percent would cover this additional $4,000,000 in the event that took place?

Mr. DUMAS. I am sure their earnings are under 7½ right at the present moment, even with the increase in rates.

Senator LUCAS. I thank you for that information.

Senator MILLIKIN. Could you generalize by saying that in a rising market a utility, such as your own, never catches up?

Mr. DUMAS. That is right.

Senator MILLIKIN. With the benefits of a raised rate?

Mr. DUMAS. That is certainly true, and absolutely so.

Senator MILLIKIN. Of course, if you had a falling economy you would be on the good side then.

Mr. DUMAS. We have had so much trouble raising this money, we are scared to death about the effects of this bill.

Senator MILLIKIN. I am not concerned a great deal about a falling economy, either.

Mr. DUMAS. No, sir.

Senator BUTLER. I have two short statements and a telegram on the same subject that I would like to insert on behalf of the Bell Telephone Co. in our area.

The CHAIRMAN. Without objection, they will be inserted in the record at this point by the reporter.

(The documents above referred to are as follows:)

MEMORANDUM RE PROPOSED EXCESS PROFITS TAXES BY THE SOUTHERN NEW ENGLAND TELEPHONE CO.

The Southern New England Telephone Co. operates within the State of Connecticut, and provides practically all telephone service within the State. It is an independent company, its stock for the most part being in the hands of private investors, 90 percent of whom are residents of the State of Connecticut. Throughout its history, the company has financed its growth by selling common stock to its stockholders and the public, and by borrowing money. The company has grown steadily since 1882, but its rate of growth since 1945 has been, in many respects, remarkable. Since the latter year, telephones in service have more than doubled, toll calls have increased, and more than 100,000 customers have had their service upgraded from party line to individual line. This growth has required large and expensive additions to the plant and equipment of the company. Since 1945 gross additions to plant have totaled $100,000,000, and current annual additions are running at $25,000,000. As in the case of other utilities whose earnings are subject to regulation by public authority, the cost of new plant had to be met primarily by the sale of stock and bonds on the investment market. In the years 1946 to 1950, inclusive, the company has borrowed $14,000,000 and issued bonds therefor, and has obtained more than $42,000,000 from issues of common stock. The total of $56,000,000 thus obtained represents new money put into the business by investors who believed that the earnings record of the company and its future prospects justified the investment they were making.

At the present time, we find ourselves in circumstances similar in many respects to 1945. As was the case then, we are deficient in normal working margins of plant; in many areas cable plant is insufficient to provide the type of service demanded, and in many central offices the spare equipment is fast running out; demand for telephone service is greater than last year's and promises to increase next year; toll business has loaded to capacity many of our toll cables and switchboards. Major additions to our plant continue to be necessary and with it appeals to investors to put new money into the enterprise. But such appeals can scarcely be effective unless earnings are deemed satisfactory by the investing public.

It is our sincere belief that the excess profits tax suggestions of the Treasury Department, unless amended to permit utilities a fair over-all return after all taxes, will seriously impair our ability to procure new capital for the business, and will endanger the growth and development of the telephone system in the State of Connecticut.

The current increase in combined normal tax and surtax to 45 percent as of July 1, 1950, will cost this company approximately $850,000 on an annual basis and reduce the rate of return on the net investment in telephone plant by approximately 10 percent to a level well below that determined as fair by courts and commissions in many States.

Any further increase in the normal tax and surtax or the imposition of an excess profits tax without adequate provision for a reasonable return on all invested capital would jeopardize the company's ability to provide service. The use of the years 1946–49 as an excess profits tax base would be almost disastrous to us since earnings in this period averaged lower than a fair rate of return. In 1947, for the first time in 20 years, it was necessary to apply for permission to increase rates. Because of the high postwar wage and price levels, earnings had fallen to less than 3 percent on total capital. In nonregulated industries, on the other hand, there were no ceilings on prices or profits, and profits as well as prices were abnormally high in this period of unlimited demand. An excess profits tax using the years 1946–49 as a base period would reduce earnings of this company by approximately $2,000,000 and lower the rate of return on net plant investment in 1951 to 4 percent or less. Obviously, the company's ability to furnish satisfactory service would be seriously affected since its low earnings would limit if not make impossible the sale of additional securities.

The company respectfully submits to the committee for its consideration, which, while not completely solving the problems of utility companies seeking new capital, will be of some help in their efforts to maintain vital services abreast of the growth and progress of the country:

1. The excess profits tax should be applied only after the deduction of normal and surtax as ordinary business expense, under any method of determining excess profits net income. This provision was contained in the 1940 tax law,

and is consistent with the determination of fair rates of return by public utility commissions familiar with the financing problems of utilities

2. Under the invested capital method of determining excess profits credit, borrowed capital should be included in invested capital at 100 percent . This again would be consistent with the methods followed by public utility commissions in determining proper rates of return for utilities seeking new capital.

3. Since current conditions are comparable in many ways with 1940, the 8 percent allowance under the invested capital method permitted by the 1940 tax law should be reinstated unless and until the war situation becomes more critical. This would effectively recapture war profits and yet permit regulated business to raise new capital.

4. Under either method of determining excess profits credit, provisions should be made for a fair return on capital additions—equity, debt, or retained earnings—during and after the base period, with a corresponding adjustment to excess profits income for related interest on the debt additions.

5. Provision should be made for an option to select a single year of the base period as the basis for the credit, and public utilities should be permitted to adjust earnings for the base period to include the effort of rate increases granted during the period or thereafter. The first and only rate increase obtained by this company in 20 years was granted late in 1947. Obviously, a 1946–49 base period would defeat a public utility commission determination of what constituted a proper return in that period, and would recreate the very conditions giving rise to the rate application. Furthermore, there is a well-known and substantial time lag between an application for, and receipt of, rate adjustments of utilities, which should be recognized if equality of treatment with other taxpayers is to be achieved.

MEMORANDUM RE PROPOSED EXCESS PROFITS TAXES BY NORTHWESTERN BELL TELEPHONE CO., OMAHA, NEBR.

Northwestern Bell recognizes the very serious obligation confronting Congress to enact a tax measure which will enlarge tax support of our expanding defense program. It is aware of the need to curb "excessive" war profits. The company is equally mindful that, as a good citizen, it should be and is fully prepared to shoulder its fair share of the total tax burden.

As a regulated utility, furnishing an essential communications service to the public—including business, agriculture, and the military—Northwestern Bell must first address itself to maintaining, in the fullest measure possible, its ability to meet the growing telephone needs of the territory it serves. Important and unprecedented as such demands have been since the end of World War II, they have not yet been completely filled and a huge, further expansion of our defense effort is even now just getting under way.

Faced with these prospects, the company's paramount concern is that of fulfilling its service obligations, however imposing they may be. To do this job promptly, effectively, and, in the long run, economically, the company must be in sound financial health and able to attract investment capital on favorable terms. Since the excess profits tax measure, as it now stands, would seriously impair the company's capacity to render such services by perpetuating the era of low, postwar earnings; Northwestern Bell urges prior consideration of two important factors, which constantly bear upon its operations, as follows:

1. Under regulation, excess profits as such are nonexistent in the telephone business, now, in the post and in the foreseeable future.

2. The telephone customer is already subjected to one of the heaviest tax burdens ever imposed upon the user of an essential adjunct to our national economy.

The obligation and responsibility of State regulatory commissions, including the Nebraska Railway Commission, is to insure through continuing review that the rates charged telephone users for services under their regulatory jurisdiction will produce earnings which are fair and reasonable in relation to a proper evaluation of the properties devoted to public service. Such continuing regulation in fact conclusively eliminates any possibility of excess profits at any time. Thus, a tax proposal which purports to distinguish between the "normal earnings" required to maintain Northwestern Bell on a continuingly sound financial and customer rate-paying basis and "excess profits," is at once self-contradictory. Such a law, if enacted as presently proposed, would:

1. Severely hamper, and perhaps foreclose, Northwestern Bell's financial ability to meet in full measure and on a sound basis the essential demands for service now being placed upon it.

2. Invade and defeat in part the purposes of continuing State regulation in the interest of Nebsaka telephone users.

It is evident, therefore, that the measure as presently under consideration might do irreparable damage to the telephone business at the very time when the services it furnishes to every essential segment of our economy are in utmost demand and of surpassing neecssity.

Important projects already under way as the result of the expanding defense actively include those at Omaha, Bellevue, and Sidney, Nebr.; Rapid City, S. Dak.; Burlington, Iowa; Duluth and Minneapolis, Minn.; and at numerous points on the basic long-distance network throughout the five-State territory served by Northwestern Bell. These projects alone involve an investment in the order of $4,000,000 and many other important additions will undoubtedly have to be made.

As to the user, he already pays a tax on telephone services far beyond that levied on almost any other product or service of comparable magnitude or importance in our local or national economy. In 1949 alone, out of each $100 paid by Nebraskans for services furnished by Northwestern Bell, $30.01, or 30 percent, constituted tax payments.

This levy, based upon the 1949 corporate Federal tax rate of 38 percent, normal and surtax, will of course be higher in 1950 with a 42 percent rate, and still more burdensome in 1951 under the enacted 45 percent rate.

Beyond any reasonable doubt, the telephone-rate payer is already very substantially taxed in his use of communications services, so indispensable to his own and to the national welfare.

There is compelling evidence, then, to suggest that Federal action to curb excessive war profits on the part of Northwestern Bell is at one and the same time both unnecessary under the existing proposals, damaging. Present regulation, under state authorities intimately familiar with and responsible to the needs of the public and the problems confronting the local telephone company, should indeed be best suited to the purpose of insuring a completely adequate telephone service and reasonable earnings.

The company is mindful that in view of the present international crisis, the committee may nevertheless find itself obligated to proceed promptly with tax legislation on a fairly broad basis, recognizing, however, the regulatory aspects of public utility operations.

If such is the case, then Northwestern Bell, to preserve its financial ability to meet the huge, foreseeable demands for additional telephone service in its five-State territory strongly recommends that the 6 percent point-of-entry in the proposed bill be increased to at least 7½ percent.

OMAHA, NEBR., *December 5, 1950.*

Hon. HUGH A. BUTLER,
United States Senate, Washington, D. C.

DEAR SENATOR BUTLER: Thank you for your letter of December 1. I appreciate having opportunity to comment on proposed tax bill and have following suggestions:

1. I believe a normal commercial corporation should pay excess profits tax only on those excess profits created by abnormalities such as war and the accompanying inflationary spiral.

2. I think that tax should be assessed against excessive income only after allowing as expense, the normal and surtax. This would be a sound provision for all corporations, public utilities and others.

3. Re item (4) of the summary, since earnings of public utilities are subject to regulatory authorities, there are no "excess profits" as such, and it would seem proper to exclude regulated public utilities from the provisions of the act.

However, assuming such consideration is not feasible, the following suggestions relating to public utilities offered:

(*a*) Allowance of normal tax and surtax as a credit is sound. This is very important and should be retained.

(*b*) Likewise, inclusion of all capital in invested capital base is sound.

(*c*) In the case of utilities particularly, due to the tremendous expansion since the war and the present backed up demand still to be served, the 6-percent allowance is inadequate. Past experience indicates that to obtain the substan-

tial sums of capital required to meet defense efforts and satisfy civilian demands for service, an allowance of not less than 7½ percent is necessary.

(*d*) It is stated in the summary under item (4) that all public utilities have a basis of a rate of return of 6 percent other than railroads and airlines, which should have a 5-percent base. I cannot understand why railroads, with the great expansion problem necessary, together with increased costs and such low earnings, should be restricted to a 5-percent base as against the recommended 6-percent base for other utilities.

With sincere regards and best wishes, I am,

ELLSWORTH MOSER.

The CHAIRMAN. Mr. Sprague, I believe you are next on the list. You may be seated and proceed with your statement.

Identify yourself for the record.

STATEMENT OF ROBERT C. SPRAGUE, PRESIDENT, SPRAGUE ELECTRIC CO., NORTH ADAMS, MASS., AND PRESIDENT, RADIO-TELEVISION MANUFACTURERS ASSOCIATION

Mr. SPRAGUE. Mr. Chairman and members of the committee, I am president of the Sprague Electric Co., North Adams, Mass., and I am also president of the Radio-Television Manufacturers Association.

There are some charts that are attached to this brief statement. I will not have time to more than just refer to them by number during this brief statement, but I would be glad to answer any questions afterwards. We have some enlarged charts here, if that will be helpful to the committee.

The CHAIRMAN. Yes, sir. Thank you.

Mr. SPRAGUE. I am appearing today on behalf of America's fastest growing industry, the television-set manufacturers and their suppliers. Because their principal growth occurred in the first 6 months of 1950, the House bill will severely discriminate against this group of manufacturers.

Our position may be summarized as follows:

1. The House bill discriminates against the television-electronics industry by subjecting a much larger portion of its earnings to excess profits taxes than those of corporations in general.
2. The provisions of the House bill which purportedly relieve growing business are grossly inadequately and unfair to our industry.
3. One important result of this discrimination is that production for the rearmament program will be hindered.
4. The House bill should be amended to give a company having substantial and continuing growth in the first 6 months of 1950 the benefit of an adjustment to its excess profits credit designed to produce a tax consistent with that of corporations in general.

Senator KERR. Do you not think the same would apply for the 6 months' period beginning July 1, 1950, or any time thereafter, aside from those industries directly related to defense expenditures, as what you have said with reference to the first 6 months of 1950?

Mr. SPRAGUE. That is perfectly true. The reason it was put in this report in this way is that we understood the basic purpose of an excess profits tax was to isolate and to seize profits resulting either directly or indirectly from this unfortunate war in Korea. So, in order to make that crystal clear, we here refer to the rate of growth established in the first 6 months before the Korean war started.

Senator KERR. If the principle is justifiable—and I, for one, think it is—is it not just as apt to continue the growth of the business and industry which is not associated with the defense spending directly?

Mr. SPRAGUE. Yes; that is correct.

Senator MILLIKIN. Of course, the basis of your claim for special treatment is the rapid growth of your own industry?

Mr. SPRAGUE. That is right.

Senator MILLIKIN. As distinguished from what might be called a normal growth of other industries?

Mr. SPRAGUE. Yes, sir.

Senator MILLIKIN. Once you carve yourselves out of that, you have left nothing. I assume that your case is that you deserve special treatment because you have an especially rapid growth?

Mr. SPRAGUE. Yes, sir. Particularly rapid after January 1, 1950.

Senator MILLIKIN. And you are a new industry, and that differentiates you from industries that have had a chance, you say, in a relative sense, to stabilize?

Mr. SPRAGUE. Yes.

Senator MILLIKIN. You are in a state of complete and happy instability, in that you are growing up, and growing up rapidly and profitably; is that not correct?

Mr. SPRAGUE. That is correct.

I would like to elaborate on these points:

1. The House Bill discriminates against the television-electronics industry by subjecting a much larger portion of its earnings to excess profits taxes than those of American industry in general.

The television industry is the fastest growing industry in America and the principal part of its growth occurred in 1950 prior to the Korean war. The telephone, automobile, refrigerator, and radio industries are frequently cited as illustrations of unusually rapid growth. Yet to date, as shown on chart 1, the growth of television has outstripped even the phenomenal achievements of every one of those industries.

Television is still in its infancy. Today there are only 107 television stations, and large areas and many important cities have no television at all. It is estimated by the Federal Communications Commission that the number of stations will grow to 2,000 once it lifts the "freeze" on the construction of new stations which it imposed in 1948. Chart 2 shows the potential for continuing growth of the industry.

To date the principal growth in our industry occured in the first 6 months of 1950, and was in no way attributable to the Korean war.

Senator MILLIKIN. What percentage of your products goes to the Defense Establishment?

Mr. SPRAGUE. At the present time, for the industry as a whole, I would think that it is somewhere between 5 and 10 percent—5 percent minimum and 10 percent maximum.

Senator MILLIKIN. Prior to the Korean war?

Mr. SPRAGUE. Prior to Korea it was considerably less than 5 percent.

Senator MILLIKIN. What would you say?

Mr. SPRAGUE. Three or four percent, I would say.

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This is revealed by the following table, which uses the proposed base period as a yardstick:

Sales

[1946–49 average=100]

Year	Television electronics industry	All industries
	Percent	*Percent*
1946	77	80
1947	98	102
1948	105	112
1949	120	106
1950 (estimated)	178	108

These are taken from Department of Commerce figures.

You will note from this table and chart 3 that aggregate sales of "all industries" reached their postwar peak in 1948. In contrast to the general trend, our industry shows a continued and accelerating rate of expansion.

The years 1946–49, proposed in the House bill as the base period, was a time of preparation for our industry and hence its application to television manufacturers would be unfair. Plants were being built and enormous amounts of money in research were being expended. It is estimated in the years from '39 to '49 our industry has spent $100,000,000 out of capital on research and development for the television industry. A comparison of our profits pattern with that of general business is illumination:

Net profits (before taxes)

[1946–1949 equals 100]

Year	Electronics industry	All industries
	Percent	*Percent*
1946	49	81
1947	97	106
1948	119	117
1949	136	96
1950	298	116

Senator MILLIKIN. Does your industry confine itself to the making of parts for television, or does a part of it make the complete set?

Mr. SPRAGUE. Our association has 312 members, made up of about 45 end producers, that is, manufacturers who make radio equipment, television, and communication equipment, and the balance of them are manufacturers of tubes and the various bits and pieces, such as capacitors, resistors, tuners, and all of the various parts that go to make it. We take the whole thing, the parts. That does not include any raw material manufacturers.

Senator LUCAS. What part of it is radio now?

Mr. SPRAGUE. Well, in 1950 there will be 7½ million television sets built, and 14 million radio sets, but because of the difference in value, probably 75 percent of the dollars are in television, and 25 percent in radio.

Senator LUCAS. Do you make that distinction any place in this paper?

Mr. SPRAGUE. No; we did not, because the radio business has declined from a peak in 1946 of 22 million sets, last year, to a low of 10 million, and this year is increasing to 14 million. During that period television had a contrary trend, starting from 6,000 sets in 1946 to about 7½ million this year. So the expansion in the industry, both as far as the end producers are concerned, and as far as the parts are concerned, has been due to the television increment; in other words, the radio increment has declined, but the television increment has expanded very rapidly, and more than made up the decline in the period 1946 to 1949. And then this year, due to the increase in radio and the large increase of television, and the enormous expansion in 1950——

Senator LUCAS. You cannot place radio in the same category with your television, so far as the development is concerned.

Mr. SPRAGUE. No; that is correct.

Senator LUCAS. And you have made no distinction between the two of them. In other words, you placed the two of them together in this manuscript as though there has been that development in radio, the same as in television.

Mr. SPRAGUE. Well, as we will bring out later, the enormous expenditures for fixed assets in the industry of those manufacturers who make both radio and television, have been in order to keep up with this television development. But the money has been expended by the same people, so the effect is the same as if it was all the same.

Senator LUCAS. That may be true. I am not questioning that. You may be correct. Do you agree with me that so far as radio is concerned, that it ought to be placed on the same basis as the automobile or any other industry that has been going for a long, long time?

Mr SPRAGUE. I think that is entirely a matter of the rapidity of growth. Can I illustrate by taking my own company, to get some figures out?

Our fixed assets at the start of 1946, the amount that we had invested in plant and equipment, was $700,000. As of the end of this year, the amount increased to $4,200,000. In other words, in a period of 5 years—and we are considered, I think, in the category of the smaller companies—we have expended our fixed assets by a ratio of 6 to 1.

We make substantially the same items for television as for radio, but because of the larger number of parts used in television, we have had to expand our facilities by that ratio, in spite of the declining radio market. So that as far as we are concerned, the effect is the same.

The tremendous amount of money we have had to put back into fixed assets, into inventory, into accounts receivables, and all of the problems related to that, has been the result of this mixed trend in which the television increasing increment has much more dominated the increase, or the leveling off of radio, as indicated by the expansion of facilities, of 6 to 1.

Senator MILLIKIN. There may be a fallacy some place here, but on the surface, Senator Lucas has made a point. I do not know whether it would be practical to segregate the two things, but you are combin-

ing something that is subject to a normal growth calculation with something that is not. Is it possible to unscramble the eggs?

Mr. SPRAGUE. I am afraid, Senator Millikin, that for most of the companies, it is not.

Senator LUCAS. What about electrical appliances? Are they included in here too?

Mr. SPRAGUE. In our proposed formula, Senator Lucas, we simply use as a qualification the rate of growth, and we do not limit it just to television. We do not say that television manufacturers should have special treatment. We say that any manufacturer or group of manufacturers who has the same accelerated growth problem should qualify.

Senator LUCAS. Do your electrical appliances have the same rate of acceleration?

Mr. SPRAGUE. I do not think so. I do not know of any other industry that has this particular rate of acceleration, particularly between 1949 and 1950. And that, certainly, is clearly indicated as between the electronic industry, on the one hand, and business, in general, on the other, which these previous figures demonstrate.

For example, between 1949, where general business is going from 106 to 108 in 1950 the electronic industry has jumped from 120 to 178.

Senator LUCAS. In this statement, you have admitted there are electrical appliances that are involved in here, that radio is involved. What other industry of normal growth is involved in this statement that you are giving to the committee?

Mr. SPRAGUE. Do you mean what other industry?

Senator LUCAS. What other, outside of television? You came here on the theory that you are presenting a case for television. Now we find that electrical appliacnes are in this statement. We find that radio is in it.

Mr. SPRAGUE. They are not in here, that is, electrical appliances, in general.

Senator LUCAS. What do you mean in general? Are they in here in any way whatsoever? Do you make electrical appliances?

Mr. SPRAGUE. We do not.

Senator LUCAS. They are not in this statement?

Mr. SPRAGUE. No, sir.

Senator LUCAS. I understood you to say they were.

Mr. SPRAGUE. I am sorry. I am glad you cleared that up. I am representing the Radio-Television Manufacturers Association which, by name, is a group of manufacturers whose business principally is in the radio-television electronics industry. The NEMA, which is the National Electrical Manufacturers Association, includes in its membership, appliance manufacturers and manufacturers of motors, and so on. Those manufacturers are not, in general, included in our group. There are a few companies that have divisions, but none of those figures are in here. These figures in here are the figures of manufacturers, substantially the largest part, or 95 percent or more of businesses in the radio and television electronic industry.

So I think to the extent that you can isolate a group of manufacturers, they are isolated in this particular presentation. We have been very careful to get figures of that type.

Senator MILLIKIN. Could I interrupt with a question?

Senator LUCAS. Certainly.

Senator MILLIKIN. What percentage of your membership, or in some other terms of volume, for example, can you tell us who devote themselves exclusively to the television business?

Mr. SPRAGUE. Well, I cannot answer that very well, Senator Millikin, because most of them manufacture television and radio and electronic equipment. A very large percentage of the manufacturers in this group devote themselves entirely to that activity. They are interrelated. They use the same parts, the same design and equipment and have the same problems. Over 90 percent of the manufacturers in this group manufacture exclusively for that industry which we call the electronic industry.

Senator KERR. I do not know whether I understand what the witness is here for. And if I do, it may have a different implication than what Senator Millikin and Senator Lucas have been asking. As I understand it, you are seeking to have consideration of the proposal that this bill take into account the growth of any industry in the first half of 1950?

Mr. SPRAGUE. That is correct, Senator Kerr.

Senator KERR. You are not seeking that exclusively for your group?

Mr. SPRAGUE. No, sir.

Senator KERR. What you are seeking would be a general provision which would recognize the phenomenal growth in the first half of 1950 with reference to any industry?

Mr. SPRAGUE. That is correct, Senator.

Senator KERR. And in support of that effort on your part you are giving the specific data of your own industry and showing how it would be inequitably handled in the absence of such a general recognition of the expansion of any industry in the first half of 1950?

Mr. SPRAGUE. That is exactly correct, Senator Kerr.

Senator MILLIKIN. Do you have a formula later in your paper?

Mr. SPRAGUE. Yes, sir.

The CHAIRMAN. All right, suppose you proceed, Mr. Sprague. Maybe it will become clear.

Mr. SPRAGUE. This data and chart 4 further demonstrate that the growth of television is not the result of the national emergency.

Under the provisions of the House bill 85 percent of the average earnings for the three highest years in the period 1946 through 1949 are used as a credit and approximately 7.3 billion dollars or about 22 percent—based on the data used by Secretary Snyder, this figure would be approximately 29 percent—of 1950 earnings of all corporations would be subject to excess profits taxes. Applied to our own industry, these provisions result in about 65 percent of our indicated 1950 earnings being subject to excess profits taxes.

The House bill taxes smaller companies in the industry more severly than the larger ones. This is revealed by chart 10 which shows the following:

Percent of 1950 profits subject to excess profits taxes

Size groups (net worth):	*Percent*
Less than $1,000,000	68.34
$1,000,000 to $20,000,000	65.36
Over $20,000,000	62.13

Senator TAFT. Have the small companies grown faster, is that the reason?

Mr. SPRAGUE. That is right, sir.

Senator TAFT. Comparatively to what they were in the beginning?

Mr. SPRAGUE. That is right.

Senator TAFT. The percentage of growth is greater?

Mr. SPRAGUE. That is right, sir.

II. The provisions of the House bill which purportedly relieve growing business are grossly inadequate and unfair to our industry: This results from the fact that the industry had its principal growth in 1950 prior to the Korean War. Therefore, the application of the growth formula of section 436 (e) affords negligible relief to companies in our industry who qualify.

The qualifying requirements based on sales or payroll expenditures in the base period have the same fundamental weakness: they fail to give recognition to those companies whose principal growth occurred between 1949 and the first half of 1950. About 60 percent of the companies in the industry would not qualify. For example, my own company fails to qualify although it will have increased its fixed assets six times between January 1, 1946, and the end of 1950, and its 1950 earnings will also be about six times its 1946 earnings.

In spite of that enormous expansion of equipment and facilities, our particular company does not qualify under this formula.

Charts 7, 8 and 9 show why the "growth formula" is a snare and a delusion. Chart 7 shows that whereas approximately only 22 percent of the 1950 earnings of "all corporations" would be subject to excess profits taxes, the levy would apply to 56 percent of the 1950 earnings of members of the industry who would be eligible for the growth formula; even giving effect to the growth formula, those companies, 47 percent of them, would still have to pay a tax on 56 percent of their 1950 earnings, and would apply to 65 percent of the earnings of members who cannot qualify.

Chart 8 discloses that, even if all members of the industry were eligible to use the growth formula, the discrimination would still exist because 59 percent of the industry's indicated earnings would be subject to the tax. Chart 9 summarizes the impact of the proposed tax upon various segments of the industry.

The provisions for the relief of new corporations and companies changing products and for capital additions do not eliminate the discrimination against the television industry: These provisions are obviously inadequate where the problem is early 1950 growth for the industry itself as well as the individual companies. The concept of a fixed or historical rate of return on assets is also inadequate for a growth company in a new industry. It fails to give recognition to the heavy risks of this new business. It ignores the post-pioneering rate of earnings actually realized in prewar 1950.

III. One important consequence of the discrimination is that production for the rearmament program would be hindered: There is one very startling figure that I will give you on this. A retroactive excess profits tax under the discriminatory House bill would financially cripple many key producers in the electronics industry, including important television manufacturers and their suppliers. Everyone knows that the Army, Navy and Air Force depend to an ever-increasing extent on electronic gear of all kinds. Guns and ships and tanks, guided missiles, jet planes, and so forth.

Profits do not mean cash in the bank. As volume of business grows, larger inventories are needed, payrolls are greater, accounts receivable are increased.

But even more significant were the necessary additions to plant facilities to which members of the industry became committed prior to the Korean War.

Here is the figure I referred to. For example, the fixed assets of 34 suppliers of parts aggregate 85.4 million dollars as compared to 84.1 million dollars of capital and retained earnings. The group of 34 companies, who are the smaller companies in the group, have increased more than all of their capital and retained earnings in fixed assets; in other words, they are operating entirely on borrowed capital of some kind. Capital and earnings have been tied up in productive equipment and are simply not there to pay the tax collector without a most damaging effect on the financial health of these companies.

Senator MILLIKIN. There is no other way they could do it?

Mr. SPRAGUE. Some of them, they cannot, that is correct. That is the reason this whole industry is so disturbed on this particular feature of the tax. Most of the companies are not published companies, the figures are not available to the public. They are concerned about the information getting to their customers, and yet there are 80 of them who sent the figures in to a committee of men to have analyzed.

IV. This discrimination should be eliminated by raising the needed revenue through an increase in the corporate tax rate. In any event, an excess profits tax law should give companies having their principal growth in early 1950 a tax status generally consistent with " all corporations."

(*a*) No company whose principal growth occurred in early 1950 should have an earnings credit less than that of corporations in general.

As I pointed out earlier in the statement, the House bill would mean that approximately 22 percent of the earnings of all American corporations in 1950 would be subject to the excess profits tax and the balance of 78 percent[1] would represent that part of their 1950 earnings not subject to excess profits tax.

The discrimination could be corrected by permitting a rapidly growing company to use as its credit, on the earnings method, 85 percent of the average of the highest 3 years of the base period, as now proposed in the House bill, with the proviso that such credit will not be less than 78 percent of its 1950 earnings. This suggestion would assure such companies of treatment roughly equivalent to that of corporations generally.

(*b*) A company entitled to this protection should be one whose 1950 earnings are at least 50 percent greater than its earnings in the year 1949.

For business in general the estimated earnings in 1950 will be approximately 21 percent[2] in excess of 1949 earnings. We, therefore, recommend that in order to qualify, a company should show an increase of 50 percent in its 1950 earnings over those of the preceding year.

---

[1] Using the data employed by Secretary Snyder, this figure would be approximately 71 percent.

[2] Our own estimates are based on Department of Commerce statistics. Using data employed by Secretary Snyder, this figure would be 38 percent.

The statute should provide that 1950 earnings for this purpose should be either actual earnings—that is, for the year—or annualized earnings for the first 6 months of 1950, whichever is the lesser. This would exclude companies which have particularly benefited since the start of the Korean War. It would not exclude any company merely because of size or value of assets, as the House bill does. There is no justification for the House bill's provision excluding companies who otherwise qualify, merely because of size.

We would like to be of help to the committee and its experts in analyzing the possible effect of this proposal. If we can be of any assistance in exploring it further, we hope you will give us the opportunity.

The CHAIRMAN. The charts which you have attached to your presentation will be incorporated in the record at this point.

Mr. SPRAGUE. Thank you.

(The charts referred to are as follows:)

CHART 1

AMERICA'S FASTEST GROWING INDUSTRY: THE GROWTH OF TV COMPARED WITH THE EARLY GROWTH OF RADIOS, REFRIGERATORS, AUTOMOBILES, AND TELEPHONES

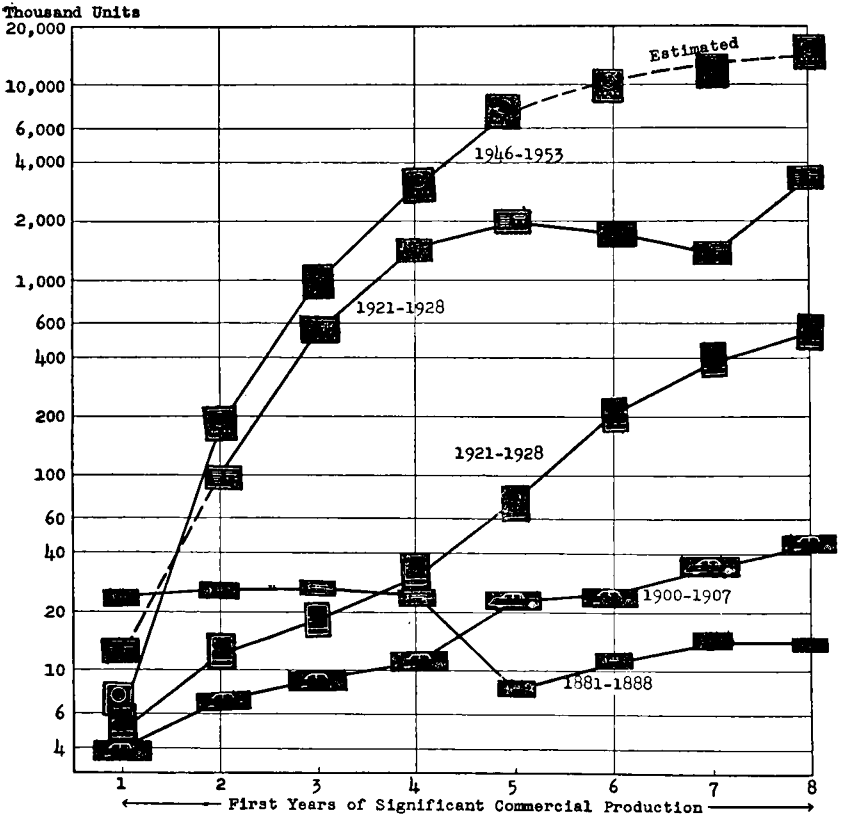
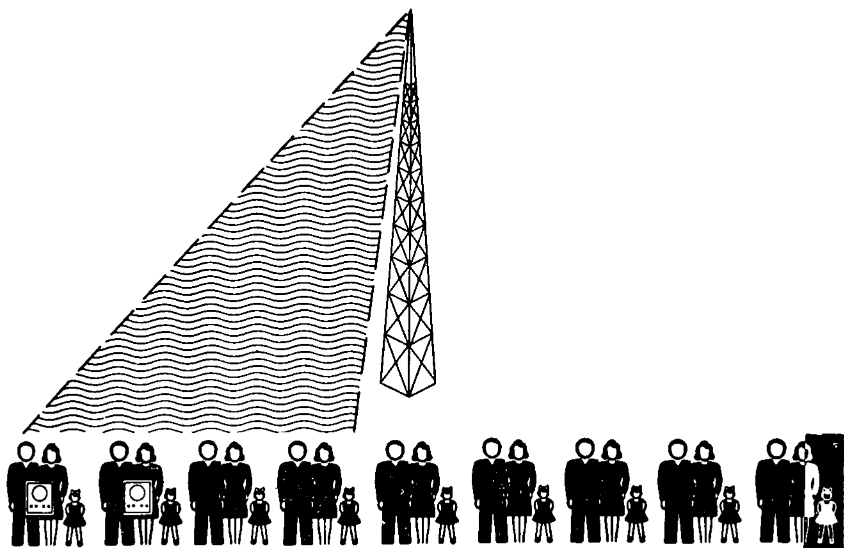


CHART 2.—THE TV MARKET TODAY



THE HAVES

Ten million families own TV sets and twenty million families, or 46 percent of all families in the United States, are within present range of TV broadcasting.

THE HAVE NOTS

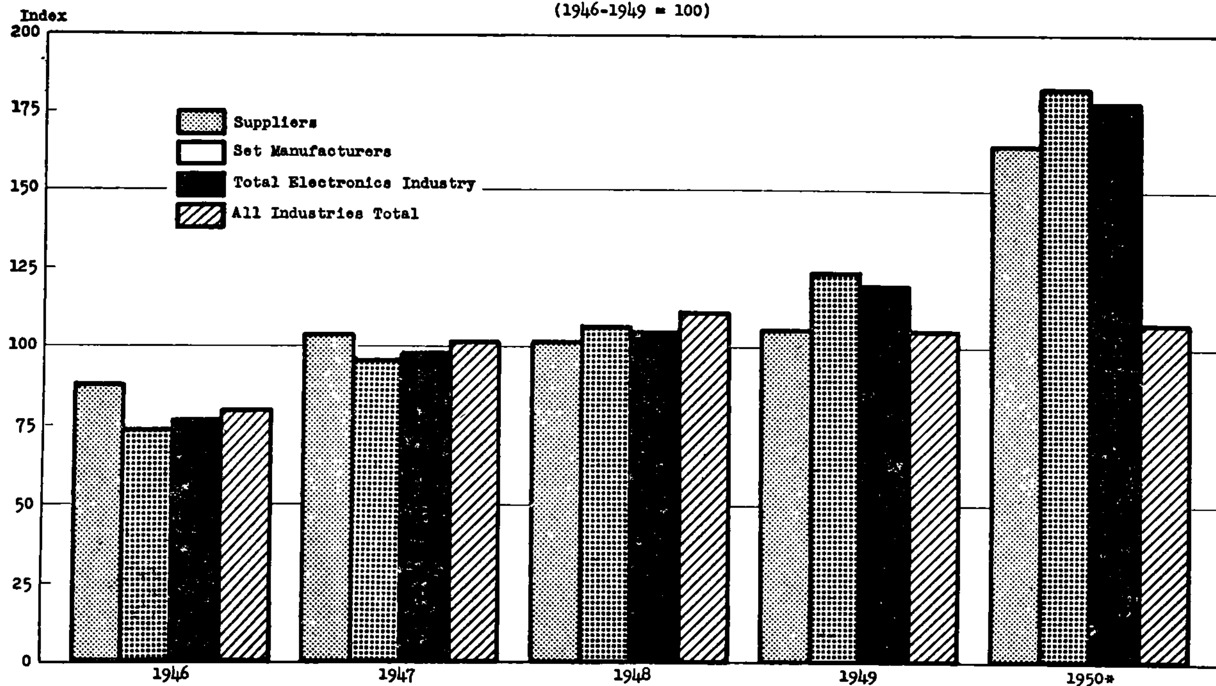
Thirty-three million families do not own TV sets and twenty-three million families in the United States are outside the present range of TV broadcasting.

Each family symbol denotes five million families.

CHART 3

SALES: COMPARISON OF SUPPLIERS, SET MANUFACTURERS, AND TOTAL ELECTRONICS INDUSTRY WITH ALL INDUSTRIES TOTAL FOR THE YEARS 1946 THROUGH 1950

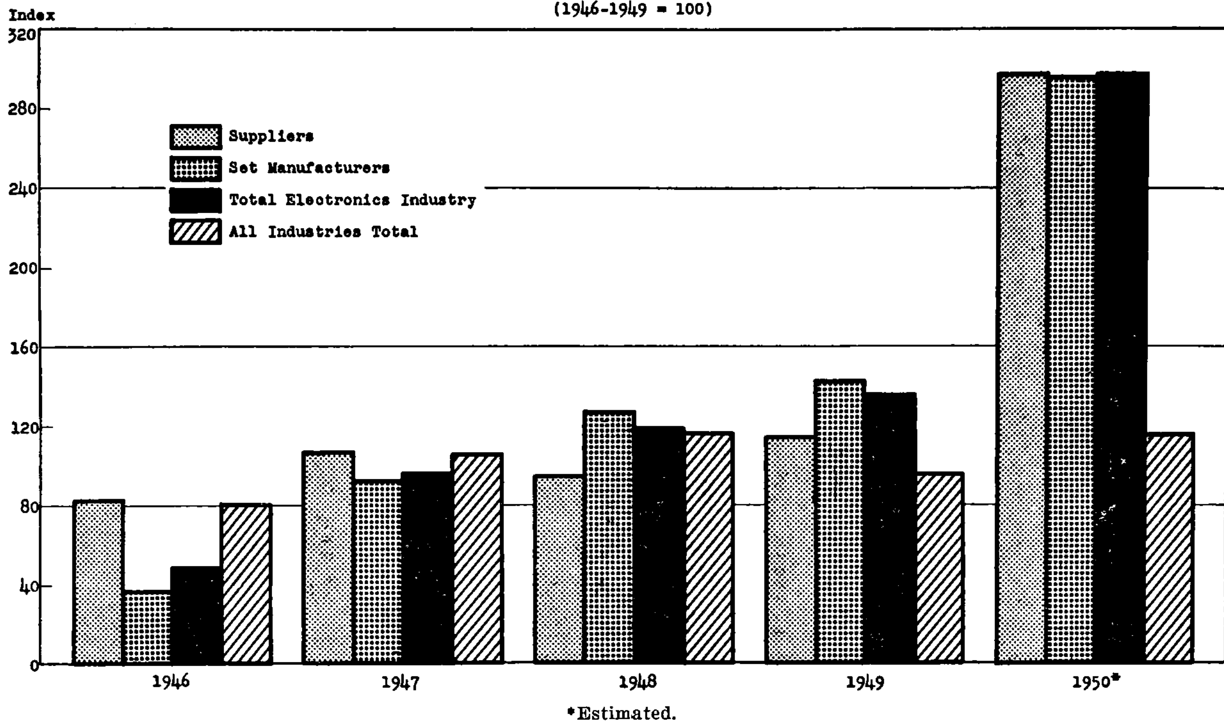
(1946-1949 = 100)



*Estimated.

CHART 4

NET PROFIT BEFORE FEDERAL INCOME TAXES: COMPARISON OF SUPPLIERS, SET MANUFACTURERS, AND TOTAL ELECTRONICS INDUSTRY WITH ALL INDUSTRIES TOTAL FOR THE YEARS 1946 THROUGH 1950



*Estimated.

CHART 7

A COMPARISON: PORTION OF 1950 NET PROFITS SUBJECT TO EXCESS PROFITS TAXES FOR MEMBERS OF THE ELECTRONICS INDUSTRY QUALIFIED TO USE GROWTH FORMULA AND MEMBERS NOT QUALIFIED TO USE GROWTH FORMULA WITH ALL CORPORATIONS

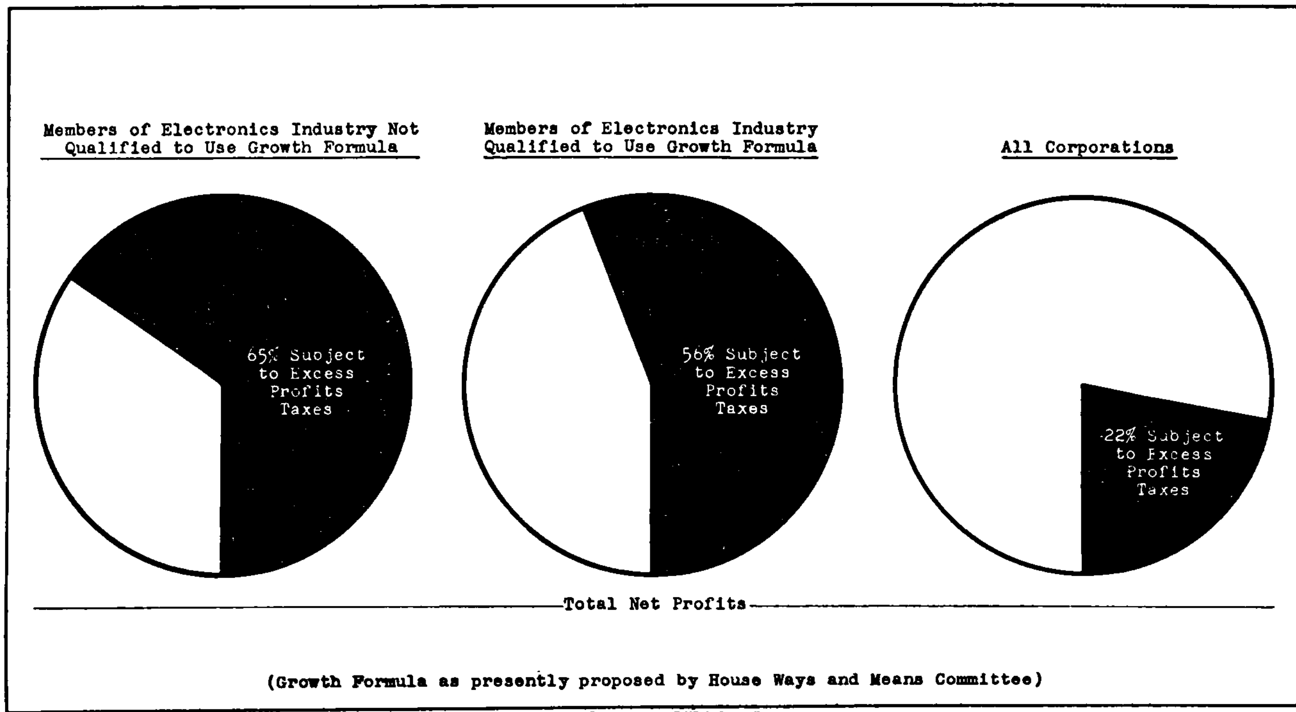


CHART 8

THE PROPOSED GROWTH FORMULA IS INADEQUATE: A COMPARISON OF THE PORTION OF 1950 NET PROFITS SUBJECT TO EXCESS PROFITS TAXES FOR THE ELECTRONICS INDUSTRY, ASSUMING ALL MEMBERS WOULD BE ENTITLED TO USE GROWTH FORMULA, WITH ALL CORPORATIONS

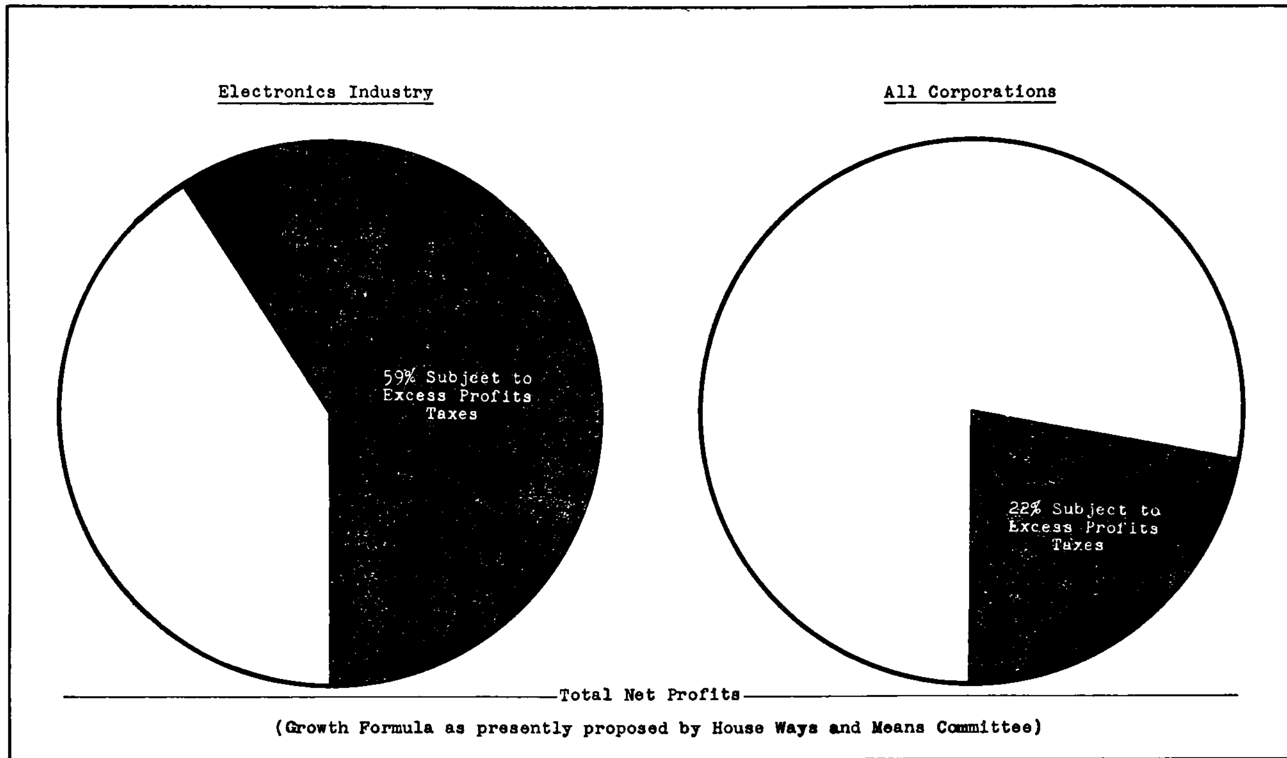


CHART 9

THE PROPOSED GROWTH FORMULA IS INADEQUATE: A COMPARISON OF THE PORTION OF 1950 NET PROFITS SUBJECT TO EXCESS PROFITS TAXES FOR MEMBERS OF THE ELECTRONICS INDUSTRY AND ALL CORPORATIONS WITH AND WITHOUT APPLICATION OF THE GROWTH FORMULA, AS PRESENTLY PROPOSED BY HOUSE WAYS AND MEANS COMMITTEE

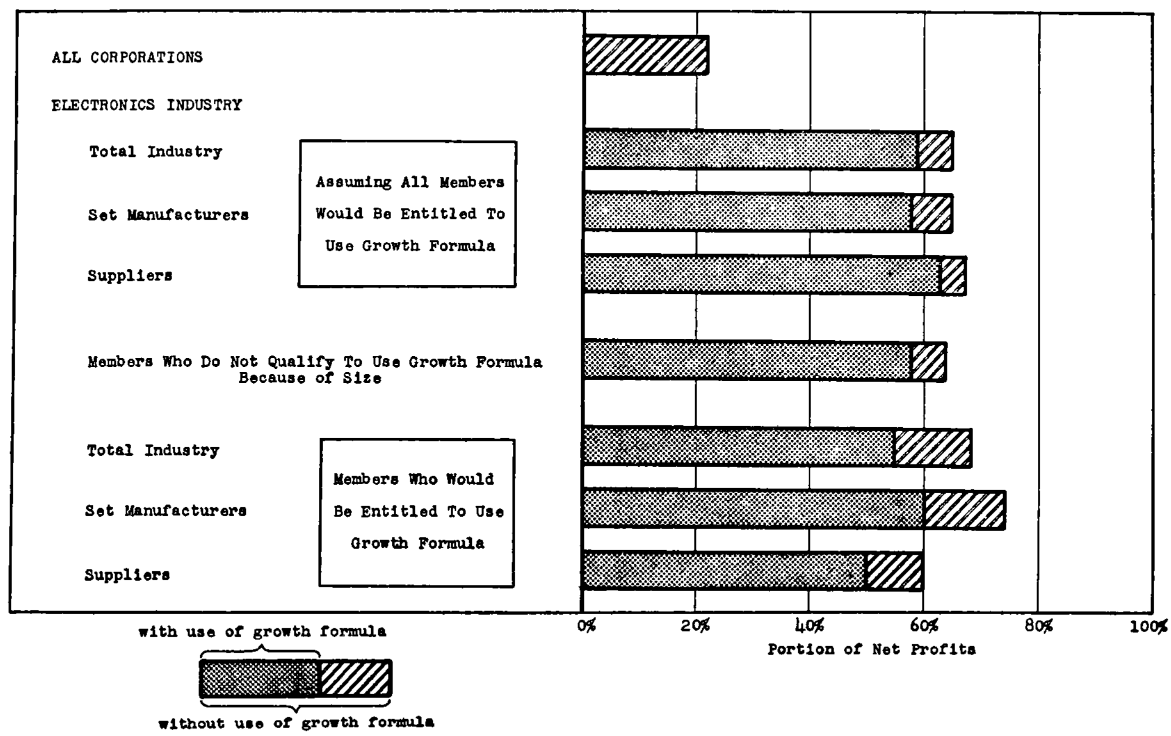
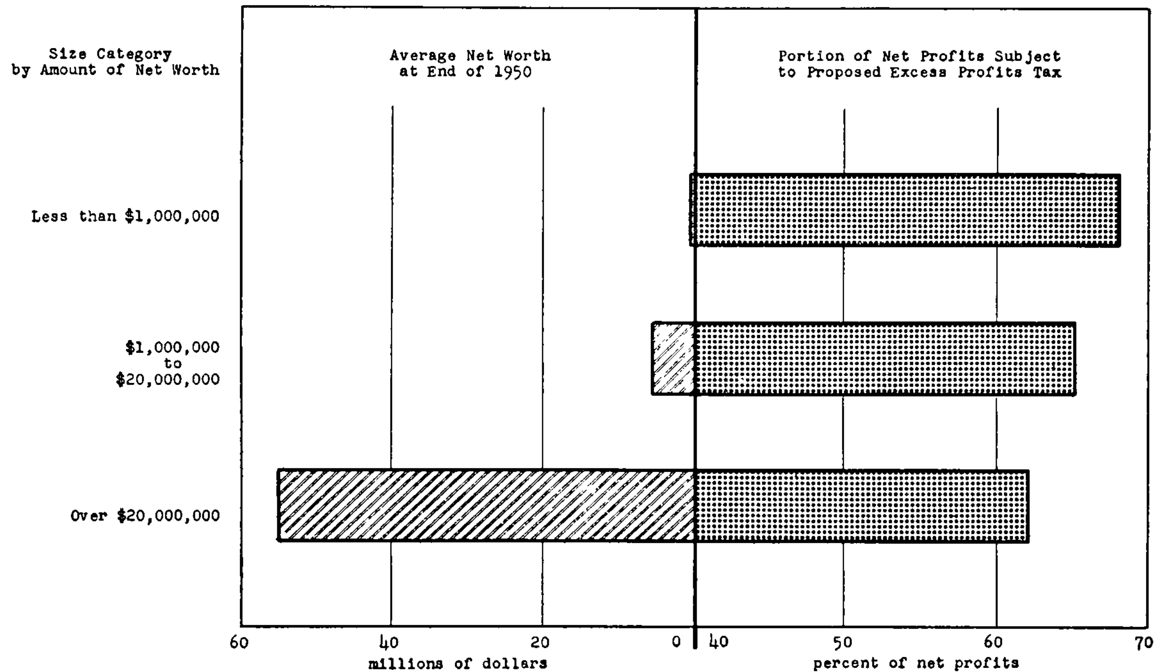


CHART 10

THE PROPOSED EXCESS PROFITS TAX IS MOST DAMAGING TO THE SMALLER MEMBERS OF THE ELECTRONICS INDUSTRY: A COMPARISON OF THE PORTION OF 1950 NET PROFITS SUBJECT TO EXCESS PROFITS TAXES FOR THE INDUSTRY MEMBERS BY SIZE CATEGORY



SCHEDULE FOR CHART 1

The growth of TV compared with the early growth of radios, refrigerators, automobiles, and telephones

Year of significant commercial production	TV production		Retail radio sales		Refrigerator sales		Automobile factory sales		New telephone installations	
	Period	Thousands of units	Period	Thousands of units	Period	Thousands of units	Period	Thousands of units	Period	Thousands of units
1	1946	6	1921	[1] 12	1921	5	1900	4	1881	23.5
2	1947	179	1922	100	1922	12	1901	7	1882	26.3
3	1948	975	1923	550	1923	18	1902	9	1883	25.9
4	1949	3,029	1924	1,500	1924	30	1903	11	1884	24.1
5	1950	6,933	1925	2,000	1925	75	1904	23	1885	8.1
6	1951	[1] 10,000	1926	1,750	1926	205	1905	25	1886	11.2
7	1952	[1] 13,000	1927	1,350	1927	375	1906	34	1887	14.0
8	1953	[1] 14,000	1928	3,281	1928	535	1907	44	1888	14.0

[1] Estimated. (See chart 1.)

Source: TV—Radio-Television Manufacturers Association; radios—Broadcasting Publications, Inc., 1940 Broadcasting Yearbook; refrigerators—McGraw-Hill Publishing Co., Inc., Electrical Merchandising, automobiles—Automobile Manufacturers Association, Automobile Facts and Figures; telephones—American Telephone & Telegraph Co.

SCHEDULE FOR CHART 3

Sales: Comparison of suppliers, set manufacturers, and total electronics industry with all industries total for the years 1946 through 1950

[Dollar amounts in millions]

Year	Suppliers		Set manufacturers		Total electronics industry		All industries total	
	Amount (1)	Index [1] (2)	Amount (3)	Index [1] (4)	Amount (5)	Index [1] (6)	Amount (7)	Index [1] (8)
1946	$213.6	88	$540.3	73	$753.9	77	$270.9	80
1947	253.0	104	709.2	96	962.2	98	347.8	102
1948	248.7	102	786.1	107	1,034.8	105	381.3	112
1949	258.6	106	915.0	124	1,173.5	120	359.7	106
1950	[2] 399.5	164	[2] 1,348.5	183	[2] 1,748.0	178	[3] 367.4	108
1946–49 average	243.5	100	737.7	100	981.1	100	339.9	100

[1] 1946–49=100.
[2] Estimated.
[3] Estimated on schedule for chart 5.

Source: Columns 1, 3, and 5, Radio-Television Manufacturers Association; column 7, U. S. Department of Commerce, Bureau of Foreign and Domestic Commerce, Survey of Current Business, July 1950, p. 23.

SCHEDULE FOR CHART 4

Net profit before Federal income taxes: Comparison of suppliers, set manufacturers, and total electronics industry with all industries total for the years 1946 through 1950

[Dollar amounts in millions]

Year	Suppliers		Set manufacturers		Total electronics industry		All industries total	
	Amount (1)	Index [1] (2)	Amount (3)	Index [1] (4)	Amount (5)	Index [1] (6)	Amount (7)	Index [1] (8)
1946	$16.4	83	$21.8	37	$38.2	49	$23.5	81
1947	21.3	108	54.2	93	75.5	97	30.5	106
1948	18.7	94	74.0	127	92.7	119	33.9	117
1949	22.8	115	83.4	143	106.2	136	27.6	96
1950	[2] 59.2	299	[2] 173.5	297	[2] 232.7	298	[3] 33.5	116
1946–49 average	19.8	100	58.35	100	78.15	100	28.88	100

[1] 1946–49=100.
[2] Estimated.
[3] Estimated on schedule for chart 5.

Source: Columns 1, 3, and 5, Radio-Television Manufacturers Association; column 7, U. S. Department of Commerce, Bureau of Foreign and Domestic Commerce, Survey of Current Business, July 1950, p. 17.

SCHEDULE FOR CHART 5

Net profit before Federal income taxes as percentage of sales: Comparison of suppliers, set manufacturers, and total electronics industry with all industries total for the years 1946 through 1950

	1946	1947	1948	1949	1950
Suppliers:					
Net profit (thousand dollars)	16,389	21,294	18,722	22,770	[1] 59,205
Sales (thousand dollars)	213,628	253,001	248,687	258,562	[1] 399,485
Net profit as percentage of sales:					
Percent	7.67	8.42	7.53	8.81	14.82
Index (1946=100)	100	110	98	115	193
Set manufacturers:					
Net profit (thousand dollars)	21,816	54,195	73.972	83,419	[1] 173,468
Sales (thousand dollars)	540,292	709,152	786,063	914.981	[1] 1,348,541
Net profit as percentage of sales:					
Percent	4.04	7.64	9.41	9.12	12.86
Index (1946=100)	100	189	233	226	318
Total electronics industry:					
Net profit (thousand dollars)	38,205	75,489	92,694	106,189	[1] 232,673
Sales (thousand dollars)	753,920	962,153	1,034,750	1,173,543	[1] 1,748,026
Net profit as percentage of sales:					
Percent	5.07	7.85	8.96	9.05	13.31
Index (1946=100)	100	155	177	179	263
All industries total:					
Net profit (million dollars)	23,464	30,489	33,880	27,625	[2] 33,454
Sales (million dollars)	270,898	347,801	381,300	359,678	[3] 367,411
Net profit as percentage of sales:					
Percent	8.66	8.77	8.89	7.68	9.11
Index (1946=100)	100	101	103	89	105

[1] Estimated.
[2] Net profit estimated as follows: (1) First half 1950, $16,634 million; (2) first half 1949, $13,738 million; (3) percentage change, 1950 from 1949, 121.1; (4) percentage change applied to 1949 net profit ($27,625×121.1)= $33,454 million.
[3] Sales estimated as follows: National income (at annual rate): (5) First half 1950, $223.0 billion; (6) first half, $218.3 billion; (7) percentage change 1950 from 1949, 102.15; (8) percentage change applied to 1949 sales ($359,678×102.15)=$367,411 million.

Source: Electronics industry, Radio-Television Manufacturers Association; all industries, total, U. S. Department of Commerce, Bureau of Foreign and Domestic Commerce, Survey of Current Business, 1946-49, July 1950, pp. 17 and 23.

SCHEDULE FOR CHARTS 7, 8, AND 9

A comparison of the portion of 1950 net profits subject to excess profits taxes for members of the electronics industry and all corporations with and without application of the growth formula as presently proposed by House Ways and Means Committee

	1950 net profit before Federal income taxes [1]			Portion subject to tax as percentage of total 1950 net profit	
	Total	Portion subject to excess profits tax			
		With use of growth formula	Without use of growth formula	With use of growth formula (2)÷(1)	Without use of growth formula (3)÷(1)
	(1)	(2)	(3)	(4)	(5)
				Percent	*Percent*
All corporations (dollars in millions)	$33,454		$7,389		22
Electronics industry (dollars in thousands):					
I. Assuming all members would be entitled to use growth formula:					
Total industry	227,003	$133,629	150,330	59	65
Set manufacturers	173,468	100,010	112,059	58	65
Suppliers	53,535	33,619	38,271	63	67
II. Members who do not qualify to use growth formula because of size	116,320	67,748	74,011	58	64
III. Members who would be entitled to use growth formula:					
Total industry	28,102	15,706	19,225	56	68
Set manufacturers	16,583	9,968	12,349	60	74
Suppliers	11,519	5,738	6,876	50	60

[1] Estimated.

Source: Column 1, all corporations, schedule for chart 5, electronics industry, Radio-Television Manufacturers Association.

SCHEDULE FOR CHART 10

A comparison of the portion of 1950 net profits subject to excess profits taxes for members of the electronics industry by size category

Size category, by amount of net worth	1950 net worth [1]	1950 net profit		Portion subject to excess profits tax as percentage of total 1950 net profit (3)÷(2)
		Total	Portion subject to excess profits tax	
	(1)	(2)	(3)	(4)
				Percent
Less than $1,000,000	$463,000	$6,140,000	$4,196,000	68.34
$1,000,000 to $20,000,000	5,642,000	92,340,000	60,352,000	65.35
Over $20,000,000	54,972,000	132,320,000	82,211,000	62.13

[1] Average per company.

Source: Radio-Television Manufacturers Association.

The CHAIRMAN. Would you be able to formulate a recommendation or a recommended provision for insertion in the bill?

Mr. SPRAGUE. Yes, sir.

The CHAIRMAN. Would you do that and furnish it to the committee so that we may put it in the record?

Mr. SPRAGUE. Yes. We have our counsel here, Mr. Cleveland Hedrick, and I will ask him to make it in statutory language.

The CHAIRMAN. And put it in language that you can offer here for further consideration.

Mr. SPRAGUE. Yes, sir.

The CHAIRMAN. Are there any further questions of Mr. Sprague?

Senator LUCAS. How long has the Radio-Television Manufacturers Association been in existence?

Mr. SPRAGUE. Since 1924.

Senator LUCAS. What have you been making since 1924?

Mr. SPRAGUE. Until 1946 radio equipment, electronic equipment, and communication equipment, sir, the various parts like capacitors and resistors and tuners and tubes and things of that kind that go into that kind of equipment.

Senator LUCAS. I notice on page 5, for instance, you say everyone knows that the Army, Navy, and Air Force depend to an ever-increasing extent on electronic gear of all kinds.

Mr. SPRAGUE. Yes, sir.

Senator LUCAS. What portion of your business deals with electronics; that is, did it prior to 1950, would you say?

Mr. SPRAGUE. You mean what part of it was military equipment.

Senator LUCAS. Yes, sir.

Senator KERR. I do not think you mean that.

Senator LUCAS. What part was military equipment. I want that first.

Mr. SPRAGUE. I was asked that question before. I think it is around 5 percent.

Senator LUCAS. What part of electronics that we deal with otherwise and not taking into consideration television.

Mr. SPRAGUE. Well, you cannot separate it because the same people who make television equipment also make the military equipment.

Senator LUCAS. Do you dispose of electronics to any other concern except television people and the Army and the Navy and the Air Force?

Mr. SPRAGUE. Well, radio and communication equipment, for example, for aircraft, automatic pilots and things of that kind.

Senator LUCAS. Do you not think that your radio and your electronics that do not deal directly with television ought to be segregated and give this committee some notion as to what part of your business deals with electronics and with radio, prior to the rapidly increasing part of your business in the first part of 1950, because as I understand it, you linked all of these together; and if we should follow right along that line and write something into the statute, some provision that your attorneys might suggest—I take it that you are figuring on the entire business here including electronics and radio and television, as far as 1950 is concerned; am I correct in that?

Mr. SPRAGUE. Yes, sir. Can I explain that?

Senator LUCAS. Well, I think you have explained it, but not to my satisfaction.

Mr. SPRAGUE. I would like to take another crack at it. I will make it short.

We can make an estimate of the over-all figures. It would have to be an estimate, because, again, I know more about my own business

than I do about anybody else's. Our business is the manufacture of capacitors.

Senator KERR. Manufacture of what?

Mr. SPRAGUE. Capacitors, or electric condensers; electric condensers to determine capacity, which is one of the three fundamental characteristics in all electronic circuits—the capacity, resistance, the induction. The things that control those three fundamental factors are the capacitors, the resistors, which control resistance, and transformers that control induction.

We make one of the three fundamentals, along with the electronic tubes. Whether it is television, radio, communcation equipment, or military electronic equipment, these four things are basic in all of them.

Senator LUCAS. How long have you been doing that?

Mr. SPRAGUE. Since 1926, sir.

When we sell a company a particular capacitor, the capacitor sold on that particular order, we really do not know what they are going to put it in. All we know there are 200 capacitors in the television set, and there are probably 20 capacitors in the radio set. So, we can multiply the number of radio sets produced in a given period, and the number of television sets, and estimate what percent of our output is television, and what percent is radio. But, as far as our problems in growth and expansion, it does not make any difference at all to us, because we have had to turn out more product, and we have had to increase our plant facilities from 700,000 to 4,200,000, balancing out the trend in regular electronic equipment and radio and television.

So, our basic problem on the growth of 1950, even though it has been largely caused by television, it is a composite picture, and the effect on the company is the same as whether it be all television.

To make a simple illustration, let's take two companies—there are companies in this category. Say one company starts from zero in 1946, has never made anything for radio or communication equipment, and it expands its business by $10,000,000 in volume between 1946 and 1950. Here is another company that starts in 1946 with a $10,000,000 business. It has been supplying radio and electronic equipment, and it expands its business in an equal amount, $10,000,000. The expansion has been the same. The percentage growth is less, but the problem of expansion, the financing of expanded business, is just the same whether you start from nothing and expand it to $10,000,000, or start with $10,000,000 and add $10,000,000 television on top of it.

Because of the difficulty of segregation, and because it seemed to us it was a general problem that applied not only to companies in our industry, but companies in any industry that has had a rate of accelerated growth in the early part of 1950, we did not attempt to distinguish and isolate to television, because it seems to us the problem is common to all manufacturers, whether in our industry or without our industry in that respect.

Senator MILLIKIN. You do know radio is a declining industry.

Mr. SPRAGUE. Not in 1950. Last year, 1949, it was $10,000,000, and this year we estimate $14,000,000.

Senator MILLIKIN. Is it phenomenally growing?

Mr. SPRAGUE. No; it is more of a mature industry.

Senator MILLIKIN. Then you can deduce that television is responsible for the phenomenal increase?

Mr. SPRAGUE. That is correct, sir.

Senator TAFT. You cannot very well apply a formula to the telephone industry. It seems to me you have to develop a general formula.

Mr. SPRAGUE. That is what we thought.

Senator TAFT. And your suggestion is that these earnings must be at least 50 percent greater?

Mr. SPRAGUE. That is right, sir.

Senator TAFT. In 1950 than it was in the previous year?

Mr. SPRAGUE. Yes. That is to indicate a rate of growth between 1949 and 1950 which is considerably greater than the growth of the business in general.

Senator TAFT. Why should there not be a general growth formula that does work?

Senator KERR. That is what I would like to know.

Senator TAFT. Instead of having 50 percent, could we not get a general growth formula?

Mr. SPRAGUE. Our original suggestion, Senator Taft—I am glad Mr. Stam is here. We had two meetings with him. My original suggestion to him was—and it does not apply just to our industry—a growth formula that took into account the first 6 months' volume, or earnings of 1950 annualized. We gathered from our discussions with the Joint Committee on Taxation, Mr. Stam's committee, and I had two meetings with him, that it probably would not be very seriously considered unless we had some sort of a qualifying formula. So our qualifying formula was introduced, not because we thought it was basic, but because we gathered from our conversation with Mr. Stam there was a better opportunity of some consideration being given to companies in that category if we included a qualifying formula. But our original proposal to Mr. Stam's committee did not have a qualifying formula.

Senator MILLIKIN. What are some other rapidly growing industries?

Mr. SPRAGUE. The biotics. Some of the chemical companies got into the matter of biotics.

Senator MILLIKIN. What else?

Mr. SPRAGUE. I should imagine some parts of the aircraft industry. I think the biotics is the only one that approaches—the only one I am familiar with that has similar problems to ours in the same degree.

Senator MILLIKIN. Mr. Chairman, I would like to ask Mr. Stam:

Assuming you have developed a formula that would take in all of the rapidly—exceptionally rapidly—growing corporations, what would be the effect on the revenue?

Mr. STAM. You see, you run into this problem. I think Mr. Sprague will bring it out to some extent. If you are looking at the actual dollars of price increase, some of these corporations had a very phenomenal growth in the base period, as far as dollar volume is concerned. Now, you bring in an awful lot of very large companies and give them the benefit of the growth formula, and that might have a tendency to further make the competitive situation a little worse between those that had very large credit in the base period and those that did not that you were trying to help. I think that is one of the reasons why,

in talking with Mr. Sprague, we should have some limitative qualifying formula would be better to meet that situation.

Senator TAFT. I do not understand, Mr. Stam, why the growth formula does not go right on into the future. I do not see why you stop at 1950. After all, most of these things we want to increase production on. We want to put a company in a position where it does not decrease, but increases, production in many things. If they can get material, and it is recognized as a proper war industry, I do not see why the formula should not go on indefinitely and not stop in 1950 any more than in 1949.

One of the great objections to the tax is a tendency to limit production, and we want to increase production. I do not know whether anythink can be worked out on the basis of increase-in-production formula—increase in units even rather than price.

Mr. STAM. In units rather than price. Price is the stumbling block you run up against. We have not been able to work out a formula on the basis of the unit basis that is satisfactory. We have discussed that, but we just have not been able to evolve anything up to the present time. That has been one of the great difficulties—where you tie it to price.

The CHAIRMAN. Undoubtedly an excess profits tax would be much sounder and much better if you allowed the added production to pay the tax.

Mr. SPRAGUE. Yes, sir.

The CHAIRMAN. Now, of course, there are a lot of difficulties. Presumably, if you do not have this qualifying factor in here, you might bring in such companies, just as an illustration, as General Electric or General Motors, because they might have increased, in 1950, 50 percent over the previous year.

Mr. SPRAGUE. We have felt basically, Senator George, exactly as Senator Taft has expressed it—that the thing that the tax bill should encourage is further expansion.

The CHAIRMAN. Undoubtedly. That is the reason I said you could be allowed to produce the tax.

Mr. SPRAGUE. And that is the trouble with a fixed period.

I was asked by the House Ways and Means Committee the same thing: Even though we brought in 1950, taking the first 6 months on an annualized basis, why did we not extend it beyond that. I told them we had discussed it, and that one of our committee had suggested an idea that might be worth considering, but we did not have time enough to whip this formula into adequate shape to present. That was that each year you drop off a year and take on the next year.

For example, if the base period is 1946–49, you take off 1946 and add 1950, then the next year, drop 1947 and add 1951. I am not making that suggestion, but frankly, we did give the problem some thought, and were not smart enough to come up with the complete answer.

Senator LUCAS. Let we ask what part of your expansion is due to price increase, and what part of it is due to increased capacity.

Mr. SPRAGUE. I can answer that from my own company, and I think very accurately for the industry, Senator Lucas. For our own company, our average prices in 1950 are lower than they were in 1949.

Senator KERR. Were they lower in 1949 than in 1948?

Mr. SPRAGUE. They were lower in 1949 than in 1948. In other words, our price trend has been down since the end of World War II.

Certainly even though there have been some price increases in the television industry, I think I am correct in stating that the unit price of a television set today, and certainly for the year 1950, is substantially lower than it was in 1949.

Senator LUCAS. That hardly answered my question. I asked you what part of your expansion is due to price increase and what part is due to increased capacity.

Mr. SPRAGUE. More than all of it is due to plant capacity, sir, because I say our average price for 1950 is less than for 1949, and therefore, more than all of our expansion in 1950 is due to volume units, and not to price. None of it is due to price.

Senator KERR. I believe maybe Senator Lucas might have been asking you with reference to the fixed asset figure you gave him, Mr. Sprague.

Mr. SPRAGUE. Is that it? There may have been some price increases on individual equipment, but that is all due to increased equipment.

Senator KERR. I understood you were talking about the 700,000 up to 4,200,000; were you not, Senator Lucas?

Senator LUCAS. I was talking about the general proposition as a whole and not taking any specific figure. The question Senator Kerr asks, however, is a pertinent one.

Mr. SPRAGUE. I am sure it is quite an accurate statement to say that substantially none of the increased volume in business in 1950 of this industry is the result of price increases. There were very substantial price decreases early in the year, in the first part of the year, and as a result of increasing basic material costs, in copper, zinc, and so on, there have been some increases since August. But I am sure the decreases in the first 8 months more than offset the increases in the last 4 months of the year.

Senator MILLIKIN. We deal here with the basic difficulty that we have no way whatever of separating what might truly be called war profits from other profits. That compounds our difficulties in every phase of this tax bill. No one yet has come up with a formula that would do that. Therefore, we have to engage in certain rough assumptions which may be completely inaccurate as to some businesses, to wit, that all business benefits from war expenditures.

Mr. SPRAGUE. Well, our specific suggestion on that to Mr. Stam, again, Senator Millikin, was that we annualize the first 6 months' results of 1950, which was the period before the Korean War, and we suggested doing it in this way: That you take the results for the first 6 months, and multiply them by their traditional ratio in earnings as determined by the base period. In other words, you take the total year earnings for 1946–49, and divide them by the earnings for the first half of those years for each individual company. In our particular case, the Sprague Electric Co., that ratio was 2.16. In other words, the traditional ratio between the last 6 months' results and the first 6 months for 4 years of the base period was 2.16. So we said, "Now, take our earnings for the first 6 months, and multiply them by 2.16, or multiply by 2." But that would, I think, on a reasonably scientific basis develop what might be expected in 1950 as a result of what happened prior to the Korean War, even before there was this inflationary period, or before military contracts were placed.

Senator MILLIKIN. Now, supposing that your business stabilizes, as all of these new businesses do eventually, then what modifications in the formula would you want?

Mr. SPRAGUE. If you are going to have an excess-profits tax, I think the formula reasonably takes care of more established businesses who have approached that situation. These companies that have particularly had a very substantial growth in the early part of 1950 and who have had to invest a large part of their anticipated earnings to build up their facilities are the ones that are very hard hit by this proposed bill.

Senator MILLIKIN. I can see no reason why we should not include the first half of 1950, but we have got to work out a formula that will include it fairly. That is where our problem is.

Of course, I speak for myself, but I suspect there is great sympathy in this committee for taking the first half of 1950 into consideration where business is not stabilized. But the question still remains: Just how are we going to do it in a fair way?

The CHAIRMAN. Are there any other questions of Mr. Sprague?

If not, we will be very glad to have you prepare the technical language as far as you can, and put it in the record.

Mr. SPRAGUE. Thank you very much, Senator.

The CHAIRMAN. You are quite welcome.

Mr. SPRAGUE. We will do that.

The CHAIRMAN. We appreciate your appearing here.

(The information submitted by Mr. Sprague is as follows:)

PIERSON & BALL,
Washington 6, D. C., December 8, 1950.

Hon. SCOTT W. LUCAS,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR LUCAS: This will confirm the information supplied to you during the conference on December 6, 1950, with Mr. Robert C. Sprague, president of the Radio-Television Manufacturers Association, with reference to a question raised by you in the course of Mr. Sprague's testimony before the Senate Finance Committee.

You will recall that you raised a question as to whether it would not be necessary to segregate the television increment of the business done by members of the industry in order to get a true picture of the growth of television business. As we pointed out to you, we do not believe that it is necessary to make such segregation. The special provision recommended by Mr. Sprague whereby a growing company is entitled to use as a credit 78 percent of its 1950 income in lieu of a credit based on 85 percent of its average base period net income would actually make more of such company's 1950 income subject to excess profits tax than the aggregate of such amounts for two separate corporations, one of which was in the radio business and the other which was engaged exclusively in television. For example, the following table demonstrates that if the business of manufacturing radios and television sets or parts is conducted by one corporation which qualifies under the special provisions recommended by Mr. Sprague it would receive a less advantageous credit than if the business had been conducted by a separate corporation for each phase of the business.

Average	Radio	Television	Radio and television
1946–49	$1,000	$333	$1,333
1949	1,000	1,000	2,000
1950	1,000	3,000	4,000
Credit	850	[1] 2,340	[1] 3,120
Subject to excess-profits tax	150	660	880
		150	
Total		810	880

[1] Credit under our proposal.

At your suggestion, I discussed the foregoing with Mr. Colin Stam this morning and advised him that you planned to submit a copy of this letter for the record of the Finance Committee hearing. Incidentally, we are submitting to Senator George today for the record alternative provisions to carry out Mr. Sprague's proposal but the principles set forth in this letter will not be affected thereby.

Very truly yours,

PIERSON & BALL,
F. CLEVELAND HEDRICK, Jr.,
Special Counsel to Radio-Television Manufacturers Association.

WASHINGTON 6, D. C., *December 8, 1950.*

Subject:Provision for growth companies under new excess profits law

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee.
Senate Office Building, Washington 25, D. C.

DEAR SENATOR GEORGE: This letter will propose specific statutory language to carry out the proposal made by Mr. Robert C. Sprague, president, Radio-Television Manufacturers Association, who testified before your committee on December 6, 1950, with reference to the problems of the television-electronic industry under an excess profits tax simliar to that proposed in H. R. 9827. We are attaching the following:

1. Radio-Television Manufactures Association proposal No. 1.
2. Radio-Television Manufacturers Association proposal No. 2.
3. Explanation of percentages used in Radio-Television Manufacturers Association proposals.

Mr. Sprague's specific suggestion was as follows (quoted from page 6 of his statement):

"(*a*) No company whose principal growth occurred in early 1950 should have an earnings credit less than that of corporations in general.

"As I pointed out earlier in the statement, the House bill would mean that approximately 22 percent of the earnings of all American corporations in 1950 would be subject to the excess profits tax and the balance of 78 percent[1] would represent that part of their 1950 earnings not subject to excess profits tax.

"The discrimination could be corrected by permitting a rapidly growing company to use as its credit, on the earnings method, 85 percent of the average of the highest 3 years of the base period, as now proposed, with the proviso that such credit will not be less than 78 percent of its 1950 earnings. This suggestion would assure such companies of treatment roughly equivalent to that of corporations generally.

"(*b*) A company entitled to this protection should be one whose 1950 earnings are at least 50 percent greater than its earnings in the year 1949.

"For business in general the estimated earnings in 1950 will be approximately 21 percent[2] in excess of 1949 earnings. We therefore recommend that in order to qualify, a company should show an increase of 50 percent in its 1950 earnings over those of the preceding year.

"The statute should provide that 1950 earnings for this purpose should be either actual earnings or annualized earnings for the first 6 months of 1950, whichever is the lesser. This would exclude companies which have particularly benefited since the start of the Korean War. It would not exclude any company merely because of size or value of assets, as the House bill does. There is no justification for the House bill's provision excluding companies who otherwise qualify, merely because of size."

The principle of Mr. Sprague's proposal was that the use of 78 percent (or 71 percent under Secretary Snyder's figures) of 1950 earnings as a credit would put qualified growing companies on a par with business in general which uses 85 percent of the average of the three highest years of the base period. A qualified growing company under Mr. Sprague's proposal would be one whose annualized earnings for 1950 is more than 150 percent of 1949 earnings.

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[1] Using the data employed by Secretary Snyder, this figure would be approximately 71 percent.

[2] Our own estimates are based on Department of Commerce statistics. Using data employed by Secretary Snyder, this figure would be 38 percent.

We are submitting herewith two proposed amendments to section 435 (a) (1) (A) of H. R. 9827. Proposal No. 1 would give a qualified growing company an option of using as its credit 80 percent of its annualized first 6 months' earnings computed by determining the actual earnings for such 6 months and doubling the same. Proposal No. 2 would give a qualified growing company an option of using as its credit 75 percent of a corrected 1950 earnings determined by multiplying actual 1950 earnings by the ratio of total sales for the first 6 months of 1950 to total sales for the year 1950 and doubling the result.

The differences between the two proposals are in:

1. The percentage of the annualized or corrected 1950 earnings.
2. The methods used in arriving at the 1950 figure.

Both are designed to remove the abnormal effects of events after the start of the Korean War. An explanation of the percentages used in the proposals is attached.

An example of the application of proposal No. 2 follows:

Total sales first 6 months 1950	$200,000
Total sales year 1950	500,000
Excess profits net income 1950	100,000
$\frac{200,000}{500,000} \times 100,000$	40,000
$40,000 \times 2$	80,000
Credit 75 percent of 80,000	60,000

We sincerely hope the proposals submitted herewith will be helpful to the committee in its deliberations.

Sincerely yours,

PIERSON & BALL,
By F. CLEVELAND HEDRICK, Jr.,
Special Counsel, Radio-Television Manufacturers Association.

RADIO-TELEVISION MANUFACTURERS ASSOCIATION

EXPLANATION OF PERCENTAGES USED IN RADIO-TELEVISION MANUFACTURERS ASSOCIATION PROPOSALS

The 80-percent factor in proposal No. 1 was determined as follows:

Corporate profits before taxes (all corporations)

		Billions
1946	23.5	
1947	30.5	
1948	33.9	
1949	27.6	
Average, 3 highest years	30.7	
One-half average		15.3
1950:		
First quarter	7.3	
Second quarter	9.3	
		16.6
Excess of first 6 months of 1950 over average 3 highest years		1.3
Percentage adjustment		8

Stated differently, 92 percent of corporate profits before taxes for first 6 months of 1950 equal 100 percent of average corporate profits before taxes for the three highest base-period years. Since taxpayers generally are only permitted 85 percent of the average of the three highest years, the credit under this proposal should be 85 percent of 92 percent, or approximately 80 percent.

Unlike proposal No. 1, which is limited to actual earnings during the first 6 months of 1950, proposal No. 2 employs actual margin of net profits on sales for the entire year 1950. Recognizing that the net margin of profit on sales for the entire year may reflect abnormalities due to the Korean War, a further abnormal adjustment of 5 percent may be appropriate. Economic data available to us indicate that for all corporations, net profits on sales for 1950 will run about 6½

percent in excess of average for base period 1946 to 1949. It also appears that the wholesale commodity index for the last half of 1950 will exceed the pre-Korean index by approximately 6 percent. Since a correction factor of about 3 percent is indicated (6 percent for one-half year), the additional abnormal adjustment of 5 percent would appear to be in the Government's favor.

PROPOSAL NO. 1

(Amendment to sec. 435 (a) (1) (A) of H. R. 9827)

SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) AMOUNT OF EXCESS PROFITS CREDIT.—The excess profits credit for any taxable year, computed under this section shall be—

(1) DOMESTIC CORPORATIONS.—In the case of a domestic corporation, the sum of—

(A) 85 per centum of the average base period net income; *provided that if the taxpayer meets the requirements of subparagraph (iii) hereof it may use in lieu thereof 80 per centum of an amount determined under subparagraph (i) hereof. For the purposes of this proviso—*

(i) *the amount to which such 80 per centum shall apply shall be determined—*

(aa) *By computing, in accordance with regulations prescribed by the Secretary, the excess profits net income for the first six calendar months of 1950.*

(bb) *By multiplying by 2 the amount determined under subparagraph (i) of this proviso.*

(ii) *the excess profits net income for the calendar year 1950 of the fiscal year taxpayer shall be an amount computed as follows:*

(aa) *By reducing the excess profits net income of the fiscal period ending after December 31, 1950, by an amount which bears the same ratio thereto as the number of months after such date bears to the total number of months in such taxable year; and,*

(bb) *By adding to the amount ascertained under subparagraph (aa) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of excess profits net income for such last preceding taxable year.*

(iii) *A taxpayer shall be entitled to the benefits of this proviso if the amount determined under subparagraph (i) hereof is 150 per centum of its excess profits net income for the calendar year ended December 31, 1949.*

(iv) *The excess profits net income for the calendar year 1949 for a fiscal year taxpayer shall be an amount computed as follows:*

(aa) *By reducing the excess profits net income of the fiscal period ending after December 31, 1949, by an amount which bears the same ratio thereto as the number of months after such date bears to the total number of months in such taxable year; and,*

(bb) *By adding to the amount ascertained under subparagraph (aa) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as the number of months after December 31, 1949, bears to the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of excess profits net income for such last preceding taxable year.*

(v) *If any taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.*

PROPOSAL NO. 2

(Amendment to section 435 (a) (1) (A) of H. R. 9827)

SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) AMOUNT OF EXCESS PROFITS CREDIT.—The excess profits credit for any taxable year computed under this section shall be—

(1) DOMESTIC CORPORATIONS.—In the case of a domestic corporation, the sum of—

(A) 85 percentum of the average base period net income; *provided that if the taxpayer meets the requirements of subparagraph (iii) hereof it may use in lieu thereof 75 per centum of an amount determined under subparagraph (i) hereof. For the purposes of this proviso—*

(i) *the amount to which such 75 per centum shall apply shall be determined by multiplying taxpayer's excess profits net income for the calendar year 1950 by a fraction, the numerator of which shall be 200% of the taxpayers total gross receipts (as defined in Section 435 (c) (5)) for the first six calendar months of 1950, and the denominator shall be total gross receipts of the taxpayer for the entire taxable year.*

(ii) *the excess profits net income for the calendar year 1950 of a fiscal year taxpayer shall be an amount computed as follows:*

(aa) *By reducing the excess profits net income of the fiscal period ending after December 31, 1950, by an amount which bears the same ratio thereto as the number of months after such date bears to the total number of months in such taxable year; and,*

(bb) *By adding to the amount ascertained under subparagraph (aa) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as the number of months after December 31, 1950, bears to the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of excess profits net income for such last preceding taxable year.*

(iii) *A taxpayer shall be entitled to the benefits of this proviso if the amount determined under subparagraph (i) hereof is 150 per centum of its excess profits net income for the calendar year ended December 31, 1949.*

(iv) *The excess profits net income for the calendar year 1949 for a fiscal year taxpayer shall be an amount computed as follows:*

(aa) *By reducing the excess profits net income of the fiscal period ending after December 31, 1949, by an amount which bears the same ratio thereto as the number of months after such date bears to the total number of months in such taxable year; and,*

(bb) *By adding to the amount ascertained under subparagraph (aa) an amount which bears the same ratio to the excess profits net income for the last preceding taxable year as the number of months after December 31, 1949, bears to the number of months in such preceding year. The amount added under this subparagraph shall not exceed the amount of excess profits net income for such last preceding taxable year.*

(v) *If any taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.*

The CHAIRMAN. The next witness is Mr. Gerhard Mayer.

Mr. Mayer, will you identify yourself?

STATEMENT OF GERHARD MAYER, REPRESENTING COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.

Mr. MAYER. I am a certified public accountant, member of the bar of the State of New York. I appear here as a member of the committee on taxation and public revenue of the Commerce and Industry Association of New York, Inc.

The Commerce and Industry Association is probably the equivalent of the local chamber of commerce. It has approximately 3,000 members, which we believe are a representative cross section of the business of the city of New York. The majority of them represent small business. It also includes large business houses, and business of every description, mercantile as well as manufacturing, also utilities and professional people. I would like to submit with your permission a memorandum adopted by the committee which I will present. I would like to summarize a few high points of this memorandum, which will not take up much of the time of this committee.

The CHAIRMAN. You may offer your memorandum for the record, and then summarize it.

Mr. MAYER. The tax bill under review by your committee is expected to yield approximately 3½ or 4 billion dollars. Our committee is of the opinion that the business of this country, including the incorporated business on which this burden will be imposed, has no reason to complain about this additional tax burden. It is a burden which should be fairly expected to be contributed by business, which is a mainstay as well as a prime beneficiary of our system of government.

We are, however, seriously concerned, seriously bothered by the form which this proposed additional exaction takes. We believe that the excess profits tax in the proposed form, or any other form imaginable of an excess profits tax, cannot be made to be fair, or to serve the primary requirements of the situation confronting us.

We are confronted with several forms of war, one of them being a war of attrition, a war which can be won only if we make the utmost use of the qualities which have distinguished American business—our ingenuity, our efficiency, and our productivity.

The excess-profits tax—and I have to make this point, although I believe it has not met with friendly reception in the House—is a tax which substantially but unavoidably encourages wastefulness and inefficiency. Its administration is most cumbersome. It will require great efforts on the part of the taxpayer, their help and their advisers, and even greater efforts and greater use of manpower on the part of the Government. I do not think I have to elaborate on this. It is probably quite clear to everybody here.

But the more important and more dangerous aspect is that whether we condone it or not—and there is nobody who condones it less than we do—that it encourages wasteful spending by business. It is a stark, unpleasant but unavoidable fact. It has been proven during the last war.

There are no other statutory provisions available, nor can I think of any, which would enable the Treasury Department and its enforcement officials to prevent that kind of expenditures. It makes corporations more amenable to demands of various kinds, which add to the purchasing power, which add to the demand for consumer goods.

Its indirect effect—and I think there should be no doubt about it—is inflationary. If we want to combat inflation, this is not the way to do it.

In addition—and this may perhaps meet with more friendly reception here—the very structure of the statute submitted to you gentlemen would seem to indicate that it is impossible to provide a fair excess profits tax statute. The bill, as submitted to you, consists of some 35 sections. Almost one-quarter of these sections is wholly or in part devoted to special relief, the growth formula relief for installment houses or long-term contracts, and many others which you gentlemen are familiar with.

Now, the mere fact that it has been necessary so far to devote such a substantial part of a tax bill to special relief, to special privileges, seems to indicate the difficulty, if not the impossibility, of fairly determining what are excess profits sought to be recaptured by this tax bill.

You have heard many pleas for special relief and you will hear

more, and by the time this bill leaves this committee no doubt these provisions will have been enlarged even to an extent greater than they have now.

The justification generally given for an excess-profits tax is that there should be no war profits go untaxed. Now, I submit that this bill, as it is written, does not capture all war profits, and that to the extent that it does capture profits, it captures much more than war profits. A substantial portion of war profits, according to companies on an invested capital basis, will naturally not be captured until a time which sees profits which are much higher than the present ones because it allows those companies to make substantial extra profit without being subject to the excess-profits tax. The invested capital basis has been in all provious excess profit tax acts, and I am sure it will be continued, but its mere presence seems to indicate this tax is inadequate to capture war profits.

It also captures more than war profits. To the extent that war profits are attributable to production of direct instruments of war, they can be easily segregated and can be easily recaptured by way of renegotiation. I believe a very good job was done in the last war by the agencies entrusted with renegotiation.

To the extent that profits made during this and ensuing years are indirectly the result of the war economy, they cannot be segregated from normal profits. Some companies will make more money during the war years than they made before, and yet none of this will be due to the war economy.

One example has been submitted. I can think of many others in standard industries which have shown that they made more money after the war than they made before the war. Yet everybody would have thought that the profits shown by them during the last war were war profits.

Senator TAFT. Are there not many individual firms in particular industries where the individual firm has increased because of new discoveries or new methods or something much more than the general industry?

Mr. MAYER. Yes, sir. I am thinking of one example——

Senator TAFT. That has no relation to the war?

Mr. MAYER. Absolutely not. I have one example in mind: A manufacturer of soft goods, the principal employer in two medium-sized cities in the Commonwealth of Kentucky, had embarked upon a certain merchandising program in 1939 and 1940. At that time its annual profits were in the low six figures. During the war its annual profits before Federal taxes ran in the high six figures. Its merchandising program, which it had contemplated before the war, could not be carried out until about 1946–47, and its profits in each of the postwar years were in excess of 1 million, and in the average about 2½ million dollars, as compared with 100,000 to 150,000 before the last war and approximately five to eight hundred thousand during the war.

So although apparently the profits realized by that taxpayer during the last war would prima facie have been considered as war profits, and was so taxed at the effective rate of 80 percent, it developed that in fact they were not due to the war economy.

Now, to the extent that profits by manufacturers of other than war implements are increased during the coming years, they merely re-

flect a general increase in prosperity. There are no war profits segregable in business as distinguished from those generally accruing to the people of this Nation.

The corner cigar store, the saloonkeeper, and the factory worker is going to have war profits. It is simply a case in many situations of increased utilization of productive facilities. Naturally, if you run a plant at 100 percent of capacity it makes many times more profit than if you run it at, say, 80 percent. It is just the margin of profit produced above the break-even point. The same applies to individuals.

There is no fairness in burdening corporations with an excess-profits tax which, as I said before, does not capture all war profits, and if it captures profits, it captures much more than war profits.

It is our suggestion for the reason that this tax is unfair in effect and conducive to waste, that it should be contemplated only as a last resort, and that for the time being the sum proposed to be levied could be levied much more fairly, much more efficiently, and with much less waste by a flat increase in the normal corporation income tax.

Senator MILLIKIN. As war hysteria increases, you might get an excess-profits tax that you would like a whole lot less than the one which is before you. Do not forget that, please.

Mr. MAYER. Senator Millikin, it has been the experience of this tax, as well as that of other taxes, that you start with a moderate tax rate. That happened during the last war. I am quite sure if we are going to have an excess-profits tax the rates provided by the present bill will not stand. They will be increased.

Senator MILLIKIN. Since you are quite sure that we are going to have an excess-profits tax bill and so are, I believe, the most of the rest of us, our job is to get as good a one as we can make. I think everyone acknowledges that the best you can do leaves a lot of injustices and inequities.

Mr. MAYER. If the Congress of the United States enacts an excess-profits tax, we believe that the revenue-raising purposes of the tax would be served better by a flat increase in corporate taxes.

Senator MILLIKIN. Take back to your friends in business and my friends in business the thought that there could be many things a whole lot worse, and if you do not have an excess-profits tax you might get a lot of taxes of a different nature that you like a whole lot less. This is a practical business we are in.

Mr. MAYER. Senator Millikin, we are fully aware that we are going to get more taxes and other taxes, whether we get an excess-profits tax or not, and we are fully facing that prospect.

Senator MILLIKIN. I am suggesting to you that you might get a type of a tax a whole lot worse than an excess-profits tax if you do not deal with the excess-profits tax. Carry that to your business associates. Let them think a little bit and a few things will suggest themselves, and perhaps a longer view than is taken by many of the critics of the excess-profits tax would be a good thing in their own interests and in the interests of the country.

Mr. MAYER. I appreciate your remarks, Senator.

Senator MILLIKIN. If you start with the assumption that you are going to have an excess-profits tax—and I take the liberty of assuring you there will be one this year or there will be one next year—I repeat that you might not like a later one nearly as well as you like this one.

I am repeating that if you killed an excess profits tax bill you might very easily get some taxes of a nature which you would like a whole lot less than an excess profits tax bill.

Mr. MAYER. We have faced certain alternatives, Senator Millikin, and we——

Senator MILLIKIN. You would not like, for example, a progressive tax on corporations, would you? That you abhor more than anything that could be suggested. I could give you a half a dozen alternatives, but I do not want to put any ideas into anyone's mind.

Mr. MAYER. I appreciate that.

Senator MILLIKIN. I do not think you gentlemen are looking through your problem. That is what I am trying to suggest to you.

Mr. MAYER. We are here to express our conviction of what we think is best for the commonwealth as a whole.

Senator MILLIKIN. This is not a business that rests on syllogisms or strict logic. We here, as Senators from our States, have very practical problems, and so do the people at home. They are sending their sons to war, which has certain discriminations and certain injustices in it. They are deprived of the opportunity of making profits. They have the opportunity to give their lives and get their feet frozen. There are just a lot of practical things that you have got to think about in this business.

Mr. MAYER. I have not come to plead for less taxes, Senator. I thought I made that clear.

The CHAIRMAN. Yes, we understand that. But you may get more taxes now of some other kind and get an excess-profits tax on top of all that. So you might as well face the issue now, it seems to this committee, I think, of trying to work out the best tax that you can.

We will put your whole statement in the record.

Mr. MAYER. Yes, sir.

The CHAIRMAN. Thank you very much.

(The statement submitted by Mr. Mayer reads in full as follows:)

STATEMENT OF GERHARD MAYER, COMMITTEE ON TAXATION AND PUBLIC REVENUE OF THE COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.

The association membership numbers over 3,000 firms of every type and size in the New York metropolitan area.

THE EXCESS PROFITS TAX DURING REARMAMENT

Since a spokesman of the Commerce and Industry Association of New York appeared before the House Ways and Means Committee on November 16, world conditions have worsened. The critical situation in Korea is painfully clear and, as a consequence, there is a sense of urgency in these hearings. But it is more important than ever now that Congress should act coolly in enacting new taxes, even if it must act in haste.

With the revenue-raising objectives of the excess profits tax bill before your committee we are in agreement. Certainly, the whole country knows that new taxes must be enacted to finance rearmament. Business expects to bear its fair share of the tax burden. It is with the proposed means of raising revenue from corporations that we vigorously disagree.

We are strongly opposed to an excess profits tax at this time. In answer to the prime question of how revenue should be raised, we support a straight increase in the corporate rates. Such a uniform increase of 10 percent in the form of a temporary war profits tax or emergency defense tax would produce $4,000,000,000 in additional revenue.

We urge this course of action for the following reasons:

1. An excess profits tax discourages maximum production

As stated by Hanson Baldwin, military editor of the New York Times, "The greatest of our assets—one which must be preserved and fostered—has been and still is our enormous industrial strength and our capacity for mass production."

Under an excess profits tax the strongest inducement for a firm to expand production and undertake the maximum amount of war production is removed. The incentive of higher profits for greater productive effort and capital investment disappears. The Government has the power in wartime, of course, to require manufacturers to accept war orders. The same end can be achieved by allocations and priorities on raw materials. Certainly, patriotism is a strong factor in inducing firms to undertake war production. However, the great gap that exists is between the level of war production that will yield an income similar to the prewar period and the much higher war production that can be achieved if there is proper financial incentive for management to exert its full ingenuity to achieve an absolute maximum level of production.

Conversely, a uniform raise in corporation rates, instead of an excess profits tax, induces the fullest production possible. This would mean that a firm would be penalized if it did not expand its production and thereby increase its income.

Under an excess profits tax desperately needed plant expansion is discouraged. New equity capital is difficult to raise because only a nominal profit can be anticipated. Increased profits are so severely taxed that larger investments in plant expansion paid from profits are precluded.

At the very time when maximum production is most needed this tax provides a roadblock to the objective.

2. A straight corporate increase is a simple, clear-cut revenue raiser. It will save manpower and administrative cost

The excess profits tax bill before your committee (H. R. 9827) is one of the most complex tax measures in history. The bill is twice as long as the World War II law, and contains entirely new concepts. It is virtually impossible for Congress or taxpayers to understand and give adequate consideration to the bill in a few days. The solution we propose of a temporary increase in corporate rates could be accomplished by a one-page bill and one line on the tax return. The savings in administrative costs to the Government and to taxpayers would be tremendous.

At the very time when companies should devote their full energies to conversion they will be required to assign some of their most competent personnel to making up the entirely new detailed records for an excess profits tax. The effect on the Government will be even more serious. For instance, the relief provision requiring the Government to establish average earning schedules for various types of industries will be a complex and time-consuming problem.

It has been pointed out many times that an excess profits tax is economically unsound. It encourages mismanagement, since cost controls tend to be relaxed.

A simple course of action is available to Congress—that being to replace the present bill for an excess profits tax with a measure imposing a temporary corporate increase.

3. The excess profits tax is unfair to small business and particularly to new and expanding firms

The excess profits tax is widely heralded as being a tax on big business, thereby improving the competitive position of small firms. The facts, based on World War II experience, are to the contrary. In 1944, three-fifths of the firms paying the tax were in the small category—that is, those reporting excess profits income of under $50,000. When over 60 percent of the firms subject to the tax are classified as small business it can hardly be called a tax on big business.

Small business suffers, as a general rule, from the usual method of computing excess profits taxes, namely, comparison of prewar profits with wartime profits and a heavy tax on the increase. Many small businesses, particularly subcontractors, of necessity operate with limited production during normal times. Only in times of full production, such as in wartime, are these firms able to utilize their full productive capacity, the reward for this valuable service is that nearly all the profits are taxed away.

A pertinent example is the machine shop industry in the New York area. A survey by this association in March 1950 of 233 machine shops employing from 1 to 300 workers, showed that a majority—in fact 60.3 percent—of the plants were operating at less than 50 percent capacity. With the new rearmament pro-

gram, as in World War II, these firms now will be called upon to do subcontract work at not only 100 percent capacity but to add second and third shifts, thereby upping the effective capacity to 200 or 300 percent.

Certainly an excess profits tax is a severe penalty on the many small businesses that provide a reservoir of the country's industrial might.

4. The tax discriminates—All companies should be mobilized

In general an excess profits tax applies most heavily to active, productive, and efficient companies. Companies which shy away from expansion and full war production often come out on an equal basis since their profits remain at a prewar level.

This is illustrated by World War II experience in which only approximately one-sixth of the total corporations reporting a profit became subject to the tax. In 1944 only 55,912 corporations paid excess profits taxes out of 288,904 corporations so reporting. As has been pointed out, the comparatively few corporations subject to the excess profits tax were not just the large firms.

There are two philosophies that can be employed in raising added revenue from corporations. One is the excess profits theory which taxes the increased profits of a comparatively few corporations. The other is to raise corporation rates uniformly so that all firms bear the load. We advocate the second method on the grounds that every corporation should be mobilized in financing the war effort. There is little justification in all-out mobilization to exempt the many and tax the few, particularly when a tax against the few is largely in the form of a penalty.

The CHAIRMAN. Mr. Clarence D. Laylin.

I see you are from the Council of State Chambers of Commerce.

Mr. LAYLIN. That is correct, Mr. Chairman.

The CHAIRMAN. You may be seated.

We also have a representative from the Pennsylvania State Chamber and the Los Angeles Chamber of Commerce. You gentlemen are not speaking on the same point, are you?

Mr. LAYLIN. In general, I am familiar with what the representative of the Pennsylvania State Chamber of Commerce will say; yes, sir.

The CHAIRMAN. You may proceed. I was thinking maybe you might consolidate your statements if they are to the same general effect.

You may proceed. Identify yourself, please, for the record.

STATEMENT OF CLARENCE D. LAYLIN, COLUMBUS, OHIO, ON BEHALF OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE, AND THE OHIO CHAMBER OF COMMERCE

Mr. LAYLIN. Mr. Chairman and gentlemen of the committee, I am Clarence D. Laylin, a lawyer of Columbus, Ohio. I am authorized—and, I might say, "authorized"—to speak for the Federal Finance Committee of the Council of State Chambers of Commerce, for a majority of the 31 constituent State and regional chambers, and especially for the Ohio Chamber of Commerce. These State chambers of commerce represent nearly every section of the country, and their combined membership is made up of over 40,000 business concerns, mostly small and medium-sized. Each of them acts separately upon proposals submitted for its consideration by the committee which I have mentioned and frames its own views. Some have not completed their studies of the very weighty fiscal problems which face the Congress. It is for that reason only that my authority to speak is limited to a majority of them, for there is no fundamental disagreement among those who have acted. I shall try to give you a fair statement

of their views—I think I might interpolate here with apologies to Senator Millikin.

The State chambers thoroughly understand and appreciate the magnitude and the urgency of the questions posed by the program of national defense, accentuated, as they are, by the grave turn of affairs in North Korea. They fully accept the duty of business to bear its full share of the necessary defense costs. Their program is positive.

First, they look to the Government to find money for defense by saving, as well as by taxing. Many civilian spending programs will naturally wither, and should be allowed to do so. Others should be curtailed or postponed. Foreign commitments should be reexamined. New spending programs should be avoided. Military outlays should be made with the same care and efficiency as should be expected in the case of any other function of the Government. Several billions could be made available by such policies.

Second, the State chambers regard the Revenue Act of 1950, to the extent that it increased tax rates, as a defense tax measure, just as surely as any bill which this committee may recommend at the present session or hereafter might be so regarded. So they believe that seven percentage points of the present normal corporation income-tax rate of 25 percent should be set apart and merged into a defense supertax, the present surtax rate remaining at 20 percent. Such a special defense tax could well take the form of a percentage of the tax payable at normal and surtax rates, which would be a very simple calculation. One State chamber would prefer a separate rate on the normal net income.

Revenue is the prime objective now. The program which we advocate would produce a fair share of that revenue from incorporated business—and do it without complication or discrimination. What constitutes the corporation's share of the revenues which must ultimately be raised should be determined in the light of the duration of the defense spending program, which we take to be indefinite, in the light of the capacity of the economy to bear heavy corporation taxes over a long period and in the light of the fact that the ultimate burden of corporation taxes falls upon people without regard to ability to pay. If the productive capacity of America, in which lies our strength, is to be maintained and enhanced while the country is rearming, then the corporations must retain sufficient earnings to replace and enlarge their facilities, without unduly impairing their ability to pay their obligations and reasonable dividends. In our judgment this is the most important consideration to be kept in mind as your committee approaches its present task.

The corporations cannot bear the entire burden. A complete defense tax program must extend across the board, into the fields of individual income and excise taxation.

Third, the so-called excess profits taxes of former years have been tried in the crucible of experience and found wanting, as a method of taxation. Justification for them has been found only in the belief that they recaptured for the revenues some part of the corporate profits which were abnormally inflated by war conditions or defense spending—that they took the profits out of war. But every attempt to measure normal or reasonable profits has resulted only in discrimination; and the attendant complexities of such legislation have en-

gendered intolerable administrative and compliance problems, especially vexatious when business is giving its energies to a war or defense effort. The inflationary effect of the former excess profits taxes is a familiar story.

As I have said, business is willing to bear the first brunt of war taxation. But the State chambers for which I am speaking—and I am speaking as a reporter, you will understand—are unanimously opposed to the imposition of that burden in the form of an excess profits tax. I have given you some of their reasons for that opposition, and have described what they would favor instead.

As an excess profits tax measure, H. R. 9827 embodies certain improvements over the World War II tax called by that misleading name. The invested capital base is evidently intended to be more equitable than of the former law, but the shift to a tax basis net worth leaves us in doubt as to its effect. The rate of return on the invested capital base is an improvement. But it would be still better if full credit were given for borrowed capital, if normal and surtax were added to excess profits tax credit, and if no deduction were allowed for interest on borrowed capital in computing excess-profits-tax credit.

We think the income base period of 1946 to 1949, inclusive, is well chosen. The options given seem intended to promote equity and minimize need for special relief. In fact, the House committee is to be commended for attempting to write into law what in the World War II act was left to administrative discretion. But at what a price of complexity. A mere reading of this voluminous measure is enough to expose the futility of even the most sincere effort to frame a law of this character which will be fair to all. Fairness seems to have been forgotten, when an arbitrary qualification of $20,000,000 of assets is set up for the use of an otherwise inadequate growth formula. What I have said about borrowed capital could be applied also to base period capital additions.

Whatever may be the merits of the House bill's provision concerning base period earnings credit are set at nought by the 85-percent limitation. This means that 15 percent of the normal profits of a corporation will be taxed at the 5-percent rate. The base period of the bill does not reflect any war profits as such, nor any substantial influence of defense spending on corporate profits. True, during the last year or so the country as a whole enjoyed prosperity, and the corporations naturally participated in that prosperity. But their profits were not "excessive" in any sense material to the framing of a war excess profits tax. The 85-percent limitation in effect destroys whatever pretension the House bill may have to bring a true excess profits tax measure.

Another serious objection to the House bill is its retroactive application. We are well aware of the mandate of the Revenue Act of 1950 in this regard, and of the President's recommendation. Yet we submit that retroactive tax legislation so near the end of a calendar year is confusing and oppressive, and could be justified, if at all, only by imperative necessity. To our knowledge, no showing of such necessity has been made.

To be sure, if the bill were amended in the very general particulars which I have mentioned, its revenue yield would be materially less. As the State chambers see it, that is beside the point. Revenue should be a byproduct of a reasonable excess profits tax—if there be such a thing—and not a point of departure.

The CHAIRMAN. Are there any questions?

Thank you very much, Mr. Laylin, for your appearance.

Mr. LAYLIN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Clarence L. Turner. You may identify yourself for the record, please, and proceed.

STATEMENT OF CLARENCE L. TURNER, CERTIFIED PUBLIC ACCOUNTANT, PHILADELPHIA, ON BEHALF OF THE PENNSYLVANIA STATE CHAMBER OF COMMERCE

Mr. TURNER. My name is Clarence L. Turner; I am a certified public accountant, of Philadelphia, Pa., and am appearing here today on behalf of the Pennsylvania State Chamber of Commerce. It is my privilege to be a member of the committee on Federal taxation and to submit to you the conclusions of that committee and the board of directors of our State chamber of commerce with respect to an excess profits tax.

We are appreciative of the opportunity to express our views on excess profits and alternative corporate taxes in this critical period when national defense costs are soaring and additional taxes must be imposed. Within the capacity of the economy to produce effectively for military and civilian needs, rising expenditures should be met by increased taxes. But taxes on both individuals and corporations are already heavy and have been acting as a drag upon initiative and investment. Further tax increases should be minimized by eliminating all wasteful and nonessential expenditures. The Government should refrain from initiating new non-war-spending programs during this period when national defense needs are paramount and labor and materials are becoming increasingly scarce.

Senator TAFT. What do you think about road money?

Mr. TURNER. I beg your pardon?

Senator TAFT. What do you think about highway money? I think we have increased highway money about $100,000,000 this year. Do you think that ought to be cut back?

Mr. TURNER. I think that ought to be cut back during this period when money is needed for national defense.

Senator MILLIKIN. We found in World War II that the maintenance of highways was one thing which performed a very essential war purpose.

Mr. TURNER. I think in some cases that might be true, Senator, but I think the expanding program of roads, new turnpikes, ought to be very critically surveyed to make sure that they are needed. If they are needed and required in order to expedite the movement of troops and materials in the war, then, of course, they should be built.

Senator MILLIKIN. You know that term "reexamination" is unpopular.

Mr. TURNER. Military expenditures should also be scrutinized to avoid, so far as possible, wasteful outlays. Like the unnecessary spending of the individual, any wasteful spending on the part of Government contributes to the inflationary spiral.

So far as our time has permitted, we have been studying the various excess-profits tax proposals advanced in recent months, including those of the Treasury and those incorporated in the House bill re-

ported by the Ways and Means Committee. We have studied the so-called excess-profits taxes imposed during the First and Second World Wars. Our conclusions are also based upon the experience of many corporations in their struggles with the complexities, inequalities, and uncertainties with our previous excess-profits taxes.

We have not yet found any so-called excess-profits tax measure which was really an excess-profits tax in the sense that it accurately defined excess profits generally and imposed a selective tax upon them. Instead, all such taxes have been arbitrarily imposed upon crude and discriminatory determinations of profits assumed to be excessive.

The bill reported by the Ways and Means Committee is a current example of the unintelligible complexities of a so-called excess-profits tax. I think we had some illustrations of that with the previous witnesses this morning. It will make a lot of business for tax attorneys and accountants—I suppose personally I ought to keep still—if it is adopted. But even the tax expert will find that this bill defies human understanding and fair and intelligent enforcement.

We believe that at this critical time, corporations as well as individuals must accept increased taxation. But an excess-profits tax, which is both economically and administratively unsound, is not required to raise additional corporate taxes. Equivalent revenues, in our opinion, can be raised by upward adjustments in the rates of the corporate income tax without the complications, inequalities, and inflationary effects of a high-rate excess-profits tax. Such a tax can only result in increased costs both to the Government and the public generally. Our experience with excess-profits taxes during two world wars demonstrates conclusively that they discourage incentives for prudent management on the one hand and encourage waste and inefficiency in business practices on the other. Prices are thus increased, to the disadvantage of the Government and the consumer.

This type of tax is bound to penalize the smaller businesses affected, especially the new and rapidly growing progressive concerns and industries which have had years of losses or low incomes and are greatly in need of funds to finance their expanded production. It is bound to fall heavily upon the smaller concerns furnishing war materials which must finance their capital requirements by retaining their earnings. It will also act as a deterrent, because of its high rates, to the production of war and civilian goods generally.

A so-called excess-profits tax inevitably penalizes many concerns which cannot escape its harsh burdens. It invariably becomes, to a very substantial extent, a tax on normal earnings. Even with the application of complicated formulas and the use of various relief provisions, it has been found impossible to develop a fair and sound basis for separating normal and necessary profits from excessive and unnecessary windfall profits.

Any abnormal profits which may be realized from filling war contracts with the Government can be effectively prevented by efficient over-all renegotiation, with the amounts recaptured going into the Treasury. Over-all renegotiation also has the advantage of allowing losses on some contracts to be offset against profits on others.

I would like to inject right there that I think that renegotiation gives some idea of the only way that you can really give relief in this way. Relief, I believe, is an individual proposition.

What I mean to say is that the circumstances and facts with respect to a particular company governs whether or not they require relief. I think it is very difficult to write into a statute a general provision which will give relief in all cases.

Now, when you are before the Renegotiation Board, they take into consideration all elements and whether or not you have gotten a fair return. Maybe a board similar to the Renegotiation Board is the way to get the relief.

If it is found that the taxpayer has paid too much taxes, have the Board have the authority to recommend a refund as well as taking excess profits.

Senator MILLIKIN. What about taxpayers who are not subject to renegotiation; those who have not contracts with the Government?

Mr. TURNER. Well, of course, in time of war it is very difficult to find any company or any business in some way or the other that is not contributing to the war effort either directly or indirectly, either through a contract or subcontract.

Senator MILLIKIN. Would you expand the original to include all corporations?

Mr. TURNER. You know in the 1918 act we had what was called 327–28, which to my mind was must more satisfactory than the whole 722 we had in the prior act, where a corporation or a business was willing to have its taxes measured by what its competitors paid in relation to the return, amount invested, and all the other elements that had a bearing on earning capacity. To my mind, that was very satisfactory.

I know so far as our office was concerned in our private practice we were successful in getting more refunds for taxpayers that required relief under the 327–28 then we were under the 722.

I have one illustration of a steel company, and after eliminating the two big ones, they had the figures of seven steel companies, and before taxes their profits to sales compared very favorably with the competitors. After taxes they had about one-half as much left as their competitors. 722 claims were filed, and we were told that we had a case. However, in determining a base period in income they insisted that we should take the years from 1921 through to 1939 as an average, and as a result of those figures adjustments were made in the income of certain years, so that the base period net income constructively arrived at, was about the same as it was on the statutory basis. So there was practically no relief. But if we had been under 327–28, we would have gotten relief, and they should have had relief. The reason they were in that predicament was because their plant was bought up at a bargain price, and they did not have the capital investment.

So-called excess profits are finally determined by controversies and compromises between the Government and the taxpayers. Unsettled disputes may drag on for many years, as they did after the First World War and as they are now doing after the Second World War when thousands of cases are still unsettled.

Because of its greater equity to all corporations sharing in the profits, directly and indirectly, from wartime production and prosperity, its greater simplicity, its ease of administration and compliance, its minimum of inflationary effects, and its availability to raise such increased

revenues as can safely and wisely be raised from taxing corporations, the corporate net income tax should be employed at this juncture for increased revenues rather than an excess-profits tax. We, therefore, propose that the normal corporate income tax rate should be set at 10 percent and the surtax at 20 percent. The latter rate is established by the Revenue Act of 1950. Then such additional revenues as must be raised from corporations should be obtained from an emergency defense tax imposed as a percentage rate added to the total amount of the normal and surtaxes computed at such rates. With the addition of the emergency defense tax, the maximum corporate tax rate could be increased to 50 percent or such other rate level as may be required.

We respectfully submit, however, that all corporate taxes are impersonally levied upon the individuals who pay them as these taxes ultimately fall upon investors, if they are not shifted, or upon consumers, employees, or other groups if they are shifted. The double taxation of dividend income by the personal as well as the corporate income tax, which now exists, adds to the burdens upon those who own corporate stocks. Many stockholders are persons of moderate means. Certainly all corporate taxes disregard the personal abilities of individuals to pay them since they fall upon all alike, regardless of their personal incomes and their economic responsibilities.

We realize that great pressure is being brought to bear upon Congress to impose an excess-profits tax, in spite of its many known evils and grave and inherent complications. If such a tax should be adopted as an emergency measure of political expediency, it should be formulated with great care to minimize the inequalities and the serious administrative and compliance problems which are bound to arise.

Some of the important points to be considered are as follows:

1. Alternative bases: H. R. 9827 provides two bases of distinguishing normal profits from excess profits, the taxpayer to use the basis resulting in the lesser tax. This is certainly essential; both the average earnings and invested capital methods should be provided. Furthermore, the ultimate tax liability should be determined under the method which will produce the lesser excess-profits tax.

II. Allowances of 100 percent of base period earnings and the deduction of normal tax and surtax: Full credit should be given for base period earnings. The House bill provides for only 85 percent of the average earnings of the three best years of 1946 through to and including 1949. The previous law allowed 95 percent of the average base period income.

In our opinion the use of that 85 percent is in effect applying an excess profits tax on normal earnings.

Senator TAFT. Is that very different from just increasing the corporate rate from 45 to 50 percent? If you make this 100 percent instead of 85, it seems to me you have got to increase the corporate tax 5 percent to make up the difference in money. Is there much difference?

Mr. TURNER. I think the direct rate is much more preferable, Senator Taft. Here as it is now written, we have a base, which the first thing we do, we take 85 percent of that base.

Senator TAFT. What I mean is: Admitting you are taxing normal income——

Mr. TURNER. That is right.

Senator TAFT. Well, if you do not tax it this way, you have to tax it some other way if you want to get the money.

Mr. TURNER. That is right. I agree with that, and we prefer direct tax instead of this complication. I mean, if the revenue has to be raised, and we know it does, the corporation is willing to pay its share.

Senator TAFT. I think this is an argument against the excess profits tax as a whole, but assuming you have complications anyway, what is the difference in taking this 4½ million out of what may be called normal earnings this way instead of taking it out by direct taxes?

Mr. TURNER. Well, we think it would be better to allow 100 percent credit, and leave the chips fall where they may.

Senator TAFT. Even if you have to increase the normal tax 5 percent?

Mr. TURNER. Well, either that or increase your rate, one or the other.

There is no justification in contending that corporation profits were actually excessive during the years 1946–49 in view of the expanded economy in that period with its sustained high-level employment, production, price levels and national income.

Moreover, normal and surtax should be deducted in determining excess profits. And that is what was done in the 1940 act.

III. Deduction of normal tax and surtax under the invested capital method: While the House bill increases the invested capital credit over that provided in the prior law, a minimum rate of 8 percent of invested capital as a credit base before deducting income taxes would be inadequate. With income taxes at the rate of 45 percent all profits after such taxes over 4.40 percent of invested capital will be considered excess profits. Therefore, the normal and surtaxes should be deducted before any excess profits tax is computed.

I think one of the inequities is the fact that the difference in the dollar applied to capital invested in the base period of prior periods is compared with the dollar of today. I realize that what has been done here was boosting this rate from 5 to 8, the minimum rate; and the maximum rate to 12 is to give effect to that. But unfortunately it takes care of corporations who invested their capital in the last few years, but corporations who have had their capital invested for years, when the dollar was a dollar instead of what it is today, naturally do not get the same benefit from it, and they are not treated the same as those who are investing their capital during this high period.

I have discussed with some of the Treasury folks, and some of Mr. Stam's staff the posibility of using the construction indices and apply it to the invested capital December 31, 1939, taking that as a base, and then apply it to each addition thereafter up to December 31, 1949. That may sound complicated, but if the particular industry is named and specified in the law, I do not believe it is any more complicated that some of the other provisions of the act, and I think it would be equitable, and would help offset the comparison and analogy between corporations who have installed their plant and equipment and made heavy additions during these high prices, and are getting depreciation at a commensurate rate, with those who have plants that were erected long years ago, and are still taking depreciation at historical bases.

IV. Borrowed invested capital: The provisions of the House bill would unduly limit the allowances for borrowed capital in computing the invested capital credit. We think that full credit should be given for bororwed capital with corresponding disallowance of deductions for interest on such capital.

We do not believe the provisions as they now are treat the borowed capital as well as the provisions in the old law, not considering, however, the increased allowance in the rate.

V. Retained earnings: The provisions of the House bill that reinvstment of earnings should be recognized under the average earnings method as well as under the invested capital method is certainly meritorious. The earning of a corporation which are retained are identical, for this purpose, with new capital contributions and therefore should receive similar treatment.

VI. Taxation of public utilities: We submit that in any excess-profits tax that may be adopted, consideration should be given to the peculiar problems of regulated public utilities. I personally believe that section 446 of H. R. 9827, granting special treatment of public utilities, is a step in the right direction. However, with respect to electric, gas, telephone, water, and certain intrastate transportation companies, this section permits a 6-percent return on assets valued for tax purposes; whereas the Pennsylvania Public Utility Commission recognizes the fair value of utility assets. Possibly some increase in the 6-percent rate specified in section 446 might be considered to compensate for this difference.

VII. Relief provisions: We commend the House Ways and Means Committee on its endeavors to provide equitable relief in the case of businesses for which no practical standards are available to measure normal earnings and in other hardship and unusual cases. However, we have not had enough time to really study them to make sure that they are enough to take care of all situations.

VIII. Effective date: We strongly recommend that the excess profits tax should not be made retroactive to any portion of the year 1950 and that it not become effective before January 1, 1951.

IX. Procedural matters: We understand that it is contemplated to include a provision in the act—I couldn't say whether it was in there yet or not—that will consolidate the income and excess profits taxes for the purposes of the statute of limitations, credits and refunds, interest computations and all other administrative provisions. We recommend that such a provision be adopted in order to facilitate the administration of collection and payment of these taxes.

These, gentlemen of the Senate Finance Committee, are our views on corporate and excess profits taxation. In closing, I wish to state that we wholeheartedly endorse the statement submitted so ably to you by Mr. Clarence L. Laylin, of Columbus, Ohio, on behalf of the Council of State Chambers of Commerce, an organization with which the Pennsylvania State Chamber of Commerce is happily affiliated.

Thank you.

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

Mr. Harold Wright?

Mr. Wright is not present, apparently. So we will recess now until 2 o'clock.

(Whereupon, at 12:30 p. m., the committee recessed, to reconvene at 2 p. m., of the same day.)

AFTERNOON SESSION

(The committee reconvened at 2 p. m., upon the expiration of the recess.)

The CHAIRMAN. The committee will come to order.

Please enter into the record a statement submitted by the Hawaiian Sugar Planters Association, relating to the proposed excess profits tax. The statement is submitted by Mr. Ernest W. Greene, vice president of the association.

And, also, a statement on behalf of the King Broadcasting Co., May Broadcasting Co., and Meredith Syracuse Television Corp., on this bill, which statement is submitted for the three organizations by Mr. Andrew G. Haley.

And, also, a statement submitted by Mr. William B. Stafford, for the American and Foreign Power Co., Inc., New York, on the pending bill.

Also a statement on the present bill, submitted by the National Small Business Men's Association of Evanston, Ill. This statement is presented by the president, Mr. DeWitt Emery.

All of these statements are submitted in lieu of personal appearances.

(The statements referred to are as follows:)

HAWAIIAN SUGAR PLANTERS' ASSOCIATION,
Washington 5, D. C., December 5, 1950.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
United States Senate, Washington 25, D. C.

DEAR SIR: This statement is filed on behalf of the Hawaiian Sugar Planters' Association which represents the entire sugar-producing industry of Hawaii. The Territory of Hawaii is one of the principal sugar-producing areas of the United States. Production of sugar has, for three-quarters of a century, constituted the basic industry of the Territory and is the principal source of income and employment of the peoples of Hawaii.

The sugar industry is regulated by the Sugar Act of 1948, and is dependent upon the type of protection afforded by this act from the competition of sugar-producing areas of foreign countries where wages, taxes, and other important costs are far below those of the Hawaiian sugar producers. The Hawaiian sugar industry, having suffered extensively during World War II, partially as a result of the military taking over huge areas of Hawaii and the loss of a great part of their labor supply to the armed services and defense work, is keenly aware of the need of increased revenue for the defense program, and does not oppose a tax which would bear heavily on extraordinary profits arising from defense expenditures.

The period since World War II has been for the sugar industry in Hawaii one of unsettled conditions, lengthy strikes, a tidal wave, changes in methods of production and in general, meager profits or, in many cases, losses.

The amount of capital invested in the typical sugar plantation, while large in comparison with other agricultural industries, is not large when measured by standards applicable to other types of industries.

The Hawaiian sugar industry operates under a quota system which is administered by the Secretary of Agriculture who, as a result of the powers delegated to him by the Sugar Act of 1948, is in effect, able to greatly influence sugar prices. It is also a fact that there is a traditional ceiling to sugar prices which is deeply ingrained in the mores of the American people.

The Hawaiian sugar planters, as a part of the domestic industry subject to the Sugar Act of 1948, must maintain high standards relative to wages and hours, and payments to sugarcane growers.

All of these factors combine to require the ablest and most vigorous management, and uninterrupted production to show reasonably profitable operations.

In view of the foregoing considerations and in the belief that our suggestions will be applicable to other industries which have similar problems and in the

belief that these suggestions will not result in any appreciable loss of revenue, we recommend the following for your consideration:

SUGGESTIONS

Average earnings method

1. We recommend that under the average earnings method of computing the excess profits credit that the base period years be 2 of any of the 4 years, 1946–49. Hawaiian sugar crops are harvested in 2-year cycles so that, in general, a 3-year base period would not properly reflect average earnings. We do not believe that this average should be reduced by any percentage since this would in effect tax a portion of normal earnings at the excess profits tax rate.

2. In the alternative, a company should be allowed to use the base period 1936–39 in determining normal earnings. Since this was the base period under World War II law, it has the advantage of being an ascertained figure and would eliminate much administrative detail which would arise if a new average earnings figure were developed. There are undoubtedly many companies for whom the years 1946–49 do not represent a period of normal operations and whose earnings during this period can, in no way be construed as normal or average. Conversely the period 1936–39 might more properly reflect normal earnings, particularly in war dislocated areas and in industries where a readjustment to peacetime conditions is a lengthy and arduous undertaking.

3. An additional credit for new capital, regardless of source, invested after the base period should be allowed to companies using the average earnings method of determining the excess profits tax credit. This credit should be at least 12 percent on new capital of any type.

4. An earnings credit should be allowed for additions to capital during the base period. This credit should be equal to the new additions made to capital in 1948 and 1949, regardless of the source or type of additions. This provision will benefit those industries which have expanded during the base period and those which have made a belated recovery from World War II.

Invested capital method

1. The graduated rates for excess profits credit based on invested capital should be eliminated. Such graduation has a tendency to be regressive. It would bear most heavily on the dividends of the small-stock holders who make up the overwhelming percentage of stockholders in large corporations.

2. The rate allowed on invested capital as a credit should be 12 percent.

3. The credit allowed for new capital invested during the period in which the excess profits tax will be applicable, should be at least 12 percent. This rate should apply to all types of capital whether it be equity capital, retained earnings, or borrowed capital.

4. We believe that the credit for borrowed capital should be 100 percent instead of the 50 percent allowed in the last excess profits tax law. All interest on borrowed capital should be included. We believe that it is unfair to penalize an industry, which, typically finances its operations in large measure through borrowed capital. This is true in the Hawaiian sugar industry, for example, where a 2-year crop cycle in many cases requires long-term, self-liquidating financing, of a permanent or semipermanent nature. We believe that the total capital applied by an economic entity should be considered in determining the rate of return on such capital.

Specific exemption

A specific annual exemption rather than a credit of $25,000 in computing adjusted excess profits net income should be allowed. This exemption will be sufficient to relieve the very small corporations from this form of tax. It will also protect an industry which, through no fault of its own, finds itself in the position of being a marginal producer.

General recommendations

1. The election to file a return based on either average-earnings method or invested-capital method, should not be binding.

2. Any portion of an excess profits tax credit not fully used in 1 year should be available for carry-back or carry-forward, without time limitation, to be used in any other year in which the excess profits tax applies.

3. Section 711 of the previous excess profits tax law, providing for equitable adjustment in arriving at the net income in the base period should be enacted.

4. We believe that any excess profits tax law should include general relief provisions. These provisions should provide for automatic relief insofar as possible. No matter how carefully legislation is drawn, it would be impossible to draft a law which would be applicable to every foreseeable situation. We feel that the lack of such relief provisions in H. R. 9827 should be remedied, in spite of the careful attempt made by the drafters of the bill to obviate the need for general relief provisions.

5. We do not believe that an excess profits tax should be retroactive. It would interfere with orderly fiscal planning by business and create confusion. In the case of the Hawaiian sugar planters, where a 2-year crop cycle obtains, the tax could be confiscatory if it so happened that the sugar were harvested and sold in that particular 6-month period.

SUMMARY

We believe that these suggestions will eliminate many hardship cases and thus reduce the administrative burden of considering relief claims. These provisions will not impair the revenue, will bear equitably on most taxpayers, tend to be anti-inflationary, and will encourage expansion. They will enable the Hawaiian sugar industry to produce the quantity of sugar which will be required and without stifling enterprise will permit the Hawaiian sugar industry to bear its proper share of the tax burden.

Respectfully submitted.

ERNEST W. GREENE,
Vice President, Hawaiian Sugar Planters' Association.

STATEMENT OF ANDREW G. HALEY, IN BEHALF OF KING BROADCASTING CO., MAY BROADCASTING CO., AND MEREDITH SYRACUSE TELEVISION CORP.

King Broadcasting Co. is the licensee of television station KING-TV, amplitude modulation station KING, and frequency modulation station KING-FM, Seattle, Wash. May Broadcasting Co. is the owner of television station KMTV, Omaha, Nebr., and AM station KMA, Shenandoah, Iowa. Meredith Syracuse Television Corp. is the owner of television station WHEN, Syracuse, N. Y. These three companies are not appearing in opposition to increased taxes. They realize that additional taxes must be levied to meet the heavy costs of the defense program. They do desire, however, to bring to the committee's attention certain unique facts in connection with the television broadcasting industry which, in their opinion, point to the desirability of according telecasters special treatment in any excess profits tax legislation enacted at this time.

The philosophy of excess profits taxes is that business profits resulting from wartime buying should be leveled off to the normal economy. In other words, excess profits tax legislation seeks to preserve a normal level of profits and to prevent wartime profiteering. The new television broadcasting industry, developed since World War II, cannot be grouped with many industries which, by the nature of their products, will increase their volume and profits as a result of the defense program. Instead of augmenting profits in the telecasting industry, defense preparations will curtail profits which this rapidly growing industry could have expected to realize in a normal peacetime economy in the years immediately ahead.

The channeling into the preparedness program of cobalt, copper, and other materials essential to television receiver production will curtail set production. This in turn will affect the continuing growth of TV as an advertising medium since a telecaster's revenues depend on the size of the audience he reaches. Furthermore, advertising as such becomes of less importance in a wartime than in a peacetime economy because of the inevitable shortage of goods and merchandise available for consumer consumption. Therefore, the preparedness program, instead of producing greater profits which the tax legislation of the character here under consideration is designed to siphon off, will jeopardize and constrict profits which normally could have been expected in a peacetime economy as television sets became more numerous.

In an infant industry like television, where most licensees had not even reached a break-even point in 1949 in their pioneering of this new medium of mass communication and entertainment, recourse to a base period of 1946–49 would work a patent hardship on telecasters and would not reflect the "normal" profits of this industry. At the end of World War II only one television station was on the air, operating a few hours a week. Because of the very large capital

costs involved in constructing new television stations and the heavy operational losses which then seemed inevitable for an undetermined number of years (with only a few television receivers on the market), television applications filed during World War II and immediately thereafter were being withdrawn more rapidly than new applications were being filed. The risks involved seemed too great to attract the required capital. As late as 1948 several television-construction permits for large cities were voluntarily surrendered. And as recently as the summer of 1950, one large television-manufacturing company requested permission from the Federal Communications Commission to conduct experiments with a subscription system of television whereby the cost of operating television stations, instead of being borne solely by the advertiser, would be augmented by payments from the viewer. While this pessimism regarding the ability of telecasters to furnish program service with expenses borne entirely by the sponsor, as in the case of AM broadcasting, is not now generally shared by the industry as a whole, it nevertheless highlights the fact that persons who pioneered television in 1947, 1948, and 1949, incurring huge losses during that period, assumed tremendous risks and should not now be confronted with an excess profits statute where the base period embraces the very years when television was struggling to emerge from the laboratory stage.

It is also to be borne in mind that half of the 10,000,000 television sets, which it is expected will be in the hands of the public by the end of this year, will have been produced in 1950. Before the developments in Korea, it was confidently predicted that the number of outstanding sets would be doubled by the end of 1951 (another 10,000,000 or 20,000,000 in all). It was this recent rapid expansion and prospective further expansion in the number of receivers in the hands of the public which gave telecasters some hope to amortize their large capital investments and to recoup losses suffered in the period 1946–50. However, with a wartime economy and attendant drastic curtailment in the production of television receivers now in sight, telecasters will be forced to provide a broadcasting service with a limited "circulation" until a peacetime economy again prevails. In this connection, the problem of the telecaster is not to be confused with that of the television-set manufacturer. In a national-preparedness economy, the set manufacturer can divert his plant to the production of electronic equipment urgently needed by the Government. The telecaster has no such escape. His plant has only one utility—the providing of television programs to the public supported by the advertisers' dollar.

Still other problems are looming on the horizon for television broadcasters. On October 10, 1950, the Federal Communications Commission authorized color television under a system not compatible with the present black and white. In order to televise in color, broadcasters will be required to incur additional capital outlays. Since the present receivers in the hands of the public will not even receive color pictures in black and white without the addition of adapters probably costing in excess of $50, this means that the telecaster cannot rely upon current "circulation" but must again build up an audience as it did for black and white between 1946 and 1950.

Furthermore, during the past 2 years the Federal Communications Commission has imposed a "freeze" on the construction of new television stations. As a result, all sets produced to date have been channeled into 64 communities where television stations are now in operation. With the prospect of the freeze on new grants being lifted early in 1951, we can expect television stations to be placed in operation in many large metropolitan areas not now provided with television service. This will mean that the limited number of sets manufactured in the next few years will be channeled in part into these new television centers, thus reducing the number of sets available in areas served by existing telecasters. Such will be the result of the wartime curtailment on receivers unless the proposed excess profits legislation and a ban on the production of new television sets make it impossible to attract capital willing to run the risk of attempting to provide television service with dim prospects of receivers being available in scores of markets not now served. Because of the great potentialities which television has for civilian defense purposes, in educating the public on what to do and what not to do in case of enemy air attacks, such cities should not be deprived of a potential television service by the impact of tax legislation using a nonrepresentative base period of 1946–49.

With an excess profits formula on the books similar to that used in World War II, with the base period 1946 to 1949, neither existing telecasters nor persons desiring to provide television service in new communities could ever hope to recover initial and possible long-time operating losses, nor could they hope to

amortize their original capital investment. Such a tax policy would be unfair to existing telecasters and would deprive many large cities (like Portland and Denver) of their first television service for some years to come.

That the proposed excess profits legislation, with no special provisions for a new industry like television, would operate unjustly is borne out by the capital investment and profit and loss figures for the television licensees presenting this statement.

The operating deficit for King Broadcasting Co., and the predecessor licensee of KING–TV was $51,565.16 for that portion of 1948 it was on the air, $122,166.98 for 1949, and $10,852.95 for the first nine months of 1950. Its capital investment is $442,554.22.

The operating deficits for May Broadcasting Co. were $45,269.94 during that portion of 1949 it was on the air and $62,832.67 for the first 9 months of 1950 with losses being progressively reduced each month. Its capital investment exceeds $400,000.

Likewise Meredith Syracuse Television Corp. lost $198,663 during the fiscal year ending June 30, 1949, $204,423 during the fiscal year ending June 30, 1950, and $41,329 from July through September 1950. Television Station WHEN has $617,776 in fixed assets. It is now barely approaching the break-even point.

In the light of the foregoing factors, the committee is respectfully urged to include in any excess profits tax legislation special provisions governing tax payments by telecasters. It is suggested by way of illustration that such legislation, in the case of television broadcasters:

(*a*) Provide for the continuation of the recently increased corporate tax through 1950.

(*b*) Allow a 5-year growth period starting with the tax year 1951, finally arriving at an excess tax base computed on net gains year by year.

(*c*) Permit corporations to include losses for 3 years prior to 1951 in arriving at excess profits figure.

(*d*) Include special provision for 3-year carry-back and 5-year carry-forward for the television broadcasting industry.

AMERICAN & FOREIGN POWER CO., INC.,
New York 6, N. Y., December 5, 1950.

Re: Elimination of Western Hemisphere trade corporations from consolidated excess profits tax returns.

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

DEAR SENATOR: In connection with the pending excess profits tax bill, may we respectfully request your consideration of the position of Western Hemisphere trade corporations.

The obvious inequity of imposing an excess profits tax on American organized operating companies wholly engaged in business outside of the United States was recognized in the Second Revenue Act of 1940. Such corporations were declared exempt from excess profits tax (code sec. 727 (g)). Similar exemption is provided in section 452 of the new subchapter D of the code proposed by H. R. 9827.

The 1942 act gave further recognition to the difficulties of meeting foreign capital competition in developing Western Hemisphere trade by subjecting Western Hemisphere trade corporations (as defined in code sec. 109) solely to the corporate normal tax but not the surtax (code sec. 15 (b)). However, the same act in substantial degree nullified the effect of such relief by requiring that such corporations when included in a consolidated return for income tax purposes must also be included in a consolidated excess profits tax return and their income taxed at excess profits rates. The asserted necessity for this requirement is stated in the report of the Committee on Finance, United States Senate, relating to the revenue bill of 1942 (S. Rept. 1631, 77th Cong., 2d sess.):

"Your committee, however, believes it desirable that the affiliated group of corporations be identical both for consolidated income and for consolidated excess profits tax return purposes. It has therefore amended sections 141, 725, and 727 of the code so as to provide that any corporation which has joined in a consolidated income tax return shall not be exempt from excess profits tax. Con-

sequently, an includible corporation as defined in section 141 (e) which is a member of a group filing a consolidated income tax return will be required to join in the filing of the consolidated excess profits tax return. This is administratively expedient both from the standpoint of the Government and the taxpayer. In addition, it prevents the disqualification for consolidated excess profits tax return purposes of groups which are eligible for consolidated income tax return purposes in those cases where the common parent corporation would otherwise be exempt from excess profits taxes under sections 725 and 727 of the code."

Thus Western Hemisphere trade corporations under the World War II excess profits tax law found themselves in the anomalous position of receiving the benefit of exemption from surtax upon their net income as a necessary alleviation of their tax burden, and having the same income subjected to a high excess profits tax if such corporations were a part of an affiliated group filing a consolidated income tax return.

Many American corporations operated wholly in foreign countries are subsidiaries of parent American corporations doing business in the United States, but under the law the excess-profits tax exemption accorded such companies could not be availed of unless each company of the entire group, whether operating within or without the United States, filed a separate income-tax return. This virtually denied the consolidation privilege to and was a very real discrimination against American enterprises with substantial capital risks in foreign countries. An example in point can be cited.

American & Foreign Power Co., Inc., is an American corporation engaged in the business of owning and financing operating utility companies located in foreign countries. Its principal investments are in subsidiaries operating in Mexico, Guatemala, Costa Rica, Cuba, Panama, Colombia, Ecuador, Brazil, Argentina, and Chile. American & Foreign Power Co., Inc., was organized 27 years ago and has contributed greatly to the economy of Central and South American countries in the development of electric and other types of utility business in the localities named. It and its subholding companies operate largely through wholly owned and financed operating subsidiaries and in five of the countries, to wit: Mexico, Cuba, Colombia, Ecuador, and Panama, these subsidiaries qualify as Western Hemisphere trade corporations within the meaning of section 109 of the Internal Revenue Code.

American & Foreign Power Co., Inc., and its affiliated companies file a consolidated return for income-tax purposes. Approximately $6,000,000 or one-third of the consolidated net income for the year 1949 was attributable to the Western Hemisphere trade corporation affiliates. Thus, if this affiliated group were to file a consolidated excess-profits-tax return, a very substantial portion of the consolidated net income would be considered as excess-profits net income entirely contrary to the purpose of the excess-profits tax exemption accorded the Western Hemisphere trade corporations under code section 727 (g) and section 452 of H. R. 9827.

While the excess-profits-tax exemption as to such net income could be obtained by the filing of separate returns, each company in the group would have to file a separate return and this would mean the denial to the group of a substantial part of the credit for foreign income taxes otherwise allowable with respect to the income derived from sources in the various foreign countries. For example, Cuban Electric Co., the largest Western Hemisphere trade corporation in the American & Foreign group, had net income in 1949 of approximately $3,300 000 with respect to which it paid Cuban income tax of approximately $2,100,000. The Cuban income tax is levied at graduated rates, the top rate of which is 35 percent, but the amount of net income of Cuban Electric Co. upon which the Cuban tax is levied is considerably higher than that of Cuban Electric under the United States income-tax law. This is due largely to the fact that the interest deduction allowed under Cuban law is limited to a maximum rate of 4 percent upon its indebtedness. Actually Cuban Electric paid 6 percent on its indebtedness. Most of this interest was paid to American & Foreign Power Co., Inc., or its subholding company, and a further Cuban income tax of 6 percent was withheld upon such payment. This interest income is subject to United States income tax in the hands of American & Foreign at normal and surtax rates as well as excess-profits tax if enacted as under the prior law.

When a consolidated return is filed the total net income derived from each foreign country is determined and the foreign income taxes paid thereon are allowed as a credit against the United States taxes limited to an amount not in excess of the rate at which such income is taxed under the United States law.

Under this procedure the allowable credit for foreign income taxes is determined with reference to all the net income of a given country in relation to the total foreign income taxes paid thereon in that country. This is an equitable rule, but it is defeated where a consolidated return of a closely affiliated group is not made since a foreign-income-tax credit would be denied to the parent, filing a separate income-tax return, as to any foreign income tax paid on the net income of its subsidiary, even though, as in the case of the Cuban Electric Co., net effect of the foreign income tax is a levy upon the parent. The Cuban situation described operates thus:

1949—Separate return

	Net income from Cuban sources	United States tax (before foreign tax credit)[1]	Foreign tax credit	United States tax (after foreign tax credit)
American & Foreign Power Co., Inc	$1,927,000	$732,260	$145,000	$587,260
Havana Electric & Utilities Co. (subholding company)	919,000	349,220	58,000	291,220
Ebasco International Corporation (service subsidiary)	115,000	43,700		43,700
Cuban Electric Co. (operating company—Western Hemisphere trade corporation)	3,317,000	796,080	2,128,000	None
Havana & Insular Real Estate Co	[2] 1,000			
Total	6,277,000	1,921,260	2,331,000	922,180
American & Foreign Power Co., Inc	6,277,000	[3] 1,951,000	2,331,000	None

[1] Tax shown at rates effective for 1949.
[2] Red figure.
[3] The amount of the consolidated tax allocable to total net income from Cuban sources, i. e., net income from interest and operations.

As the above tabulation shows, the total Cuban income tax on net income derived by the American and Foreign group in Cuba on a consolidated return basis exceeds the United States income tax levied on the same income, and, therefore, there is no United States income tax payable upon such income and this is an equitable result correct under existing United States income tax law. However, as the tabulation shows, were separate returns filed in order to obtain excess profits tax exemption for Cuban Electric Co.'s substantial net income, the United States income tax liability on Cuban net income would be an aggregate of $922,000. The effect would be to impose a substantial United States tax liability so that the excess profits exemption for the Western Hemisphere trade corporation, Cuban Electric Co., could be made operative.

A similar situation as to income derived in Mexico would result in increased United States tax liability of $185,000 or a total "penalty" of over a million dollars in order to secure to the Western Hemisphere trade corporation in the American and Foreign group the exemption due them if section 727 (g) or section 452 of H. R. 9827 and the excess profits tax had been in effect for 1949.

It is respectfully submitted that the exemption from excess profits tax accorded American corporations wholly engaged in active operations in foreign countries should not be denied by requiring them to be included in a consolidated excess profits tax return merely because the affiliated group of which they are a part files a consolidated income tax return.

This matter was referred to in statements submitted by Messrs. Mitchell Carroll and Ellsworth Alvord and by the Controllers Institute of America when the Revenue Act of 1943 was under consideration by the Committee on Ways and Means of the House and the Committee on Finance of the Senate. (See pp. 615, 745, and 831 of the report of the hearing before the Committee on Finance, U. S. Senate, 78th Cong., 1st sess., on H. R. 3687, and pp. 685 and 1331 of the report on hearings before the Committee on Ways and Means of the House of Representatives, 78th Cong., 1st sess., on revenue revision of 1943.) However, it does not appear that any amendment was made to the law on this subject at that time.

The remedies correcting the inequity described are quite simple. Any one of the following alternatives is suggested:

(*a*) Eliminate the net income and the excess profits credits of American corporations operating entirely in foreign countries from the affiliated group for excess profits tax purposes; or

(*b*) Exclude such corporations from the consolidated excess profits tax return and treat the investments of the affiliated group in such corporations as inadmissible assets; or

(*c*) Give the affiliated group the opinion of either including or excluding the net income of such corporations and, if excluded, treat the investment as an inadmissible asset. This follows the pattern with respect to excess profits tax treatment of income from United States Government securities under code section 711 (a) (2) (G); or

(*d*) Provide an arrangement similar to that relating to corporations engaged in the mining of certain strategic metals as provided in section 721 of the code and paragraph (c) of section 33.30 of regulations 110. (This method would be the same as that now applied in the computation of the surtax exemption of Western Hemisphere trade corporations where the latter are included in a consolidated income tax return.)

This matter has been discussed informally with members of the staff of the Joint Committee and also members of the Treasury legislative staff.

If an excess profits tax law is enacted, it is respectfully requested that appropriate provisions be included therein to meet the situation herein described.

Very truly yours,

W. B. STAFFORD, *Vice President.*

STATEMENT OF DE WITT EMERY, PRESIDENT, NATIONAL SMALL BUSINESS MEN'S ASSOCIATION, EVANSTON, ILL.

Our present national policy contemplates the building of our economy to successfully combat the Communist threat. We are informed that this will be a long hard pull in contradistinction to the situation which existed at the start of World War II when it was necessary to produce now regardless of any resulting maladjustments and frictions. Because economic strength is necessary, the basic needs of the civilian and industrial groups must be in part satisfied as well as making adequate provision for the military. Presently it is contemplated that some 15 to 20 percent of our national output will be required for the military as compared with some 40 or 50 percent which was allocated to them during World War II. It is evident that we will have to have an expanding industrial machine for some time, to come if this task is to be successfully completed. Obviously, industry will require additional capital investment to take care of these needs and this can be derived from borrowings, new equity investments or by retention of earnings. By their very nature, the small business enterprise will, generally, be unable to obtain such capital from the first two sources and will largely be compelled to depend upon retained earnings.

Under partial mobilization plans as presently formulated, the enactment of an excess profits tax at this time seems unnecessary. Such a tax would be imposed upon all corporations regardless of the nature of their activity and would result in taxing as excess profits, profits derived in large part from civilian production. Such a state of affairs is contrary to the avowed purpose of the excess profits tax enacted at the start of World War II when we were informed that no excess profits shall accrue to those engaged in war work. It may well be that an excess profits tax at this time would prevent or retard the growth of our industrial machine. This is particularly true of those businesses having small capital.

Moreover, by reducing executive branch nondefense expenses to the 1941 level a total of $6,000,000,000 could be eliminated from the budget. This, we are informed, would roughly approximate the amount realizable by the imposition of the proposed excess tax. However, since whether or not an excess profits tax is necessary is a closed issue so far as your committee is at present concerned we are glad to suggest some of the things which we believe should be carefully considered in drafting such a bill.

The proper base for determining normal profits

The alternative bases provided by the excess profits tax law of World War II should be used, except as qualified in the following. The following comments assume that the specific exemption be at least $40,000.

Earnings method of computing excess profits tax credit

The base period should be the calendar years 1946 through 1949, inclusive, with respect to calendar-year corporations and the tax years commencing in 1946 and

ending in 1950 for fiscal-year corporations. In general, the impact of the Korean incident has not appreciably caused corporate income increases arising from war orders because of the limited demands made by the military to date and undoubtedly in some cases war orders have actually decreased earnings because of plant conversion, and things of that nature. As a consequence, cut-off dates such as December 31, 1939, or May 31, 1940, contained in the old law are not desirable. Any new law should provide for the election by the taxpayer of any 3 of the 4 years in computing net income which should also be used as the excess profits tax credit. In the event 3 years are used as the base, the average net income should be determined by dividing by three. In general, the adjustments in arriving at the taxable excess profits and income contained in the old law are satisfactory. Growth formulas contained in the old law should apply under new law where appropriate.

Invested capital method of computing excess profits credit

Invested capital should be computed as under the old law except that all adjustments of Federal taxes on income, and so on, whether refunds or deficiencies should be recognized and related back to the year in which they arose. The taxpayer should be placed on equal footing with the Government in this regard. Borrowed capital should be recognized in total. Earnings accumulated after July 1, 1950, should be permitted to increase the invested capital base.

The following rates of return, we believe, should be allowed in computing the excess profits credit and the excess profits tax should be computed before normal and surtaxes:

Equity invested capital

	Percent
Up to $500,000	15
$500,000 to $2,000,000	12½
Over $2,000,000	10

Borrowed money should be considered as capital with interest disallowed.

Our principal concern is the credit allowable to corporations whose equity invested capital is $500,000 or less. It is this group which feels recessions more severely than large corporations and this is particularly true during the years 1946–49. If the 8-percent allowance in the old law was adequate—a dubious assumption that does not appear to be borne out by the facts—then 15 percent is entirely reasonable as a credit for any new law. Corporate earnings before Federal taxes on income were approximately 10 percent during the base-period years 1936 through 1939 whereas during the proposed base years they were in excess of 20 percent. During this period, that is 1946 through 1949, small business concerns generally experienced much lower earnings than the national average.

The invested capital method is the only method available to newly formed corporations. The excess profits tax imposed on them was extremely burdensome when under the old law a maximum of 8 percent was allowed. As an alternate, newly formed corporations might be allowed credits computed at higher rates than for other concerns which have alternate methods available. The relief provision contained in section 722 (c) does not afford relief to such newly formed corporations. The technical requirements of the old law are quite complicated and often, in the case of small concerns, desiring the use of the invested capital method necessary data cannot be obtained. As an alternate, invested capital as disclosed by the tax return might be used, adjusted of course, to known tax bases of assets, viz, depreciable assets and so forth. In small corporations, it would be rare indeed where such a method of determination would overstate equity invested capital and it is believed that substantial justice would result. Such corporations should be permitted to prove if they can, higher values of assets.

Relief provisions

At the outset it is submitted that the provisions of relief sections are too complicated to the proper administering of the law. The substantive provisions are on the whole adequate but it is apparent that effective directives to governmental agencies administering the law are necessary if the relief intended is to be secured. In numerous instances, administration of the law largely nullified the intent of Congress to grant relief. In this connection reference is made to the innumerable statements contained in the Treasury bulletin on excess profits tax. It is believed that this criticism is entirely justified and the inadequacy of the aforesaid bulletin is borne out by the fact that the Excess Profits Tax Council

has deemed it necessary to publish numerous interpretive EPC's to rescind and explain the bulletin.

The burden of proof placed upon the taxpayer seeking relief was unduly burdensome, particularly when a field agent, if the resulting relief to his mind was too high, "administratively determined" that a different approach granting little or no relief was the proper one. This would be offered without the slightest proof. Often an intelligent approach to the problem is beyond the average agent's ability to understand and the attitude has been noticed that things beyond the comprehension of the agent are incorrect per se. Undoubtedly there are many agents handling claims that are well qualified but such agents are not assigned to cases developed by small business concerns.

The development and presentation of claims is a costly process and open only to taxpayers who have adequate funds to prosecute them. Moreover, the cost of administering the law by Government is correspondingly high. As a result, relief provisions for the many small business concerns who had "good" claims is a myth.

The best form of relief for the small business concern that could be adopted would be based upon the principle that would require mandatory reduction in taxes in the event the taxpayer can establish his right to relief.

If determination of relief on the industry basis is used the question of what constitutes an industry raises numerous problems. For instance, 10 percent of the companies in a given industry may account for over 70 percent of the income realized. In addition, such companies may also be members of more than one industry and without departmental statements of profit and loss a tremendous distortion could obtain. This could work to the detriment or benefit of the taxpayer and conversely, the Government.

If the provisions are based entirely upon the base-period facts one can generalize that no small corporation would obtain relief since the tax rates of smaller businesses were generally lower than those of large corporations. This would not be an insurmountable objection if some adjustment was made. Of course, the easiest solution would be to increase the specific exemption, so as to eliminate most if not all of small business claims.

Any classification of corporations by industry would necessarily have to be based upon activities during the base period rather than an excess profits tax year. We believe this an essential since during periods of war economy many companies engage in activities entirely unrelated to their civilian production.

If relief is based upon war-year data using civilian industry classifications relief might be granted or denied by reason of activities unrelated to the basic civilian business of the taxpayer. We have observed as mentioned above, the marked tendency of corporations to engage in activities unrelated to their civilian business. This may well result in profits at rates which vary materially from those experienced in civilian pursuits.

The insurmountable problem as we see it is how would the Treasury Department classify such businesses as General Motors Corp., Radio Corporation of America, and Philco Corp. In these three companies such diverse products as automobiles, trucks and busses, radios, phonographs, records, and household appliances are produced and yet the latter two companies are generally regarded as being members of the same industry. In addition, in certain areas GM and Philco are competitive and yet one would be classified in the automobile industry and the other in the radio industry. In the absence of divisional or departmental profit-and-loss statements it is not seen how a true industry norm can be established that would afford adequate relief to any business and particularly to small business.

Reference is now made to the data published for the years 1947 through 1949 by the Federal Trade Commission and Securities and Exchange Commission under the title of "Quarterly Industrial Financial Report Series for All United States Manufacturing Corporations."

We make the dubious assumption that all large corporations regardless of their industrial classification experienced during the years 1947 through 1949 the same high level of earnings as large corporations did in the aggregate. By doing this we may regard the national total of this series as being data for one industry. If your committee is unwilling to grant this assumption it is then pointed out that if there are areas in which large corporations earned less than such national average it necessarily follows that other members of this group realized earnings in excess of the national average. Small business concerns who would be classified with this latter group as members of the same industry would

effectively be denied relief regardless of any reasonable adjustments to the data that could be made.

In the race to produce consumer goods after World War II the large corporation had a distinct advantage over the small corporation after complete conversion was made. In 1947 corporations having assets of $5,000,000 and over (hereinafter sometimes referred to as large corporations) owned over 80 percent of the manufacturing facilities. By 1949 this increased to almost 84 percent. During the same period their plant and equipment increased by 31 percent after allowance for depreciation. Such data does not include fully amortized facilities acquired under certificates of necessity during World War II. The inclusion of these items after allowance for normal depreciation would further increase the amount owned by large corporations.

It should be remembered that during this period the consumer public showed a preference for products of large corporations—consumer durables—which were unavailable during the war. Such a list includes automobiles, major household appliances, radios, and new products such as television sets and the like over other items.

This is borne out by the fact that in 1949 large corporations accounted for 75 percent of the sales made by all manufacturing corporations as compared with 70 percent in 1947. During the same period the large corporations' profits before taxes increased from 75 percent of the national total in 1947 to 85 percent in 1949.

In the case of small business there is observed a downward trend in production assets, earnings, and stockholders' equities.

In view of this evidence relief would be automatically denied small business if the industry norm included data of large corporations in each industry.

As a group small manufacturers did not compete successfully in the postwar period and such tendencies would be more marked in a war economy since most of the manufacturing facilities are owned by large corporations.

In the case of the newly formed small corporation the problem is even more acute. No relief would be forthcoming if based upon data for the years 1946 through 1949. Moreover, if the excess profits years are used as a norm, an income at a rate substantially over that experienced by the large corporation would be needed before relief was granted to the small corporation.

Relief provisions based upon such industry-wide data would put small business in direct competition with large business in this area and there is an abundance of evidence that this is tantamount to discrimination against the small corporation.

To provide the necessary revenue it has been suggested that base period earnings of the years 1946 through 1949 be reduced by a percentage to arrive at the excess profits credit. Some political sources have indicated that 80 percent be allowed. In view of the high corporate earnings experienced by the large corporation since the war (for example, one large Midwest corporation has increased its sales by 50 percent over peak war-years sales and is presently paying more income taxes than it did during the war) it is readily seen that little or no excess profits tax on a relative basis would be collected from such corporations, and a disproportionate amount would be borne by the small corporation.

It is therefore recommended that if the proposed excess profits tax is to be regarded (with the resulting tax being borne according to ability to pay) as a revenue-producing measure that the following be considered:

Amount of excess profits credit

Base period income:	*Percent*
Up to $50,000	100
From $50,001 to $100,000	95
From $100,001 to $500,000	90
$500,001 to $1,000,000	85
Over $1,000,000	80

In a partial mobilization situation no excess profits tax law should be considered without a review of the impact of controls on the business community. Without regard to priorities given to war business, allocations of remaining critical and other materials for the civilian economy would probably be based upon consumption during the years 1946 through 1949. Again the large corporation would have an advantage over the small corporation as it has been shown that in the aggregate they produced on a percentage basis more in each successive year from 1947 through 1949.

We think that the major fallacy, regardless of the form any relief provision might take, lies in including of all members of an industry, regardless of size, in the norm.

For instance, it has been recognized that in big business there is a growing tendency to increase the investment of plant and equipment in relation to each worker directly employed on production. The investment is made by management with the purpose of reducing costs. Three examples will suffice to demonstrate. Assume that the manufacture of tobacco products is regarded as one industry. There is no relationship between the production methods used by a large cigarette manufacturer and those employed by a cigar manufacturer employing very little or no production machinery. Yet for this purpose both are members of the same industry. Nor is it seen how du Pont with its automatic processes can be classified with a small manufacturing chemist who employs manual processes.

And finally, United States Steel and other large steel companies have continuous strip mills a half mile long controlled by one person. Should the producer of pig iron having one converter be placed in the same category?

And granting the necessity of recognizing these differences in production methods as actually requiring a breakdown of major industry classifications into component parts, we create an administrative problem of classification that has no equitable solution. Moreover, the problem is further complicated by the fact that a large portion of our manufacturing companies are members of more than one industry.

And finally, in the Government's effort to step up production for both civilian and military consumption, the most modern and efficient production tools that our economy possesses will be utilized first to their full capacity. As a nation, we are thankful that we have them since they represent one of the most valuable weapons our country owns. Under our American system the owners of these tools are entitled to a profit for their use and the ownership thereof is largely vested in the large corporations.

We do not raise the question of how a du Pont or General Motors would obtain relief under the proposed provisions. This is not our problem. We are interested in small business.

Capital gains

Capital gains should not be included in determining excess profits net income.

Normal and surtax computation

In the event that the invested capital credit rate is 15 percent or thereabouts, the excess profits tax and normal and surtax should be computed as under the 1945 law. If the rate of return allowed is 8 percent or thereabouts—a truly unrealistic rate under 1946 through 1949 conditions—tax computations should be made as under the 1940 law. During the old base period net return on stockholders' equities before income taxes was approximately 10½ percent. Such rate is based upon the Security and Exchange Commission series of registered corporations. Comparable data for the proposed base period are not available since this series was discontinued at the close of 1947. As a substitute, the Security and Exchange Commission joined with the Federal Trade Commission in 1947 and commenced publishing the industrial financial report series which covers all manufacturing concerns in the United States. A review of this new series discloses that from January 1, 1947, to the end of 1949, net return on stockholders' equities before income taxes is in excess of 20 percent.

An intelligent answer as to this computation lies in the two variables—the normal and surtax and the excess profits tax rates during the excess profits tax years and the amount of the specific exemption. It is therefore recommended that in view of these unknown factors taxpayers be granted an election so that a change in method of computation or specific exemption will not result in an increased tax for invested capital corporations as resulted when the law was amended in 1941.

This is particularly true of new corporations who are compelled to use the invested capital method in computing their excess profits and income credit.

Tax concept—one or many

The excess profits tax, normal and surtax, should be treated as one tax for all purposes.

A number of injustices arose under the old law by treating each tax separately. It is recalled that in applying the carry-backs provisions the Commissioner collecting interest on potential deficiencies from due date of return, while disallow-

ing interest on potential overassessments prior to the date of claims. We are informed that the Bureau's attitude has not changed although taxpayers are now granted the right to object to the method of interest computation. It would seem desirable to redraft sections 292 and 3771 since this issue appears to be unsettled.

Moreover, it would seem desirable to give the Tax Court jurisdiction over all matters involved including interest computations. There seems to be no compelling reason why internal revenue agents could not settle the interest question when they are settling income tax issues. Such a change would undoubtedly expedite settlements and do away with the costly remedy of taking a matter before a court of record as is required by the present laws.

Binding election

The taxpayer should not be bound by his election. So many changes can be made by Congress that substantial justice can only be obtained when taxpayer has a right to elect. Therefore we recommend that each taxpayer each year be permitted to elect the invested capital or earnings method of figuring excess profits tax credit.

By the adoption of our proposals, namely:

Specific exemption	$40,000
Excess profits credit:	
Based upon income, 1946–49, to be used as base period with election to select any 3 of the 4 years.	
Based upon invested capital (and inclusion of all borrowed capital with disallowance of interest in total):	
	Percent
Up to $500,000	15
$500,000 to $2,000,000	12½
Over $2,000,000	10
Exclusion of capital gains from excess profits income.	

An effective relief provision based upon old 722 with a congressional directive to administering agency directing them to administer the law in accord with the intent of Congress.

the small business concerns would be afforded necessary relief which was denied them under section 722 at very little loss in revenue, any excess profits tax would be borne by those concerns having the ability to pay and finally the increasing discrimination against the small-business firm would not be present—at least in this area.

The further we have gotten into this question, the more firmly we have become convinced that an excess profits tax is not the right answer to the present revenue raising problem. It is almost impossible to draw a fair and equitable excess profits tax bill, and then no matter how good the bill might be, the administrative burden would be tremendous.

A number of the members of our association have suggested as an alternative an emergentcy defense tax, this tax being a flat percentage of the corporation income tax due as computed at the present normal surtax rates.

The application of this suggestion would be that if under the present rates a corporation owed $20,000 and the emergency defense tax rate was 10 percent the total bill then would be $22,000, or $25,000 if the emergency defense tax rate was 25 percent.

The CHAIRMAN. We will next hear from Mr. Haley, of the National Coal Association.

Mr. Haley, will you come forward, please, and identify yourself for the record?

STATEMENT OF JAMES W. HALEY, SECRETARY, SPECIAL TAX COMMITTEE, NATIONAL COAL ASSOCIATION, WASHINGTON, D. C.

Mr. HALEY. Mr. Chairman and gentlemen of the committee, my name is James W. Haley. I am secretary of the special tax committee of the National Coal Association, and I am accompanied here today by Mr. L. H. Parker, who is chairman of the committee. I am also

vice president of Jewell Ridge Coal Corp., operating coal mines in the States of Virginia and Kentucky, and vice president of Virginia Smokeless Coal Co., which is engaged in the sale of bituminous coal in the eastern, southern, and midwestern markets. Prior to my affiliation with the Jewell Ridge Coal Corp. and Virginia Smokeless Coal Co., I was secretary and general counsel of the National Coal Association.

The National Coal Association is the trade association of bituminous-coal-mine owners and operators of the United States and has in its membership coal producers in every major coal-producing State in the Nation, and represents approximately 75 percent of the total commercial production of bituminous coal in the Nation.

We are aware of the need of the Government for revenue, and are not opposing a tax which would bear heavily on extraordinary profits due to the present defense program. However, such a tax should not be designed so as to dry up the net income upon the volume of which approximately 75 percent of the Government's revenue depends. If we discourage the creation of income, the revenues of the Government will be seriously affected.

We feel the Ways and Means Committee did a good job in producing H. R. 9827, in view of the extremely limited time which that committee considered available. There are, however, several of the features of that bill which we feel should be changed, and I shall deal specifically with the more important of the provisions we feel should be amended.

1. Determination of base period years: H. R. 9827 provides for the selection by the taxpayer of the best 3 out of 4 years of the period 1946–49, inclusive. We feel quite strongly that the taxpayer should be allowed to select the earnings of any one of these 4 years as representing his normal earnings. In other words, the taxpayer's normal peacetime earnings should be represented by his best peacetime year rather than an average of all or three or two of the base period years. The taxpayer should have the right to change his selection at any time up to the time the tax is finally determined; if he is not given this right, then at least a axpayer who has given waivers should be accorded that right.

The 1-year yardstick will eliminate that great majority of cases which require special relief. It is true that the House bill is a great improvement over the World War II excess profits tax law, which contained in section 722 general relief provisions most difficult of administration. However, there are numerous cases in the House bill where relief provisions have been inserted. An examination of these provisions shows that many of them could be eliminated if the 1-year yardstick were adopted.

An examination of the record of the bituminous-coal-mining industry for the period 1946 through 1949 will, I believe, demonstrate beyond question that it would be inappropriate to consider the average of any 3 years or even any 2 years within the period as a fair measure for taxpayers within the industry.

In 1946, production of bituminous coal was 534 million tons. It will be recalled that early in the year there was a lengthy strike which resulted in seizure of the mines by the United States Government and negotiation of the Krug-Lewis agreement. According to the Bureau of Internal Revenue, 627 companies in the bituminous-coal-mining industry had no net income in 1946.

Production in 1947 was 631 million tons. But even in this year of high production there were 415 strikes in the industry. While 1947 is generally considered a good year from an earnings standpoint, there were, nevertheless, 466 companies in the bituminous-coal-mining industry that reported no net income for the year, according to the Bureau of Internal Revenue.

1948 was generally considered to be a fairly good year in the bituminous-coal-mining industry. Production in 1948 was almost 600 million tons. But even in this year there were 561 separate strikes, resulting in a loss of almost 60 million tons of coal.

In 1949 the miners' union unilaterally imposed on the bituminous-coal industry the 3-day week and the so-called stabilizing period of inaction. As a matter of fact, there was very little regular production during the entire year of 1949. Production for 1949 was 438 million tons, almost 200 million tons less than the production for 1947.

In sumary on the point, we may say with respect to the suggested base period as applied to the bituminous-coal-mining industry that for a good part of 1946 and 1947 the mines were in possession of the Government and that in 1949 there was little if any regular sustained production due to the widespread national strikes. Even in 1948 I am sure there were a number of companies in the coal industry which operated at a loss.

I might say that 1947 is the latest year for which the Bureau has published statistics of income on corporations.

Certainly, as to the bituminous-coal-mining industry, taxpayers should be permitted to select any one year as the base period year.

The House Ways and Means Committee apparently realized that many taxpayers suffered so-called abnormalities during the base period. According to the House bill, if the year or years in which the abnormality occurs is included in the three highest years, the taxpayer may substitute for his actual income in the year or years in which there was an abnormality an amount determined by reference to an index based on the base period yearly rate of return for the industry to which the taxpayer belonged in the year of the abnormality.

It is submitted that for reasons stated the proposed treatment of abnormalities contained in the House bill would not be fair to the bituminous-coal-mining industry. The difficulty in such an approach as applied to the bituminous-coal-mining industry is that in the years of obvious gross abnormality in the base period, 1946 and 1949, the entire industry was subjected to unusual conditions as the result of national strikes. This, of course, would be reflected in any industry classification for such years which might be proclaimed by the Secretary of the Treasury.

2. Alternative basis for growing corporations: It is noted with interest and gratification that the House bill provides an alternative credit basis for growing corporations. This credit is computed from the income of the last 24 or the last 12 months in the taxpayer's base period, whichever is higher.

Justifying the position taken in the House bill, the Ways and Means Committee in its report states:

> The theory upon which the alternative credit for growing business is based is that by the end of the base period the taxpayer will have reached or will be approaching maturity so that its income for the last months of the base period

will be reasonably representative of its normal earnings. This logic would lead to the exclusive use of the final year in the base period, 1949. However, in many industries, 1949 earnings were substantially less than those of 1948, and in these industries a growing corporation might receive a larger credit based upon the experience of the last 2 years than one based on the single year 1949.

This theory would not apply appropriately to the bituminous-coal-mining industry for the reason that 1949, the last year of the base period, was the year of most serious strikes in the bituminous industry. For example, there were a number of growing corporations in the bituminous-coal-mining industry which had developed extensive properties to be brought into operation in the latter part of 1948 or the first part of 1949. Thus, the growth factor would not be reflected in 1948 and could not be reflected in 1949 due to the strike period. It is suggested that this situation be corrected in the House bill by the simple solution of changing the credit to be computed from the income of any 12 consecutive months of the last 24 months of the base period instead of the last 24 or the last 12 months in the taxpayer's base period.

Of course, the problem of the growing corporations, as well as most of the other unusual cases, would be adequately taken care of if the Congress would see fit to permit the 1-year base period standard.

3. Earnings credit: H. R. 9827 would provide an earnings credit of 85 percent of the base period average earnings. The World War II law provided 95 percent. We see no reason why the credit should not be 100 percent. The stated intent of Congress, as expressed in the Revenue Act of 1950, is to tax excess profits accruing to corporations as the result of the national-defense program in which the United States is now engaged. Giving less than 100-percent credit for base period profits results in an additional tax on normal income, contrary to the stated intent of Congress.

4. Minimum credit in lieu of specific exemption: H. R. 9827 provides no specific exemption, but provides a minimum credit of $25,000. We believe this should be changed to a specific exemption of $25,000. Doing so would be in accord with the principle recently adopted by Congress in the interim tax bill, which provided a $25,000 exemption in the computation of the surtax. The stated purpose of the Secretary of the Treasury in advocating the $25,000 minimum credit was to help small corporations. A $25,000 specific exemption would do much more for relatively small corporations than would a $25,000 minimum credit.

We are opposed to the graduated point. We see no point in the graduation whatsoever.

5. Graduated rates of invested capital credit: H. R. 9827 would allow an invested capital credit of 12 percent on the first $5,000,000, 10 percent on the second $5,000,000, and 8 percent on all over $10,000,000. We believe this graduation of rates is based on unsound principles. Obviously, the intention of this graduation is to extract higher taxes from large corporations. Attention should be given to the fact that the stock in large corporations, to a much greater extent than is the case in small corporations, is held by individuals with relatively small ownership interests.

The modest savings of the average American are tied up in the stock of large corporations, not in the stock of small corporations. The owners of the huge corporations are not, generally speaking, the

very wealthy but those whose few hundred dollars of savings are tied up in stock, along with the insurance proceeds left to the widows and orphans of this country. The graduation of invested-capital credit strikes at these people.

6. Borrowed capital: We recommend that borrowed capital under the invested-capital method be included at 100 percent, with disallowance of the interest deduction.

7. Retroactivity: We urge that the effective date of this tax be made January 1, 1951, instead of July 1, 1950. If this retroactive feature is contained, corporations will be in a dilemma with respect to closing their books and determining their year-end dividend policy. Such dividends will be substantially less because a retroactive tax is contemplated. The loss of tax from individuals because of such reduced dividends would largely offset the excess profits tax secured from corporations applying to only a 6 months' period.

8. Expiration date: We feel that H. R. 9827 should contain a definite expiration date, certainly not more than 3 years from the effective date.

9. Natural resource industries: We are pleased to note that H. R. 9827 continues in effect section 735 of the World War II law. That section recognizes the peculiar position of the natural-resources industries, with wasting assets, by providing certain credits for production in excess of normal production.

There are some very important changes which we feel are necessary in this section. However, the Ways and Means Committee decided to continue the section without change until there is time, after the end of this year, to give more complete study to the problem. In view of that decision, we will not now take time to explain our proposed revisions of the section. As an appendix to my statement, I am, however, for the information of the committee, filing the text of our proposed revision of the section.

Any tax similar to an excess profits tax is based on net income. Obviously, any inequities which exist in the computation of net income are magnified by the impact of an excess profits tax. It is unfortunate that a general tax-revision law removing inequities could not be passed before adding an excess profits tax.

As to the coal industry, the revenue bill of 1950, as passed by the House, corrected an inequity which had long existed as to the depletion rate allowed our competitors, the oil and natural-gas industries, and the depletion rate allowed the coal industry. That bill contained a 10-percent depletion rate for coal in lieu of the present 5 percent. We recognize the fact the Congress is acting under great pressure at this time, but we do feel this inequity should be corrected at the earliest possible opportunity.

We are grateful to this committee for the opportunity to be heard.

That concludes the statement which I have on behalf of the coal producers of the United States. I should like permission now to file for the record an additional statement which is submitted on behalf of the coal exporters of the United States. This statement centers around the fluctuations in the coal export business in the base period. I point out in my statement that in the peak year of 1947 coal exports were almost 47,000,000 tons, and then in 1949 they were down to

something under 13,000,000 tons. In 1950 they will be less than 2,000,000 tons, but there is much interest being evidenced now in the European countries in the importation of American coal. And, certainly, our allies across the Atlantic need much coal, and the only place they can get it is from the United States.

The CHAIRMAN. You may file your additional statement in the record.

(The statements referred to are as follows:)

STATEMENT OF JAMES W. HALEY, GENERAL COUNSEL, COAL EXPORTERS ASSOCIATION OF THE UNITED STATES, INC.

The Coal Exporters Association of the United States, Inc., is, as its name implies, an incorporated voluntary association of coal exporters. The association, as presently constituted, was incorporated in 1945 as successor to a similar unincorporated organization which had its inception back in the years immediately following World War I.

Purposes of the association is to promote and encourage the increased exportation of the products and byproducts of the coal and coke industries in the United States; to promote and encourage the consumption of United States coal and coke in any and all foreign countries; to cooperate with members of the coal and coke industries and the public on problems affecting the exportation of coal and coke: to prepare, develop, compile, issue, and distribute such written or other information and materials as may be deemed advisable to carry out these purposes; to use all lawful means of promoting the general welfare of the exporters of United States coal and coke.

The association's membership exports more than 90 percent of all the coal exported from the United States.

The coal-producing industry of the United States is highly competitive, not only within the industry itself but with the oil, gas, and hydroelectric industries, all seeking constantly a larger part of the over-all fuel and energy market. The export of United States coal has a healthy and stabilizing effect upon the entire coal industry, and the general economy of our country. To the quantitative extent that our coals are shipped abroad, running time is improved and equalized in the United States mines, labor given more employment, railroad revenues increased, railroad employees benefited, and competition created for gearing production within a reasonable range of peak wartime requirements.

Notwithstanding the fact that the United States is the largest coal-producing country in the world, our coal and coke exports (not including Canada) throughout the years have varied from a few thousand tons a year to the peak export of 47,758,443 net tons in 1947. Due to the fact that Canada is a contiguous country, and the related fact that shipments to Canada are handled differently from our oversea movement, that market has never been looked upon as an export market in the true sense; therefore, any figures cited herein, or in the accompanying table, will not include our coal shipments to Canada, although they are indeed sizable, varying between fifteen and thirty million tons annually.

The attached table shows exports of solid fuels (coal and coke) for the years 1946 to 1949, inclusive, to oversea destinations. The four columns on the right show the tremendous variation in those 4 years. It will be noted that the tonnage shipped in 1949 was only 50.4 percent of the 4-year average, while 1947 tonnage was 182.2 percent of the 4-year average, and 1946 and 1948 were about 80 percent of the 4-year average.

Of all American industries, it is doubted that there is another one which shows the fluctuations in business activity reflected in the record of the American coal-export business. Naturally, the coal-export business is subject to the same difficulties which beset the coal-producing industry in the United States, such as national strikes, governmental regulations, car shortages, etc. But over and above the many outside influences which bear directly on the coal-producing industry of the United States, and with equal force upon the coal-export industry, the coal exporters of the United States are subject to serious problems of demand within the foreign consuming areas, hazards of ocean shipping, monetary exchange, import licensing, and political considerations in foreign countries, with whch the members of the committee are no doubt familiar.

The table appended to my statement and a realization of the factors which led to the wide variation in the figures shown thereon, is conclusive proof that it will be grossly unfair to the coal export industry of the United States to measure normal earnings on the basis of an average of 3 years in the base period 1948 through 1949, as is provided in H. R. 9827.

It is submitted that beyond question so far as the coal-export industry of the United States is concerned, the nearest thing to a fair standard for measuring profits would be on a 1-year base period basis.

Moreover, it should be kept in mind that due to the nature of the business the coal exporters as a general rule would have little or no basis for credits under the invested capital method.

From our 1947 peak export tonnage overseas of nearly 48,000,000 net tons, we dropped in 1949 to 13,341,841 net tons. Exports in 1950 will total less than 2,000,000 tons. This demonstrates conclusively that there are no combined 3 years in the industry that could be considered normal. The United States has been able to export its coal in large quantities only in those periods when the European production was insufficient to meet consumer demand. Our high vessel rates, contrasted with Britain's willingness to move her coal in ballast, in order to gain and retain markets, have contributed in no small degree to the inability of the United States coal exporters to sell their product abroad. England even made sizable inroads into our coal markets in neighboring South America due to her advantage in ocean freight rates and her return purchases of beef and other products from the Southern Hemisphere.

The fluctuations in the coal-export industry are further demonstrated by the record of the industry antedating 1946. In the year 1926 we shipped approximately 22,000,000 tons of coal overseas, over 12,000,000 of which was shipped to the United Kingdom by reason of the coal strike in England that year. Nineteen twenty was another year of sizable coal exports overseas, when some 22,000,000 tons were shipped out of the country.

In recent weeks what has been expected for several months has materialized. Notwithstanding our low exports of 1950, practically every country in Europe today is crying for American coals, including England. Boat rates have jumped more than $3 per ton, and efforts are being made to take some of our merchant vessels out of the laid-up fleet to meet the increasing demand for ships.

Why this sudden turn?

Let us look at the European coal production.

In September 1950 Great Britain produced 18,226,000 metric tons, or 715,000 tons less than in September 1949. Her monthly average production in 1937 was 20,354,000 tons. Between September 1949 and September 1950 the number of men so employed in Britain's mines declined 23,000.

During the first 9 months of 1950 France produced 37,678,000 metric tons, or 469,000 tons less than in the corresponding period of 1949.

Belgium's production during the first 9 months of 1950 was 20,141,000 metric tons, or 381,000 tons under the same period of 1949.

Italy's production likewise is down.

Western Germany's production is running about 6,000,000 tons above 1949, an increase of about 8 percent. However, the sharp increases in industrial activity has not been accompanied by a corresponding rise of coal output. A recent survey shows average industrial coal consumption in Western Germany is now about 30 percent higher than before the war, and for some industries, such as electric plants, consumption has risen by 95 percent. If Germany meets her export obligations for the fourth quarter of 1950, the remaining tonnage available for her own economy during the quarter will be short more than 2,000,000 tons. Cut-backs in her essential production industries seem inescapable.

The situation in every country on the continent is the same as it is in Germany, in greater or lesser degree.

Great Britain, the second largest coal producer in the world, is buying more than 1,000,000 tons of the United States coal for delivery between now and April 1, 1951.

Diagnosis is simple. Coal production in England has nowhere near kept pace with increased industrial activity, and the fact that in England and elsewhere in Europe, miners are leaving the pits for above-ground work in defense and other industrial plants portends that the situation will worsen long before it improves.

In sum, all this means that the United States is the only great reservoir for supplying coal, as well as other goods and defense matériel, in times of shortage,

and we must remember and never forget that unless we maintain our production and our "know-how" we will surely find ourselves in the position of needing to import the very things we are now in position to export.

We have plenty of coal, but it is of no use to anyone in its indigenous posture in the earth. It must be produced and marketed to be of value. It can only be produced and marketed under the free enterprise system if there remains sufficient incentive for American businessmen to risk their capital and devote their time and acumen thereto.

The coal-export business is a unique and risky business. It experiences more lean years than so-called fat ones. Some coal exporters tie their business in with other export business. Some try to coast through lean years on whatever profits they may have made in the years of profits. To unduly tax profits of coal exporters, which have always been ephemeral, and which over any sustained period show a very low average, would be to strike at the very heart of the industry, and thus eliminate from our economic arena this group of specialized American businessmen. This could not help but pull the lever, so to speak, and throw into reverse the beneficial effects that the production and export of United States coals has upon our whole economy, and hasten the day when we ourselves would be seeking to import the very products of which we now have a plethora, and as above pointed out, no country would have them for sale. We would like to see the United States remain an exporter. This can be done only if there remains a reasonable profit incentive.

APPENDIX A—*Principal oversea exports of solid fuels (coal and coke)*[1] *years 1946 through 1949*

[Net tons

Destination	1946	1947	1948	1949	Annual average shipments to each destination	Percent 1946 of average	Percent 1947 of average	Percent 1948 of average	Percent 1949 of average
All South America	1, 742, 039	2, 975, 623	1, 899, 283	829, 263	1, 861, 552	93. 6	159. 8	102. 0	44. 5
Europe:									
Sweden	1, 115, 043	2, 709, 083	585, 280	437, 012	1, 214, 105	91. 8	223. 1	49. 0	36. 0
Norway	753, 376	995, 295	46, 598	246	448, 879	167. 8	221. 7	10. 4	. 1
Denmark and Faroe Islands	1, 060, 464	2, 418, 165	52, 141	10	882, 695	120. 1	274. 0	5. 9	(2)
United Kingdom		675, 057			168, 764		400. 0		
Eire	11	1, 022, 149	28		255, 547	(2)	400. 0	(2)	
Netherlands	1, 700, 830	2, 745, 208	775, 600	466, 419	1, 422, 014	119. 6	193. 1	54. 5	32. 8
Belgium and Luxemburg	1, 665, 329	4, 860, 766	840, 004		1, 841, 525	90. 4	264. 0	45. 6	
France	5, 850, 831	13, 958, 133	9, 884, 590	4, 691, 584	8, 596, 285	68. 1	162. 4	115. 0	54. 6
Germany		54, 202	70, 777		31, 245		173. 5	226. 5	
Austria		102, 029	58, 447		40. 119		254. 3	145. 7	
Switzerland	333, 523	805, 439	420, 621	186, 655	436, 560	76. 4	184. 5	96. 3	42. 8
Finland	265, 370	637, 271	6, 273		227, 229	116. 8	280. 5	2. 8	
Azores	1, 608	6, 966			2, 144	75. 0	324. 9		
Spain			20, 117		5, 029			400. 0	
Portugal	464, 251	849, 402	257, 230	184, 275	438, 790	105. 8	193. 6	58. 6	42. 0
Gibraltar	9, 330	156, 884			41, 554	22. 5	377. 5		
Italy [3]	4, 935, 962	8, 996, 437	4, 689, 416	3, 941, 911	5, 640, 932	87. 5	159. 5	83. 1	69. 9
Free Territory of Trieste			60, 385	11, 226	17, 903			337. 3	62. 7
Yugoslavia	59, 906			6, 548	16, 614	360. 6			39. 4
Greece	91, 676	34, 056	62, 830		47, 141	194. 5	72. 2	133. 3	
Total Europe	18, 307, 510	41, 026, 542	1, 7840, 337	9, 925, 886	21, 775, 069	84. 1	188. 4	81. 9	45. 6
All Africa	877, 747	2, 082, 907	963, 601	611, 751	1, 134, 002	77. 4	183. 7	85. 0	53. 9
Japan			719, 596	1, 443, 329	540, 731			133. 1	266. 9
Other Asia	207, 040	353, 116	79, 207	45, 084	171, 112	121. 0	206. 4	46. 3	26. 3
Total Asia	207, 040	353, 116	798, 803	1, 488, 413	711, 843	29. 1	49. 6	112. 2	209. 1
Total	21, 134, 336	46, 438, 188	21, 502, 024	12, 855, 313	25, 482, 465	82. 9	182. 2	84. 4	50. 4

[1] Includes all coal and coke, but not briquets.
[2] Less than one-tenth of 1 percent.
[3] Figures through 1947 include shipments to Trieste.

Source: Reports of the Bureau of Mines.

RECOMMENDED REVISION OF SECTION 735

(Appendix to statement of James W. Haley)

In the new excess profits tax bill, insert a section (corresponding to section 735 of the old law) as follows:

"SEC. —. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES

"(a) DEFINITIONS.—For the purposes of this section, section 711 (a) (1) (I) and section 711 (a) (2) (k)—

"(1) PRODUCER; LESSOR; NATURAL GAS COMPANY.—The term 'producer' means a corporation which extracts minerals from a mineral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term 'lessor' means a corporation which owns an economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term 'natural gas company' means a corporation engaged in the withdrawal, or transportation by pipeline, of natural gas.

"(2) MINERAL UNIT, NATURAL GAS UNIT, AND TIMBER UNIT.—The term 'mineral unit' means a unit of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term 'natural gas unit' means a unit of natural gas sold by a natural gas company. The term 'timber unit' means a unit of timber recovered from the operation of a timber block.

"(3) EXCESS OUTPUT.—The term 'excess output' means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

"(4) NORMAL OUTPUT.—The term 'normal output' means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not beginning after December 31, 1949 (hereinafter called 'base period'), of the person owning the mineral property or the timber block (if such person is the taxpayer or a corporation which is a component corporation of the taxpayer under Supplement A). The term 'normal output', in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not beginning after December 31, 1949 (hereinafter called 'base period'), of the person owning the natural gas property (if such person is the taxpayer or a corporation which is a component corporation of the taxpayer under Supplement A). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the base period by the number of months for which the mineral property, natural gas property, or timber block was in operation by the taxpayer (or by a corporation which is a component corporation of the taxpayer under Supplement A) during the base period and by multiplying the amount so ascertained by twelve. In any case in which the taxpayer establishes, under regulations prescribed by the Commissioner with the approval of the Secretary, that the operation of any mineral property, natural gas property, or timber block is normally prevented for a specified period each year by events outside the control of the taxpayer, the number of months during which such mineral property, natural gas property, or timber block is regularly in operation during a taxable year shall be used in computing the average annual mineral units, natural gas units, or timber units, instead of twelve. Any mineral property, natural gas property, or timber block, which was in operation by the taxpayer (or by a corporation which is a component corporation of the taxpayer under Supplement A) for less than six months during the base period, shall, for the purposes of this section, be deemed not to have been in operation during the base period.

"(5) NATURAL GAS PROPERTY.— * * *.

"(6) MINERAL PROPERTY.—The term 'mineral property' means a mineral deposit (a mineral deposit to include tailings, ponds and basins, and slush or culm banks), the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction. The taxpayer at its election (such election to be a continuing election and subject to change at any time by the taxpayer) may

group properties operated as a unit in a 'mine' or 'mineral property' for the purposes of this section.

"(7) MINERALS.—The term 'minerals' means ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulphur, and talc.

"(8) TIMBER BLOCK.— * * *.

"(9) NORMAL UNIT PROFIT.—The term 'normal unit profit' means the average profit for the base period per mineral unit for such period, determined by dividing the net income with respect to minerals recovered from the mineral property (computed with the allowance for depletion computed in accordance with the basis for depletion applicable to the current taxable year) during the base period by the number of mineral units recovered from the mineral property during the base period.

"(10) UNIT NET INCOME.—The term 'unit net income' means the amount ascertained by dividing the net income (computed with the allowance for depletion) from the coal or iron ore or the timber recovered from the coal mining property, iron mining property, or timber block, as the case may be, during the taxable year by the number of units of coal or iron ore, or timber, recovered from such property in such year. In respect of a natural gas property, the term 'unit net income' means the amount ascertained by dividing the net income, computed in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, from such property during the taxable year by the number of natural gas units sold in such year.

"(b) NONTAXABLE INCOME FROM EXEMPT EXCESS OUTPUT.—

"(1) GENERAL RULE.—For any taxable year, the nontaxable income from exempt excess output for such year shall be an amount equal to the excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

"(2) COAL AND IRON MINES.—For any taxable year, the nontaxable income from exempt excess output of a coal mining or iron mining property which was in operation during the base period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year, or an amount determined under paragraph (1), whichever amount is the greater.

"(3) TIMBER PROPERTIES.— * * *.

"(4) COAL AND IRON MINES AND TIMBER PROPERTIES NOT IN OPERATION DURING BASE PERIOD.—For any taxable year, the nontaxable income from exempt excess output of a coal mining or iron mining property or a timber block, which was not in operation during the base period, shall be an amount equal to one-third of the net income for such taxable year (computed with the allowance for depletion) from the coal mining or iron mining property or from the timber block as the case may be.

"(5) NATURAL GAS COMPANIES.— * * *.

"(c) NONTAXABLE BONUS INCOME.—The term 'nontaxable bonus income' means the amount of the income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of—

"(1) A mineral product or timber, the exhaustion of which gives rise to an allowance for depletion under section 23 (m), but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the output in excess of such quota; or

"(2) A mineral product extracted or recovered from mine tailings by a corporation which owns no economic interest in the mineral property from which the ore containing such tailings was mined, but such amount shall not exceed the net income attributable to the output in excess of such quota.

"(d) RULE IN CASE INCOME FROM EXCESS OUTPUT INCLUDES BONUS PAYMENT.—In any case in which the income attributable to the excess output includes bonus payments (as provided in subsection (c)), the taxpayer may elect, under regulations prescribed by the Commissioner with the approval of the Secretary, to receive either the benefits of subsection (b) or subsection (c) with respect to such income as is attributable to excess output above the specified quota.

The CHAIRMAN. Is there anything further?

Mr. HALEY. That is all I have, Mr. Chairman.

Senator CONNALLY. Is it your idea to increase or decrease the export of coal? Is that what your idea is designed to do?

Mr. HALEY. Designed to increase.

Senator CONNALLY. You do not want any excess profits tax?

Mr. HALEY. We are not opposing the excess profits tax.

Senator CONNALLY. Are you for it?

Mr. HALEY. Well, we recognize that the Government needs additional revenue and I personally do not see any particular objection to the excess profits tax. I am suggesting changes in the House bill.

Senator CONNALLY. All right.

The CHAIRMAN. Very well, we thank you very much.

Mr. HALEY. Thank you.

The CHAIRMAN. Mr. Carroll, you are appearing for the National Foreign Trade Council?

STATEMENT OF MITCHELL B. CARROLL, SPECIAL COUNSEL, NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N. Y.

Mr. CARROLL. Yes. My address is 66 Broad Street, New York. My name is Mitchell B. Carroll.

I should like, with your permission, to submit for the record my statement.

The CHAIRMAN. You may do so.

(The statement referred to is as follows:)

STATEMENT OF MITCHELL B. CARROLL, SPECIAL COUNCIL, TAX COMMITTEE, NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N. Y.

Mr. Chairman, and members of the Committee on Finance: The National Foreign Trade Council has studied H. R. 9827 and is glad to note that it contains a number of provisions that accord with its recommendations presented to the Ways and Means Committee of the House. However, on behalf of its membership which includes most American companies with investment or business interests abroad I ask leave to call your attention to certain facts relating to income from foreign sources in the hope that various provisions in the hurriedly framed House bill may be liberalized so as to facilitate the realization of the Government's declared policy of aiding in the economic development of foreign countries.

The first question is, What should be the criterion for determining excess profits from foreign sources? For the purposes of the World War II excess profits tax, the excess profits were measured, briefly, by the excess over an assumed normal income, computed by either (*a*) applying a certain rate of return to invested capital, or (*b*) averaging the income of certain previous years called a base period. Essentially the same criteria are embodied in the House bill.

Regardless of how well these criteria may have served in computing excess profits from domestic sources, let us consider how either of these criteria would be applied in determining whether there have been excess profits from foreign sources. In the first place, it must be kept in mind that a minority of domestic corporations derive profits from operating abroad through direct branches. On the contrary, a majority of domestic corporations derive income from foreign sources in the form of dividends from subsidiaries operating abroad, interest on loans to subsidiaries, royalties from patents and similar rights, and management fees or service charges received from foreign corporations for furnishing technical data and "know how."

WAR LOSSES

Companies which had property in enemy or enemy occupied countries were deemed by section 127 of the Internal Revenue Code to have lost the property in enemy countries when war was declared on December 7, 1941, or a later date, and those in areas overrun by the enemy were deemed to have lost their property when the area was occupied.

Because of the abnormal situation that exists in Germany and Japan some companies have not, from a tax viewpoint, yet declared their properties as recovered. In cases where the owners have retaken possession they cannot transfer profits out of either country. Those who wrote off properties in eastern European countries which fell under Russian domination have as a rule not been able to take them back. Corporations which recovered their properties in China have in fact lost them again.

Obviously such unrecovered property could not be included in invested capital, and if recovery takes place in 1950 or a later year the presumed income should not be considered as excess profits net income.

BLOCKED INCOME

Since 1945 most of the countries of Europe, Asia, and even South America have resorted to exchange controls to protect their dwindling foreign exchange reserves, and income derived by nonresidents has been blocked. The situation has been so general and so serious that the Treasury, after 2 years of study, finally issued on March 1, 1950, mimeograph 6475, which allows domestic taxpayers to elect to defer for United States tax purposes that portion of their income as long as it is not convertible into dollars.

Even where profits have in principle been remittable, limitations have been placed on the amount of income that may be transmitted.

If income of past years should become convertible into dollars in 1950 or a later year, obviously it would be unfair to include it in the excess profits tax net income of the year of conversion. Where the blocked income consists of dividends from a foreign subsidiary, under provisions in H. R. 9827 such dividends would be exempted.

However, other classes of swollen income might be subject to excess profits tax in the year of receipt unless such income could be allocated to prior years under relief provisions in new section 454, Internal Revenue Code, as embodied in H. R. 9827. Obviously such released income is not excess profits and should also be covered by the credit.

HOUSE BILL—CRITERIA OF EXCESS PROFITS INAPPLICABLE

In view of the generally abnormal situation abroad, if the House bill criteria for determining excess profits were applied only with regard to foreign income what would be the result? What would be the foreign invested capital to which a prescribed percentage could be applied to measure excess profits?

Are the years selected in the House bill to be considered sufficiently normal to serve as a base period in computing the excess profits credit on an income basis? There are no reliable or acceptable answers to these questions.

In short, due to world conditions and circumstances over which the taxpayers have had no control, real income may have been accumulated over a long period and when released from blocking or restriction in a single tax period such income would appear to be excessive. This might occur under whichever system the taxpayer elects for the determination of excess profits tax liability. Obviously this would produce a highly inequitable result.

SUMMARY BY ALLEVIATIONS IN WORLD WAR II LAW AND H. R. 9827

In framing the World War II legislation, Congress acknoweldged the inappropriateness of subjecting certain foreign income to the excess profits tax and these provisions offer a partial basis for dealing with the present situation. In the first place, Congress, for obvious reasons, exempted from excess profits tax a foreign corporation not engaged in trade or business in the United States, under old section 727 (f), Internal Revenue Code. This same provision has been incorporated in H. R. 9827, as new section 452 (e), Internal Revenue Code.

Secondly, World War II legislation similarly exempted a domestic corporation which was tantamount to a foreign corporation, because it derived 95 percent of its gross income for a prescribed period from sources outside the United States and 50 percent from the active conduct of a trade or business (old sec. 727 (g), I. R. C.). This provision has been incorporated in H. R. 9827 as new section 452 (f), Internal Revenue Code.

Thirdly, World War II legislation granted a credit without limitations against excess profits net income for dividends from foreign subsidiary corporations if the domestic parent corporation took its excess profits credit on an invested

capital basis (old sec. 711 (a) (2) (A), I. R. C.). In H. R. 9827, this adjustment is provided by new section 433 (a) (1) (A), Internal Revenue Code, whether the excess profits credit is computed under the invested capital method or the income method. NFTC recommended this change to the Committee on Ways and Means. Correspondingly, the investments in stock of such foreign corporations were inadmissible assets (old secs. 715 and 720 (a) (1) (A), I. R. C.). The corresponding section in H. R. 9827 is new section 440 Internal Revenue Code.

All of these provisions taken together do not relieve the inequity particularly with respect to income of foreign branches of domestic corporations and with respect to income other than dividends from foreign subsidiaries.

SUMMARY OF PROPOSED AMENDMENTS

In behalf of our members we respectfully urge the Congress to enact in H. R. 9827 the provisions referred to above, and broaden their application.

1. May we suggest that your committee recognize, as has been done in numerous tax treaties, that the permanent establishment abroad of a domestic corporation is economically equivalent to a foreign corporation and should be treated in the same manner as a foreign corporation, or a domestic corporation, within the scope of old section 727 (g), Internal Revenue Code, or new section 452 (f), Internal Revenue Code, as embodied in H. R. 9827.

As may be seen in our presently applicable tax conventions with France, Canada, the United Kingdom, Sweden, Denmark, and the Netherlands, and in the tax conventions and supplementary protocols, awaiting ratification, which have been concluded with Canada, Belgium, the Union of South Africa, New Zealand, Norway, and Greece, a permanent establishment is taxable in the country where situated on the basis of a separate accounting which reflects the income properly allocable to it from transactions effected on an arm's length basis with the other establishments of the enterprise, just as if the permanent establishment were an independent foreign corporation.

The term "permanent establishment" includes, inter alia, an oil well, plantation, assembly plant, factory, sales office, and also an installation with substantial equipment of a construction enterprise engaged in building a harbor, dam or road. Such construction enterprises often operate under contracts the performance of which takes more than 12 months and if this proposal were not adopted they should be allowed to report fees received at the completion of their services on a percentage of completion basis as was allowed under section 736 (b), Internal Revenue Code, which has been incorporated in H. R. 9827 as section 453 (b), Internal Revenue Code.

The Commissioner of Internal Revenue should be authorized to define the term permanent establishment along the lines of definitions in our tax conventions. Obviously, the treatment provided in new sections 452 (e) and (f), Internal Revenue Code, as embodied in the House bill, could readily be applied to such a permanent establishment. If this provision were adopted it would be necessary to exclude from invested capital that portion of such capital which pertains to the foreign establishment, when the excess profit credit is computed on the invested capital basis, and to exclude the foreign establishment's income from the base period years when the excess profits credit is computed under the average income method.

Collaterally, we urge that just as a foreign corporation would not as a rule be included in a consolidated return under section 141, Internal Revenue Code, so corporations qualifying under new section 452 (f) and permanent establishments abroad as described above should be excludible from a consolidated return for purposes of the excess profits tax if the taxpayer so elects. We note that in section 201 of H. R. 9827 the provisions of section 141 (e) (7), permitting an election for a corporation qualifying under new section 452 (f), relate to both income and excess profits taxes and require inclusion of such corporations which have consented to be included in a consolidated return for a taxable year beginning after December 31, 1943.

The date of December 31, 1943, seems to have been copied inadvertently from section 141 (e) (7), Internal Revenue Code, and should be changed to allow a new election after December 31, 1949.

2. Congress recognized in the World War II law the fairness of allowing an unlimited credit for dividends from foreign subsidiary corporations, provided the domestic recipient computed the excess profits credit under the invested capital method. As previously stated, H. R. 9827 amends this credit to cover dividends from foreign corporations even if the domestic corporation takes its

excess profits credit on an income basis and we recommend the adoption of this amendment.

3. Domestic corporations often finance their foreign subsidiaries in part by means of loans, or contribute to their operations by way of licensing patents, secret processes, or similar rights, or supplying technical knowledge or administrative services. Such technical know-how is frequently supplied to foreign corporations which gave the licensor a block of stock to assure the latter's assistance in using the rights. We therefore urge that the unlimited credit for foreign dividends should also cover other types of income, including interest, royalties, management and service fees, from a foreign corporation in which the domestic corporation has a substantial interest. Such income would also be excluded from the base period income.

CONCLUSION

In closing, let me stress that the foregoing proposals are made in the light of the continuous state of abnormality abroad over the last 10 years during which period the amount of foreign income, for a variety of reasons, has been excessively low rather than excessively high.

Furthermore, we must assume that while engaged in military action against the enemy in certain areas, the Government intends to continue its economic action to build up resistance to the enemy in other areas. This job will have to be done in a large measure by American corporations operating abroad through permanent establishments, foreign subsidiaries, or by foreign corporations to which capital has been supplied by American corporations in the form of equity investment or loans, or to which patents have been licensed, or technical or administrative know-how has been supplied.

As the corporate rate for 1951 of 45 percent is already higher than the rates in many foreign countries, American corporations operating therein already suffer a serious competitive disadvantage, measured by the excess of the American rate over the credit allowed for the lower foreign tax. If liability to the excess profits tax is piled on top of existing high American rates, it will tend to destroy whatever disposition remains to go abroad and incur all the risks, expenses, and other burdens that are not encountered in the United States. Foreign business involves greater risks and costs than does domestic business. The superimposition of a United States excess profits tax on income from foreign sources seems definitely unwise. Such a tax would inevitably tend to block the flow of capital and enterprise to other areas whose economy should be built up in order to withstand the inroads of communism.

The importance of giving favorable consideration to private investments abroad is stated in the summary and recommendations of the Report to the President on Foreign Economic Policies, of Mr. Gordon Gray, and particularly in the following paragraphs:

"Private investment should be considered as the most desirable means of providing capital and its scope should be widened as far as possible. * * *

"Further study should be given to the desirability and possibility of promoting private investment through tax incentives, in areas where economic development will promote mutual interests, but where political uncertainty now handicaps United States private investment."

Obviously the amendments to give effect to the foregoing suggestions raise technical problems which can be discussed with the technical staff of the Joint Committee on Internal Revenue Taxation and we trust that you would have no objection to our doing so.

Mr. CARROLL. And then I will, in order to save time, simply emphasize some of the points that are contained herein.

The CHAIRMAN. Yes, sir; you may do so.

Mr. CARROLL. Contrary to what the others have done this morning, we are asking you to simply look at the income from foreign sources as if it were a separate problem from that of income from domestic sources.

Our first point is this: that when you look at income from foreign sources, per se, you realize that the criteria that have been adopted for determining what is excess profits, domestically, does not apply readily when related to foreign income.

In the first place, the reason is that in Germany, for example, and in Japan, and it can well be in other areas, east of the iron curtain, American companies that had investments, so to speak, prior to World War II, have lost those investments and have not actually recovered them. And those that have recovered their investments in China have again lost them.

So that your invested capital basis, to a large degree, is shot.

In the second place, even if you had recovered your properties in Germany and Japan, or in China, you could not get the income out. As a matter of fact, the situation as regards income from foreign sources has been so serious because of the general application of exchange restrictions and blocking, that the Treasury last spring issued a general ruling, Mimeograph 6745, permitting the taxpayer to defer for tax purposes blocked income. The reason being that if you could not get your income in, you could not pay the tax on that income unless you used other income or capital.

The CHAIRMAN. What treatment did we give the foreign income?

Mr. CARROLL. You permit the American corporation with blocked income for, say, a country like Argentina, to attach to his return a special return of deferrable income, it is called.

The CHAIRMAN. I was speaking of the World War II Act.

Mr. CARROLL. Well, you remember apropos of that you permitted in section 127, you deemed property situated in enemy countries to be lost as of the day that war was declared. And, if it was in occupied countries, it was deemed lost as of the time the enemy moved in and took over your properties. So that, generally speaking, you have a chaotic situation all over the world in regard to your income from foreign properties.

Because of the general inapplicability of these criteria we urged certain amendments before the Committee on Ways and Means, one of which was adopted. We pointed out that in World War II Congress had exempted, in the first place, from excess profits tax a foreign corporation that is not engaged in trade or business in the United States.

The CHAIRMAN. That is my recollection of it; yes.

Mr. CARROLL. Then, because it is in a similar situation to such a foreign corporation, you exempted a domestic corporation that derived 95 percent of its income from sources outside of the United States and 5 percent from the active conduct of a trader business.

We are glad to see that that provision has been embodied in the House bill. We heartily applaud that and hope that you will go along with it.

There are many corporations that have branches abroad, direct-owned, permanent establishments with a separate accounting, and from an economic viewpoint they are just in the same situation as a foreign corporation, or one of these old 727 (G) corporations, and we asked in the House that this same treatment be extended to them. We understand that some consideration was given to this proposal, but there was not enough time to deal with it and we hope, if you do have a spare moment, that possibly Mr. Stam and his associates can look at it again.

However, the great majority of American corporations operate abroad through subsidiary companies. And as a part of this gen-

eral program of economic development abroad, our corporations are encouraged to give their know-how and administrative experience, and all of that, to foreign corporations so that they can build up their plants abroad and be more efficient in production.

Our corporations derive their income from foreign corporations, and I am speaking mainly of foreign subsidiary corporations, through various ways. In the first place, dividends; secondly, interest; thirdly, royalties on patents licensed. And then also on management fees and fees for supplying know-how. That is not patented. And we are very glad to note that in the House bill they extended an exemption or a credit that had been granted for dividends received from foreign corporations where the domestic corporation was on an increased capital basis, to cover also the case where the dividends from a foreign corporation are received by domestic corporations which takes its excess profits credit on an income basis.

That is a net gain. It is very important. But we advocated that this credit be enlarged to cover these other items of foreign income which do not loom large from the viewpoint of national revenue but are very important to the industries concerned, namely, to extend this credit to cover interest or royalties or management fees, and the like, that are derived from foreign corporations in which the domestic corporation has substantial interest.

If that were done it would certainly take care of most of the problems.

There are several minor considerations that I wish to bring to your attention.

The first is, if you adopt this idea of treating a foreign establishment with an independent accounting like a foreign corporation, the problem would be solved, but if you do not you have the situation of construction companies that enter into contracts with foreign governments for installing a harbor or building a dam or a road. And frequently it happens that they do not get paid until the end of the contract after, perhaps, they have been on the job for 2 or 3 years.

In 1942 you listened to our plea and put in section 736 (b) which permits the corporation deriving this income at the end of the contract to apportion it back over the years on a percentage of completion basis of accounting. I am very glad to see that that amendment has been included in the House bill. I hope that you will give your endorsement to it, because that would certainly be helpful in any event.

Another question is this: If a corporation qualifies for 727 (g) treatment or the new section, and I forget the number of it, it is in the act—I have it here some place—but if it happens to come within the definition of an affiliated corporation, it would have to be included in the consolidated return.

In World War II they were excluded unless they elected to be included in the consolidated return. By some inadvertence the old provision was incorporated, but there needs to be permission for a new election, and I have spoken to Mr. Stam about that, and he will probably be able to take care of it.

Then there is a third point that regards blocked income in general. Of course, if you adopt these provisions, a great part that I have proposed; that is, a great part of this problem will be disposed of.

I understand that in the House this morning an amendment was adopted which would permit a corporation that received in 1950 or

1951 a big block of income that has been accumulating in, say, Argentina, over a period of 4 or 5 years and is suddenly released, this new amendment would permit that income to be apportioned back over the years that it was earned abroad, for the purposes of the excess profits tax.

But it seems there is some question as to whether income that might be related to the base years would be included. I pointed that out to Mr. Stam and he will probably take care of that.

Those are essential points. They are very important to the corporations that are engaged in foreign business.

At the end of the report we quote from the report of Mr. Gordon Gray, who takes cognizance of these difficulties in saying,

> Further study should be given to the desirability and possibility of promoting private investments through tax incentives, in areas where economic development will promote mutual interests, but where political uncertainty now handicaps United States private investment.

Mr. Gray talks of tax incentives. We are asking you to abstain from imposing an additional burden. Tax incentives implies giving something from what they bear now. Under the 1951 rates, as you know, the top rate for corporations will be 45 percent, which is already higher than most companies have to bear in other areas where our corporations have to compete, so that our corporations suffer a competitive disadvantage of the difference between the foreign rate and our rate, the foreign rate being allowed as a credit against our tax.

So we entreat you not to add to this competitive disadvantage by piling on top of the domestic tax the excess profits tax liability.

I think that covers my principal points. They are covered in greater detail in the memorandum.

The CHAIRMAN. Did you notice this language as it appears in the record of yesterday, in speaking of this amendment which deals with the treatment for excess profits tax purposes of blocked foreign income?

Mr. CARROLL. Mr. Stam told me about it verbally. I have not seen the actual language, sir.

The CHAIRMAN. They say that this amendment provides that the excess profits tax shall not apply to income which, but for monetary restrictions imposed by a foreign country, would have been reported for tax purposes for a period prior to the excess profits tax years.

Mr. CARROLL. Yes.

The CHAIRMAN. It does not give the exact language here.

Mr. CARROLL. That will be a great help. That will certainly be a great help.

The CHAIRMAN. They seem to have dealt with the subject.

Mr. CARROLL. We can look at the language more closely to see if it needs touching up.

The CHAIRMAN. Are there any questions of Mr. Carroll?

If not, we thank you very much.

Mr. CARROLL. Thank you.

The CHAIRMAN. We will next hear from Mr. John S. Dawson, secretary and general counsel of the Bridgeport Brass Co.

You may be seated, and please identify yourself for the record.

STATEMENT OF JOHN S. DAWSON, SECRETARY AND GENERAL COUNSEL, BRIDGEPORT BRASS CO., BRIDGEPORT, CONN.

Mr. DAWSON. My name is John S. Dawson, and I am secretary and general counsel of the Bridgeport Brass Co.

I want to thank you, Mr. George, and the members of the committee for this opportunity to tell the story of this company.

The CHAIRMAN. We will be glad to hear from you.

Mr. DAWSON. We are a long-established Connecticut company, with our main offices in Bridgeport, Conn. We have been going on for some 85 years, and we make a complete line of brass mill products. We have some fabricated business. We make plumbing goods, tire valves, and aerosol products. We are the largest independent company in the brass mill industry, but we want to tell primarily our story as a growth company rather than to speak for the whole industry, although many of the things that are true of us are likewise true of others in our industry.

We employ about 5,200 people. Over a period of years we have had a fairly steady growth, unlike the television companies and others whose positions were stated to you earlier today. So we would simply like to point out to you how excess profits tax worked in our case in World War II and how we may be affected by the House proposals.

As I say, we have grown steadily in the 85 years that we have been in business, but until the last 15 or 20 years it was a fairly slow growth.

During the last 15 years our sales and assets have grown about six times. So during the last 15 years we have had a position more analogous to the rapidly growing companies.

In the prior base period, in the years 1936 to 1939, we expanded our facilities by over $5,000,000, which was a very great deal of money to us in comparison with our total assets at that time. And we built the first continuous rolling mill in the brass industry. Previously, they had had continuous methods used in the steel industry. And we tried to adapt those ideas to our own industry and we built this mill in 1937 and 1938.

You see, that knocked our earnings in the 1936-through-1939 period into a cocked hat, because our manufacturing facilities were all upset during those 2 years. So our average earnings during that 1936–39 base period did not represent what our ordinary normal situation would have been from those additional facilities.

I would like to point out that the experience we got in building that mill in 1937 and 1938, which was available for work for the Government in World War II, the plans and designs were made available to the Government for the building of the five brass mills that were built by the Defense Plant Corporation in 1941—as a matter of fact, it was as a result of a study which Mr. Steinkraus, president of our company, made in 1940 to increase brass-strip capacity for Mr. Patterson, who was then, I believe, the Under Secretary of War, that these five plants were begun. And during the war the brass strip that we made was available in much larger quantities because of our own expansion for making the cartridge cases, small-arms cups, and the assorted other products that can be made from brass mill products.

During World War II excess-profits taxes invested capital did not help us, as I suppose it did not help most other manufacturing com-

panies very much, particularly where they are independent, because we have to make our capital turn over more rapidly than the rates allowed.

And, again, the provisions in the World War II excess profits tax law for growth did not apply to us because our earnings toward the middle and end of the period did not increase above what they were in the early part of the period, because our plants were disrupted during this period while we were building these new facilities. The result of that all was, as you can glean from the tabulation on page 3 of our statement, and I would like to have the whole statement made a part of the record——

The CHAIRMAN. You may do so. You may offer it for the record after you are through.

Mr. DAWSON. The result of our whole efforts during those war years resulted, at least taxwise, in our paying out some $25,000,000 in taxes and renegotiation, which were more than our total assets at the end of the war.

The significance of that was that we were not in a strong position at the end of the war to continue our growth and to meet the postwar inflation.

As you can gather, our military products are made from copper and zinc and I think all of the members of the committee know what has happened to the price of copper since the end of the war.

The result was when we continued to expand during the 1946 to 1949 period we repeated almost the same pattern that we had earlier, that we acquired new plants in the years 1946, 1947, and 1948, which we had to go into debt to pay for. We borrowed about $13,000,000 to pay for the plants that we bought and to give us the additional working capital required in running them.

Senator KERR. What form of indebtedness was that?

Mr. DAWSON. It was a long-term debt, Senator.

Senator KERR. Direct or debenture?

Mr. DAWSON. It was a combination. The $10,000,000 part of it was a combination bank credit arrangement and debentures held by some institutions. I have set it all forth in exhibit 2 attached to the statement. And in addition to the $10,000,000 that we borrowed from those sources, we borrowed another $3,119,000 when we bought a plant from the Government and gave a mortgage as part of the purchase price. So we had a total debt of $13,000,000.

As applied to this company, after that second period of expansion, during the postwar period, the House proposals are not suited to our type of growth at all because it has been an uneven kind of growth. Our growth has not been steady, so that we wind up in the last 2 years of the base period a given percentage ahead of the early years in the base period.

And we have found, too, that in our type of industry it takes a long time to train people and to build up an organization to get new facilities working. As a matter of fact, we believe that the people in our organization, their work and efforts, are much more important than our plants, although they have to have the facilities to work with. We believe that the people are the things that turn our profits.

I have listed in the statement, on page 6, a few statistics to show that our profit percentage in normal times has tended to be around

5 percent, or a little higher, on sales, and that during these periods of expansion our experience has been that the disruption caused by acquiring new facilities and putting them into operations results in a very substantial decrease in the percentages, apart from excess profits tax periods.

We set all of that out in exhibit 1 in my statement, which shows that during the 1936 to 1939 period our profits went from 6.2 percent down to 3.5 percent, down to a loss of 1.9, to a profit of 2.3; and during the whole war period, because of the taxes that we had to pay, our average percentage went from 2.6 to 1.5. And we returned again in 1946 to our more normal percentage of 5.5, but then we got back into expanding again and the percentage went right down again.

So in our case, we have had growth during the two base periods, and our growth penalized us in the application of the World War II excess profits tax law. And the House proposals give us a good deal of difficulty, too.

Senator MILLIKIN. What do you propose?

Mr. DAWSON. I listened with a good deal of interest to the proposals as made this morning, Senator, by Mr. Sprague. It seems to us, and we have set forth at the end of our statement some recommendations which are just some thoughts, that we know when we come here and try to point out a specific case like ours, where we would like to remain strong so that we can do a long-range job—and I think everybody recognizes that we are in a long-range problem here, rather than one of just a few years—so we have just offered these suggestions by way of illustration, and one of them was that we have the right to elect as a base period any two of the years, 1946 through 1950, but Mr. Sprague's proposal, in which he suggested that we annualize 6 months' earnings of 1950 would work in the case of our company as it would in the case of some of the companies that he was talking about.

Senator MILLIKIN. Do you agree that your plant expansion during the base period proposed was an extraordinary plant expansion?

Mr. DAWSON. It was for us.

Senator MILLIKIN. Most all businesses had plant expansion during the base period; did they not?

Mr. DAWSON. Some of them had a little and some of them had a lot.

Senator MILLIKIN. How can we distinguish? What is bothering me is, how can we distinguish between companies that have had some plant expansion and extraordinary plant expansion, and companies that have not had that? That is why I am asking you what you are proposing.

Mr. DAWSON. Well, in our case, let me just relate it to that, because that is what I know most about:

We acquired plants and equipped them in 1946, 1947, and 1948, and we had a tremendous loss year in 1949, which was applicable to our whole industry, because the price of copper fell right out of bed, as one of the charts here shows. It went from 23½ cents down to 16 cents in less than 90 days. And anybody who has to have large inventories of copper on hand was hit by that experience. So 1949 was a bad year for us, and for our whole industry.

In 1950 we just got our plants to running—I mean, our additional plants, as well as our old plants—on a basis that we would consider more normal.

You inquired this morning of Mr. Sprague what percentage of the industry he was talking about, what percentage of the sales was Government business. I can tell you that not only through the first 6 months, but right up to date in our company, even though we have stand-by arrangements, and arrangements to get into Government work upon request, our total sales to the Government have been less than one-tenth of 1 percent.

Senator MILLIKIN. Are you talking about contracts or actual consummated delivery?

Mr. DAWSON. I am talking about actual shipments. Our contracts have not amounted to anything substantial, either, so that our sales up to date have been a minimum of Government work. And, surely, during the first 6 months of 1950 our business was not affected by the war, by the Korean War.

Senator MILLIKIN. Let us take since the Korean War; have you received a lot of orders, an extraordinary amount of Government orders since that time?

Mr. DAWSON. We have not yet, and perhaps the reason, Senator, is this: That we turn out brass sheet, and rod and tube, and the brass sheet is used for making small arms cups and cartridge cases of various sizes, of which we made a tremendou number during World War II, but they still have a lot of that material left which they are using now, and they are just starting to consider plans for the making of additional small arms and cartridge cases.

In the main plant that we acquired during this postwar period, which was one in which me made brass strip and cartridge cases for the Government during the war, we have kept all of the original equipment on the site in a warehouse, so that we can get back into rapid service whenever the Army needs us again.

Senator MILLIKIN. What is your principal Army supply, brass for cartridges?

Mr. DAWSON. During the war, the principal fabricated product was cartridge cases. We made as much, I think, as 50 percent of the Navy's requirement of certain antiaircraft shells, and we made a very large number of different sizes of cases available to the Army. And in addition, our brass rod, tube, and sheet were made available to various other munitions manufacturers for other munitions purposes. Our wire, naturally, was used for electrical and electronic use. That is why I pointed out in our brief here that we furnished something over 2,000,000,000 pounds of that type of stuff to the services.

Senator MILLIKIN. Your business should reflect very substantially war orders, if the war goes on; should it not?

Mr. DAWSON. It has alway been that way, and we have tried to build up in between wars to be in shape to carry on and do a better job for the Government, but my main point is that these plants have been converted to civilian use, and we would get a benefit from them in 1950. We are just starting to get the benefits from these new and additional plants.

The CHAIRMAN. Would you not have a more favorable credit under the old base period of 1936 to 1939 than you will have now?

Mr. DAWSON. Percentagewise, we may.

The CHAIRMAN. Percentagewise, yes.

Mr. DAWSON. Yes. And the relief provisions, of course, have not been spelled out as carefully in the House bill as they were in the old law, and we could not qualify for the growth provisions of the House proposal, because our assets are somewhat more than $20,000,000. We did not have the big increase in sales and payroll during the second half of the base period, because we expanded unevenly.

The CHAIRMAN. I see.

Mr. DAWSON. It is difficult for a small company like us to be specific and tell you what to do. All we can do is say, "This is our case. We think that our earnings during the first half of 1950 would be normal earnings. If we were allowed to build a base period by annualizing the first half of 1950, that might give us a much fairer treatment than the one we would have under the House proposal as now written."

Senator MILLIKIN. May I ask Mr. Stam: What is in the bill to relieve a situation like the one we have heard about here?

Mr. STAM. Your figures here are given after taxes.

Mr. DAWSON. They are.

Mr. STAM. We cannot tell too much about what they were before taxes. I notice that in 1949 you have a loss. Of course, that would be thrown out.

Mr. DAWSON. That is right, Mr. Stam.

Mr. STAM. I cannot say on these figures, because they are after the taxes. It must be much higher than this figure which you have now.

Mr. DAWSON. What chart are you looking at? No. 1?

Mr. STAM. At exhibit 1.

The CHAIRMAN. It is exhibit 1.

Mr. DAWSON. I would be glad to give you those figures. As a matter of fact, I could tell you what our total profits were for those 3 years, if you would like to know.

Mr. STAM. It is hard to tell, until we see the figures before taxes. You see, these are after taxes, but looking at this table that you have on a comparative basis, it looks like you would have had a higher credit under 1936 to 1939 than you do now, because when you had that loss in 1938 of a million nine——

Mr. DAWSON. Percentagewise that would be true. It would not be true in dollars.

Mr. STAM. You throw that out.

Mr. DAWSON. Yes.

Mr. STAM. And take 75 percent of the average of the other 3 years.

Mr. DAWSON. I can give that to you right here, the actual figures before Federal income taxes, in dollars, for the years 1946 through 1949. They were five million nine, approximately, for 1946; three million eight for 1947; four million one for 1948; and a loss of three million eight for 1949. That is all before the application of Federal income taxes. And in the case of 1949, a carry-back claim.

Mr. STAM. That would give you about 16 million, would it not?

Mr. DAWSON. Well, if you just take the 3 years, yes; about 14 million.

Mr. STAM. That is about right. We cannot tell, generally speaking, Senator Millikin, about this until we have a picture of their whole net profits before taxes, so that we can see what their experience has been in the World War and in the growth period, and after the period. If we had those figures, we could tell.

Senator MILLIKIN. Is the law so constructed that if they produced the set of figures that would coincide with what appears on the surface to have an equity in it, at least, would there be relief for a situation of that kind?

Mr. DAWSON. Not so far as the House bill is concerned.

Senator MILLIKIN. Is there an avenue for relief?

Mr. STAM. Some of these provisions might help them. I am not sure about that. I cannot tell. If we had the figures, we could tell. If you can submit those for the record, that information, then we will have them and talk about them in the committee.

Mr. DAWSON. What figures in addition to the ones that I have given?

Mr. STAM. What I think is important that you might put down would be your net profits before taxes, covering this period from, say, 1946 through 1949, so that we can get a pretty good picture of the whole trend.

Mr. DAWSON. I see.

Mr. STAM. And then we can tell about whether some of those provisions cover.

Mr. DAWSON. To save the committee's time, I have the figures here, but it would, probably, be better to make an exhibit which I could send in later on this afternoon, giving you those figures.

The CHAIRMAN. You may do so, and they will go into the record.

Mr. DAWSON. I would like to point out, Senator, one further thing, that we had to finance this expansion by debt, as did most medium and small-sized companies that did not have capital available to them after the end of the war. We did not have any debt during World War II. We got a debt of, approximately $10,000,000, now, that we incurred in order to buy these facilities, and we have to meet the service requirements of this debt. It would be extremely difficult for us to do that on the basis of the proposals we have seen placed before the House.

Senator KERR. What is the average rate of interest on that debt?

Mr. DAWSON. I would say it is between 3¼ and 3½, as an average.

Senator KERR. Then if you are permitted to earn 133⅓ percent of the interest requirement, that would mean you would wind up with about a net of 1 percent on that part of your capital that is borrowed; would you not?

Mr. DAWSON. Well, I do not think it is the interest provisions that would bother us.

Senator KERR. Will you please answer my question at this point? That is all you would have with reference to that part of your investment; is it not?

Mr. DAWSON. If I understand you correctly, I think you would.

Senator KERR. Do you think your company would go out and borrow ten to fiteen million dollars to expand, either for civilian or military production, if it knew ahead of time that the ceiling on what it could earn was 55 percent of 1 percent or a little over half of 1 percent on the amount of money it borrowed; there would not be much incentive in that to get you to borrow ten or fifteen million dollars to expand, would there?

Mr. DAWSON. You say if the ceiling of what it could earn was 55 percent of what?

Senator KERR. I started to say 55 percent of 1 percent. If it is 1 percent and the normal tax rate on it is 45 percent, that reduces it to where it is just a little over half of 1 percent. Do you follow me?

Mr. DAWSON. I do not think I do.

Senator MILLIKIN. The Senator is trying to develop what your possibilities of profit are out of that part of your business represented by debt, and he is pointing out that it is practically nothing, and that therefore people will not be running businesses to make practically nothing.

Senator KERR. I was trying to find out whether this gentleman would have any inclination to borrow 10 or 15 or 20 million dollars to expand his business, if all that he was permitted to make on it was one-half of 1 percent.

Mr. DAWSON. Even if I had the inclination, Senator, I would have some difficulty finding a source of capital like that.

Senator KERR. I understand, but you could not fail until you started.

Mr. DAWSON. That is true.

Senator KERR. No matter how certain the failure might be upon starting, would there be any incentive for you to start?

Mr. DAWSON. No, there certainly would not, Senator.

What I started to mention in answer to your earlier question, too, was something along the same line, that you have payments, usually, in this type of debt, payments on account of the principal, under which you have to pay the debt back.

Senator KERR. I understand that. That would enter into the matter of difficulty in getting your money. But the point of my question was, whether or not there would be any attitude or incentive on your part to try to get the money.

Mr. DAWSON. I think that our incentive would be practically demolished.

Senator KERR. You were talking about the volume of your business for 1950, and that thus far it had been less than 1 percent that had gone to the Government, I think.

Mr. DAWSON. Less than one-tenth of 1 percent; yes, sir.

Senator KERR. In the figures on your 1950 report of business, or calculations of profit, the only thing that would affect that would be deliveries in 1950, would it not?

Mr. DAWSON. Yes, sir.

Senator KERR. If you had $100,000,000 worth of war contracts, and had processed and delivered, and either had paid or had the obligation to pay for only a million dollars in 1950, that is all of that order that would be reflected in your statements for 1950?

Mr. DAWSON. That is right. And that is why I agreed.

Senator KERR. I believe that is the reason that you suggested the inclusion of the year 1950 along with one or two of the other years in the calculation in fixing the base?

Mr. DAWSON. I noticed in your questioning of a witness this morning—I believe Senator Milligin was doing the questioning—he inquired what share of the business of the electronic industry was defense business during 1950, and I think the figure given was something like 5 percent, in that case. What I wanted to point out was that in our case, even though we are ready, we have, in fact, made negligible ship-

ments for Government purposes. And up to the moment any contractual arrangements with the Government are, likewise, negligible.

So we have not had defense business during 1950.

Senator KERR. Is it not a fact that actually a part of your source of supply, if not in your particular instance, in your industry, has been taken from you, due to its being set aside for war work, but that, actually, you have not had that implemented by the processing and delivery of any war contractual operations?

I do not know whether that would apply to your particular company, but is that not true with reference to your industry?

Mr. DAWSON. Our industry uses copper, Senator, and as you know, copper has been stockpiled.

Senator KERR. Yes. I understand.

Mr. DAWSON. Copper has been, that is, domestic copper, in short supply in our industry. You know a good deal more about the situation with respect to the import duty on copper than I do, but over all the total copper supplies available in the country are limited, and they are below those which could during 1950 be used for commercial purposes, so that what you say is true, that the stockpiling, the taking of some of that copper for stockpiling, has made less available to the general civilian economy.

Senator KERR. As I understand it, it has actually reduced the amount of operation that you would have had in the civilian economy, and the situation has not yet been affected by increased military production with that same amount of copper which is being saved for military production, but not being used, but which would have been used in the civilian economy had it not been set aside for the other.

Mr. DAWSON. Yes, so that during the last 3 months in our industry and in our company, specifically, our volume of business has been less.

Senator KERR. And actually has been curtailed rather than expanded?

Mr. DAWSON. That is right.

Senator MYERS. Do you know whether or not you have been selling sheets or rods to other fabricators who may be engaged in Government contracts?

Mr. DAWSON. Senator, we have a set-up for the identification of military orders, whether they are on subcontract or otherwise, and the reason I have given you that figure of less than one-tenth of 1 percent is because we analyzed the subcontracts.

Senator MYERS. That includes not only yourselves as fabricators, but other fabricators?

Mr. DAWSON. That is right.

Senator MYERS. To whom you sold sheets?

Mr. DAWSON. Our customers who are Government suppliers, that is right.

Senator MYERS. I think that clarifies the situation.

Mr. DAWSON. Thank you, sir.

The CHAIRMAN. Your paper will be included in the record at this point. And you will furnish the additional information that Mr. Stam suggested for the record?

Mr. DAWSON. Yes, sir; we will do so. Thank you very much.

(The information requested is as follows:)

EXHIBIT A

1. Average earnings before taxes, 1936–39 and 1946–49:

	Per published statement	Per revenue agent's report
1936	$1,444,000	$1,620,506
1937	895,000	942,999
1938	(297,000)	(259,023)
1939	782,000	866,002
		Tax return
1946	5,893,000	5,670,979
1947	3,834,000	3,811,042
1948	4,133,000	4,050,120
1949	(3,805,000)	(3,778,130)

Figures in parentheses denote loss.

2. Retained earnings for 1948 and 1949 as per tax returns:

1948	$2,299,442
1949	(2,579,561)

3. Equity capital investment of base period and 1950 at each year end:

1946	$19,020,000
1947	20,285,000
1948	22,573,000
1949	19,743,000
1950 (estimated)	23,000,000

4. Amount of capital borrowed during last 2 years of base period, i. e., 1948 and 1949, and interest rates thereon:

(*a*) *Long-term debt.*—$3,119,500 was borrowed on June 1, 1948, from RFC for 15 years. Interest rate 4 percent; $10,000,000 of long-term bank debt and debentures borrowed in February 1947 and payable over 15 years was serviced during 1948 and 1949 as shown in exhibit 2 attached to my statement to Senate Finance Committee of December 6, 1950.

(*b*) *Short-term debt* outstanding at end of month and interest rate thereon:

	1948		1949			1948		1949	
	Amount	Percent	Amount	Percent		Amount	Percent	Amount	Percent
January			$1,000,000	2¼	July			$1,000,000	2½
February			1,425,000	2¼	August	$1,000,000	2	825,000	2½
March			2,425,000	2¼	September	1,000,000	2¼	1,325,000	2½
April	$1,500,000	2	3,425,000	2½	October	1,000,000	2¼	1,825,000	2½
May	1,500,000	2	2,775,000	2½	November			2,325,000	2½
June			1,500,000	2½	December			1,800,000	2½

5. It is estimated that net profits before Federal income taxes for 1950 will be $7,275,000.

6. It is estimated that retained earnings for 1950 will be approximately $3,000,000, at present tax rates.

7. Equity capital increase during 1950 will be approximately $2,900,000, at present tax rates.

8. Increased borrowing for 1950:

(*a*) Long-term—none. It was, in fact, reduced in accordance with exhibit 2 of my statement to Senate Finance Committee of December 6, 1950.

(*b*) Short-term balances during 1950 at end of various months and rates of interest thereon:

	Amount	Percent
January	$1,800,000	2½
February	2,300,000	2½
March	1,750,000	2½
April	1,950,000	2½
May	(1)	(1)

[1] None—and none after May 31.

The CHAIRMAN. Thank you for your appearance here today, sir.

Mr. DAWSON. Thank you.

(The paper referred to is as follows:)

BRIDGEPORT BRASS CO.,
Bridgeport 2, Conn., December 6, 1950.

The Honorable WALTER F. GEORGE,
Chairman, Finance Committee, the Senate,
Washington, D. C.

DEAR MR. GEORGE: Thank you for according us an opportunity to be heard by this committee.

The Bridgeport Brass Co. is a long-established Connecticut corporation with its main offices located at 30 Grand Street, Bridgeport, Conn. It manufactures and sells a complete line of brass mill products in the form of sheet, rod, wire, and tubes, as well as fabricated products such as plumbing goods, tire valves, and aerosol pressure-packaged products. It is the largest independent company in the brass mill industry. We do not purport to speak for our industry although many of our observations may voice the opinions held by others in our industry.

Our manufacturing plants are located at Bridgeport, Conn., Indianapolis, Ind., and Exeter, N. H. The company provides employment for 5,200 with current payrolls at the rate of $19,000,000 annually.

This company is in full accord with the fact that the expanded defense program will require the raising of substantial additional revenue, of which a fair share must come from increased income taxes on corporations.

However, it would like to call your attention to how excess profits taxes worked out for us in World War II and how we may be affected by the House proposals.

WORLD WAR II TAXES WERE BURDENSOME

During the period from 1936 through 1939, used as a base period for World War II excess profits taxes, this company expanded its facilities by over $5,000,000. In 1938 it completed the first continuous process rolling mill in the brass industry. By reason of this expansion it was ready to make available to the Government increased facilities in World War II.

However, the company received little benefit in net earnings from these new facilities during the 1936 through 1939 base period, since the company's experience has shown that it takes several years to get new facilities into really efficient operation. What is more, the disruption in the company's operations caused by the new construction in 1937 and 1938 tended to reduce the profits it would have obtained from its old facilities.

Yet, the plans, designs, experience, and know-how from this new mill were incorporated in the five defense plants patterned after our mill and built by the Government during the war period. During World War II the company went all out to build up production needed by the Government. It produced a total of over 2,000,000,000 pounds of brass mill products as well as approximately 500,000,000 cartridge cases, 71,000,000 pounds of small arms cups, and 285,000,000 pounds of cartridge case disks for Government end use, all at abnormally low profits.

The invested capital credit allowable to this company during World War II was entirely inadequate, since independent companies such as ours are required

to make their capital turn over more rapidly than the rates stipulated in the World War II law.

The growth provisions in the World War II excess-profits-tax law did not cover our type of growth, but were designed to apply to a steady growth in which earnings in the latter part of the base period were higher than those in the early years.

World War II taxes and renegotiation left the company an extremely small profit as a percentage of sales compared with all manufacturing. It averaged approximately 2.3 percent for the 4 years, as compared with approximately 4.3 percent for the nonferrous metal industry, and approximately 4 percent for all manufacturing. The yearly averages are shown in exhibit 1.

The net profits retained left the company with an extremely small profit as shown in the following table:

Summary of earnings before and after provisions for renegotiation and Federal income taxes, years 1941–45

[Parentheses indicate red figures. 000 omitted]

Year	Sales before renegotiation	Profits before renegotiation and Federal income taxes	Percent of sales	Renegotiation	Provision for Federal income taxes	Net profits	Percent of sales as shown
1941	47,951	7,075	14.8		(4,876)	2,199	4.6
1942	65,674	11,691	17.8	(4,700)	(5,406)	1,585	2.4
1943	70,281	9,132	13.0	(1,574)	(5,837)	1,721	2.4
1944	63,039	6,612	10.5		(5,004)	1,608	2.6
1945	53,162	3,110	5.9		(2,300)	810	1.5

NOTE.—Profits include management fees for operating defense plant at Indianapolis. This company paid in Federal income taxes 72 percent of its taxable income for the years 1942 through 1944, inclusive, and 69 percent in 1945.

POSTWAR EXPANSION WAS FINANCED BY DEBT

As a result of World War II taxes and renegotiation, the company was in a weakened position to continue its growth in the postwar period and to meet the postwar inflation.

Since the end of the war the company has purchased and turned to peacetime purposes certain plants and equipment which it operated for the Government during World War II. At the same time it has endeavored to retain the basic characteristics of these facilities as national defense assets. We have been informed by the National Military Establishment that the company's action in preserving these facilities will be of material benefit to the national security effort.

In order to preserve its competitive position as an independent in the industry, this company invested in the period 1946 through 1949 approximately $10,000,000 in these plants and equipment. The more than $13,000,000 debt incurred by the company to acquire these facilities and obtain the additional working capital needed is shown in exhibit 2.

HOUSE PROPOSALS ARE UNSUITED TO THIS COMPANY

The House proposals would not develop adequate excess profits credits for this company on either an average earnings basis or on the invested capital basis. In addition, the provision for growth of companies is so restricted that it would not apply to cases such as ours.

A. House average earnings method does not permit us a proper base

The average income for the best 3 years out of the years 1946 through 1949 in the case of this company does not reflect its earnings potential under normal economic conditions for the following reasons:

1. Its $10,000,000 investment in modernization and expansion of facilities during 1946–49 was not reflected in the company's earnings in the suggested base

period years. A large part of these facilities was acquired toward the end of the suggested base period as shown by the following tabulation:

Year:	Amount
1946	$2,850,000
1947	2,450,000
1948	4,025,000
1949	400,000
Total	9,725,000

Efficient use of these facilities required conversion from a military to a civilian type of production and the building and training of the necessary organization. Consequently, earnings realized during the proposed base period will not reflect the return which our stockholders had a right to expect from these facilities. In fact, the potential increase in earnings from these facilities through increased output and reduced unit costs has not yet been fully realized.

2. The company recognized that the development of efficient operations in these facilities would take a number of years.

As a result of all-out efforts to obtain maximum production during World War II, production was stressed at the expense of other considerations, and break-even points were high at the beginning of the postwar period. Progressive improvement in efficiency has occurred in subsequent years. However, for our program to become fully effective will take an extended period beyond 1949. If this were to be followed by normal peacetimes, we could reasonably expect to obtain the full profits from our expanded facilities and organizations. In fact, 1950 operating results substantiate this conclusion, even though Government work has been less than one-tenth of 1 percent of our sales.

The company's profits as a percentage of sales were below normal during its postwar expansion as well as during its growth in the base years 1936 through 1939. It will be noted by reference to exhibit 1 that prior to 1937 this company's profits as a percentage of sales exceeded 5 percent and compared favorably with the average for other industries.

However, as a result of plant expansion programs in 1937 through 1939 and 1946 through 1949, the return on sales in these periods was subnormal in comparison with other industries as well as our own previous experience. Although the percentage of profit returned to 5.5 percent in 1946, by reason of the company's expansion program it was reduced to 2 percent in 1947 and 2.6 percent in 1948, and as a result of adverse industry-wide conditions was reduced to a 2.2 percent loss in 1949.

Obviously, therefore, the proposed base years 1946 through 1949 would be inappropriate for the determination of excessive profits in 1950 or subsequent years.

Nevertheless, the employment opportunities resulting from our growth have more than doubled since the year 1933, and payrolls have increased many times as illustrated by exhibit 3.

3. Depressed business conditions in our industry contributed to subnormal earnings for our company during the postwar period.

In 1947 and 1949 the business level in the brass industry was considerably lower than for business in general, which naturally affected our earnings for those years. (See exhibit 4.)

This industry is a highly competitive one, in which a sustained high volume of output is necessary to compensate for the low unit profit margins obtainable, in order that a fair return may be made on the efforts involved.

4. Inventory losses adversely affected our results.

Due to the drastic decline in the prices of copper and zinc in the second quarter of 1949 (see exhibit 5 and exhibit 6), this company sustained a metal loss of $4,000,000 in that year.

B. House invested capital method does not develop an appropriate credit

Applying the invested capital credit, proposed in the House, to this company would not accomplish the legislative purpose. The credit would be even less than that developed under the proposed average earnings method.

This company is the largest independent producing a substantially complete line of brass and copper mill products. It doe snot have large amounts of capital available to it as do the leaders in the industry, and for that reason has had to make its capital turn over more rapidly. The company has had to depend on its organization rather than on its capital alone to accomplish effective results.

We have always felt that the thinking and planning and teamwork of our people have contributed more to our results than the bricks and mortar involved in our fixed assets, and that these factors should be considered and rewarded.

By reason of having limited access to capital during the postwar period, this company has had to finance its postwar expansion through borrowings. The present balance of the long-term debt incurred for this purpose amounts to approximately $10,000,000.

In stiuations such as ours, allowable rates of return on invested capital must be very much higher than those proposed. In fact, the average rate on invested capital for all manufacturing industry during the postwar period has been much higher than those proposed.

House Growth Provisions Are too Restrictive to Aid this Growing Independent.

We have stressed that this campany has grown consistently over the years. However, the growth has been irregular rather than year by year. The expansion in facilities which took place in the base period 1936 through 1939 and also 1946 through 1949 was not immediately accompanied by corresponding increased sales, profits, and payrolls. The growth in these factors occurred largely after the 1936–39 period and would naturally be expected to follow the 1946–49 period. In addition, during the period 1946–49, the brass industry went through a period of inventory liquidation occuring in 1947, and another more severe inventory liquidation in 1949. As a result of this, our business volume and profits were adversely affected.

The House proposals recognize that growth companies are entitled to special consideration in the development of the tax structure. However, the specific provisions for growth companies contained in the House proposals fail to cover our situation for several reasons. In the first place, while not a large company, we somewhat exceeded the $20,000,000 limitation on assets. Secondly, by reason of depressed conditions in our industry during 1949, our average monthly receipts and our average monthly payrolls in the second half of the proposed base period did not exceed those in the first half of the period by sufficient percentages to meet the House requirements.

SUGGESTIONS

In the light of the above data this company respectfully recommends that the committee give consideration to the following:

1. Since the determination of what is "normal" and what may be called "excess" should be particularized to each individual taxpayer, and since taxpayers had such diverse experience during the base period years proposed by the House, each taxpayer should be given the right to elect as its base period any 2 of the 5 years 1946 to 1950, inclusive.
2. That special consideration should be accorded growth companies which do not meet the restricted provisions contained in the House proposals. This is especially true where the investment behind that growth has relieved the Government of the expense of acquiring facilities in an emergency period. An alternative credit could be developed in such cases which could be worked out to permit a profit of 5 percent of sales after income and excess profits taxes. We would expect that such a provision should be appropriately restricted.
3. In view of the fact that the House proposals giving special consideration to growth companies do not apply to this company, and many others in a similar condition, we respectfully recommend that this committee schedule specific hearings to consider appropriate relief provisions for growth companies.
4. The company respectfully suggests that an increase in normal and surtax rates is more suitable to most growth companies including this company, and is more practicable to administer than an excess profits tax. It therefore, leads us to favor this type of measure and to oppose excess profits tax proposals.

Respectfully submitted.

Bridgeport Brass Co.
John S. Dawson,
Secretary and General Counsel.

EXHIBIT 1.—*Comparison of Bridgeport Brass Co. and selected industry groups net profit after taxes, percent of sales*

	Bridgeport brass	Autos/equipment	Chemicals	Iron and steel	Rubber	Textiles	Nonferrous metals	All manufacturing
Post depression period:								
1933	4.1	2.1	11.4	[1] 0.4	0.8	4.1	3.8	1.7
1934	5.9	2.8	8.5	.3	.4	.4	5.9	2.6
1935	5.4	5.1	8.1	2.9	2.3	1.4	6.7	3.7
Base period wartime excess profits tax:								
1936	6.2	6.7	8.5	5.0	4.0	3.3	7.0	5.2
1937	3.5	6.4	7.7	5.8	2.2	1.5	5.9	4.8
1938	[1] 1.9	1.2	6.5	[1] .3	1.6	[1] 1.0	2.8	2.3
1939	2.3	7.3	9.8	4.2	4.7	3.4	7.7	5.2
War period:								
1942	2.6	3.4	6.5	4.6	5.1	4.3	4.6	4.5
1943	2.5	3.8	5.8	3.9	3.0	3.7	4.8	4.1
1944	2.6	3.8	4.8	3.6	2.7	3.7	4.3	4.0
1945	1.5	1.6	4.2	2.5	2.3	3.6	3.3	3.1
Postwar period:								
1946	5.5	.4	8.3	4.5	6.0	8.4	5.7	5.2
1947	2.0	6.7	7.9	6.4	3.6	8.2	7.0	5.9
1948	2.6	7.7	8.0	6.9	3.7	8.2	6.3	6.1
1949	[1] 2.2	8.7	7.4	5.8	2.8	4.0	3.8	5.0

[1] Indicates loss.

Source: Department of Commerce, National Conference Board Business Fact Book.

EXHIBIT 2.—*Bridgeport Brass Co. loans from various sources, February 1947–August 31, 1950*

	Increase (decrease)				
	Total	Short-term bank loans	Long-term bank loans	Serial debentures 3½ percent to 1962	Mortgage payment to U. S. Government 4 percent to 1963
Balance prior to refinancing February 1947	$6,750,000	$3,500,000	$3,250,000	----------	----------
Net change in refinancing	3,250,000	(3,500,000)	750,000	$6,000,000	----------
Balances after refinancing Feb. 28, 1947	10,000,000	----------	4,000,000	6,000,000	----------
Mortgage on acquisition of Indianapolis plant, July 1, 1948	3,119,500	----------	----------	----------	$3,119,500
Payments on above loans	(2,561,000)	----------	(1,800,000)	(345,000)	(416,000)
Balances, Aug. 31, 1950	10,558,500	----------	2,200,000	5,655,000	2,703,500

EXHIBIT 3.—*Bridgeport Brass Co., Bridgeport, Conn., average number employees, total payrolls*

Year	Payrolls	Number of employees, average	Year	Payrolls	Number of employees, average
1933	$2,122,665.41	2,024	1942	$17,846,019.42	6,574
1934	2,706,371.41	2,303	1943	22,061,310.56	7,599
1935	3,909,129.81	2,904	1944	19,695,178.77	6,809
1936	4,357,658.49	3,083	1945	17,439,583.18	6,026
1937	5,215,481.97	3,312	1946	16,917,156.56	5,816
1938	3,857,380.80	2,566	1947	16,490,990.87	5,323
1939	5,072,948.29	3,062	1948	17,751,263.66	5,186
1940	7,043,294.04	3,756	1949	15,650,209.42	4,391
1941	11,871,107.57	5,146	1950 (estimated)	18,896,556.88	5,238

NOTE.—During the years 1942 to 1945, inclusive, we operated the plant at Indianapolis for the Government on a management-fee basis. The payrolls and number of employees for that plant during that period are not included herein.

EXHIBIT 4

1946-1949

BRASS INDUSTRY SHIPMENTS

As Compared With

FEDERAL RESERVE INDEX OF INDUSTRIAL PRODUCTION

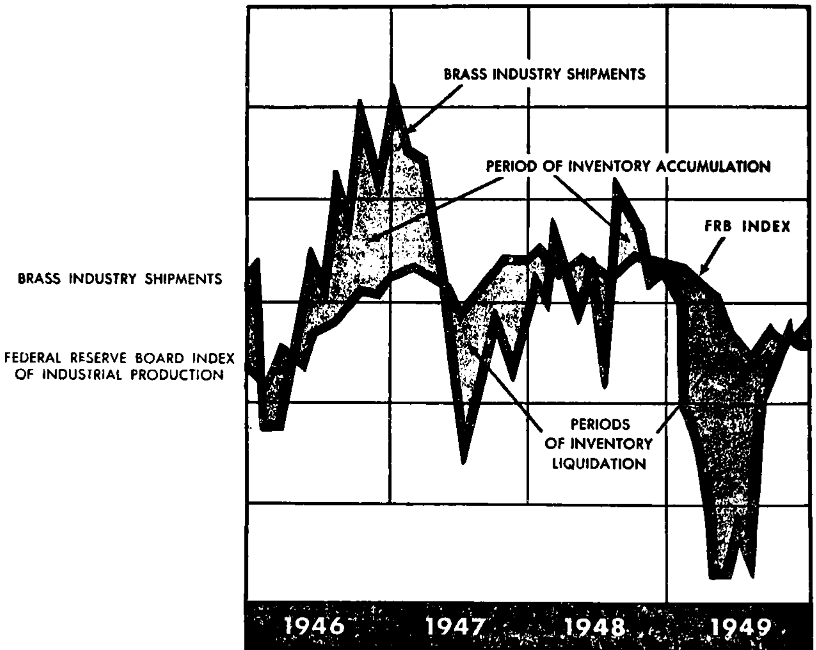


EXHIBIT 5

RANGE OF COPPER PRICES 1945-1949

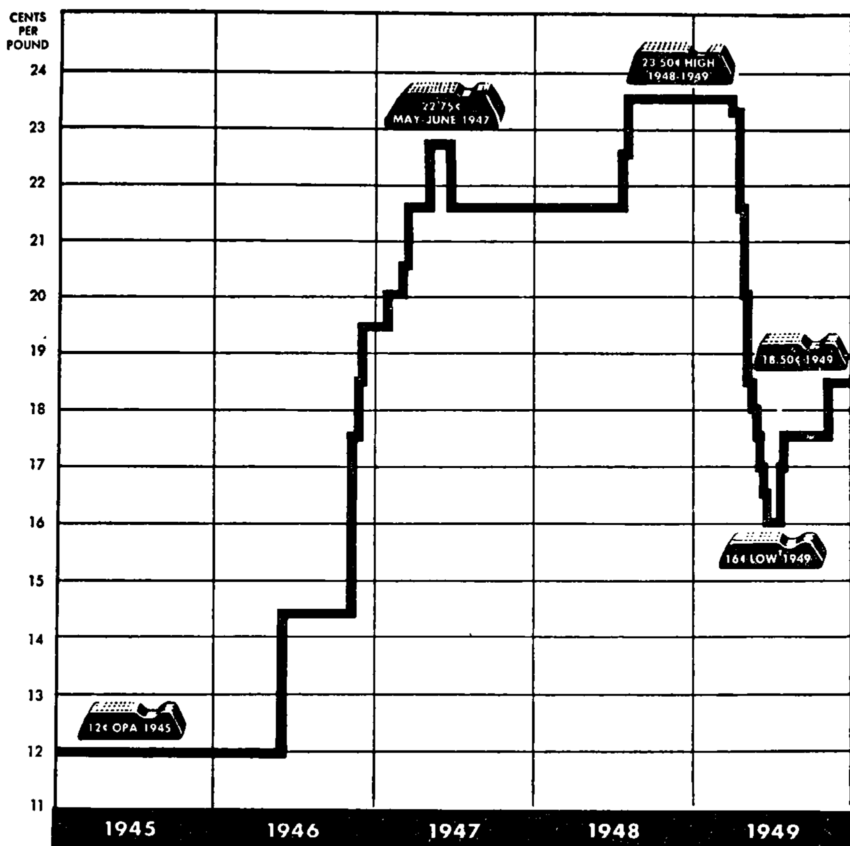
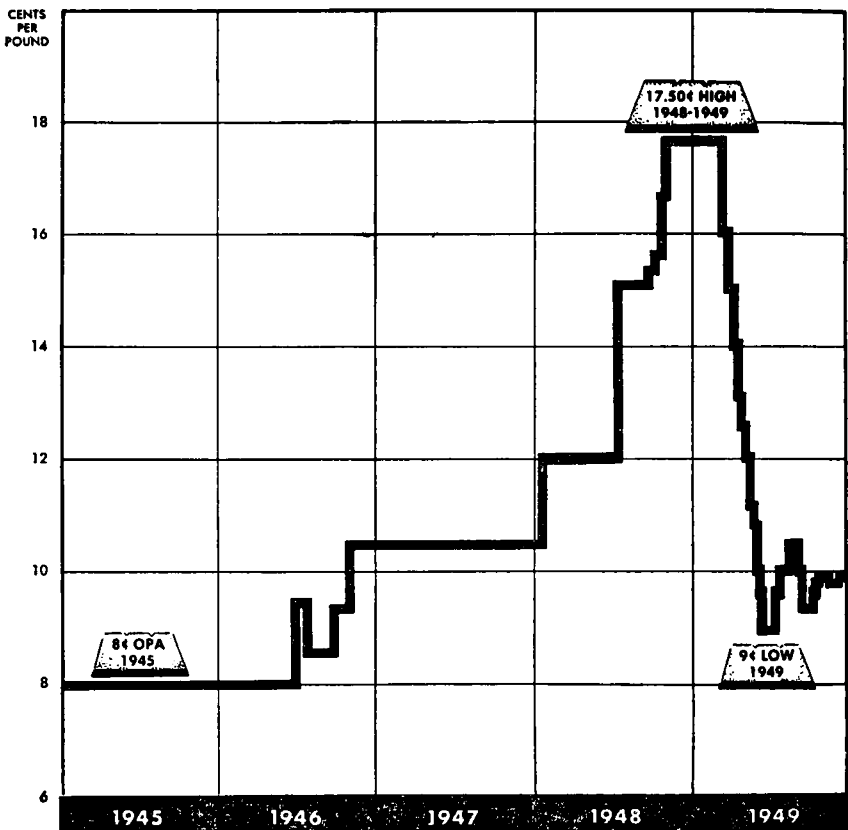


EXHIBIT 6

RANGE OF ZINC PRICES 1945-1949



The CHAIRMAN. We will next hear from Mr. J. W. Haddock.
You may have a seat, please, and identify yourself for the record.

STATEMENT OF J. W. HADDOCK, PRESIDENT, AMI, INC., GRAND RAPIDS, MICH.

Mr. HADDOCK. My name is John Haddock, and I am president of AMI, Inc., a manufacturing concern located at Grand Rapids, Mich., where I reside.

We employ about 375 persons.

I am here because it appears that under the House bill our excess profits tax credit will be only about 10 percent of what we consider our normal earnings, resulting in 90 percent of such earnings being subject to excess profits tax, whereas we understand the intent of the act is that 85 percent of presumed normal earnings shall be free from this excess profits tax.

We had hoped the House bill would provide some degree of relief for us.

I was unable to obtain a copy of the House bill until yesterday afternoon, and, consequently, I have not had time to prepare a written statement, but with your permission will submit one as soon as possible.

Our peculiar situation arises out of the following circumstances:

In April 1945 control of this company was acquired by a new group, with a complete change in management and policy.

Senator MILLIKIN. What do you make?

Mr. HADDOCK. Phonographs, Senator.

The new management, in effect, started a new business. The new management was faced with the necessity of recruiting, training, and developing an engineering and manufacturing and selling organization, capable of holding its own against its major competitors, as the company had sunk to a point where there was only a skeleton organization.

Completely new equipment, designs, and models were required to meet postwar conditions.

Obviously no profit could be obtained until all of the preliminary work was carried through, and production attained sufficient volume to absorb the steadily increasing overhead.

The time to accomplish this was greatly extended as the result of the postwar dislocations.

The company was handicapped in the competition for materials during a period of shortages, due to its relatively small size and lack of previous channels of supply. The cost of tools, dies, et cetera, was greatly increased by the rapid postwar rise in wages and prices.

The company's liquidity became impaired, and short-term bank loans were obtained. When even these proved to be inadequate, large stockholders, allied with the new management, contributed additional loans.

Initial postwar production commenced in June of 1946, but it was the first part of 1947 before sufficient volume and efficiency were obtained to bring operating results to the break-even point. As a result, substantial loss was suffered in 1946.

In the meantime, trade obligations had become burdensome in amount, and many were past due. The commercial bank became panicky, and on April 7, 1947, these loans were called, and the company's bank account was seized by the bank as an offset against the indebtedness. This compelled the company to seek the protection of the Federal Bankruptcy Act. It filed a petition in the Federal district court in Grand Rapids under chapter 10, asking for the appointment of a trustee, and freezing of all past obligations.

For a time, the company's operations were severely limited. However, it became apparent that the business had turned the corner, and was able to operate profitably.

Eventually arrangements were concluded with creditors to satisfy their claims in full by the issuance of serial notes to be repaid out of earnings over a period of several years.

No reorganization of the capital structure was necessary. And the proceedings were transferred from chapter 10 to chapter 11 of the Bankruptcy Act, but the bankruptcy court retained control of the business until all notes were paid in full, together with interest, fees, and so forth.

No material changes were made in the production policies or program of the management which continued to serve under court jurisdiction and control.

The freezing of past-due obligations until they could be paid out of earnings provided the necessary time which some of the creditors, particularly the commercial bank involved, were unwilling voluntarily to grant to the company.

The success of a fast-moving, highly competitive business depends on quick decisions, in many instances, with respect to controversial problems. In our case these decision were several times delayed to the point where the ability of the business to continue was jeopardized.

It was necessary, under the conditions in which we operated, not only to formulate our own conclusions as to what should be done, but to obtain the permission and approval of the creditors' committee, of the bank, of the attorneys for each of these, and, finally, the approval of the referee in bankruptcy.

Gradually as management's efforts bore fruit, and as the obligations to creditors were reduced by periodic payments, these difficulties diminished. But the earning power of the business, during 1947, 1948, and 1949, was substantially curtailed, and was well below what might have been achieved by the same management, operating under normal corporate procedure.

Receivership expenses alone approximated $200,000, which is about 40 percent of the operating profits from the commencement of the court proceedings in December 1949, December 31.

Although delayed and limited, progress toward management's objectives continued, and during 1950 began to bear fruit in the form of lower costs, greater efficiency, and more aggressive distribution, all resulting in a normal earnings capacity of about 10 times the 1946 to 1949 average profits.

As a result, the bank and trade creditors' obligations, amounting to about $1,200,000, have now been repaid in full with interest. Our profits and costs in round figures are as follows: 1946, loss $650,000; 1947, loss $10,000; 1948, profit $100,000; 1949, profit $200,000; 1950, profit $850,000.

That is all before taxes, and disregarding loss carry-overs.

Senator MILLIKIN. Disregarding what?

Mr. HADDOCK. Carry-overs.

Senator KERR. Let me ask you if that means that these profits are in addition to an amount sufficient to take up losses for the previous years?

Mr. HADDOCK. No, sir.

Senator KERR. Before applying the losses of previous years to them?

Mr. HADDOCK. Yes, sir.

Senator KERR. Thank you.

Mr. HADDOCK. The $850,000 profit for 1950 represents 17 percent of sales of $5,000,000, a good, but not excessive rate for our kind of business. In no degree that we can measure does it reflect the effect of the war or defense program. The volume in numbers of units produced and sold does not exceed past experience. And our unit selling prices are nearly 25 percent lower than in 1947. So the greatly increased profits are, primarily, a measure of increased—and we

think normal—efficiency which we would have obtained 2 years earlier had it not been for our enforced operation under court control.

Ours is the type of business in which the results derived from the brains and energy brought to bear, rather than from the size of the assets employed. Consequently, the increased capital alternative to average earnings seems unlikely to improve our excess profits tax credit. The only possible relief in the House bill seems to lie in section 442, but whether our situation comes within the scope of the language used, seems uncertain and likely to depend upon an administrative decision.

Furthermore, section 442 assumes and requires that there be within the base period one normal year, which, in our case is obviously lacking. It is, therefore, our conclusion that the House bill provides little or no hope of relief.

Consequently, we propose: That for a corporation which at any time after December 31, 1945, operated under chapters 10 or 11 of the National Bankruptcy Act, the average base period net income for the purpose of computing its excess profits credit shall be the earnings of the highest taxable year during the base period, or 1 year thereafter—but not including any year ending after December 31, 1950—while operating under chapter 10 or chapter 11, during all or part of such year.

Perhaps there is a better way to equalize the effect of this bill upon our company as compared with others which operated normally during the base period years, but we feel that any business which has overcome the handicaps we have, and honorably paid off its creditors 100 cents on the dollar, deserves a chance to maintain itself against an uncertain future with no greater handicaps than those facing our competitors and similar businesses, generally.

The Munitions Board survey made of our facilities states that we have shown extraordinary ability, and recommends us for the manufacture of electronic or highly intricate electro-mechanical devices.

Senator MILLIKIN. You are not in any of that yet?

Mr. HADDOCK. No, sir. We have not yet been able to obtain any contracts. I anticipate that it will, probably, be several months before contracts of the size we are prepared to handle will become available.

Senator MILLIKIN. In other words, you do not believe that it will be reflected in your business this year?

Mr. HADDOCK. We have none. It is divided about evenly between the first and second half.

Senator KERR. Did you hear the suggestions of Mr. Dawson who preceded you?

Mr. HADDOCK. I was too busy thinking of my own problems, I think, to be attentive.

Senator KERR. One of his suggestions was that the taxpayer be given the right to elect as its base period any 2 of the 5 years, 1946 to 1950, inclusive.

Mr. HADDOCK. Well, sir, that would be of a great deal of help.

Senator KERR. Would that not meet your situation, such a general provision, the same as the specific suggestion you have made?

Mr. HADDOCK. I have suggested a single year, Senator. Mr. Dawson's suggestion, as I understand it, would require that we add together 1949 and 1950.

Senator KERR. 1950, and any of the other 4 years that you wanted to.

Mr. HADDOCK. In our case, it would obviously be 1949 and 1950, which would give us a total for the 2 years of about $1,050,000, divided by two, which would give us a yearly figure of $525,000, multiplied by 85 percent, which would give us about $435,000 base. That would be of a great deal of help, sir, but it would not go quite as far as the suggestion I propose.

I feel that our circumstances are different.

Senator KERR. I thought your suggestion was two of the years?

Mr. HADDOCK. No, sir; 1 year.

The CHAIRMAN. Just 1 year of the years.

Senator MILLIKIN. May I ask Mr. Stam whether there is any administrative reason why in certain cases—let us assume, first, we could not include the first half of 1950 in the base; is there any administrative reason why you could not do that?

Mr. STAM. I do not think it is a question of administrative reason.

Senator MILLIKIN. That is all I am trying to get at, whether splitting the year would present a problem.

Mr. STAM. You would have to do it by proration. You would have to prorate the year to some extent.

Senator MILLIKIN. I was wondering whether it would be practical to do so.

Mr. STAM. It would depend upon how the accounting system employed by the company was, if they kept their books in such a way that you could determine the income up to a certain period. If so, something would be worked out, I imagine.

Mr. HADDOCK. In that connection, Senator, I would like to point out what occurs to me, from a very casual observation of the bill—that is all I have had time for since yesterday afternoon—that any corporation whose fiscal year ends June 30, 1950, will, by the terms of the bill, reconstruct its base period, so that the 6 months from July 1 to December 31, 1949, will be an average of the experience during the last half of 1949 and the first half of 1950; and to the extent then that their 1950 business—that is, their first half—may represent improvement over 1949, they do benefit by the first half of 1950. I think, sir, that those of us whose fiscal year is on a calendar basis and who feel that we need relief have some grounds for feeling that we should receive no less favorable treatment with respect to the inclusion of 1950, or at least the first half of the year. The mere accident of a fiscal year which does not correspond to the calendar year is likely to prove of considerable benefit to some companies.

Senator MILLIKIN. It is those accidents that require business judgment.

Mr. HADDOCK. Yes, sir. I have learned that very well, sir.

I am pleading for treatment which will permit us to hold together our skilled organization and to enable us effectively to do our job, whatever it may be, during the crisis ahead. If the impact of the House bill is not softened by some degree of relief, I, frankly, do not see how we can maintain our financial health after payment of the tax at the ceiling rate provided for in the House bill.

I want to thank you gentlemen for the opportunty of being present and telling our story, which may be peculiar to ourselves. And I

might add that we have in our proposal tried to avoid any loophole which would permit any great number of companies to come through. Whether there are any others in the United States who have been operating under chapter 10 or chapter 11 whose circumstances are similar to ourselves I do not know.

The CHAIRMAN. We thank you.

You wish to file an additional statement after you have had time to read the bill?

Mr. HADDOCK. No, sir. With your permission, sir, I would like to file a statement which will contain approximately what I have given to you orally here, which I did not have time to have typed up in advance.

The CHAIRMAN. That is all right; that will be taken as part of the record. Thank you very much for coming here.

Mr. HADDOCK. Thank you.

(The statement referred to above, when received, will be placed in the committee files.)

The CHAIRMAN. We will next hear from Mr. John A. Kennedy.

You may be seated and identify yourself for the record.

STATEMENT OF JOHN A. KENNEDY, CHAIRMAN, TV EXCESS PROFITS TAX COMMITTEE, HUNTINGTON, W. VA., ACCOMPANIED BY MORTON P. FISHER, ATTORNEY, BALTIMORE, MD.

Mr. KENNEDY. Mr. Chairman and members of the committee, my name is John A. Kennedy, of WSAZ-TV, Huntington, W. Va.

The TV Excess Profits Tax Committee, of which I am chairman, was formed by those television broadcasting companies which are not owned by manufacturing companies or networks to present to the Congress the serious situation confronting such companies in the event of the adoption of an excess profits tax law.

Our committee has submitted a formal and detailed statement, which I would like to file for the record.

The CHAIRMAN. You may do that.

(The statement referred to is as follows:)

STATEMENT MADE ON BEHALF OF THE TV EXCESS PROFITS TAX COMMITTEE

By: John A. Kennedy, Chairman
To: Committee on Finance of the United States Senate

Mr. Chairman and members of the Committee on Finance, my name is John A. Kennedy. My address is 2121 Sunset Boulevard, San Diego, Calif. I own 48 percent of the capital stock of television station WSAZ-TV, an independent television-broadcasting station operating in Huntington, W. Va.

The TV Excess Profits Tax Committee, of which I am chairman, is an autonomous committee appointed by those television-broadcasting companies which are not owned by manufacturing companies or networks, to present to the Congress the serious situation confronting these independent television-broadcasting companies in the event of the adoption of an excess profits tax law.

Television broadcasting is a pioneer industry. In 1946, there were only 8 television stations in commercial operation; in 1947, there were 17; in 1948, there were 50, including 10 belonging to the 4 networks; and in 1949, there were 97, including 13 belonging to the 4 networks.

During the 4 years 1946 to 1949, inclusive, television broadcasting was in the pioneering and experimental stage. In recognition of this fact, the FCC, as a condition to the granting of a television license, required the applicant to demonstrate that it had made provision, and was financially able and willing, to invest, not only the amount of capital required to build and operate its television-broadcasting

station, but also to take care of the inevitable deficits which the station would suffer for an extended period. The period of anticipated deficit operations was estimated by the Commission to be for as long as 5 years after the station began operations.

That the policy of the Commission was sound and proper was demonstrated by the fact that, in 1949 (when, as of December 31, the average period during which the 97 stations then doing business were in commercial operation for only 15.48 months), a staggering proportion of the capital invested by such stations was lost in their operations.

The official figures, on file with the FCC, show that, as of December 31, 1949—

(*a*) The 4 networks, with their 13 stations, had an aggregate capital investment, at cost, of 19.1 million dollars. Their aggregate loss was 11.7 million dollars. The percentage of their aggregate loss to their aggregate capital investment, at cost, was 61.3.

(*b*) The 84 independent stations had an aggregate capital investment, at cost, of 36.8 million dollars. Their aggregate loss was 13.6 million dollars. The percentage of their aggregate loss to their aggregate capital investment, at cost, was 36.9.

(*c*) All 97 stations had an aggregate capital investment, at cost, of 55.9 million dollars. Their aggregate loss was 25.1 million dollars. The percentage of their aggregate loss to their aggregate capital investment, at cost, was 45.2.

The 106 television stations, which, according to the official records of the FCC, were in commercial operation on November 1, 1950, had at that time been in operation for an average period of only 23.82 months.

Under the circumstances applicable to television broadcasters, the average earnings credit is patently futile for the obvious reason that there were no net earnings from television broadcasting during the base period. Operating net loss carry-overs and unused excess profits tax credits will temporarily delay the application of the tax until they are exhausted; but, once a television-broadcasting company is on its feet, the nonexistent earnings credit will afford no relief from the heavy impact of the excess profits tax. Since television broadcasting is essentially a matter of service, with invested capital relatively unimportant in the production of income, the earnings credit is the one to which such companies would ordinarily look for the establishment of normal earnings, since the purpose of the law is to tax only excess profits. The complete absence of earnings experience creates a situation in which these pioneering taxpayers are wholly deprived of the natural basis for their credit.

If there is anything in connection with the proposed excess profits tax, about which everyone is in accord, it is that the law should be so drawn so as not to tax normal profits. The fundamental purpose of the law is to tax only excess profits.

In most instances, it is quite difficult to ascertain with any degree of exactitude what are normal profits, as distinguished from excess profits. But there is no such problem in respect of the television-broadcasting industry because the whole industry has never had the opportunity (and will not have the opportunity during the period in which the proposed tax is expected to be operative) to demonstrate what its normal profits may be.

The television-broadcasting industry is an infant industry. The 97 television stations in commercial operation on December 31, 1949, had been doing business for an average period of only 15.38 months. When all these companies began commercial operations, the industry was still in the experimental stage. There were rapidly changing technological developments. Transmission facilities were in a state of experimentation. There were comparatively few telvision receivers in the hands of the public. At the present moment, the technology of the industry is still in the process of development. The transmission of television in color is one of the serious problems confronting the whole industry.

Moreover, there is little likelihood that a norm of earnings will be reached within the next 5 years. Because of the acute national emergency, the Federal Government has already rationed and will continue to ration essential component materials which will result in a substantial curtailment of the production of television receivers.

The profits of the industry depend entirely on the number of television receiving set in the hands of the public. Like the newspaper, magazine, and radio business, the television-broadcasting industry depends for its advertising, which is the sole source of its profits, upon circulation. And, for the reason stated, the normal circulation of the industry cannot possibly be reached until there

are sufficient television receiving sets in the hands of the public to justify the advertiser in using this medium for the promotion of his product.

That this is true is demonstrated by the staggering losses heretofore suffered by all of the television-broadcasting companies (according to the official figures, on file with the FCC).

These figures show that, during any base period that may be adopted by Congress, the television-broadcasting industry had no profits. They had only losses. And no single television-broadcasting station has been able to demonstrate what normal profits in the industry may be.

Accordingly, there is no criterion that can be incorporated in the statute for determining or estimating normal profits. There is no measuring rod for establishing a reasonable basis for determining what the norm might be.

In other words, with respect to this whole industry, a determination of excess profits for the purpose of taxing them under the proposed law would be utterly impossible. There is no alternative basis for such determination which the Congress could adopt.

Sections 443 and 444 of H. R. 9827, while no doubt intended to remedy the problem of lack of base period experience, failed to offer any practical relief for television broadcasters. It may be said, parenthetically, that no one knows at this time what the practical effect of the application of industry figures may be, and any relationship to the problem of the television broadcasters would at best be fortuitous and unrelated to the applicable facts.

Section 443, by its express language, makes itself inapplicable to the problems of the television broadcasters. A little over 88 percent of the companies engaged in television broadcasting on December 31, 1949, were also engaged in activities other than television broadcasting. Television broadcasting began after January 1, 1946, so that there was a substantial change in the products or services furnished under the provisions of section 443 (a) (1). Nevertheless, section 443 (a) (2) deprives such companies of relief because relief is allowed only where more than one-third of the net income of the taxpayer during one or more of the applicable years is attributable to the changed products or services. As stated above, there was no net income from television broadcasting during the base period, and therefore the one-third requirement cannot be met by television broadcasters.

Moreover, section 443 (a) (3) requires that the net income for one of the taxable years meeting the requirements of section 443 (a) (2) must exceed 125 percent of the average net income for the preceding base period years. It is impossible at this point to state how many, if any, companies engaged in television broadcasting (together with other activities) could meet even this test. It is reasonable to assume that television-broadcasting losses would make the later years' net income less instead of 25 percent more than in the earlier years; so that this subsection also eliminates any likelihood of relief. This is mentioned for completeness (because of the possibility of amendment of section 443) since, as H. R. 9827 now reads, section 443 (a) (2) alone defeats relief.

Section 444 of H. R. 9827 might fortuitously grant some measure of relief to the less than 12 percent of companies engaged exclusively in television broadcasting on December 31, 1949, which commenced business after January 1, 1946. This would depend solely upon the applicable percentage to be determined upon the basis of some industry classification which could only by fortunate chance have some reasonable relationship to television broadcasting. Even if such data produced a satisfactory result, however, it would apply only to the less than 12 percent of companies engaged in television broadcasting on December 31, 1949, which began business after the beginning of the base period.

Thus, a substantial segment of the very type of business for which relief was intended under section 443 is deprived of relief by the provisions of the section itself, leaving such chance measure of relief, if any, as may be afforded to the more fortunate few (without applicable difference in principle) which began business on or after January 1, 1946. Those organized with other activities prior to that date are likewise pioneers in the television field who have suffered very heavy losses in the television activities of their businesses.

It is hardly necessary to add that since the important source of television broadcasting income is service, an invested capital credit is fundamentally and inherently an inadequate standard of normal earnings. What with the need to recoup losses, and the subsequent impact of excess profits taxes, a fair return on capital could be hoped for, if at all, only in the dim and doubtful future.

The reasons above stated demonstrating the inadequacy of the average earnings basis of credit apply in principle to the application to the television broadcasting industry of the invested capital basis for credit.

Business indexes demonstrate that what is a fair return on invested capital for one industry is not necessarily a fair return for another industry.

When an industry, such as the television broadcasting industry, is primarily engaged in the business of selling service, invested capital is not significant in the determination of what a normal profit should be.

Moreover, in one industry, where the capital risk is not great, the reasonably expected return from the investment would be less than that of an industry in which the capital risk assumed is greater.

There is no imaginable industry in which the capital risks assumed are or have been greater than in the television broadcasting industry.

The industry is still in the pioneering and experimental stage. Deficit operation for a long period of time was not only expected, but the FCC, as a condition to the granting of a televiison license, required the applicant to demonstrate that it had the capital required to take care of the inevitable deficits which would be suffered.

What incentive would there have been to the existing television broadcasting companies to take such enormous risks if the ultimately expected norm of its profits were to be limited to a yield on its capital investment comparable to that reasonably expected by other industries who were not required to take such risks?

And what incentive will there be, in the event additional television channels are allocated, for new corporations to assume such risks so as to make it possible to secure Nation-wide public coverage for the purpose of disseminating, by this unparalleled medium of publicity, public information, which is so vital, not only to public education, enlightenment and culture, but even to public safety and military operations?

And in this connection, it should be pointed out that the risks assumed are not merely conjectural or theoretical. The figures for the whole industry, which are a matter of public record, demonstrate that the losses thus far suffered by the industry were not only staggering but are probably unparalleled for any pioneer industry in history.

For the reasons stated, it is clear beyond peradventure that the invested capital basis for determining the credit on normal profits of the television broadcasting industry is not only inadequate but eminently unfair.

Moreover, and of paramount importance to the little fellow in the television broadcasting business, many of the independent television broadcasting companies have borrowed large sums for comparatively short terms. Should the Federal Government impose on them a confiscatory excess profits tax, with a credit of a limited percentage of their capital investment (even if the credit be allowed in respect to the full amount of these borrowings), or with an inadequate average earnings credit, where, and in what manner, will these companies be able to secure the funds with which to repay these loans?

It is apparent that television broadcasters cannot be poured into the general mold, either on the basis of an earnings credit, an invested capital credit, or a relief provision of general application.

The reason for this is that the problem of the television broadcaster is sui generis. In support of this assertion, we submit the following:

(a) There is no foundation in experience, analogy, statistical computation or other technique (barring the crystal ball) for the determination of normal earnings from television broadcasting.

(*b*) In the meantime, television broadcasters have suffered enormous losses which, in fairness and equity they are entitled to recoup, plus a fair return for the pioneering risks assumed by them, such fair returns to encompass in retrospect the period of losses and experimentation as well as the periods of earnings.

(*c*) Pioneering industries of great importance to the public, and entailing great financial risk, warrant encouragement at the hands of Congress. Pioneering and further development losses attributable to color television are in the offing. Investment for this purpose should be encouraged.

(*d*) There is no hurry about applying excess profits taxes to television broadcasting income. Any excess profits tax fortuitously resulting at this time would be negligible in the over-all picture but harmful and discriminatory to the comparatively few taxpayers affected thereby.

(e) In the meantime, any net income from television will be taxed at the not inconsiderable rate of 45 percent.

(*f*) In from 3 to 5 years, Congress will have available the basis for a fair and equitable determination of credit through continuously developing data in the records of the FCC and the Bureau of Internal Revenue.

(*g*) If the suggestion is made that the excess profits tax law is intended only as a temporary measure, the answer is that there is less reason to subject television broadcasting income to its possible application on a hit or miss basis.

We conclude, therefore, that the only logical and practical answer is to defer the application of the excess profits tax law to net income from television broadcasting until the broadcasters have developed to a point where the application of the law will be fair, practical, and equitable. When that point is reached, Congress will be able from data in the FCC and Bureau of Internal Revenue to devise a proper credit in the light of then existing facts, and can then make the law applicable. It will not then be in the position of trying to force square pegs into round holes. Draft of the proposed statutory provision to implement this viewpoint is hereto attached, marked exhibit A.

Special legislative relief is, of course, not without precedent. In the 1917 excess profits tax law, even partnerships and sole proprietorships were subject to an excess profits tax. However, in the 1918 Revenue Act, not only were partnerships and sole proprietorships excluded but also personal service and eleemosynary corporations. Gold mining companies and maritime companies were also excluded.

In the excess profits tax laws in effect during World War II, and in H. R. 9827, the same groups were exluded, and, in addition, the following:

- Regulated investment companies.
- Corporations subject to the Civil Aeronautics Act.
- Corporations completing contracts under the Merchant Marine Act.
- Companies engaged in the mining of antimony, chromite, manganese, nickel, platinum, quick-silver, sheet mica tantalum, tin, tungsten, fluorspar, flake graphite, and vanadium.
- Companies engaged in certain timber operations and in the natural gas business (within certain limits).

Regulated investment companies were exempted because their assests consisted solely of securities of other corporations, which were subject to the excess profits tax.

The other corporations to which relief was granted fell into the following broad categories:

1. Corporations receiving subsidies from the Federal Government; and
2. Corporations that the Congress thought should be encourages to produce, by offering the incentive of the elimination of the excess profits tax burden.

We respectfully submit that television broadcasting corporations fall within the second category.

They not only assumed an extraordinary financial risk when they went into the business, but they are a strictly regulated industry. Their licenses from the FCC are granted for only 1 year at a time, and these licenses are subject to forfeiture if the licensees fail to render the public service required of them under the Federal Communications laws.

Under the Federal Communications Act, it is a recognized responsibility of a licensee to devote a reasonable portion of its programing time, without cost, to the public service.

It is well known that broadcasting companies have already been briefed by defense agencies to carry out vital functions in the event of a war emergency in the interests of public safety.

In addition, as already indicated, with the uncertainty and confusion attendant upon the development of color television, the existing stations are far from out of the woods financially. When a color system is finally adopted by the FCC, additional capital must be invested by television broadcasting corporations for the equipment needed to telecast in color. And, until there are a sufficient number of receivers in the hands of the public to make color programs profitable to the advertiser, there will be large operating losses just as has been the case in the initial telecasting of black and white programs.

Again, as indicated above, the FCC has now under consideration the granting of many additional licenses, when technically feasible, looking toward complete Nation-wide television coverage. In the event of a war emergency, Nation-wide public coverage will be a vital public necessity for the purpose of disseminating, by means of this unparalleled medium of publicity, public information which would be vital to public safety and indispensible to military operations. If investment in new stations is to be encouraged in the face of calculated long-term initial deficits, there must be no emasculation of later profits by application of excess profits tax rates with inadequate or negligible credits.

Within a few short years television has established itself as the most powerful medium for disseminating public information. With the growth of television throughout the Nation, it can reasonably be predicted that television will rival newspapers in influencing public thought. As a result, it is fundamentally important that the control of television stations be placed in the hands of individual groups to assure the presentation of diverse viewpoints.

Initially the establishment of a television station requires a capital of upward of $250,000. To the average radio-station owner, this involves a major expenditure; however, to a large newspaper chain or to a group of wealthy industrialists this outlay would be of relatively minor significance. Unless some tax relief is afforded to the smaller station licensees and similar relief promised for those who hope to get into the television business, the control of these stations will eventually pass to the people who control the bulk of the most expensive and presently most influential media of communication.

In conclusion, therefore, we submit that deferment of the application of the excess profits tax law to net income attributable to television broadcasting operations is not only warranted, but necessary in the public interests. Any other course will be a course of destruction to a vital, and otherwise vigorous group of hardy and worthy pioneers.

TV EXCESS PROFITS TAX COMMITTEE,
By JOHN A. KENNEDY,
WSAZ-TV Chairman.
GEORGE B. STORER, *WJBK-TV, Treasurer.*
HERBERT LEVY, *WAAM-TV, Secretary.*
RICHARD A. BOREL, *WBNS-TV.*
JACK O. GROSS, *WFMB-TV.*
MORTON P. FISHER, *Tax Counsel.*

EXHIBIT A. DRAFT OF PROPOSED PROVISION DEFERRING NET INCOME FROM TELEVISION BROADCASTING OPERATIONS FROM THE APPLICATION OF EXCESS-PROFITS TAXES

In the case of any domestic corporation engaged, in whale or in part, in the business of television broadcasting, the tax imposed by this subchapter shall not exceed an amount which bears the same ratio to the tax imposed without regard to this section as the portion, if any, of the adjusted excess profits net income, not attributable to the television broadcasting business, bears to the entire adjusted excess profits net income.

Mr. KENNEDY. I can only hope at this time to high light certain significant factors.

We are not opposed to an excess-profits tax as we understand its theory, which is to siphon off excess profits arising from the war.

Likewise we are aware of the most serious condition in which this country now finds itself. We know that the Government is going to have to tax heavily.

Our only plea is that Congress recognize our predicament and tax us at a rate no higher than the tax it places on all corporations, large or small.

During the 4 years, 1946–49, inclusive, we who have been in television broadcasting, have been pioneering and experimenting. The Federal Communications Commission, before granting a television license, required the applicant not only to have sufficient initial capital to build and operate its station but also to have sufficient capital to absorb the inevitable deficits which the station would necessarily suffer for an extended period—estimated by the Commission to be as long as 5 years.

The soundness of the Commission's requirement is demonstrated by the fact that as of December 31, 1949—the period during which the 97 stations were in commercial operation was only 15.48 months—a staggering proportion of the capital invested by such stations was lost in operations.

Senator MILLIKIN. Does it include all licensed stations, or those of a particular category that you describe?

Mr. KENNEDY. No, sir. The stations of that time, as of December 31, 1949. There were 97 on the air.

Senator MILLIKIN. Altogether?

Mr. KENNEDY. Altogether.

Senator MILLIKIN. Owned by everybody?

Mr. KENNEDY. Owned by everybody. Since that time additional stations have gone on to the extent of 108, which is the present population.

Senator MILLIKIN. How many of your own category?

Mr. KENNEDY. Eighty-five of our own category.

Senator MYERS. Were those authorized before the freeze?

Mr. KENNEDY. All authorized before the freeze, Senator.

Well, now FCC official figures show that, as of December 31, 1949, the 97 stations had an aggregate capital investment, at cost, of $55,900,000. Yet their aggregate loss was $25,100,000, which was 45.2 percent of their aggregate investment.

Again, the 85 independent stations had an aggregate capital investment, at cost, of $36,800,000. Yet, their aggregate loss was $13,600,000.

In 1946, there were only 8 television stations in commercial operations; in 1947, 17; in 1948, 50, including 10 belonging to the 4 networks, and in 1949, 97, including 13 belonging to the 4 networks, and now, 108, as I said.

Thus under the circumstances applicable to television broadcasters, the average earnings credit is patently futile for the obvious reason that there were no net earnings from television broadcasting during the base period.

In other words, Mr. Chairman, we have the dubious distinction of being the only industry in the Nation, all of whose members had a red-ink average for the base period suggested both in the House bill and the one presently before your committee.

Senator MILLIKIN. It looks to me that your base should be established on your losses instead of your profits.

Mr. KENNEDY. Perhaps so.

Since television broadcasting is essentially a matter of service, with invested capital relatively unimportant in the production of income, the earnings credit is the one to which such companies would ordinarily look for the establishment of normal earnings, but the complete absence of the base period earnings has wholly deprived these pioneering taxpayers of the natural basis for such credit.

Take the case of our Huntington, W. Va., TV station. We first invested something in excess of $250,000 for buildings and the necessary equipment. Then, the telephone company could not go out to Huntington, W. Va., with a microwave cable. We had to put up our own microwave relays from Cincinnati to Huntington to enable us to connect with the chains. Otherwise, we could not bring our viewers necessary live shows. That cost us an additional $87,000.

We have been on the air now for 12½ months. Up to October, we have been operating in the red. Our operating losses were $110,221.85. And that, Senators, is made up of good, hard American dollars.

Senator TAFT. I did not know there were any.

Mr. KENNEDY. I am not sure, Senator. All I know is that we had to dig them up.

That is why it is impossible to determine with any degree of exactitude what are normal profits as distinguished from excess profits by using any average base earnings credit.

Senator MILLIKIN. Turn back a page or two, the third paragraph. The aggregate loss of $25,100,000 could be added to the $55,900,000 as an investment base, could it not?

Mr. KENNEDY. I will have to turn to our counsel. I do not think it would work out, because our problem is that we have a mixed company situation. Some of us have been operating other businesses. Some are new companies. But I would prefer to refer that to Mr. Fisher, our tax counsel.

Senator MILLIKIN. Am I correct in my statement?

Mr. FISHER. No, Senator Millikin. As the statute is drawn, it would not apply to something over 80 percent of the television broadcasters. The reason for that being that there must be net losses. You are speaking of this recent loss section? And with respect to the more than the 80 percent of the television broadcasters, there were other activities such as radio or what not, and profits would offset the losses from television operations. They would suffer the losses, but they would not get that benefit. If I could give you one brief example, I think I could make it clear.

Senator MILLIKIN. Is that your understanding?

Mr. STAM. I was looking at the total net loss. You say that there are other activities where you did not have a net loss?

Mr. FISHER. To the less than 20 percent which operated television stations only, the recent loss provisions would undoubtedly apply, but not to the other 80 percent.

Senator MILLIKIN. Thank you very much.

Mr. KENNEDY. We have had no chance to determine what normal profits might be.

The invested capital basis is likewise clearly inadequate. Television broadcasting is essentially a matter of service—service of a highly specialized nature and of a very highly technical and artistic caliber. Imaginative people—artists and technicians—are the basis of our business. They produce our income.

Many of us have borrowed what for us are large sums of money. We have bought equipment on credit. Our earnings from standard radio or other activities have been drastically cut and, I know in our case, have become red ink during the base period by the operation of our television station—and we still owe $180,000. If you take our earnings by a tax on what obviously are not war profits, where are we going to get the money to pay our bank loans and other debts?

Senator KERR. You owe $180,000?

Mr. KENNEDY. Yes, sir.

Senator KERR. What is 1 percent of that?

Mr. KENNEDY. $1,800.

Senator KERR. $1,800?

Mr. KENNEDY. Yes.

Senator KERR. What is one-half of that?

Mr. KENNEDY. $900.

Senator KERR. $915. If you were permitted to earn $915 a year that was not subject to taxes, you could eventually pay that $180,000 off.

Mr. KENNEDY. Yes, sir. Only we could not pay the stamps on the notes.

Senator KERR. I was not talking about that.

Mr. KENNEDY. We have to sign those.

Senator TAFT. And that might cut the interest, besides.

Mr. KENNEDY. Yes, sir.

In addition, as already indicated, with the uncertainty and confusion attendant upon the development of color television, the existing stations are far from out of the woods financially. Additional capital must be invested for equipment needed to telecast in color. And, until there are a sufficient number of receivers in the hands of the public to make color programs profitable to the advertiser, there will be large operating losses just as there have been in the case of initial telecasting of black-and-white programs.

There will be many new stations to be built when the FCC lifts the freeze. If investment in new stations is to be encouraged in the face of calculated long-term initial deficits, there must be no emasculation of later profits by application of excess profits tax rates with inadequate or negligible credits.

There is only one practical answer. I have listened to all of the proposals that have been made to both your committee and the House Ways and Means. Mr. Sprague wants to annualize the first half of 1950. Our business, actually, got started the 1st of September of this year. Television has been experimenting. But in your own personal homes, perhaps, if you watch it, you will find the programs are now becoming more or less of age. So, we are just getting underway; we are not fully underway yet—and this avalanche hits us. There is only one practical answer. Defer the application of the excess profits tax laws to net income from television broadcasting until we have developed to a point where the application of the law will be fair, practical, and equitable. Congress will know when that point is reached because all relevant data will be available in the records of the FCC and the Bureau of Internal Revenue. When that point is reached, Congress will be able to devise a proper credit in the light of then existing facts, and can then make the law applicable.

Special legislative relief is, of course, not without precedent. In all the earlier excess profits tax laws there were a number of exclusions such as corporations subject to the Civil Aeronautics Act, the Merchant Marine Act, and certain mining and timber companies.

We respectfully submit that there is a greater justification for special treatment for television broadcasters.

Special treatment has been given railroads and utilities and other regulated industries in the House bill. Our larger industrial corporations have a tremendous average earnings base period credit. In many cases, their excess war profits will not be reached by the bill as now drawn.

Senator MILLIKIN. What cases?

Mr. KENNEDY. I am glad you asked that.

Senator MILLIKIN. You are speaking of larger corporations that have a tremendous average earnings base period credit.

Mr. KENNEDY. Yes, sir. There is a table prepared by an accounting firm—Poor's—on the 50 largest corporations of this country, and the last column gives the percentage of what their base for the three best years will be as compared with the base they had during World War II.

Senator MILLIKIN. Assuming the correctness of the figure, is that a correct comparison?

Mr. KENNEDY. I am not sure. I am only giving an example of some of the results that they will obtain.

The CHAIRMAN. That may be made a part of the record.

(The table referred to is as follows:)

Net earnings before Federal taxes of 50 largest industrial corporations

[In thousands]

Name of corporation	Average of 1936–39 (1)	1946 (2)	1947 (3)	1948 (4)	1949 (5)	4 years average 1946–49 (6)	Percentage of column 1 to column 6 (7)	Treasury plan best 3 years average (8)	Percentage of column 1 to column 8 (9)
General Motors	$221, 672	$12, 865	$554, 052	$801, 521	$1, 124, 927	$623, 341	281	$826, 833	373
United States Steel	58, 883	121, 275	220, 801	242, 293	295, 314	219, 921	373	252, 803	429
E. I. Dupont	91, 807	175, 807	207, 141	252, 470	333, 856	242, 318	264	264, 489	288
Ford Motor									
General Electric	54, 536	24, 193	176, 669	241, 582	203, 639	161, 521	296	207, 296	380
Bethlehem Steel	20, 444	57, 231	84, 988	152, 952	171, 383	116, 638	570	136, 441	667
Union Carbide	42, 452	92, 933	122, 168	159, 516	145, 854	130, 118	306	142, 513	336
Chrysler Corp	51, 752	33, 089	118, 481	144. 687	213. 170	127, 357	246	168, 779	307
American Tobacco	30, 775	48, 364	55, 662	70, 649	74, 486	62, 290	202	66. 932	217
International Harvester	29, 088	29, 052	75, 533	87, 082	94, 347	71, 504	246	85, 654	294
Westinghouse Electric	17, 956	[1] 52, 477	96, 480	97, 772	110, 772	63, 137	352	101, 674	566
Western Electric	22, 023	12, 330	68, 163	96, 525	69, 211	61, 557	279	77, 966	354
R. J. Reynolds	33, 983	49, 309	56, 703	60, 939	68, 925	58, 969	173	62, 189	183
Aluminum Co. of America	25, 171	27, 364	50, 250	67, 141	40, 718	46, 368	184	52, 703	209
Republic Steel	7, 518	25, 114	54, 507	80, 589	81, 304	60, 379	803	72, 133	959
Swift & Co	7, 636	22, 868	55, 284	53, 904	46, 342	44, 599	584	51, 843	678
Goodyear	13, 240	94, 232	62, 594	59, 344	42, 125	64, 574	488	72, 056	544
Armour & Co	8, 513	57, 093	52, 386	[1] 1, 935	1, 893	27, 359	321	37, 124	436
Liggett & Myers	25, 749	31, 266	38, 560	49, 423	49, 324	42, 143	164	45. 769	177
National Steel	15, 487	34, 336	46, 108	73, 421	76, 711	57, 644	371	65, 413	422
Jones & Laughlin	2, 027	15, 474	36, 489	51, 207	34, 866	34, 509	1, 702	40, 854	2, 015
Eastman Kodak	24, 834	46, 820	69, 766	89, 423	75, 770	70, 445	283	78, 319	315
International Paper	5, 930	55, 269	103. 683	100, 472	88, 973	87, 099	1, 468	97, 709	1, 647
Distillers Corp	8, 175	52, 407	74, 521	92, 428	59, 146	69, 625	851	75, 365	921
Schenley Industries	7, 456	103, 873	68, 785	49, 642	40, 489	65, 697	888	74, 100	993
Allied Chemical	25, 250	45, 944	57, 104	57, 549	63, 118	55, 929	221	59, 257	234
National Dairy Products	14, 408	51, 829	39, 226	42, 583	57, 088	47, 682	331	50. 500	350
Dow Chemical	4, 816	9, 097	21, 103	33. 644	41, 213	26, 264	545	31, 986	664
Youngstown Sheet-Tube	7, 753	23, 538	42, 941	61, 120	51, 671	44, 817	578	51, 911	669
Firestone	9, 637	64, 733	44, 864	53, 639	35, 389	49, 656	515	54, 412	564
United States Rubber	10, 952	41, 500	35, 644	35, 084	23, 288	33, 879	309	37, 409	341
Armco Steel	5, 377	30, 284	41, 867	52, 668	50, 781	43, 900	816	48. 438	900
Inland Steel	12, 672	24, 732	48, 740	62, 248	41, 286	44, 252	349	50, 758	400
Procter & Gamble	25, 373	34, 922	81, 858	108, 238	44, 818	67, 459	265	78, 305	308
Deere & Co	14. 522	18, 029	28, 508	44, 721	70, 384	40, 411	278	47, 871	329
American Can	20, 688	14, 185	35, 857	44, 702	48, 318	35, 765	173	42, 956	207
B. F. Goodrich Co	4, 692	53, 491	49, 086	53, 853	40, 277	49, 177	1, 048	52, 143	1. 111
Celanese Corp	5, 318	27, 774	40, 336	66, 137	34, 336	42, 146	792	46, 936	882

[1] Loss.

Net earnings before Federal taxes of 50 largest industrial corporations—Continued

[In thousands]

Name of corporation	Average of 1936–39 (1)	1946 (2)	1947 (3)	1948 (4)	1949 (5)	4 years average 1946–49 (6)	Percentage of column 1 to column 6 (7)	Treasury plan best 3 years average (8)	Percentage of column 1 to column 8 (9)
I. B. M	$10, 278	$31, 266	$39, 553	$45, 475	$53, 202	$42, 374	412	$46, 076	448
Borden Co	8, 603	33, 631	32, 041	29, 817	34, 761	32, 563	378	33, 477	389
Weyerhaeuser Timber									
R. C. A	9, 420	14, 346	29, 481	41, 071	41, 927	31, 706	336	37, 493	398
Pittsburgh Plate Glass	15, 664	31, 061	56, 247	53, 948	59, 435	50, 173	320	56, 543	360
Continental Can	9, 951	9, 762	20, 559	23, 711	19, 358	18, 348	184	21, 209	213
Allis-Chalmers	6, 546	[1] 25, 737	9, 072	26, 241	33, 205	10, 695	163	22, 839	348
General Foods	15, 830	34, 827	29, 846	40, 031	44, 913	37, 404	236	39, 924	252
National Distillers	9, 329	65, 054	58, 010	44, 423	40, 055	51, 886	556	55, 829	598
Coca-Cola	30, 891	38, 297	54, 044	59, 376	63, 541	53, 814	174	58, 987	190
American Cyanamid	5, 389	13, 593	14, 756	17, 775	25, 749	17, 968	333	19, 427	360
American Viscose									

[1] Loss.

Source: Moody's 1940 and 1950.
Source of corporations: Conference Board, Business Record, vol. VII, No. 10, Oct. 19, 1950, published by National Industrial Conference Board. P. 403, item, Fifty Largest Corporations.

Senator KERR. This would be wonderful if I understood it.

Suppose, on tomorrow, you give me a little time and explain it to me.

Mr. KENNEDY. I merely wanted to find out what was the difference between the basis for this tax bill as now suggested and the basis for World War II.

Senator KERR. That is all I want to find out.

Mr. KENNEDY. On the comparison, if you will take column 8 and compare that to column 1, you will find the difference between the two bases. Column 1 was the base according to these accountants, of World War II excess profits, and column 8 would be the basis, the whole basis, of the three best years. Of course, under your bill or the House bill, you take 85 percent of that.

Senator KERR. I understand that does not change the principle.

Mr. KENNEDY. It does not change the principle.

Senator KERR. Column 9——

Mr. KENNEDY. Is the percentage relationship.

Senator KERR. Let me say it in my words. Column 9 gives the figure in percent; it shows the greater amount or the degree of the greater amount, or the degree to which the base subject to this law would be greater than was the base to which the World War II excess-profits tax applied.

Mr. KENNEDY. That is correct, sir.

Senator KERR. Thank you.

Senator MILLIKIN. I think, if we assume both cases were fair, the larger profits base at the present time is readily explainable by more business.

Mr. KENNEDY. By more business; yes.

Senator MILLIKIN. And, possibly, by devaluation of the dollar.

Mr. KENNEDY. There are many explanations for it, and I am not criticizing it. I am only comparing.

Senator MILLIKIN. In many cases the excess-war profits will not be reached by the bill as now drawn. That is your statement. That would only be true if you assume that the 36–39 base is correct, rather than the 46–49 base.

Mr. KENNEDY. Some of the companies I know a little bit about, and I think my statement would be true.

Senator KERR. As I understand what he says, Senator Millikin, is this: In view of the very large earnings shown here for the years that would constitute the base, he is of the opinion that if they switched their operation from domestic to war production the profits would probably be no greater than they were during the base period in which their profits from the war operations and the production of war material would not be subject to provisions of this kind.

Senator MILLIKIN. In that case it would hardly be an excess-profits tax. If the profits are no greater, there is no excess.

The CHAIRMAN. There would be a tax on the 15 percent.

Mr. KENNEDY. Yes. I am only taking those figures to illustrate the difference, I am not criticizing these figures. Do not misunderstand me.

The CHAIRMAN. Yes.

Senator MILLIKIN. These corporations that are listed here, if they are not reached by this law—that is, reached effectively—then there is nothing effective in it.

Mr. KENNEDY. I presume the next thousand companies will have the same ratio. I do not know; I have not seen those figures, sir.

Within a few short years television has established itself as the most powerful vehicle of public information. With the growth of television throughout the Nation, it can reasonably be predicted that television will rival newspapers in influencing public thought. As a result, it is fundamentally important that the control of television stations be placed in the hands of individual enterprises to assure the presentation of diverse viewpoints.

Initially the establishment of a television station requires a capital of upwards of $250,000. To the average radio station owner, this involves a major expenditure. However, to a large newspaper chain or to a group of wealthy industrialists this outlay would be of relatively minor significance. Unless some tax relief is afforded to the smaller station owners and future small owners, the control of smaller stations will eventually pass to the people who own the most expensive and the presently most influential media of mass communications.

If I cannot pay my notes and my equipment bills—and I cannot do it at one-half of 1 percent, which you are going to give me——

Senator KERR. I think that is what the provision of the House bill would entitle you to. I think that they have been very sure to see to it that under the provisions of the bill it would be that much.

Mr. KENNEDY. I am glad to get the $900, but I am afraid that I would have to turn it over to the banks. The banks might operate it better than we can, but, gentlemen, we would still like to have a chance.

I am sure, Mr. Chairman, that your committee will not, by this bill, undercut the mandate to foster competition which the Congress already has affirmatively set up as a principle in guiding the Federal Communications Commission in determining who are to operate these stations.

Unless television broadcasting can be financed out of reasonably assured earnings, set ownership and television entertainment will be concentrated in the great population centers of this country, and the enjoyment denied rural and agricultural areas.

Local, independent telecasters will need outside capital. It will not be forthcoming if this tax law passes as presented here.

The House Ways and Means Committee recognized the seriousness of our problem—tried to help us and thought they did help us—but analysis by competent tax counsel demonstrates that that objective was not accomplished. You will find the detailed reasons why that objective was not reached in my committee's formal statement.

In conclusion, therefore, we submit that deferment of the application of the excess profits tax laws to net income attributable to television broadcasting operations is not only warranted, but necessary in the public interest. Any other course will be a course of destruction to a vital and otherwise vigorous group of hardy and worthy pioneers.

American democracy has been revitalized each time it has been threatened. The forum in America has been the courthouse square, the town meeting, the service clubs. These forums, where the speaker faces those who see and hear him, are the testing grounds for sincerity and accuracy as opposed to tyranny and propaganda. Now we give you television, regardless of transportation and weather, has brought the greatest force in strengthening democracy into the bosom

of our family life. We should sponsor the growth of this new force in democracy, for our sake, for democracy's sake, and for the safety and sanity of the world.

Senator MILLIKIN. It gives a great advantage to handsome politicians; does it not?

Mr. KENNEDY. It does, sir.

Senator MILLIKIN. I am glad I have got 6 years ahead of me.

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

The CHAIRMAN. Senator Myers.

Senator MYERS. Could you tell us, Mr. Kennedy, how many of those 97 stations might have been in the black the first 6 months of this year wholly from their television operations?

Mr. KENNEDY. I would be guessing, sir. I do not have all the figures. I would say if there are four or five I would be surprised.

Senator KERR. And they would only be those in the very large centers and those that had been in operation for a considerable period of time?

Mr. KENNEDY. Well, I have one in mind that is not in a large center, that had a rather peculiar circumstance, where the cable went right through the town. There were all sorts of circumstances by which they worked out. But, for the most part, our business has started about the 1st of September, some of them the 1st of August, some of them the 1st of July. I mean, our black ink.

In our case, in Huntington, we have just started, I hope, in November. I have not seen the figures yet.

Senator MILLIKIN. Are you folks in a position to break your income down between television and radio?

Mr. KENNEDY. Yes, sir; we are required to do that by the Federal Communications Commission.

Senator MILLIKIN. Mr. Chairman, I believe it would be a good thing if we had those figures in the record.

Mr. KENNEDY. We have the complete breakdown. In every report we submit to the Federal Communications Commission we are required to break the figures down.

The CHAIRMAN. Is that in the statement you filed?

Mr. KENNEDY. It is, so far as losses; yes, sir.

Senator MILLIKIN. I think, Mr. Chairman, it would be a good idea if we had those figures.

The CHAIRMAN. Yes. If you can break that down and furnish those figures, we would like to have them.

Mr. KENNEDY. Shall I ask Mr. Stam what he would want?

The CHAIRMAN. Yes.

(The information requested, when received, will be placed in the committee files.)

Senator MILLIKIN. You say 80 percent is mixed?

Mr. KENNEDY. Yes. Eighty-eight percent, actually.

Senator MILLIKIN. So we cannot judge the television impact of this thing until we have some general breakdown that gives us the television significance.

Mr. KENNEDY. I will get those figures just as quick as I can and file them with the committee.

The CHAIRMAN. If you will do that, we will appreciate it.

Are there any further questions?

If not, I thank you very much for your appearance, Mr. Kennedy.

Mr. KENNEDY. Thank you, sir.

The CHAIRMAN. Mr. Robert Kerr, Jr.

Senator KERR. Mr. Chairman, I would like to state that I am delighted to see this gentleman coming here. I am looking forward to his testimony with a great deal of curiosity. As far as I know, there is no blood relationship between me and him, but I expect somewhere back in the line of ancestry there probably is some.

Senator TAFT. It is a good first name, anyway.

The CHAIRMAN. Identify yourself and proceed, Mr. Kerr.

STATEMENT OF ROBERT KERR, JR., PRESIDENT, KERR MANUFACTURING CO., DETROIT, MICH.

Mr. KERR. Mr. Chairman and members of the committee, I am Robert Kerr, Jr., president of the Kerr Manufacturing Co. of Detroit, Mich., where I reside.

I am submitting a statement for the record, but for the sake of brevity I will merely summarize it.

The CHAIRMAN. Your statement will be incorporated in the record.

Mr. KERR. I wish to point out certain inequities that the present base period we will be allowed will work on our company, and probably many others. It appears to cut quite across industry lines.

Senator MYERS. You say will or will not work?

Mr. KERR. Will not work for our company.

Senator MYERS. Will not work.

Mr. KERR. We are a little company. Our volume of business this year will be a million and three-quarters, last year $1,700,000.

Senator MILLIKIN. What is your business?

Mr. KERR. We manufacture dental instruments and dental supplies.

The CHAIRMAN. When were you established?

Mr. KERR. We were established in 1891. The business was established by my father. We have paid high wages, that is, good wages for the time since then. We have never shut down for a single week in almost 60 years.

We have reinvested our profits to the point where no individual, myself or any stockholder, has grown wealthy from this little business.

Our products were declared essential to health during World War II. In World War II we made products for the dentists, for the Army Medical Corps, and at the request of the Army we attempted to produce, and did produce, a highly secret and specialized radar part which no one else was able to produce. The development work on that we paid for ourselves.

We paid excess profits taxes in only 2 years during the war, and renegotiation took from us nothing. We had to pay no money back.

At the end of the war we tried to carry on this new process we had developed at the request of the Government and adapt it to civilian use. We lost a considerable sum of money in 3 years' time trying to adapt it. It now has been adapted successfully.

Senator MILLIKIN. I missed part of it. What is this process?

Mr. KERR. This process is for production of this radar part.

Senator MILLIKIN. I see.

Mr. KERR. It was entirely outside of our line of business, and the Army requested we do it, and we did. It now has become a useful part of our business, but it caused us considerable losses in 3 years' time.

In addition, we obtained by negotiation, from a Swedish company, a secret process they had for the production of a dental drill that cuts with less pain and is less expensive for the dentist to use. It took us 3 years before we could get that out of the red, but now we are making thousands of these drills which save the dentist money and produce less pain. We have this secret Swedish process in the United States of America now in our plant.

Now, another problem with us has been our wage situation. Our wages have gone up 200 percent since 1940. Our prices have gone up 125 percent. Our competitors sell for the same prices, or lower than we do—most of them lower, because most of them pay lower wages than we do.

Now, for example, the lowest rate we pay to the lowest paid person in our plant is greater than that paid to 43 percent of the employees, all the employees in the other dental manufacturing plants. The average wage that we pay to our employees is higher than that paid to all but 15 percent of the employees in the other dental firms.

To give you an idea of the type of wage competition we have, there is a statement here by Mr. Benjamin Weinrack, who is executive secretary of the Dental Manufacturers of America——

Senator MILLIKIN. How many employees do you have?

Mr. KERR. We have about 145.

Senator MILLIKIN. Are they organized?

Mr. KERR. No; they are not.

Mr. Weinrack is executive secretary of the Dental Manufacturers of America. In testimony before the Wages and Hours he makes this statement:

> An investigation which we conducted among our members in December 1949 disclosed that instruments and plastics manufacturers—

those are the type of things we make—

> had minimum wages of 60 and 65 cents an hour.

Now, our minimum wage is $1.

So that was another reason for a highly unprofitable operation in 1946, 1947, 1948, and 1949.

We have solved our problems. We have employed outside management consultants, and we have done internal engineering. So we can now produce in competition with the low-wage competitors and produce at a profit, but that took a tremendous amount of work.

Now, under the new law, all that work is made useless and our little company faces possible extinction while our lower-wage competitors will operate and prosper.

I have only had a chance to see the bill since yesterday, but apparently the relief provisions do not help us. All of this, of course, is rather ironical in the face of the fact that we have operated since 1891 in accord with the present-day thinking, and the way the corporation should operate. We did not get rich in World War II. We have given full employment for almost 60 years. We have developed new and useful products. As a result, we had to borrow money, part of it from

the Government, the RFC, and the new law does not permit us to have enough profit to pay back and to meet our contractual arrangements with the RFC from the profit.

Senator MILLIKIN. What kind of a provision would give you relief?

Mr. KERR. The provision that would help to solve our problem would be if we could have a different base. In other words, if we could use the base that was used for World War II, plus an allowance for the decreased value of the dollar, we would be in a far better situation.

As an example, from 1920 through 1941, which is a peacetime era, our net profits before taxes on our sales were 9.5 percent on the average, whereas in the base period that has been proposed they were three-tenths of 1 percent.

Now, pre-World War II was a much more normal operation than the postwar for us.

Senator MILLIKIN. To make it specific, what base do you want?

Mr. KERR. I would suggest that we be allowed to use the World War II base.

Senator TAFT. You mean your average for 1936–39 plus 25 percent?

Mr. KERR. That is right, plus 25 percent.

Senator TAFT. That is quite interesting if you get that without apparently increasing any base of any large corporation listed on this page. They are all over 125 percent of World War II.

Mr. KERR. Of course, the dollar has depreciated more than that, but it is a little bit our hard luck we were not succesful in the new base period. We are being modest in our request.

Senator MILLIKIN. You will have a hard time basing any formula and getting away with it on the depreciated dollar, because if you establish a precedent of that kind there is just no limit where you might carry it. Since the Government itself is somewhat responsible for the depreciated dollar, I doubt very much whether the Government itself would give you much relief.

Mr. KERR. No; but this situation that we have is, of course, serious for us, and I am sure other companies in various lines of industry have the same thing.

Senator MILLIKIN. How would a later base be, to, say, include the first half of 1950?

Mr. KERR. In the first place, we are on a fiscal year ending the end of July.

Senator MILLIKIN. You could still have the first half of '50.

Mr. KERR. The first half of 1950, it really just began to become profitable about June or May because we got our methods operating, the consultant work was completed.

Senator MILLIKIN. Is the rearmament program buying anything at all from you?

Mr. KERR. Ninety-seven percent of our business in 1950 will be for the civilian dentists, and 3 percent is for the Medical Corps, plus a very small quantity of these radar things we made before.

Senator MILLIKIN. Suppose the whole calendar year 1950 were made a part of your base?

Mr. KERR. Well, it is hard to say because of the break at the end of July.

Senator MILLIKIN. Well, you can estimate your year roughly.

Mr. KERR. It would be about 30 percent of what the proposal would allow us.

The CHAIRMAN. Mr. Kerr, did you give us the invested capital? Let's see how you stand.

Mr. KERR. Our current and fixed assets, less liabilities, amount to $1,100,000. Then we have in addition to that $375,000 in loans.

The CHAIRMAN. You borrowed $375,000?

Mr. KERR. Yes.

The CHAIRMAN. So you have about a million and a half dollars actually in operation; is that right?

Mr. KERR. Our invested capital credit is $100,000 under the proposal.

The CHAIRMAN. That is all it would be?

Mr. KERR. Yes.

The CHAIRMAN. How do you get that?

Senator TAFT. Six percent of a million and a half.

Mr. KERR. I have our accountant here, if I could consult with him.

Mr. STAM. It is 12 percent before taxes.

The CHAIRMAN. Twelve percent before taxes?

Mr. STAM. We do not know what he pays on money.

Mr. KERR. We pay 4 percent.

The CHAIRMAN. Well, have you looked at the provision in the House bill for dealing with new products?

Mr. KERR. Yes; it does not give us relief.

The CHAIRMAN. That does not get you any help there?

Mr. KERR. It will not produce 33⅓ percent of the business, which is one of the provisions.

Here is the comparison: The base under the business from 1946 to 1949 will run between $25,000 and $50,000. The invested capital base would be $100,000. Our World War II credit was $150,000. And we have a larger volume of business than we had at any time during World War II.

The CHAIRMAN. Well, sir, you are filing a full statement?

Mr. KERR. Yes.

The CHAIRMAN. Thank you very much.

Mr. KERR. Thank you.

The CHAIRMAN. We will take a look at your case. That is the best we can do now.

(The statement submitted by Mr. Kerr reads in full as follows:)

STATEMENT BY ROBERT KERR, JR., PRESIDENT, KERR MANUFACTURING CO.

This statement concerns an injustice in the proposed excess profits tax law which will affect many small companies and companies in old lines of business. This injustice will be brought about through selection of the base-profit period.

It has been generally assumed that companies, large and small, have been making tremendous profits since World War II, so that a base period of 1946–49 for determination of normal profits would, if anything, be overly generous to business. Therefore no one could have objection to this period as a base and business would be sufficiently protected so that considerable profits could be earned to take care of normal expansion needs.

The foregoing assumption that all business has made tremendous profits since the war is by no means true in many lines of industry. Those industries, such as the automobile, where prices could be raised and where there was a backlog of consumer demand, did very well during the 1946–49 period; but many businesses, serving specialized markets, did not have the same profit-making experience. We can best illustrate this point by using our company as an example.

We were founded in 1891 in the city of Detroit by our present board chairman. Our business is the manufacture of dental instruments and supplies, an essential health service. We have been continuously in business in Detroit since the founding, have built our own factory, have bought our own machinery, and have given continuous employment without a single shutdown, even for 1 day, since 1891. Our company has grown slowly through reinvestment of our profits and no founder or executive of this company has grown rich through its operation. During World War II we did not make excessive profits and renegotiation did not require the return of a single cent.

The period since the war has not been profitable for us and it is not a period indicative of our normal earnings. Our profit before taxes, as a percentage of sales, averaged 9.5 percent from 1920 through 1945. Our average for 1946–49 was 0.3 percent. The reason for this situation is quite simple.

We have been unable to raise prices in the way that the large consumer industries have done, whereas our wage rates have gone up in keeping with those paid in these large industries. To complicate the situation, a sufficient number of our competitors have managed to keep their wage rates considerably below ours so that there is little chance of the price structure changing.

The immediate assumption would be that our competitors are better businessmen than we. They are, if paying a reduced wage is the criteria. On the other hand, it is the thinking in Government today that labor should be paid a fair wage. We feel that our wage structure is fair and that anything very much below what we pay is insufficient. Our starting rate is $1 per hour, and our average rate is $1.35, about average for most lines of business.

On the other hand, 42.6 percent of the hourly rated employees in our industry make less than our minimum rate and 83.5 percent make less than our average rate. This wage differential has been most apparent since the end of the war. There is nothing that we can do about our price situation, and there is nothing that we would want to do about attempting to pay lower wages. Because of paying a fair wage we have been unable to make a profit.

The picture is simply this: Our labor cost has doubled. Our cost of materials is up 165 percent. Our selling and general expense, on the other hand, has only increased 2 percent of sales during that period. It is clearly evident that increased labor cost is principally responsible for our abnormally low profit during the 1946–49 period.

Since the war we have been working desperately to put our house in order so as to make our normal profit without reducing wages and without raising prices. We are just now seeing the results of that work, which involved a streamlining of methods, the employment of outside management consultants, and a general overhaul to increase efficiency. An excess profits tax based on 1946–49 will render this work useless. It will take from our company not only excess profits but the normal profits that past history shows us we are entitled to. It will take from us the incentive to carry on as we have done from 1891 to the present day, building a business, giving employment without a single shutdown, reinvesting so that continuous employment could be provided. Meanwhile competitors paying lower wages will be making and retaining substantial profits.

Here is our suggestion: We suggest that a company have its choice of two base periods. During World War II we were allowed to use the period from 1936–39 for determination of normal profit. It would seem to us that if that period was suitable for World War II, the same period or a slight modification should be fair and equitable now. We would suggest that a company have its choice of the 1946–49 period or the 1936–39 period. If the latter period is taken, the amount should be increased by 25 percent to make allowance for the reduced value of the dollar.

As an illustration of how this would work in the case of our own company, using a base period of 1936–39 plus 2 percent, we would be allowed $185,000. Our average profit for the period 1920–45 was 9.5 percent of net sales. During the year 1950, a year in which 95 percent of our volume will be with civilian dentists—in other words, a normal year without war profits—our sales will be between $1,750,000 and $2,000,000. Nine and one-half percent of this expected volume will approximate the suggested 1936–39 plus 25-percent credit of $185,000.

When the actual normal, historical profit of our company is determined by looking over the past, and when this is applied to the 1950 year of the company, a sales year not colored by military or war orders, it is found that the World War II credit plus 25 percent is the normal expected profit based on past his-

tory; whereas the 1946–49 period is entirely out of line with our normal condition.

Furthermore, using the suggested 1936–39 plus 25 percent period, if our volume should increase through war contracts, the excess profits taxes would immediately come into effect and take away the war-produced excess.

We do not feel that our case is exceptional. We feel that there are many old established firms, firms that have in many cases been the backbone of the industrial growth of this country, whose normal profit period is not exemplified by 1946–49.

Our company, being small, does not have the advantages of a large statistical department so that we are unable to present a long list of companies confronted with our same problem, but we list here five in various branches of industry, which have not enjoyed a postwar boom.

	Average profits	
	1936–39	1946–49
Coty Cosmetics	$741,462	$522,390
Spencer Shoes	180,000	50,000
Gar Wood Industries	500,000	−1,750,000
Grey Manufacturing Co. (telephones)	140,000	30,000
F. L. Jacobs (automotive parts)	250,000	−1,750,000

We suggest, then, that the excess profits tax credit be determined by any of the following three methods:

The 1936–39 base method, as used during World War II, plus 25 percent.
The 1946–49 period.
The invested capital method.

The CHAIRMAN. Mr. Horace Ford.

Please identify yourself for the record. You are representing the American Research & Development Corp.?

Mr. FORD. That is right.

The CHAIRMAN. Will you proceed?

STATEMENT OF HORACE FORD, TREASURER, AMERICAN RESEARCH & DEVELOPMENT CORP.

Mr. FORD. Mr. Chairman and gentlemen of the committee, my name is Horace Ford. Until recently, I was for many years treasurer of the Massachusetts Institute of Technology. I am treasurer of American Research & Development Corp., and have been since its incorporation in 1946, on whose behalf I appear here today.

American Research & Development Corp. was formed in 1946 by a group of individuals and institutions interested in providing a pool of venture capital available to finance new enterprises which give promise of expanded production and employment. It offers financial backing together with engineering and business guidance to the individuals who have the vision and ability to bring forth new ideas, processes, and inventions which extend our industrial frontiers and strengthen our country.

Senator MILLIKIN. Is this the organization in which Senator Flanders is much interested?

Mr. FORD. He was the original suggester of the organization, Senator.

In the 4 years of its existence, American Research & Development Corp. has backed about 20 new enterprises. Among these are the following:

A company which has developed for use in heating the average-size home a furnace using the combustion principles of the jet engines now used in airplanes.

A company formed by a group of young scientists and engineers to operate in the field of nuclear physics and tracer chemistry, applying the new products of atomic energy to peaceful industrial production.

A company which manufactures high-voltage generators for use in combating cancer, in the sterilization of food and drug products, and in conducting nuclear research.

These are merely illustrations of the type of new and stimulating enterprises which American Research & Development Corp. endeavors to foster.

Generally speaking, after the basic idea for an enterprise has been formulated, it is our experience, it requires five or more years of hard effort and at least $100,000 to $500,000 of money to bring the new enterprise of this type to the point where its eventual success or failure can be considered adequately established.

New enterprises of this kind formed after 1945 will seldom have reached an earnings experience in the base period 1946 to 1949 which will give them a fair excess profits credit if they compute their tax on the basis of average earnings in the base period. Yet if they compute their tax on the invested-capital method the rates of return allowed under that method are still likely to provide an inadequate credit. Charts presented by Secretary Snyder before the House Ways and Means Committee showed that in the period 1946 to 1949 manufacturing corporations earned on the average some 22 percent of their net worth before taxes and some 14 percent after taxes. Nevertheless, H. R. 9827 allows on the invested-capital method a return of only 12 percent on the first $5,000,000 of invested capital, which is equivalent to slightly more than 6 percent after taxes. It is our suggestion that if a higher and more realistic rate of return were allowed to new enterprises on investments up to, say, $500,000, so as to put such companies on a basis more comparable to well-established companies, much of the problem of providing relief for new enterprises would be solved in a relatively simple fashion. New peacetime businesses could then attract the venture capital which they sorely need, but companies which mushroom in a defense economy would derive no material benefit since they typically earn an enormous return on their original investment.

What the potential investor in a new business wants to judge is how long it may take the company to recover the money which he is being asked to invest in the venture. Generally speaking, those who are interested in providing financial support for new and untried businesses may be willing to assume the risks involved if there is a reasonable prospect that the business can earn, after taxes, the amount of the original investment within a period of 5 years. If that can be done, the investor will be less concerned about the prospect of taxation in the subsequent period.

We accordingly suggested before the Ways and Means Committee that in the case of a new enterprise started after 1945 the excess profits tax should be limited to an amount which would leave the company with income, after regular corporate taxes and excess profits taxes, equal to 20 percent of the capital invested in the enterprise until the

company has earned after taxes an amount equal to the investment. This would apply only to investments up to $500,000. It would permit the companies to earn after taxes over a period of 5 years an amount equal to the capital invested in them. We feel that such a provision would be relatively simple, would provide some measure of relief to new small business, and would result in little revenue to the Government.

Senator MILLIKIN. Would you apply it to all new business irrespective of risk?

Mr. FORD. I think I would stick to the new business as outlined in the definition in the act, those who have been started since 1946. I have had very little chance to see the act.

Senator MILLIKIN. Of course, every business has risks. What I mean is, there are relative degrees of risk. You could start a business with a relative degree of risk that would not present the same kind of problems that you are discussing here.

I know in my part of the country this 5-to-1 formula you are talking about is the common method of figuring on risk businesses. But I am quite sure there are many fields of business in which that would be rather extreme.

Mr. FORD. I would not at this short notice see any great difference in making a differentiation between the company that had been small for some time before the given date or was a relatively new company. The idea was to provide some sort of ceiling on the $500,000, and give the small investor a chance to come in again.

Section 444 of H. R. 9827 contains a provision which is developed to a considerable extent along these lines. However, instead of allowing a specified rate of return on the investment, commensurate with what companies generally were earning in the base period, it allows a rate of return equal to that which the taxpayer's particular industry earned in those years. This is an interesting approach to the problem and, though we have not had an opportunity to study the provisions thoroughly insofar as they affect our companies, we feel it is likely to go far toward providing a solution. However, it is obvious that uncertainty is bound to exist in determining the industry in which a new enterprise belongs. For example, our atomic-energy companies do not seem to fit properly in any prior industry. Further, we understand that the industry statistics are not likely to be known finally until 1952.

In these circumstances we respectfully urge the committee to provide some measure of certainty in section 444 by prescribing for new enterprises some minimum rate of return on capital up to $500,000 which will bear a reasonable relation to what business generally was earning in the years 1946–49 and enable these companies to attract the venture capital which they need. We feel that the provision which we suggested to the House Ways and Means Committee, and which I have just outlined, would accomplish this quite simply and could be incorporated without difficulty as an additional provision in section 444. Such a provision would greatly reduce the area of doubt for new companies as to the eventual amount of their excess profits tax liability. It would be administratively desirable because in the case of new small business it would make unnecessary the use of industry statistics unless the industry average exceeded the prescribed minimum. It would cause little loss of revenue to the Treasury.

There are a few additional matters in the treatment of new corporations in H. R. 9827 which we should like to call to the attention of the committee. In section 444 the industry rate of return is applied to assets existing in the new business at the end of the third year of its existence if it is formed after 1946. We have found that it is generally 5 years before the enterprise has been developed sufficiently to stand on its feet, and we would earnestly urge the committee to make this period in section 444 5 years instead of 3.

A further point arises with respect to the definition of "total assets" provided in section 444 (c). As the committee knows, a new business frequently expends much of its investment in salaries, development, and other expenditures which often result in a reduction of total assets through the accumulation of deficits before the business gets on its feet. We suggest that adjustment be made to add back to total assets amounts previously lost in the new business in the same manner as has been done for invested-capital purposes through the "Recent loss adjustment" contained in section 437 (f).

In the course of the next several days we shall file with the committee a memorandum which will discuss the provisions of section 44 in more detail and set forth fully the suggestions which I have outlined for the treatment of new enterprises.

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

Senator TAFT. If you could not get 20 percent net, 12 percent would be better than 6; would it not?

The CHAIRMAN. Twelve is always better than six.

The CHAIRMAN. Thank you very much for appearing, Mr. Ford.

Mr. FORD. Thank you.

The CHAIRMAN. Mr. Robert Caffee.

Please identify yourself for the record.

STATEMENT OF ROBERT H. CAFFEE, PRESIDENT, PRINTING INDUSTRY OF AMERICA, PITTSBURGH, PA.

Mr. CAFFEE. Mr. Chairman and Senators, you have before you a former page. I was telephone page in the House for 6 years.

The CHAIRMAN. We congratulate you on your progress.

Mr. CAFFEE. I escaped.

My name is Robert H. Caffee. I am president of the William G. Johnston Co., a printing company, of Pittsburgh, Pa., and I am also president of the Printing Industry of America, in whose behalf I am appearing before you today.

Printing Industry of America is the largest trade association in the commercial printing industry, having some 3,800 companies throughout the United States as members. In order to make clear to you for whom I am speaking, let me say that we print everything from your visiting cards to the very largest magazines.

In order to make my point even clearer, the Government Printing Office, which prints your Congressional Record, your hearings, and many of your documents, is a commercial printer. The manuals which are necessary to educate the personnel which operate a tank are printed by commercial printers. The posters which urge recruitment, or support of civilian defense, are the products of commercial printers. You cannot sit at your desk for 5 minutes without being

confronted with one of the products of our industry. It is obvious, therefore, that you cannot fight a war without printing.

This is not the point of my testimony, of course, but I think it may well be stressed in order to place my testimony in its proper perspective.

The simple burden of my testimony is this: An excess profits tax, and I quote "excess profits," is a shotgun type of tax which is theoretically designed to hit those who make an undue gain from war. There can be no possible argument with such an objective. No one should make a profit from war. But an excess profits tax is a shotgun tax which hits all businesses alike, whether or not they actually do make a profit from war. Therefore, by its very definition it is inequitable.

Neither does this industry take any negative attitude toward the necessity of raising whatever revenue Congress decides must be raised. Whatever amount you decide must be raised from corporations should be raised by an appropriate increase in corporate taxation. However, as I will explain as I proceed, you should maintain the present exemption from surtax of the first $25,000 of income, and you perhaps should consider a graduated scale of taxes which would further protect the initial earnings of the smaller corporation. Obviously such protection will be to the benefit of small enterprise, because the exemption as presently constituted, and even as it might be reasonably extended, would have no real economic sifinificance to the large corporations which may be involved in your consideration. We further suggest that the proportion of the money to be raised from corporations be influenced by the necessity for maintaining a healthy condition of small manufacturing business.

The mere fact that a company is labeled "corporation" provides no basis for inflicting a supertax rate upon it. As you well know, a corporation is a legal entity, and when you tax it the effect is the same as though it were a proprietorship, because it employs men and pays wages and salaries just the same.

I want to repeat that the excess profits tax theory is a shotgun theory. It has no equity in any part of its theory, except the highly idealistic notion that it will reclaim profits made from war.

Suppose that in 1949, as a printing company, I had acquired an account which amounted to 60 percent of my business—and this is not unusual in the printing business, gentlemen. There is movement at all times. Let us submit that this was a profitable account and that from it the total earnings of my company would be substantially increased. Under the present thinking with respect to excess profits taxes, as I have studied it in the press, those profits would be subject to excess profits taxation. There is no basis for considering these to be excess profits. There is no relation whatsoever to the incidence of the present emergency, and yet that is exactly what would happen if the theory of excess profits tax were applied in this particular company's situation.

Or, suppose I were a company—and may I say, gentlemen, whereas these are suppositions, I am not going to exact figures, but they are based on actual experience that we do know of.

Or suppose I were a company which in 1950 purchased the physical assets of a company, which, in one way or another, was in distress. In purchasing those physical assets, I also undertook to maintain the business of those assets. I undertook this venture, invested additional capital, hoped for, and planned to work for an enlarged and more

substantial business. Now should I face the prospect of an excess profits tax on this imagination and this decision to take additional risk?

When we look at the American economy and when we regard such enterprises as General Motors and the United States Steel Corp., we see in effect economic states. I by no means object to their size. As a matter of fact, I praise them, because they would not have attained such size if they were not economically useful. At the same time, I think we have to recognize that this free-enterprise economy also depends very substantially upon the willingness and upon the absolute nerve of individuals to risk their savings and their futures toward enlarging their businesses and their incomes.

If there is any single thing which is fundamental in the free-enterprise idea, this is certainly it. Therefore, different from the large and relatively stable corporation, we find that the small enterprise must be, so to speak, "on the move." It has not the problem of "maintaining" itself. It has primarily the problem of "growth," because it is too small to be stable in the sense of stability in a large corporation.

Senator MYERS. Mr. Chairman, may I interrupt there?

The CHAIRMAN. Senator Myers.

Senator MYERS. I wondered why you mentioned these large corporations. Do you think an excess profits tax should apply to them? Is that the purpose of your argument? I mean you mentioned them, and mentioned they are more stable than the smaller corporations, and I wondered what your purpose migth be in going into that.

Mr. CAFFEE. The base period, sir, applied to a large corporation, in our estimation, will catch them with what will be fairly near their normal operating level.

Senator MYERS. Then you mean an excess profits tax would be more equitable to the larger corporations than the smaller ones?

Mr. CAFFEE. That is right. We are on the move. Some of us may be way down and others operating at a much higher level.

This impulse toward growth, and the ambition of individual people, must be preserved and stimulated. Any taxation theory must recognize these human factors.

It is obvious in our estimation that the conditions which require the raising of additional money for the conduct of the Government and preparation for war may last for some time, and we assert that the need for maintaining the economy which we have built, and which has made our country respected and feared, should be the preeminent consideration of tax planners.

In effect, an excess profits tax is a punitive tax. It assumes that any company or individual which or who makes a profit is in some way doing so in a dastardly manner. There is no more reason to assume that an increased profit is any more reprehensible than a wage increase, and this is not suggesting that a wage increase is necessarily reprehensible, but certainly they are both of the same kind.

Perhaps it is needless to say that we are completely sympathetic with the problem you have in raising a certain amount of revenue. This is not the place nor the occasion to testify with respect to the total amount of revenue which is required, nor with respect to its proper expenditure. For the purpose of this testimony let us assume that you have to raise x amount of dollars. There are a few elemental principles which we urge upon you.

1. The organization, whether it is a corporation or a proprietorship, has to be able to live to pay wages and salaries—and taxes. This seems perfectly obvious, but somehow or other it seems to be neglected in some of the thinking about these matters.

2. The maintenance of our system, by whatever name it is known in this country, rests substantially upon there being many hundreds of thousands of small competitive enterprises. The very large corporation can protect itself. As I have indicated before, the large corporation is, in effect, self-sufficient. I think I can say that these large economic organisms will be protected, and I do not mean that in any critical sense. But when you get down to me, even though I am a large printer compared to many of them, I have got to have some help. At least, I have to have a recognition on your part that I am not a large corporation, and that what you do to me taxwise can destroy me. Therefore, I would say that point 2 of the policy which I think should be before you is a very thorough study of the probable impact of any decision on small enterprise. Once you make the mistake of imposing any rule or regulation which makes the life of the small enterprise difficult or unbearable, you will pull out from under the structure of our system an absolutely essential part of it.

I have deliberately not testified on a statistical basis. If by any chance you would like to have statistics, I can provide them from hundreds—literally hundreds—of small companies, particularly in our industry. Over the past 5 years many small-business men have pledged their past and future savings to the development of the kind of enterprises which give you and me pride in our system.

There have been very, very substantial investments in new equipment in the printing industry in the last 5 years, stepping up each year.

It seems to me that to reduce these ideas to statistics is almost to destroy the facts. I know the difficulties that face your tax experts. You tell them to raise x dollars. They look around for who has x dollars, and generally speaking they will tend to apply a tax formula to those who have x dollars. This is not the way. If we were to become involved even more than now in a great conflict, we shall profit very little if at the end of it we have not maintained the basic elements which make this society the kind we like—one of the major factors being the fact that everyone has an urge to advance and a path to follow.

There are probably scores of formulas which have been presented to you to raise x dollars. I am not equipped to discuss these many technical questions, but I most respectfully submit that your experts should be definitely instructed to keep foremost in their thinking these ideas.

I should like to make only one basic suggestion. That to the extent—and I would emphasize and reemphasize "to the extent"—that money should be raised from corporations, that it be raised by a general increase in the corporate rate, designated as a defense tax, with the maintenance of the present exemption from surtax for the first $25,000 of income.

Gentlemen, I have talked to you as a small-business man. I am cognizant of the problems that face you. I am eager to participate and to give everything I can toward meeting the Nation's objectives. When the present management undertook the development of my

company, it was almost bankrupt. You have heard that story, I think, too.

It was most difficult for this management to bring the company to its present relatively sound position. As the designated official of this management, you can readily conceive the impact it will have upon me and upon my colleagues if a taxation theory is imposed upon us which will destroy what we are trying to do. While I cite the fact that is my own situation, I can say to you that there are many, many small businesses facing a future which is most difficult, whatever you may do with respect to taxes. These small enterprisers have attempted to plan the development and growth of their companies in a relatively normal society, and now they face a condition which is completely abnormal. Their hopes and dreams may die aborning, no matter what you do with respect to taxes, but you can literally kill them with a few inadvertent legalistic phrases in a tax law.

Let us face the extreme. Do we face the prospect of atomic bombing of the industrial centers of the United States? Let us assume that we do. When this is all done, assuming—an assumption which I confidently state—that such invasion will have failed, then the future of the country will rest in the hands of hundreds of thousands of small-business men—individual enterprisers. I leave with you the simple statement that we should not destroy these individual interprisers now.

In our judgment, an excess profits tax would destroy them.

The CHAIRMAN. Are there any questions?

If not, thank you very much, Mr. Caffee.

Mr. CAFFEE. Thank you.

The CHAIRMAN. Mr. Edgar S. Idol.

Will you please identify yourself for the record and proceed?

STATEMENT OF EDGAR S. IDOL, GENERAL COUNSEL, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, D. C.

Mr. IDOL. My name is Edgar S. Idol. I am general counsel for American Trucking Associations, Inc., with headquarters at 1424 Sixteenth Street, Washington, D. C.

The for-hire motor-carrier industry was hit harder by the World War II excess profits tax than any other segment of our economy. For proof of this statement, I refer the committee to statistics of income submitted by Secretary Snyder in hearings before the House Ways and Means Committee on H. R. 9827. In general, these statistics show that all industries earned better returns, both before and after taxes, during the war years than they did during the 1936–39 base period. In his tables 4 and 5, Secretary Snyder shows that earnings for the public-utilities classification improved during the war years, and that transportation as a whole tripled its earnings before taxes and increased them by almost 50 percent after taxes under the excess profits tax law.

I direct your attention, Mr. Chairman, to the fact that no separate data were submitted by the Secretary with respect to the earnings of motor carriers. We supplied this deficiency in exhibits 1, 2, and 3 of our statement before the House committee. Instead of our earnings advancing, as was the case with industry generally and with public utilities generally, the income of the trucking industry was steadily reduced during the war years to the point where we reached an actual deficit in 1945.

Mr. Chairman, we had presented to the House Ways and Means Committee a statement by Mr. H. L. Horton on behalf of the industry which I would like to have made a part of this record. If I may give you copies, there are two or three exhibits in the back I would like to refer to.

The CHAIRMAN. It is already in the House report?

Mr. IDOL. Yes, sir; it is.

The CHAIRMAN. You may make it a part of the record.

(The statement referred to is as follows:)

STATEMENT OF H. D. HORTON, ON BEHALF OF AMERICAN TRUCKING ASSOCIATIONS, INC.

My name is H. D. Horton. I am chairman of the board of Associated Transports, Inc., and my address is 1001 Clarkson Street, Charlotte, N. C.

I appear here as spokesman for the trucking industry, by direction of the board of directors of American Trucking Associations, Inc. ATA is the industry's national trade association, and is a federation of State associations, its affairs being directed by a board composed of seven directors from each State. I have been closely connected with ATA since its formation, having served as first vice president from 1934 through 1948, as president during 1949, and as chairman of the board during 1950.

We in the trucking industry realize, fully as well as the management of business generally, the necessity of meeting increased costs of defense and of checking inflationary pressures, and the desirability of eliminating any excessive profits resulting from participation in the defense program.

I can therefore say that we agree thoroughly with all of the objectives stated by Secretary Snyder. But, so far as our industry is concerned, the means recommended by the Secretary will not attain those objectives.

On the contrary, taxation of the type proposed will have these effects on the trucking industry:

1. Instead of increasing tax collections, it will reduce them.
2. Inflationary pressures will be increased, rather than diminished.
3. Instead of taxing high profits resulting from the defense program, even the normal profits of the trucking industry will be eliminated; and
4. Most important of all, both the defense program and the general industrial development of the country will be seriously impeded.

In support of my first point, let me describe to you our experience during the years in which the last excess profits tax was in effect. Exhibit I of my statement sets forth official statistics compiled from tax returns by the Bureau of Internal Revenue covering the field of highway freight transportation, warehousing, and storage, for the years 1943 through 1947. Total tax collections from the classified businesses declined from $36,520,000 in 1943, to $24,406,000 in 1945. Excess profits tax collections declined from $20,364,000 in 1943 to only $8,664,000 in 1945. In 1946, the first year of operation under normal tax laws, collections jumped by more than 33 percent to $32,709,000, and in 1947 to $43,429,000; $7,000,000 more than the highest tax collection year under the excess profits tax law. Nineteen hundred and forty-seven is the last year for which official Treasury figures are available.

But later information on tax collections is available from official statistics compiled by the Interstate Commerce Commission, and my exhibit II shows tax payments for the years 1939 through 1949. These figures are not comparable to Treasury Department statistics, because they include only data from carriers regulated by the Interstate Commerce Commission with annual revenues of $100,000 or more. But they are better figures for the purpose of this investigation, because all excess profits revenues come from this class of carriers.

The industry wasn't in very good shape in 1939. Revenues were at a relatively low ebb, and competitive rate wars held income before taxes down to about 17½ millions. W contributed only 2.7 millions of the Government's total income tax collections. Net was about the same in 1940, but increased tax rates produced 4.2 millions of Government revenue. Gross revenues jumped 25 percent in 1941, and so did our net. In that year, we contributed about 7.7 millions in taxes, and in 1942 the figure went up to 12.5 millions.

From that point on, although we showed small increases in gross revenue for the balance of the war, both our profits and our tax payments shriveled to the

vanishing point. In 1943 tax payments went down to 9.3 millions, in 1944 to 7.1 millions and in 1945 to 3.9 millions. In that year, the industry's tax payments were three times its net income. Neither we nor the United States got anything out of the business.

I don't want to leave the impression that excess profits taxation was solely responsible for this picture; it wasn't. We had more business than we could handle, and our great difficulties were shortage of equipment, supplies and manpower, and the inability to get our rates up fast enough to keep pace with advancing costs.

Typical of the cost increases is rubber and maintenance. Tire costs went up from 1.1 cents per mile in 1941 to 2.5 cents per mile in 1945. Over-all equipment maintenance increased from 10.2 percent of revenue in 1941 to 16.8 percent in 1945. That increase alone, 6.6 percent of revenue, was more than our entire profit for our best year, 1942.

But excess taxation played a major part. It was possible to get equipment on priority ratings. It was possible, although only after painful delays, to match increased costs by increased rates. But almost all of the carriers who could do these things had inadequate earnings records for the base period 1936–39, and therefore had to pay out so much of their earnings in taxes that they had neither cash nor credit with which to continue the never-ending task of replacing 15 to 20 percent of their worn-out equipment every year.

Secretary Snyder told you that "in developing a basis for profits taxation it will be necessary to rely largely on the past earnings experience of corporations and look to the rate of return on invested capital as a guide for taxation of those corporations with unsatisfactory earnings experience." For some industries, it may be that the suggested guide will work out all right. It won't for the trucking industry.

I would like to cover that point in some detail, because it is basic to our argument that the trucking industry cannot live under an excess profits tax of the World War II type, even though it is modified as Secretary Snyder suggested. It is difficult to understand our situation without knowing the history of the industry's development and I would like to offer for the record ATA's 1950 edition of Trends which traces the industry's growth and present development in terms of statistics and charts.

Most public utilities have a high ratio of capital investment to annual revenue. A railroad whose investment is three times annual revenue can, under an 8 percent exemption on that investment, have a net before taxes of 24 cents out of every revenue dollar without being subject to excess taxation. On the other hand, the average intercity motor carrier, whose annual revenue is five times the capital base recognized for excess tax purposes, would be exempt from excess taxation on only 1.6 cents out of the revenue dollar not protected by an average earnings record.

The question as to what a motor carrier's operating ratio (the ratio of operating expense to revenue) should be has been argued before the Interstate Commerce Commission on a number of occasions without that body's having taken a clearly defined position; but the Commission has several times approved general revenue increases on showings that operating ratios in the low nineties would result. An operating ratio of 95 is conceded to be high; but under the invested-capital method of arriving at exemptions, an intercity motor carrier would have to have an exemption of 25 percent on invested capital to escape excess taxation on even that narrow margin. So it is obvious that the invested capital alternative, suggested by Secretary Snyder as the best guide where a corporation has no average earnings record, is completely unsuited to the trucking industry.

It might be supposed that an industry which can show a very attractive rate of return on investment by keeping only a few cents out of every dollar of revenue would have a relatively simple job of attracting new capital when needed. However, out of some 22,000 carriers subject to the Commission's jurisdiction, only four have been able to attract public capital at all. Our poor earnings experience during the last world war was undoubtedly responsible for the hesitancy of investors to risk their capital with us, but there are other reasons. As public utilities go, we are a relatively new service institution. Competition is tough, both within the industry and between ours and competitive forms of transportation.

The success or failure of any particular operation is so dependent upon the energy and ability of its management that other factors bearing on the desirability of investments generally are relatively unimportant.

Increases in equipment costs make it impossible for a motor carrier to replace old equipment with new by the usual method of using money from depreciation

reserves. A unit which sold for $4,000 6 to 8 years ago today costs from $7,000 to $8,000. So almost half of replacement cost must be provided from retained earnings, or credit. Our credit has been strained to the breaking point, as any banker will tell you after looking at the average balance sheet—see my exhibit III. We have had so much difficulty in getting reasonabe rates and terms, that ATA has undertaken an extensive advertising campaign designed to acquaint the financial world with our problems.

As an example, the experience of an Illinois trucking concern with an excellent credit rating is cited.

During the latter part of 1948 and January of 1949, the management attempted to borrow approximately $400,000 to finance badly needed terminals. Twelve different institutions, including banks, insurance companies and private individuals, were approacmhed. The reaction was about the same in all cases—no interest. After getting this type of reception from private lending institutions, the carrier contacted the Reconstruction Finance Corporation. The RFC seemed to be willing to loan the money, but so many restrictions were attached to the credit, that it was decided to finance the terminal construction by heavy equipment mortgages, supplemented by retained earnings. However, equipment financing is comparatively short-term and at best is a stopgag method of providing capital for the buildings and land required to operate the business.

So, almost without exception, trucking businesses have been started on the owner's personal savings and credit, and financed from his retained earnings and gradually expanded credit.

Since capital is required for expansion, our growth during the thirties was slow, and came to an abrupt stop during the war years.

We came out of the war facing an enormous demand for service, but with facilities which were completely incapable of meeting that demand. However, our suppliers were released from their military production requirements and the return to normal tax policies reestablished the traditional profit motive. With equipment available and the incentive at hand, the industry rolled up its sleeves and went to work. In the 4 years which have elapsed since World War II, we have doubled our volume of business. There are to date twice as many class I carriers as there were 10 years ago. Between 1946 and 1949, the average class I carrier's revenue has jumped from $583,000 to over $1,000,000 annually, and his taxable income increased from about $21,000 to almost $54,000 a year. In 1945, the last excess profits tax year, we paid the Government less than $4,000,000 in taxes; that figure sky rocketed to over $35,000,000 in 1948, three times the best year under excess taxation.

In the first half of 1950, tonnage, gross revenue and profits before taxes were all running at rates more than 20 percent ahead of 1949, and the country has the best transportation service it ever saw.

Under normal tax policies, a small operator can, with smart and efficient management, build and grow to meet the ever expanding demand. I would like to give you just one example, which could be repeated hundreds of times over in the industry. Early in 1946, a smart, hard-working young fellow who had already spent 10 years learning the ropes decided that it was time to strike out for himself. With capital borrowed from a personal friend, he bought a small operation which had never shown a profit in excess of $10,000 a year. By 1949, he had quadrupled the volume of business handled in 1946, and showed a profit of almost $50,000 before taxes on about three-quarters of a million revenue. But he had only started. In August of this year, after a year and a half of hard work, he secured a certificate authorizing intrastate operations over routes where he had formerly been authorized to handle only interstate traffic. As soon as he put the additional equipment required in service, his volume doubled and if everything goes well his next year's profits will be doubled. That is the picture of the industry's growth, but neither the growth nor the profits are attributable to war or defense production. But if a tax law is enacted which won't allow that fellow to plough back a reasonable portion of his earnings into the business, he won't even be able to maintain his present volume, let alone meet an expanded demand.

The example I have given you is one of which I have personal knowledge, but it comes so close to fitting the average that I want to carry the illustration a bit further, and outline the certain effect of excess taxation on both the carrier and the Government.

In 1951, assuming normal expansion of operations, the average carrier will have gross revenues of about $1,500,000. If he is able to get rates up as costs advance without too much delay, he will have a taxable income of about $100,000. The net assets employed will amount to some $300,000 of which 70 percent will

be represented by equity capital and 30 percent by equipment obligations and mortgages on terminal properties. He will be operating about 70 power units, three-fourths of them owned and one-fourth leased. Ten of the owned units will have reached the end of their economic life, and must be retired, else he will have to pay punitive maintenance costs. To replace these units, which cost about $40,000, the carrier must today find close to $70,000 in cash or credit. He has used all his available credit already—as indicated by my exhibit III, so he must either be able to use retained earnings or cut down the size of his operation.

Under a straight 45 percent tax rate, this carrier could absorb $30,000 of inflation required to maintain his present fleet, and if he paid no dividends could even expand operations to some extent.

With the tax rate unchanged, the Treasury could expect to increase its total tax take from this carrier every year. It might increase its tax revenues from this source very considerably: if a relatively stable tax policy were devised under which the carrier could count on retaining 40 to 50 percent of added earnings, new equity capital might be found which would permit expansion at a rate commensurate with the growing demands of industry for motor transportation service.

But the tax law proposed by Secretary Snyder would immediately put an end to expansion; not only that, it would render the carrier's task of maintaining his present position difficult in the extreme. An effective rate of tax in excess of 60 percent would mean automatic retrenchment and curtailment of service. There would be no possibility of inducing an investor to part with new equity capital, because the maximum possible rate of return (1.6 percent of revenue) would be completely unattractive even to a gambler.

The average picture I have given you is far from being the worst that could be presented. Many larger carriers, who were handling a substantial volume of business during the war years, were in a deficit position during 1944, 1945, 1946, and 1947. For that class of carriers, the struggle to recover from high maintenance costs and worn-out fleets lasted well into 1948. Many of them did not recover their prewar position, with respect to condition of equipment and facilities, until 1949. In 1949 and 1950, they have good earnings records and under normal circumstances would have followed the industry's growth pattern for an indefinite period. Their earnings, their contributions to the Treasury's tax revenues, and their contribution to the country's growth would have continued indefinitely.

To many of these carriers, Secretary Snyder's proposal will mean an over-all effective tax rate of 70 percent or better. Such a tax rate will absolutely force retrenchment and reduction of service at the rate of 10 to 15 percent a year, and will even encourage liquidation.

Such a development, in the face of a rapidly expanding demand for service, will be a blow to the defense program.

In support of his proposal, Secretary Snyder submitted for your review numerous statistics. His table 4 shows rates of return on net worth before taxes for the year 1936–47 for all public utilities. From the average of 6.1 percent in 1936–39, the rate rose through the war years to a high of 12.8 percent in 1944. The breakdown of utilities lists transportation, and shows an increase from the 1938–39 average of 5 percent to a high of 15.8 in 1944. Table 5, showing the rates of return on net worth after taxes, shows transportation as increasing from 4.2 percent in 1938-39 to 6 percent in 1944. I find no breakdown, in figures submitted by the Secretary, of highway transportation data for the war period, although his table 7 does list income before taxes for our industry during the postwar years.

I would like to draw your particular attention to my exhibit II which gives similar data for our industry for the years 1939 through 1949, and estimates for 1950. Instead of our profits increasing, as did public utilities generally and the transportation industry as a whole, we actually arrived at a deficit position in 1945. The Treasury's own statistics support the Interstate Commerce Commission's figures. (See exhibit I.)

I submit to you, Mr. Chairman, that both past experience and logical analysis of present and future conditions clearly show that adoption of the Treasury's proposal for motor carriers will tend to defeat every stated objective of the administration's tax program. It will reduce total tax collections, it will eliminate needed expansion, and will force entrenchment and reduction of service in the face of a greatly expanded need.

I have one further point to cover. A prime objective of any excess profits tax is to eliminate, as nearly as may be, the ability of business to make money out of war. The trucking industry cannot do that, under any circumstances, because

its prices are regulated. Not only do we have such thorough price control that it is impossible to make unreasonable profits, but we have great difficulty in keeping our prices in step with advancing costs during any inflationary period. This Congress recognized that fact when, in enacting the Defense Production Act of 1950, it provided in section 402 (e) (v) that price and wage controls shall not apply to "rates charged by any common carrier or other public utility."

In the case of public utilities whose investment is high in relation to revenue, added volume normally means an increased rate of profits. That is not true with the trucking industry.

We have to operate our equipment at capacity at all times, because competition forces us to be almost 100 percent efficient in order to make money even under normal circumstances. When expanded demand calls for more service, we have to add more units and more terminal facilities in order to provide it.

Everyone is familiar with the fact that the Interstate Commerce Commission has power to control the rates of regulated carriers. But the amount of time necessarily consumed in increasing general rate levels to offset general cost increases is not so well known.

Two entirely different types of delay are encountered, for entirely different reasons. First, common carrier rate levels are generally established only through collective action. While there is intense competition between carriers, and many individual rates for individual movements are published separately by carriers, most of the rate publishing job is handled through the bureaus established for that purpose. An exception to the antitrust laws, section 5 (a) of the Interstate Commerce Act, was enacted by the Congress only 2 years past to expressly authorize such action. Safeguards to prevent monopolistic and abusive practices were included in the act. To meet these requirements, any proposal for rate changes to be handled by collective action must be docketed by the carriers, hearings held, general conclusions reached, and opportunity afforded individual carriers to take independent action. These steps take time; anywhere from 3 to 6 months. Second, the final conclusions reached must be translated into tariff form, and filed with the ICC 30 days before the proposed effective date. The Commission may, thereafter, decide that the increases proposed are prima facie unreasonable, and suspend them for investigation. Thus, increases may be held in abeyance for months and even years.

From the standpoint of excess profits taxation, these delays have two effects: First, they render the imposition of unreasonable charges an impossibility; second, they make the calculation of average earnings, based on past operating results, an unfair and illogical process when applied to motor carriers. I have prepared an exact illustration of the difference between the profit showing of an unregulated industry and the profit showing of a regulated motor carrier as a result of this particular circumstance.

Since January 1, 1948, my company has had over-all rate increases totaling 14.11 percent. In seven separate adjustments, during 1948, increases totaling 9.76 percent were made effective; without exception, every one of these changes was made to compensate for increased costs which we incurred prior to January 1 of that year. Had they been made effective prior to January 1, 1948, simply by decision of the management, as would have been the case in an unregulated industry, our revenues for the year would have been increased by 2.7 percent and our taxable income by 53.5 percent. Our average earnings record for the year would have been improved by the same figure.

To summarize, any proposal for taxation at punitive rates of the future earnings of motor carriers which exceed average taxable income in the years 1946 through 1949 is bad business from the standpoint of Government revenues, an obstacle both to the country's normal development and to the defense program, and furthermore is completely unfair to the motor carrier industry for the following reasons:

1. Rehabilitation beginning in 1946 took 3 to 4 years to complete and until completed, profits were subnormal because of excessive maintenance costs and inadequate facilities.

2. The entire 4-year period was one of inflation; the general commodity index went up 45 percent, wages rose 33 pecent in our industry, and delays averaging 6 months to 1 year in getting prices up to match cost increases kept the carrier's average earnings 40 to 50 percent below normal.

3. The normal level of business and taxable income in the trucking industry is today more than double the 1946 level, and considerably higher than any other year of the selected base period. It is manifestly unfair to apply punitive tax rates to normal business profits.

On this showing, I believe we are fully justified in asking the committee to completely exempt our industry from excess profits taxation. We ask that you do so, regardless of the action taken on the proposals before you.

If, in your judgment, it is essential that an excess profits tax be applied to the entire industry of the country, then we ask that a third alternative be made available to preserve the industry from a repetition of its World War II experience. The alternative we seek is application of the best operating ratio attained by a regulated motor carrier during any of the base period years to the volume of business done during any excess profits tax year.

Mr. Chairman, inclusion in any bill you report of such an alternative will not permit excess profits to go untaxed. The regulations which surround us make it simply impossible to earn excess profits. As you can see from our World War II experience, the period on which we are now entering will probably hurt our industry, rather than enable it to earn higher profits. We have never quite caught up with normal civilian demand since World War II almost put us out of business; during the past 18 months, every dollar of capital and credit that we could scrape together has been at work trying to meet the demand for service, and we have barely kept abreast of the demands of the economy. Not until this year did we finally reach the profit margin required to keep the industry in a sound financial condition, and to meet the public demand for service.

In conclusion, I should like to make it clear that we are not seeking more favorable tax rates on normal profits than any other segment of the economy. We hope the Congress will meet the threat of inflation and we realize that increased taxes are necessary to accomplish that objective. But we also hope that you won't kill the goose that lays the golden eggs.

EXHIBIT I.—*Highway freight transportation, warehousing, and storage (net income corporations only)*

[Thousands of dollars]

	1943	1944	1945	1946	1947
Cash	$64, 246	$71, 920	$69, 952	$89, 320	$104, 390
Total assets	602, 365	624, 455	610, 891	803, 571	985, 060
Gross receipts from operation	866, 853	880, 247	823, 803	1, 198, 359	1, 677, 765
Net income	76, 740	74, 448	62, 383	109, 949	139, 310
Excess profits tax	20, 364	15, 983	8, 664	147	----------
Total tax	36, 520	33, 183	24, 406	32, 709	43, 429
Dividends	12, 278	12, 841	11, 462	16, 491	17, 163

Source: Official statistics of income, Bureau of Internal Revenue.

EXHIBIT II.—*Income statistics, class I intercity motor carriers of property, 1939–50*

	1939	1940	1941	1942	1943	1944
Number of carriers	957	991	1, 076	1, 083	1, 165	1, 337
Revenues	$378, 473, 829	$431, 042, 674	$560, 166, 612	$587, 869, 636	$645, 673, 297	$710, 909, 595
Average per carrier	$395, 479	$434, 967	$520, 601	$542, 816	$554, 226	$531, 720
Taxable income	$17, 597, 783	$17, 461, 406	$25, 222, 871	$29, 882, 920	$18, 728, 766	$14, 894, 618
Average per carrier	$18, 388	$17, 620	$23, 441	$27, 593	$16, 076	$11, 140
Income taxes	$2, 703, 649	$4, 199, 879	$7, 685, 547	$12, 525, 023	$9, 290, 948	$7, 116, 329
Average per carrier	$2, 825	$4, 238	$7, 143	$11, 565	$7, 980	$5, 323
Operating ratio	95. 1	95. 6	95. 2	94. 7	96. 9	97. 9
Ratio of net income to revenue	3. 9	3. 1	3. 1	3. 0	1. 5	1. 1

	1945	1946	1947	1948	1949	1950 estimated
Number of carriers	1, 445	1, 516	1, 603	1, 825	1, 817	1, 817
Revenues	$746, 393, 799	$883, 806, 303	$1, 232, 546, 162	$1, 662, 881, 686	$1, 857, 919, 516	$2, 322, 399, 395
Average per carrier	$516, 536	$582, 986	$768, 900	$922, 542	$1, 022, 520	$1, 278, 150
Taxable income	$1, 655, 801	$30, 047, 911	$54, 428, 622	$107, 424, 605	$94, 977, 987	$139, 343, 964
Average per carrier	$1, 146	$19, 821	$33, 954	$58, 863	$52, 272	$76, 689
Income taxes	$3, 883, 092	$9, 027, 803	$17, 416, 594	$35, 240, 906	$31, 546, 162	$62, 704, 784
Average per carrier	$2, 687	$5, 955	$10, 865	$19, 551	$17, 362	$34, 510
Operating ratio	99. 8	96. 4	95. 3	93. 4	94. 7	94. 0
Ratio of net income to revenue	−3. 0	2. 4	3. 0	4. 3	3. 4	3. 5

Source: 1939–49, Official Reports of Carriers to Interstate Commerce Commission ,1950—estimate based on trend indicated in first half.

EXHIBIT III.—*Average intercity motor carrier balance sheet, 1945–49*

	1945	Percent	1946	Percent	1947	Percent	1948	Percent	1949	Percent
Total current assets	$74, 745	35. 1	$97, 496	35. 9	$109, 618	34. 0	$123, 710	33. 7	$154, 968	33. 6
Total tangible property	102, 302	48. 1	137, 513	50. 5	171, 457	53. 2	198, 368	54. 1	246, 272	53. 4
Other assets	35, 777	16. 8	36, 967	13. 6	41, 115	12. 8	44, 888	12. 2	59, 764	13. 0
Total assets	212, 824	100. 0	271, 976	100. 0	322, 190	100. 0	366, 966	100. 0	461, 004	100. 0
Total current liabilities	71, 565	33. 6	88, 757	32. 6	105, 419	32. 7	114, 566	31. 2	133, 398	28. 9
Total equipment and other long term obligations	34, 749	16. 3	52, 526	19. 3	65, 741	20. 4	71, 351	19. 4	84, 014	18. 2
Other liabilities	14, 642	6. 9	18, 639	6. 9	20, 239	6. 3	20, 191	5. 6	25, 430	5. 6
Net worth	91, 868	43. 2	112, 054	41. 2	130, 791	40. 6	160, 858	43. 8	218, 162	47. 3
Total liabilities	212, 824	100. 0	271, 976	100. 0	322, 190	100. 0	366, 966	100. 0	461, 004	100. 0
Gross operating revenue	609, 061		714, 007		927, 714		1, 096, 957		1, 322, 933	
Net income after taxes	[1] 3, 061		16, 819		26, 002		47, 063		40, 147	
	Percent		*Percent*		*Percent*		*Percent*		*Percent*	
Ratio current assets to liabilities	104. 4		109. 8		104. 0		108. 0		116. 2	
Ratio profit to revenue	[1] −0. 5		2. 4		2. 8		4. 3		3. 0	

[1] Loss.

Source: Official reports to ICC by intercity common motor carriers of general freight.

Mr. IDOL. I would like to refer you, Mr. Chairman, and gentlemen of the committee, to exhibit 2 of our statement before the House committee. You will note there that in 1940 the net revenues after taxes of the for-hire industry showed a deficit of 3 percent of our operating revenues.

Government tax collections suffered likewise. Class I intercity motor carriers of property paid 12½ millions in taxes in 1942; in 1945, the figure was reduced to 3.9 millions.

For-hire motor transportation is an essential industry. On this point, I would like to quote very briefly from a recent address by the Honorable James K. Knudson, Administrator of Defense Transport:

> The transportation problems which we would face in the event of another war would be even more staggering than any with which we have heretofore been confronted. We might be faced with fighting and sabotage in our own country. We might experience the dislocations of crippling aerial attacks. Highway transport in such circumstances would be called upon, in addition to performing all of the services performed in World War II, to play a major role in civilian defense, to transport immense quantities of food and medical supplies, and to take over land transportation service in areas where other facilities may be crippled or embargoed. Ultimate success in such circumstances might well depend upon the way in which highway transport could and would meet this challenge.

Summarized, our statement to the House committee showed that:

1. Rehabilitation of our industry, beginning in 1946, took 3 to 4 years to complete.

Unlike other industries, generally, Mr. Chairman, our facilities were worn out and were not replaced during the war years.

Profits were subnormal throughout the proposed base period because of excessive maintenance costs and inadequate facilities.

2. The entire 4-year period was one of inflation; the general commodity index went up 45 percent, wages rose 33 percent in our industry, and delays averaging 6 months to 1 year in getting prices up to match cost increases kept average earnings 40 percent to 50 percent below normal.

On that point, we are like other utilities required to obtain, in effect, permission from the regulatory authorities our prices can be increased, and we show in detail in our statement to the House exactly what effect that has on our earnings.

3. The normal level of business and taxable income in the trucking industry is today more than double the 1946 level, and 20 percent to 25 percent over 1949, the highest year of the selected base period. We took the position that it is manifestly unfair to subject normal earnings to punitive taxation, and asked the House committee to either completely exempt our regulated industry from excess taxation, or to exempt from excess taxation that percentage of revenues earned by any carrier during the best year of his base period.

Our request was ignored by the House committee. Section 446 of H. R. 9827 purports to grant the exact exemptions requested by other regulated utilities, but gives us no relief whatever. If the bill is enacted as it stands, an essential service will be severely damaged, the Government's tax revenues will be materially reduced, and a road block will be thrown in the way of the defense program.

The relief provisions of the bill delegate to the Secretary of the Treasury the authority to fix our taxes. As this delegation will probably be construed, we will have no substantial relief at all.

The delegation of authority is accomplished by directing the Secretary of the Treasury to "determine and proclaim a classification of taxpayers by industry, such classification to be generally in accord with the classification regularly used by the Treasury Department in compiling published statistics from corporation income-tax returns."

In a brief explanation of this directive, the House committee report indicates, page 18, that "the Nation's industry will be grouped according to about 50 major classifications." A quick check indicates that there are about 75 major classifications now used by the Treasury Department. There are over 200 subclassifications. It would appear that the bill grants to the Secretary broad authority to decide how far he will go in placing basically different industries in the same major classification for the purpose of computing tax credits.

Taking our own industry as an example, the primary breakdown is "Total public utilities." Under that caption are found three of what may be considered major groupings: "Transportation," "Communication" and "Other public utilities." In a further breakdown, statistics an "Transportation," now used by the Treasury, are grouped as follows: "Railroads," "Highway passenger transportation," "Highway freight transportation," "Water transportation," and "Air transportation."

It is to be noted that the classification "Highway freight transportation" also includes warehousing and storage.

Both the capital structure and the earnings records of these many different industries are variable in the extreme. Most public utilities have total assets of from three to five times annual revenues. Highway freight transportation has annual revenues which average three times total assets employed, and in individual cases may run as high as 10 or 15 times total assets. There are extreme variations in industry earnings, all grouped under this same classification "Transportation."

For example, highway passenger transportation earnings decreased from 148,000,000 in 1946 to 51,000,000 in 1949, while earnings of high-

way freight transportation increased from 93,000,000 to 206,000,000 during the same period.

In only 1 year have the for-hire motor carriers of property come close to the operating ratio found reasonable by the Interstate Commerce Commission. That was in 1948, and the ratio of total assets to earnings was about 4 to 1. The average for all utilities will be much closer to 10 to 1.

In just what classification will our industry be placed by the Secretary? His decision on this point may make a difference of as much as 50 percent in the final average earnings credit of a given motor carrier. If, as now seems probable, he uses either the general public utilities grouping or the transportation grouping, our industry will be greatly penalized. Even if he gets down to the "transportation, warehousing, and storage" grouping, our ratio of assets to earnings will be almost double what it should be.

The general theory of the House committee's approach seems sound, and if the motor carriers of property were allowed to use ratios constructed from official Interstate Commerce Commission statistics, we could get substantial relief from punitive taxation.

A further defect in the relief provisions as now set up in the bill is that a newly organized company is given a substantial advantage over a company in operation prior to the base period. Why should a newly organized company be able to use industry averages in computing its tax credits, while the same privilege is denied an older organization which for one reason or another was unable to keep its earnings up to the industry average during the base period?

Our criticisms point up the difficulties of writing a reasonable excess profits tax law, and particularly point up the impossibility of doing such a comprehensive job without careful study. We are sure that the House committee did not intentionally pass over our problems, so the haste with which the task was undertaken must be the answer.

I submit that excess taxation of regulated for-hire motor carriers is basically unsound, because it is impossible for them to earn excess profits, and impossible for them to furnish the service demanded and needed by the public under punitive taxation of normal profits.

We do not seek, and cannot use, the type of special exemption requested by other public utilities; this because of the radical difference between ratios of assets employed to revenues or earnings.

If the trucking industry is not granted full exemption from punitive taxation, then special provisions should be enacted which will ensure our ability to retain sufficient earnings to replace worn-out equipment and finance essential expansion. Full relief can be granted only by complete exemption, but substantial justice can be done by granting to for-hire motor carriers the right to determine normal earnings by applying to gross income of any excess profits tax year the best operating ratio determined in the base period.

A measure of relief can be extended by opening up the relief provisions to old as well as new companies, provided official statistics of the Interstate Commerce Commission are used as the basis for determining the ratio of assets employed to earnings of for-hire class I motor carriers, instead of the broad functional group statistics maintained by the Secretary of the Treasury.

That is our principal objection to those relief provisions, Mr. Chairman. They group too many basically different industries in one major

classification with resulting benefit to a portion of them, and disadvantage to another. The disadvantage in this case is all on our side.

The CHAIRMAN. You have pointed those out to us, and we thank you very much for your appearance and observations.

Mr. IDOL. Thank you.

The CHAIRMAN. Mr. John K. Holbrook.

Mr. Holbrook, please identify yourself for the record.

STATEMENT OF JOHN K. HOLBROOK, ATTORNEY, NEW YORK, N. Y.

Mr. HOLBROOK. I am John K. Holbrook, attorney, New York City.

Mr. Chairman, and gentlemen of the committee: To save the time of the committee, I will limit my comments on the proposed excess profits tax, to the base period to be used in determining the tax. Specifically, I am going to speak of smaller corporations which would have no benefit whatever from a base period calculation employing 3 of the 4 years from 1946 to 1949, inclusive. Notwithstanding an impression which seems to be rather general that 1946–49 were prosperous for all business, I can assure the committee that such companies do exist and furthermore that their weak position under such an excess profits tax may have resulted to a large extent from their being so involved in war work that they could not return to peacetime operations without sustaining losses in more than 1 year in the period after 1945. The proposed bill seems to imply that there was only one postwar year of losses since it gives the choice of 3 out of 4 years.

In the course of consideration of this legislation, I have urged that years after 1945 in which a company was in reorganization under chapter X of the National Bankruptcy Act be automatically excluded from any base period used in computing the excess profits tax credit. This would help those companies which were most seriously affected in the transition from war to peacetime business. Because 1946 was probably the most difficult year for even such of those companies which did not invoke chapter X, I have also urged that 1946 be omitted completely from any base period computation and that a taxpayer company be given the choice of 2 of the 3 years 1947, 1948, and 1949. I urge the above suggestions for the consideration of this committee.

I may illustrate my argument by the example of a company in the electronics field, of whose experiences I have some knowledge. It was organized in 1938 primarily for research work, but during the war its products came to be in such demand for use in such critical items as radar, gunfire controls, and other war items, that it went into production in three plants. When its war contracts were practically 100 percent canceled in September of 1945, its business was practically 100 percent canceled also, because war business had come to be its whole business. Its losses in 1946 and 1947 were such that they could be carried back against the income of 1944 and 1945, and the remainder carried forward against the incomes of 1948 and 1949, and still leave the company with a net balance of loss for which it has no carry forward privileges and no tax benefits at all while, at the same time, the company is left in a very unfavorable situation as regards a base period calculation under the proposed excess profits tax.

It may be that particular attention should be given to companies such as this one, which converted entirely to war production and is now practically on 100 percent defense order production with such pressure upon it for increased shipments of its products that it has already had to plan on increases of its production facilities. It would seem to be true that the smaller company which converted most completely to war work had proportionately the greater amount of problems in entering postwar peacetime business and to some extent the selection of the 4 years 1946 to 1949 as the base period years penalizes these companies for the thoroughness of their contribution to the war effort and at the same time to handicap them in their present contribution to defense in which their services may be again extremely essential.

At the end of the last war, the companies most likely to prosper in 1946 were large companies with long civilian records of production which might have conversion problems but adequate capital to meet them, and time-saving advantages in established products, known outlets and a waiting market. Also there are those companies which through force of circumstances could contribute little to the last war effort. For example, the men's hat trade was a war producer in the First World War when millions of field campaign hats were needed. There were few if any required in the Second World War, and the specialized equipment of the hat industry had probably little or no conversion possibilities. On the other hand, there was probably an excellent market for men's hats at the war's end, as several million young servicemen returned to civilian life. Then there were companies with a specialized product, for example, in the food or pharmaceutical line, which operated perhaps in only limited fashion during the war because of war material shortages, perhaps of sugar or alcohol. When these materials became readily available at the war's end, the accumulated demand for the product might have made 1946 a spectacularly profitable year. The smaller war companies which I have been discussing, are quite unlike any of these examples.

If it is found that few companies exist which had comparatively large losses in 1946 and 1947, with the result that they entered this new defense period with depleted assets, then it will not be a tax loss of any consequence to the Treasury if at least the following suggestion is adopted for the benefit of such companies. This suggestion is that the tax carry-forward policy adopted in the 1950 Revenue Act, namely that of giving a 5-year carry-forward on losses, be applied to tax years commencing in 1946 so that unused loss credits of 1946 and 1947 may be carried forward against profits at least of 1950–52. The 1950 Revenue Act grants the 5-year carry-forward only in respect to years commencing with 1950, leaving for prior years only the 2-year carry-forward which Congress has now recognized to be inadequate.

The administration of such a loss carry-over would not create an additional burden on the Treasury Department. To determine the excess profits tax credits for the years 1946–49, if those base years are adopted, the Bureau of Internal Revenue will have to examine or reexamine the returns for these years. It will require only a slight further step at most to determine the loss which might be carried forward to 1950–52. In other words, this amplified loss carry-forward and the proposed excess profits tax are of themselves closely linked in administration and, in fact, not too far apart in theory. If the profits of selected past

years are to determine the profits to be retained in future years then it is natural that the losses of these selected past years be applied to give a company a limited benefit in at least the first 2 years of an excess profits tax period.

I have had a short opportunity to review the House committee's report. At page 25 it states, "A net operating loss in the base period may be carried forward to the excess profits tax years."

I suppose this means a loss of the years 1948 and 1949, because if it does not, it is what I am asking for. But I do not believe it means the losses of any of those 4 years, 1946–49.

The CHAIRMAN. Thank you very much for your contribution here.

Mr. HOLBROOK. Thank you.

The CHAIRMAN. Mr. Robert W. Cleveland.

Please identify yourself for the record, Mr. Cleveland, and proceed.

STATEMENT OF ROBERT W. CLEVELAND, PRESIDENT, CLEVELAND BROS. EQUIPMENT CO., HARRISBURG, PA.

Mr. CLEVELAND. My name is Robert W. Cleveland. I am president of the Cleveland Bros. Equipment Co. We are construction-equipment distributors in Harrisburg, Pa.

I would like to submit my statement for the record, and talk extemporaneously.

The CHAIRMAN. You may do so.

Mr. CLEVELAND. Cleveland Bros. are a very small company. We are only 3 years old. We invested $500,000 in our business. We have 100 people employed, and we have made steady progress.

The excess profits tax law, as I understand it now, although I have not finished with the House version of it, will practically put us out of business, although this year we will make a net profit equal to our original capital investment.

This is mainly so because of a chart that I have here. Our business is not a business where we keep all our money in cash or anything else. We have continually increased our plant. We now have two buildings that we purchased at a cost of $285,000, and we are renting another, and we have been contemplating two other places to rent, which at the present time we do not dare do because we are afraid to make any further commitments.

We own a fleet of trucks and cars which have cost us approximately $57,000.

We purchased tools and machinery for approximately $80,000, and we employ now 110 people at an average monthly payroll of over $40,000.

This, as we can show you, has been a very steady progress since the first year of our business. This is where we started [indicating], and we have increased our employment, we have increased our payroll, and we have increased cash in our business. Our sales have increased considerably. With these sales we have had to put a lot more money in inventory. We have had to carry a lot more accounts receivable.

We also have had to borrow a whale of a lot of money. Our banks tell us if we reduce the money that we have in our business by any means, such as payment of dividends or anything else, they will no longer loan us any money, so we will just be absolutely out of the business.

This business has been somewhat as good for the tax collector as for the owners of the business. In our first year we earned $148,000 and paid $41,000 in taxes. Last year we earned $163,000, because we were able to reinvest some money, and we paid $61,000 in taxes. This year we have an anticipated earnings of $500,000, and under the present tax laws would pay approximately $200,000. Under the law, as I figure it, it would be so much in excess of that that it would just cause us to liquidate our assets, lay off some of our employees, and face virtual bankruptcy.

We committed ourselves for our buildings long before there was ever any thought of excess profits. The last building we built was designed and started just a year ago. However, it has been completed during the past year.

As I say, we have plans for other things that we have had to table at the present time.

I think that our actual success is going to put us out of business.

I also think that this is true of a number of other small businesses in this country.

I therefore feel that any excess profits tax that would discriminate against this group of small growing corporations, one of which we find ourselves, will not allow them an opportunity to expand and continue growth, and it will react to a much greater degree than it does to older, bigger, and better-established companies.

If small growing corporations are given a chance to expand through reinvesting up to, say 50 percent of their annual earnings, they will probably pay more Federal profit taxes in the next 10 years than they will under any excess profits tax program.

The CHAIRMAN. You have all the facts stated in your written statement that you are offering for the record?

Mr. CLEVELAND. Yes, sir.

The CHAIRMAN. That will enable us to look at your picture, then, Mr. Cleveland, and we will be glad to do so, of course.

Mr. CLEVELAND. Thank you.

The CHAIRMAN. Thank you very much for your appearance.

(The statement submitted by Mr. Cleveland reads in full as follows:)

STATEMENT OF ROBERT W. CLEVELAND, PRESIDENT OF CLEVELAND BROS. EQUIPMENT CO., HARRISBURG, PA.

I am grateful for this opportunity to discuss before the Senate Finance Committee, a matter I feel to be of great importance to ourselves and to all small growing corporations. Every small growing corporation is faced with an excess profit tax which is at once unfair and unrealistic, since the basic conception of the tax does not allow for growth and expansion. My purpose today is to call to your attention one of the phases of the operation of this proposed excess profits tax which seems to have been overlooked. I propose to show you how it discriminates against small growing corporations to the advantage of large well-established corporations.

It is our firm belief that the Senate of the United States is the body representing conservatism in this country; by this I do not mean conservatism in a political sense, I mean conservatism stemming from the stake in the community represented by the Members of the Senate, and in conservation as it relates to the conservation of the assets that have made this the greatest country in the world. The Senate is also the body that should halt the inflationary trend that would be caused by an excess profits tax.

In a small privately owned business such as ours, growth and expansion can be accomplished only through the time honored method of reinvesting earnings.

This is necessary because of the impossibility of obtaining equity capital on any reasonable basis. We cannot sell stock without surrendering at least in part, control of the management of our business. Any change in management would change the flexibility of our operation, and could lead to a loss of earning power.

We are a very small and a very young company. Cleveland Bros. Equipment Co. is only 3 years old. Therefore, we have no reasonable base period upon which to judge our present earnings. We are engaged in the unspectacular business of selling and servicing heavy equipment to the construction and coal mining industry of central Pennsylvania. We have invested a total of $500,000 in our business and employ approximately 110 people.

Our earning power is entirely dependent upon our ability to satisfy our clients in the sale and service of construction machinery. Our earning power is dependent upon the maintenance of a capital plant which at present consists of three business locations (two of which are wholly owned and one rented), a fleet of 43 cars and trucks, and adequate tools, machines and equipment to service the needs of our clients. Our earning power is dependent upon the maintenance of adequate stocks of machines and parts at all times. From a cash investment standpoint this has varied from 12.7 to 15.3 percent of our annual gross business. Our earning power is also dependent upon maintaining sufficient working capital to carry our accounts and operate successfully.

Our only means of maintaining this working capital is by reinvesting all of our earnings and continually borrowing substantial sums of money. Unless we can continue to borrow, our operations would be seriously curtailed. Since this ability to borrow money is contingent upon our working capital and our net worth, the reinvesting of earnings is a primary necessity. If an excess profits tax becomes effective on our 1950 earnings and reduces our working capital considerably, it will seriously limit our borrowing capacity. It could be so great as to force us to liquidate a large part of our inventory. This would lead to a reduction in sales, which in turn would lead to a reduction in employment and in the facilities that we now have in operation. This could lead to a point where we would be useless to our clients, who in turn would be adversely affected since they have come to depend upon us to help them maintain efficient operations. With a smaller gross volume of business, we would have a reduced net profit and of course a smaller tax bill. If we can keep a substantial part of our earnings, we will reinvest them, earn more and live to pay bigger taxes in the years to come.

Right here is the point I have come to explain. It is one phase of the tax that seems to have been overlooked. The excess profits tax discriminates against small growing corporations. It does not allow them an opportunity to expand and continue growing. It reacts against them to a much greater degree than it does to older, bigger, and better established corporations. If small growing corporations are given a chance to expand through reinvesting up to 50 percent of their annual earnings they will probably pay more Federal profits taxes in the next 10 years than would be possible under the excess profits tax program. This would be true because of increased profit possibilities with greater capital and expanded organizations.

We all know that taxation is the source of income of our Government. If increased revenue is necessary from corporations it should be realized by raising the present tax rate sufficiently to meet the need.

Straightforward revenue raising taxes should be levied on corporate earnings, neither discriminatory nor punitive taxes should ever be imposed. Since Congress has the responsibility of raising taxes, it also has the responsibility of controlling inflation and of assurng the Nation that it will not dry up any sources of tax income. If the proposed excess profits taxes becomes law, it will seriously affect many small growing concerns like our own, and make them smaller taxpayers in the future rather than larger taxpayers. This will become a fact because it will not leave enough of their earnings for expansion and working capital, and it will therefore reduce their ability to earn profits.

Certainly in the Senate where we believe the conservatism of the country lies, there should be given consideration to the conservation of the assets of small business, so that they can continue to help support the Government.

If the presently proposed excess profits tax goes into effect for 1950, we believe that it would be unfair to all small growing corporations and will be a case of killing the goose that is laying the golden egg.

The CHAIRMAN. Mr. Simons. You may be seated and identify yourself.

STATEMENT OF GUSTAVE SIMONS, ATTORNEY FOR AMERICAN MANAGEMENT COUNSEL, NEW YORK, N. Y.

Mr. SIMONS. I am Gustave Simons, 60 East Forty-second Street, New York City. I appear as the attorney for American Management Counsel.

Mr. Chairman and Senators, I should like to address myself primarily to sections 442, 443, 444, and 445 of H. R. 9827.

In a recent report on the administration of excess profits tax relief under the prior law, the American Bar Association, after extensive study, criticized that administration as not having enough room for discretion, as being too rigid.

The House bill, instead of curing that defect, attempts to make the law more rigid, and I think renders it entirely unworkable in the light of the experience of those who have worked with relief matters under the prior law.

There is a provision permitting adjustment to industry standards if there is abnormality during the base period. This is unworkable for several reasons.

First, it is necessary to have 1 year of normal experience. To this 1 year the reconstruction is tied. But there are many corporations who suffered abnormal interferences with sales or production during substantially all of the base period.

Furthermore, 1 year is not generally a statistically significant period. The Bureau of Internal Revenue has consistently tended to reject reconstructions of normal income which are based on 1 year's experience.

Passing to the provision dealing with new companies or new products. In the case of new companies reconstruction is based on the relation to total assets and an industry comparative is used. In many cases there is no real connection between invested capital and earnings. That was recognized in the provisions of section 722 (c) of the old law.

Secondly, by tying the relief to the industry averages, the corporation itself is tied to the industry. No provision is made for the company that contributes to the community and thus pulls ahead of its industry, the only basis for economic progress this country has ever had.

If every company stayed with its industry, we would never have any progress.

There is no provision for relief akin to section 721 (a) (2) (C) in the case of an invention of a new product where the product was perfected after the base period. It is provided that the product must be introduced by December 31, 1949.

There are many very important section 721 cases pending under the old law where, after years of research the perfection, the fruition of the research came after 1939, and I imagine that there are many where new products are developed but do not happen to have been perfected by December 31, 1949.

There is no adequate provision where an entire industry grows at one time as in the case of television. But the most serious aspect of this overly rigid attempted but mythical objective standard is the very proposition of tying it to an industry. For one thing, many

companies are in several industries. Warner & Swasey make machine tools and textile machines. We all know of innumerable examples. The disentanglement of a corporation that is in various industries is a well-nigh impossible task.

Secondly, there will be great difficulty about industrial classifications. The Bureau of Internal Revenue rejected the comment of this very committee when this committee indicated that the machine-tool industry might be a depressed industry in connection with its report of the 1942 act. That rejection was contained in a letter dated June 22, 1944. It used as an industry standard the 32 largest corporations which had in the years 1936 through 1939 large export sales to European countries that were rearming. It omitted the thousands of small machine-tool companies that did not have that export business, and we will just have years of litigation over industry classification if the law goes through on that basis.

In a recent case having to do with a company manufacturing a pharmaceutical product, which is the basis of the saving of lives of hundreds of thousands of people, a proposed industrial comparison advanced by the Bureau of Internal Revenue included one company which manufactured and sold perfume, and another company that manufactured products having to do with hog cholera. And yet the excess profits tax of this corporation developing one of the most notable advances in human medicine is supposed to be predicated on that kind of a comparison.

Furthermore, within an industry there are variances in the case of companies that have exporting, those that do not, those that subcontract a lot and those that do not.

The Bureau of Internal Revenue itself has warned against this kind of relief. In its own bulletin on section 722 in part V (2) (c) (1) (c) it states:

> Since the normal operating conditions of all members of the industry are likely to be more widely divergent than a selected segment thereof, the same caution as noted above should be observed in the use of industry data. Indiscriminate use of such data would serve to give a particular taxpayer merely the average for the industry instead of earnings which are normal for it. This would discriminate against the taxpayer which is above the average of its industry and would favor a taxpayer which is below such average. The reference to industry data, therefore, is justified only in the case of a well-knit homogeneous industry where the taxpayer can be demonstrated to be typical of its industry.

And I know, gentlemen, of very few companies that qualify on that basis.

In some cases, as with the development of frozen orange juice in Florida, there is apt to be no industry at all. Thus, the efforts to objectify and make purely mathematical the application of what is essentially an equitable provision is doomed to failure from the start. Yet equitable relief is essential since no two companies are alike, and many of those coming within the province of sections 721 and 722 and are entitled to equitable relief.

The fact that the administration of those sections is broken down is no reason why the section should be eliminated. It means that the administration should be changed.

Canada, which had a comparable provision of law, has successfully administered it. Only one case is unsettled at the present time, 123 claims were denied, 8,166 out of 8,398 have been allowed on a satisfactory basis. I know many Canadian tax attorneys and have dis-

covered none who is dissatisfied with the administration of their relief provision, while I know none in the United States who is satisfied with the administration here. The law is substantially similar in both countries.

The reason for the difficulty has been that the administration has been on a basis of advocacy instead of judicial impartiality. We have not drafted the kind of men they had up in Canada. They drafted industry leaders.

Now, the success of the excess-profits tax depends on support of the public. Support depends on a sense of fairness. The sense of fairness depends on equitable administration of special relief provisions. That administration is one of the most important jobs in the economics of this country and demands the services of leaders of business, finance, labor, and the public.

Therefore, it is recommended that provisions for relief substantially similar to those of sections 721 and 722 be included in this law; that provision be made that it be administered impartially by the finest type of administrator. Consideration should be given to giving this administration to the National Security Resources Board, as was done with certificates of necessity under the Revenue Act of 1950, because that Board, is less concerned with the raising of revenue and, therefore, does not sit as advocate, judge and jury all at the same time.

Finally, a Court of Tax Equity should be established having equitable jurisdiction phrased in terms of section 722 (a), which is a broad general grant of equitable power. Any effort to confine equitable adjustment by limitation such as those contained in the regulations now in effect in the House bill must fail. Equity must be done in accordance with the kind of equitable procedure which has been established through centuries of experience in our courts of equity, and a very simple provision for that would do the job.

The CHAIRMAN. Thank you.

Mr. SIMONS. May I submit a supplementary statement?

The CHAIRMAN. Yes, sir; you may do so.

(The statement submitted by Mr. Simons is as follows:)

STATEMENT OF GUSTAVE SIMONS, ESQ., OF NEW YORK

I make this statement as attorney for American Management Counsel, an impartial and fact-finding organization, which has made extended studies of methods of stimulating capital formation through equitable taxation. The American people are willing to pay any necessary tax to support their Nation in its present peril. But, since the Boston Tea Party, the American people have resisted an inequitable tax. A tax that falls unevenly and unfairly on certain deserving segments of the community is inequitable and destroys the confidence of the people in the equity of the tax.

The excess profits tax approved by the Ways and Means Committee of the House of Representatives is discriminatory. Suppose on December 15, 1949, a corporation commenced the manufacture of a new drug, so wonderful that its inventor had won the Nobel prize. Scientific know-how rather than tangible invested capital creates the income. Obviously, such a corporation would have no adequate capital or earnings base. This type of corporation would be entitled to relief under either section 721 or 722 as provided in the Revenue Act of 1942. But, such provisions have been omitted in the House bill to date. The continued omission would be fatal to a just and equitable excess profits tax law.

But the mere reinstatement of these relief provisions will be insufficient. Those provisions, under the 1942 act have broken down in practical administration. This complaint is so widespread that the American Bar Association has made a special report on the subject. Not only this, but in February 1946 the Joint Committee on Internal Revenue Taxation held hearings on charges of

maladministration of section 722. I testified before that committee at that time on behalf of the Federal Tax Forum. As a result of those hearings, an Excess Profits Tax Council was formed. As the American Bar Association report points out, it has failed in its purpose.

It was supposed to expedite consideration of cases. There is not an attorney in the country who will not tell you that it has delayed the closing of cases. Thousands of cases closed by agreement in the field are held up in Washington. The Council was supposed to liberalize the administration of relief. In thousands of cases relief granted in the field has been cut down by the Council and I know of no case where the Council increased the relief or granted relief where it had been denied in the field.

Just one example is necessary to demonstrate how the will of Congress has been thwarted. Section 722 (b) (3) provided relief for corporations which were members of depressed industries. An example of a depressed industry given in its report on the 1942 bill by this very committee was the machine-tool industry, whose financial stability is the very heart and soul of our defense efforts. On June 22, 1944, the Bureau of Internal Revenue issued a letter stating that the machine-tool industry was not depressed. This war based on the data for the 32 largest corporations in the industry. As pointed out in my testimony before the joint committee in February 1946, the data for all machine-tool companies creates a very different picture. Yet this situation has not been remedied in the almost 5 years since that time.

I am not aware of any published ruling by the Bureau or the Council holding any industry to be depressed and entitled to relief under section 722 (b) (3). This section might just as well have been omitted from the law and the comments of this committee in 1942 expunged.

This need not necessarily be the case. Canada, during the last year, had a similar law. Relief was administered by a board of referees. There were 8,398 claims made; 108 were withdrawn; only 1 is yet undecided; in 123 no relief was allowed. In 8,166 out of the original 8,398 some relief was allowed. Dr. Joseph A. Bechman, Assistant Assistant Director of the Tax Advisory Staff of the Treasury, received these data some weeks ago. This compares with the thousands upon thousands of undecided cases in this country. True, there were fewer cases in Canada but their personnel was proportionately fewer as well. There is not one tax attorney in Canada who does not have confidence in the equity of tax relief administration in that country and there is not one tax attorney in the United States who does have confidence in the equitable administration of tax relief in this country.

One of the major reasons for the difference between Canadian and American tax equity administration was that in Canada leaders of the business community participated in the administration of relief. They have not been enlisted or drafted in this country for this urgent purpose. Instead the Council is loaded down with ex-Bureau men thoroughly indoctrinated in the Bureau point of view, consistently striving for reduction of the amount of relief and not taking a judicial approach.

In case an excess profits tax bill is recommended by this committee my recommendations are as follows:

1. That it contain relief provisions generally similar to those in the previous law.
2. That additional provision be made for the administration of these provisions either (*a*) by the National Security Resource Board, which now administers certificate of necessity and has the confidence of the business community, or (*b*) by a special court of tax equity which, as in the case of the old courts of equity will have a general mandate to administer equitable relief in tax matters where the strict letter of the law and administrative regulations creates a manifest injustice, contrary to the intent of the people in Congress assembled.

These changes should be applied to claims already pending under the 1942 act.

(Mr Simons later submitted the following supplementary statement:)

SUPPLEMENTARY STATEMENT OF GUSTAVE SIMONS BEFORE THE SENATE FINANCE COMMITTEE, DECEMBER 7, 1950

This document supplements my oral and written statements presented to the Senate Finance Committee on December 6, 1950, in connection with the Excess Profits Tax Act of 1950.

I shall particularly discuss sections 443 and 444 of H. R. 9827 which passed the House on December 5, 1950.

These two provisions are among the most dangerous and ill considered pieces of tax legislation in our history. The people and possibly most of the Congress are unaware of their implications.

Necessity for adequate equitable relief provisions is recognized if we are to tax war profits without unduly impeding economic progress. Sections 443 and 444 are intended to accomplish this result but will have an exactly opposite consequence.

SECTION 443—CHANGE IN PRODUCTS OR SERVICES

This section provides relief if there was a change of products or services within the 3 years ending December 31, 1949. If the new product (or service) meets certain tests, relief is allowed. The tests are inadequate and the measure of relief is both impractical and bad.

Inadequacy of qualifying provisions

1. It is required that the product or services be introduced prior to January 1, 1950. Suppose a corporation has been carrying on experiments for many years. The research is complete and the product introduced in 1950. Its success has nothing to do with the war. Why should such a corporation be denied relief? An example of the foregoing is the introduction in 1950 of color television by the Columbia Broadcasting System. Another possible example is the introduction of a wonderful, new synthetic yarn, Orlon, by the du Pont Co. There are innumerable other scientific discoveries which will come to fruition during the existence of this tax. Section 721 (a) (2) (C) of the old law did not limit its relief to products introduced prior to January 1, 1940, and the proposed time limit will put a most serious brake on scientific progress.

2. The requirement that the new product must account for one-third of the taxpayer's net income is not good. This would mean that with two corporations similarly situated, one where the new product accounted for 30 percent of its net income would not obtain relief, whereas one where it accounted for 40 percent of its net income would receive relief. Taxation should not depend on such accidents. This will discourage the introduction of new products or research by corporations which have many products and may be in the best position to do research. It is also unfortunate that no relief is proposed for companies which materially increase their income because of a change in method of operation.

Impracticality and evil of the measure of relief

1. This section would reconstruct base period income by granting the taxpayer the same rate of return on its assets as was earned by the taxpayer's industry. There are many situations in which normal earnings have no relationship to capital but are dependent on scientific know-how or management ingenuity. This was recognized under the old law by the provisions of section 722 (c). Suppose a management engineering corporation was organized on December 1, 1949 (if organized on January 1, 1950, it would not even qualify for relief), and developed an excellent form of production incentive which expedited critical production in this country. Since its "assets" under this bill would be negligible, it would receive negligible relief. Suppose a corporation developed a patent for an essential new product which it licensed to other corporations It might have negligible asset value and receive no relief. Section 721 of the old law properly covers such cases.

2. It is particularly bad to limit the tax credit to the earnings of the taxpayer's industry. The very core of American industrial progress lies in the corporation which pulls ahead of its industry. To tie a corporation to the earnings of this industry would be to destroy all incentive for the introduction of a new product.

The Tax Court has measured relief under section 721 by the extent to which the taxpayer's income from a new product exceeded the progress made by its industry. The greater progress of earnings is taken to be the measure of inventive income and the measure of relief. Under this proposal a taxpayer would be penalized for pulling ahead of its industry. This is exactly the opposite of the solutions worked out by the Tax Court under section 721. (See *W. B. Knight Machinery Co.* v. *Commissioner*, 6 T. C. 519, March 19, 1946; *William M. Bailey Company v. Commissioner*, 15 T. C. ———, No. 65 (promulgated October 10, 1950; and *Sommerfeld Machine Company* v. *Commissioner*, 15 T. C. ———, No. 64 (promulgated October 10, 1950)).

Under section 722 (b) (4), dealing with the introduction of new products or services, the Bureau of Internal Revenue also measured relief by the extent to which the taxpayer pulled ahead of its industry in a fashion exactly opposite to what the House bill proposes. See Bulletin or Section 722, United States Treasury Department, part V (II) (C) (3) (c), which reads as follows:

"The fact that income had not reached normal by the end of the base period may be exhibited in the year-by-year progress made by the taxpayer. If no such progress is observable, there is no indication that the taxpayer was in a stage of initial *development* so that an exended period of two years would be expected to result in an improvement in earnings. It is not sufficient, however, that the taxpayer's earnings had been increasing, if they were increasing only at the same rate as comparable mature members of the industry; this would show only normal industry growth. A marked upward trend for the taxpayer as compared with mature concerns is needed to indicate development growth necessitating the use of the push-back rule." [Emphasis in the original, not supplied by me.]

3. The industry comparative is absurd and unworkable. It will be the source of complete confusion and much litigation for the following reasons:

(*a*) Many corporations are in several industries. If CBS color television did qualify for relief, would it be granted on the basis of CBS being a member of the radio industry or the television industry? Warner & Swasey makes both machine tools and textile machinery. What is its industry classification? If du Pont did qualify for relief on Orlon, what industry would it come under?

(*b*) There are many variants within an industry. Some members of an industry do export work; others do not. The critical nature of this difference was emphasized in my testimony before the Joint Committee on Internal Revenue Taxation in February 1946, in connection with the division within the machine tool industry between companies that did do exporting and those that did not. Within a given industry many companies subcontract, while others do not, etc. This danger is recognized by the Treasury in the aforesaid bulletin. The Bureau itself states at part V (II) (C) (1) (c):

"Since the normal operating conditions of all members of the industry are likely to be more widely divergent than a selected segment thereof, the same caution as noted above should be observed in the use of industry data. Indiscriminate use of such data would serve to give a particular taxpayer merely the average for the industry of earnings which are normal for it. This would discriminate against a taxpayer which is above the average of its industry and would favor a taxpayer which is below such average. The *reference to industry data, therefore, is justified only* in the case of a well-knit, homogeneous industry, where *the taxpayer can be demonstrated to be typical of its industry.*" [Emphasis supplied.]

In the course of the handling of a great many relief cases under the old law, I have found very few industries which conform to this requirement. Suppose the average manufacturer of industrial furnace sells only 2 percent of its product to the automobile industry but a given taxpayer sells 100 percent of its product to the automobile industry and can demonstrate that its financial situation has always depended on that of the automobile industry. Why should its relief be measured by a comparison with the furnace industry rather than with the automobile industry?

The recent Tax Court decision in *William M. Bailey Company* v. *Commissioner* (15 T. C. ——, No. 65), promulgated on October 10, 1950, reinforces our position on this question.

In the Bailey case taxpayer's products were employed in operation of blast furnaces for the production of pig iron. As to the choice of index which should be chosen for determining improved business conditions, the Tax Court makes the following statement:

"The remaining question concerns the choice of an appropriate index to reflect the portion of net abnormal income due not to research and development but to improved business conditions (W. B. Knight Machinery Co., 6 T. C. 519 (Dec. 15.038); regulations 112, sec. 35, 721.3). We have chosen the factors for pig iron production. While not themselves pig iron, each of the products in question was employed exclusively in operation of blast furnices for the production of pig iron. An increased demand for the iron therefore inevitably accounted for some portion of petitioner's increased sales. It is not shown that application of different business improvement factors would change the result. See Rochester Button Co., supra, 554."

(c) Finally, I fear arbitrary and unfair industry classification by the Commissioner. In 1942 this very committee, in connection with section 722, suggested that the machine-tool industry was a depressed one. In my 1946 testimony I demonstrated how this expression of intent had been thwarted by the Commissioner, when on June 22, 1944, he circularized machine-tool industry data based on the experience of the 32 largest companies, all of whom did an export business. This gave an utterly distorted picture for the vast majority of small machine-tool companies which did not do an export business. A decision as to whether the textile industry is to be divided into a northern or southern industry, or treated as one, will have critical results and may be entirely arbitrary and unfair. There is a case now pending before the Commissioner, where relief is claimed by a pharmaceutical manufacturer, manufacturing a drug whose inventor had won the Nobel prize. It is proposed by the Bureau that relief be limited by comparing this company to an industry classification which includes a manufacturer of perfumes and another manufacturer of a hog cholera remedy, together with many others equally irrelevant.

The industry classification concept is unworkable, unfair, and destroys all incentives to progress.

SECTION 444—NEW CORPORATIONS

This section provides for relief along the same general lines as the preceding one. Its relief is limited to corporations organized after the base period. This is an arbitrary limitation. Corporations organized at the very end of the base period might not obtain adequate relief under the various complicated growth provisions in the House bill and should not be deprived of relief under this section. All of the other evils resulting from measuring relief by the amount of assets of a corporation (suppose a corporation has huge assets but they are not involved in the new product or in the novel enterprise) and in the industrial comparative as mentioned in connection with section 443 apply here.

SECTION 442

This section deals with a corporation which suffered an abnormal interference with income during the base period. Here relief is measured by an industrial comparison. All the evils of such industrial comparison mentioned before also apply here. Furthermore, it would be permitted to reconstruct an entire base period experience on the basis of only 1 year of actual experience. The Commissioner in relief cases now pending is consistently and energetically declaring that 1 year of experience is not a statistically significant basis for reconstruction of normal earnings. Yet section 442 would legislate this very proposition now opposed by the Commissioner.

Solution

The reason for these unwise and unsound proposals in the difficulty of administering sections 721 and 722 of the old law.

The American Bar Association, in a recent report on section 722, pointed out that the difficulties of fair administration arose out of the failure to exercise adequate discretion, flexibility, and liberality. The House bill instead of making relief administration less rigid, proposes to make it more rigid. This will never work.

There is no necessity that provisions such as section 721 and 722 should not work. As pointed out in my statement of December 6, 1950, similar provisions have worked spendidly in Canada, where out of 8,398 cases only 1 is now undecided, only 123 received no relief and 8,166 received relief. Every one of the many Canadian attorneys and accountants with whom I have spoken states this was a fair solution of the problem. If Canada can do it, why cannot this country? There are approximately 700 cases pending before the Tax Court. Administration should be decentralized and detechnicalized. In each State of the Union there should function a Federal court of tax equity. The Senators from each State should propose three members of this court for each State, with three alternates. One should be selected from business, one from labor, and one from the public. The President should select from these 12 individuals in each State a 3-man court, with 3 alternates, subject to confirmation by the Senate. The members should serve without pay. Their determination should be subject to review by the circuit court of appeals only as to errors of law. They should have broad, equitable jurisdiction to administer

the provisions of law which should be substantially similar to the former sections 721 and 722. Any taxpayer having a case now pending before the Bureau or before the Tax Court under the old provisions of law should have an election to transfer his case, prior to the hearing, to the appropriate court of tax equity. Ultimately, these courts should be vested with jurisditcion to do equity in any tax case where the letter of the law does an injustice. The Tax Court has frequently recognized that its hands are bound by the rigid provisions of law and that it is compelled to do a manifest injustice. The Supreme Court of the United States itself has recognized that equitable jurisdiction with regard to the tax law does exist (see *Bull* v. *United States*, 295 U. S. 247, 55 S. Ct. 695 (1935)), and a specific tribunal for this purpose will do much to increase the confidence of the people of the United States in the fairness of the tax laws with consequent substantial increase in tax revenues annually collected.

Respectfully submitted.

GUSTAVE SIMONS,
Attorney for American Management Counsel.

DECEMBER 7, 1950.

The CHAIRMAN. We have two additional witnesses, Mr. Schultz and Mr. Paul.

Mr. Schultz, identify yourself for the record and proceed.

STATEMENT OF RAYMOND H. SCHULTZ, ATTORNEY, CHICAGO, ILL.

Mr. SCHULTZ. My name is Raymond H. Schultz. I am an attorney at law with offices in Chicago, Ill.

Mr. Chairman and members of the committee, I desire to present the case of debtor corporations subject to debt arrangements confirmed under chapter XI of the National Bankruptcy Act prior to 1950. The proposed new excess profits tax does not provide for such corporations. Such a law without an appropriate provision for the determination of the normal profits of such debtor corporations will impose a destructive and inequitable burden on such corporations with resulting tax loss to the Government and economic loss to the country. An appropriate and equitable provision for such corporations is readily at hand which renders such destruction needless and unwarranted.

A chapter XI proceeding involves only unsecured debts of the debtor corporation and the creditors involved are not investors in the business but are suppliers seeking collection of their trade accounts receivable as soon as possible. An arrangement with such creditors is effected only if they, from their exhaustive analysis of the business, determine that the indebtedness will be paid in a short period of time through continuation of the business as opposed to payment by liquidation of the business. An arrangement requires payment of the indebtedness in definite installments over a short period of time and such arrangement necessarily involves and is based upon the best judgment obtainable as to the future profits of the business. An arrangement confirmed prior to 1950 is based upon a forecast of normal profits of the business. The provisions of the excess profits tax law proposed, however, fail to recognize, or to give any effect to that qualified judgment as to the normal profits of the business. The debtor corporation necessarily has a poor earnings record during the proposed base-period years and losses sustained during such period have decreased its invested capital. While its indebtedness must be paid according to the normal profits of its business as forecast in the arrangement, the proposed excess profits tax law will tax such normal earnings as excess

profits, thereby preventing the debtor corporation from paying its indebtedness and forcing it into bankruptcy with resultant tax loss to the Government and economic loss to the country.

The following is an actual situation which will serve as an example in this statement. A corporation which has been in business for more than 50 years was required at the close of 1947 to seek a creditors' arrangement under chapter XI of the National Bankruptcy Act. While it had net income of $1,080,000 in 1946, exclusive of capital losses, it incurred net losses of $600,000 in 1947 and $1,300,000 in each of the years 1948 and 1949. In October 1949 a plan of arrangement was accepted by the creditors and confirmed by the court. Under this arrangement the corporation was required to pay its unsecured debts at the close of 1947 in the amount of $3,100,000 in five equal annual installments of $620,000 each.

The arrangement clearly reveals that the creditors appraised the debtor as follows: That the debtor under normal operations should make profits of not less than $1,000,000 a year, that such profits after normal and surtaxes would leave a balance of the profits of not less than $620,000 to pay the installments required under the arrangement. As the arrangement was confirmed in October 1949, this forecast of the profits of the debtor was a forecast of normal profits because the present defense economy and excess profits could not then have been foreseen and any mind that could have then forseen such excess profits would also have foreseen an excess profits tax which would deny the corporation the benefits of such profits. Clearly such forecast of normal profits was the basis of such arrangement for without such forecast it would have been realized that the arrangement could not be performed and the arrangement would not have been accepted by the creditors and confirmed by the court.

But what will be the position of this corporation under an excess profits tax law similar to the prior law? Obviously the corporation cannot use its actual experience in the base-period years as a basis for excess profits credit. Its invested capital has declined through losses to $4,000,000. On an invested capital basis of 8 percent it would have an excess profits credit of only $320,000 and its income in excess of such amount would be deemed excess profits.

Should the normal and surtax rates be 45 percent, the excess profits tax rate be 80 percent, and its earnings $1,000,000, the amount of its appraised normal net income, it would retain out of its $1,000,000 of earnings only $310,000 with an obligation to pay $620,000 under the plan of arrangement. When the experts determined what should be normal earnings of the corporation, they undoubtedly considered the possibility of an increase in normal and surtax rates and concluded that the earnings of the corporation would be sufficient to absorb any foreseeable increase. It was realized that if such combined rates be increased to take 50 percent of the normal profits, the corporation would be required to earn only $1,240,000. However, under an excess profits tax burden of 80 percent the corporation would be required to earn in excess of $2,500,000 to have sufficient funds to pay the required $620,000. It is obvious that no increase in earnings of the corporation would be possible which would enable it to make up the funds necessary to meet the payments required by the arrangement. Such excess profits taxes would deprive the corporation of its normal profits and not take just its excess profits. The most thorough examination of this

particular business has resulted in the best judgment possible that the normal profits before taxes of this particular business should be not less than $1,000,000. The law, however, does not recognize this judgment but provides by general standards that do not fit the above situation that the normal profits of this business are only $320,000.

The same situation exists as to practically every debtor corporation which sought the benefits of chapter XI of the National Bankruptcy Act and obtained a plan of arrangement prior to 1950. Its arrangement necessarily is framed upon a forecast of the normal earnings of its business and the payments required thereunder are specific and definite.

On the other hand, the debtor corporation in the example, and any other debtor corporation under a chapter XI arrangement confirmed prior to 1950, is peculiarly amenable to a particular relief provision which can be inserted into the proposed excess profits tax law and which will be wholly equitable and relatively easy to apply and administer with the least possible delay in the granting of the relief. This relief provision would recognize and utilize the arrangement proceedings in measuring the normal earnings of the debtor. As pointed out above the arrangement in our example, and every other arrangement, necessarily involves and is based upon the most qualified forecast of the normal earnings of the debtor corporation. The arrangement therefore furnishes a tailor-made measurement of the normal profits of the particular business of the debtor and the debtor's excess profits credit should not be less than the normal profits reflected in the arrangement.

The debts required to be paid under the arrangement can only be paid from two sources of funds. These sources are: First, net profits; and second, proceeds from the liquidation of assets. If the amount of the total payments on account of principal indebtedness required of the debtor in each year under the arrangement is first reduced by the proceeds received from the liquidation of assets, and by the proceeds which would have been received if assets which should have been liquidated had been liquidated, and the reduced amount is then increased so that such reduced amount would remain after the payment of an income tax at the rate in effect at the time of the confirmation of the arrangement, the resulting amount is the minimum normal net profits forecast under the arrangement. Such minimum amount at least is normal profits of the debtor and should not be subject to excess profits tax as such tax is not intended to be, nor should it be, a tax imposed on normal profits. The excess profits credit of the debtor therefore should not be less than such minimum amount. If it is less, the debtor is being taxed on normal profits and not on excess profits.

The minimum excess profits credit proposed above is not only the minimum amount of the debtor's normal profits but it is also the minimum amount which will permit the debtor to survive. The debtor is not relieved of any burden imposed by increased normal or surtax rates, it is merely relieved from an excess profits tax on its normal profits and certainly it is entitled to such relief. The means of granting the relief proposed is immediately at hand in the arrangement of the debtor and can be readily and easily applied as illustrated above. Certainly the destruction of the debtor by an excess profits

tax with the resulting loss to the Government and the country is inequitable, needless, and unwarranted.

There is attached hereto a suggested section to be incorporated into the new excess profits tax statute which it is believed will accomplish the relief so necessary to companies having taken advantage of chapter XI of the National Bankruptcy Act prior to 1950, and which will fully protect the Government's revenue.

The CHAIRMAN. Thank you very much. The reporter will place your proposed provision in the record.

(The proposed provision submitted by Mr. Schultz is as follows:)

PROPOSED PROVISION—EXCESS PROFITS TAX

Add the following at the end of the subsection of the proposed excess profits tax law which corresponds to section 713 (d) (1) of the Internal Revenue Code (relating to the average base period net income):

"In the case of a taxpayer with respect to which an arrangement has been confirmed under Chapter XI of the National Bankruptcy Act prior to January 1, 1950, the average base period net income of such taxpayer, for the purpose of determining the tax imposed by this chapter on such taxpayer for any taxable year, shall be deemed to be not less than an amount of which the aggregate of all payments, required by the arrangement to be made by the taxpayer during such taxable year on account of principal indebtedness of the taxpayer provided for in the arrangement, is 62 per centum. For the purposes of the preceding sentence the aggregate of all payments, required by the arrangement to be made by the taxpayer during such taxable year on account of principal indebtedness of the taxpayer provided for in the arrangeemnt, shall be determined by excluding therefrom so much of such payments as could have been made by the taxpayer other than from income included in the taxpayer's excess profits net income for such taxable year (determined at the close of such taxable year as though such payments were required to be made at the close of such taxable year) without undue hardship to the taxpayer or its business."

The CHAIRMAN. Mr. A. Harding Paul.

Mr. PAUL. If it is agreeable, I can come back in the morning, Mr. Chairman.

The CHAIRMAN. We have a full schedule for tomorrow.

Mr. PAUL. I will enter my name and appearance and file my statement, and simply tell you the things that are in it, without reading it.

The CHAIRMAN. All right, you file it for the record, the full statement. You may proceed.

STATEMENT OF A. HARDING PAUL, ATTORNEY AT LAW, WASHINGTON, D. C.

Mr. PAUL. I am A. Harding Paul, an attorney practicing law in Washington, D. C., and represent certain of my firm's corporate clients, namely: R. B. Davis Co., grocery products manufacturers of Hoboken, N. J.; Getz Bros. & Co., exporters and importers of San Francisco, Calif; E. A. Merkle, Inc., printers and publishers of Washington, D. C.; Mohican Stores, Inc., a chain of food stores in New York City; and the Locomotive Finished Material Co., manufacturers of locomotive parts and other materials, of Atchison, Kans. These are all small to medium-sized corporations and all are vitally concerned with the problem of excess profits taxation. They would all prefer that there be no excess profits tax but that the needed revenue to finance the defense program be raised in some other manner.

I will exclude the rest of my remarks and file them, except that I would like to say, Senator, that we think that there should be a termination date to the excess profits tax law.

I think that the chairman is familiar with the direct advocacy of the general revenue revisions to correct the inequities of the 1942 act. It has been almost accomplished but never quite. If there is a termination date prescribed in this law, it will more certainly reassure the taxpayers that the matter will be brought up again.

We think that that termination date should be December 31, 1952, so that at the end of the next Congress they will have a chance to reexamine the law.

We also think that there should be some provision for using current earnings in the base to determine the three best years. This could be accomplished by an index prepared by the Bureau of Internal Revenue or the Department of Commerce to show the trend of normal earnings, and with that in view it would cure a lot of these inequitable cases by permitting 1950 to come into the picture in determining 1951 normal profits, by having the taxpayer select the year from 1946 through 1950, 1950 to be reconstructed on the basis of this industry index as to what is normal.

We think that we should have 100 percent of what is normal and not 85 percent or 75 percent.

We think also that there should be some provision in this law to eliminate the imposition of section 102 tax on corporations during the year 1950. During World War II, or the operation of that law, the Commissioner did not enforce that section because corporations were generally unable to determine what was an unreasonable accumulation. But if 1950 this statute should provide that there would be no imposition of a penalty under section 102, it would be very beneficial, because no board of directors at this date can say what the amount of excess profits tax is going to be. It is extremely harsh to have to look back and say, "Well, we accumulated this for a tax," which may be lower than they expect or may be higher. It is impossible to say.

So, it seems to me suspension of that penalty tax during the imposition of a retroactive tax would be of very great benefit.

We also believe that this section 117 (j) losses should not be eliminated. You recall in the provision on the Revenue Act of 1950 before, this committee and the Congress refused to eliminate the benefit of section 117 (j) losses, in determining the losses subject to the higher normal and surtax, but there is a provision in the House law, in H. R. 9827, which eliminates that for excess profits tax.

We think that there is no reason for the elimination of that because there is every reason to encourage the scrapping of old, obsolete equipment and installations for the purpose of making a more effective and efficient productive facility to carry on the defense program.

The CHAIRMAN. Yes, sir. Thank you very much for your appearance.

(The prepared statement of Mr. Paul reads in full as follows:)

STATEMENT OF A. HARDING PAUL, ATTORNEY AT LAW, WASHINGTON, D. C.

I am A. Harding Paul, an attorney practicing law in Washington, D. C., and represent certain of my firm's corporate clients, namely: R. B. Davis Co., grocery-products manufacturers of Hoboken, N. J.; Getz Bros. & Co., exporters and importers of San Francisco, Calif.; E. A. Merkle, Inc., printers and publishers of Washington, D. C.; Mohican Stores, Inc., a chain of food stores of New York City; and the Locomotive Finished Material Co., manufacturers of locomotive parts and other materials, of Atchison, Kans. These are all small to medium-sized corporations and all are vitally concerned with the problem of excess

profits taxation. They would all prefer that there be no excess profits tax but that the needed revenue to finance the defense program be raised in some other manner.

I have presented my clients' and my views on the subject of excess profits taxes before the Ways and Means Committee, and some of the provisions which we advocated have been included in H. R. 9827. There are a few provisions, however, which have not been included in the bill just passed by the House that we believe should be included in any excess profits tax law to be enacted. I have no extended statement in the premises, but with permission of the committee will merely summarize these proposals and ask permission to submit a more detailed analysis for the record.

One thing we have advocated is that there should be a termination date fixed for the expiration of any excess profits law. We believe it should be no later than December 31, 1952. This would permit the next Congress near the end of its term to reexamine the situation in the light of events at a definite future date. I am sure the members of the committe are familiar with the fact that there has been frequent advocacy of a general revenue revision bill, mainly to correct the inequities of the Revenue Act of 1942. Except for the repealing of the excess profits tax law in 1946 and the making of a few minor changes, no general overhauling of the tax structure has taken place. By including a termination date to the excess profits tax, taxpayers could be reassured that a time for revision will definitely come before Congress and that outstanding bad provisions of the law which may be enacted can then be corrected.

We also advocate that a provision be included to permit the use of current earnings data in determining normal profits which should not be taxed as excess. Specifically, we recommend that the law provide for the use of an index to be prepared by the Bureau of Internal Revenue or the Department of Commerce to measure normal growth of profits by industries so that years subsequent to 1949 can be brought into the period of years a taxpayer may select from in determining its average base period earnings credit. Based upon data known to various industry groups and governmental agencies prior to July 1, 1950, a trend chart by industries of normal profits can be erected. Such index can be applied to the average earnings of a particular taxpayer for the years 1946 to 1949, inclusive, to reconstruct normal profits for the years 1950 and 1951. The taxpayer should then be permitted, if it chooses to do so, to use the earnings of such years so reconstructed, together with other years' actual earnings in the period 1946 to 1949, inclusive, in making its 3-year selection to determine its average normal profits for the purpose of credit. The statute should also provide that a taxpayer could, by following certain standards, prove, if possible, that its particular earnings trend exceeded the industry average and then should be permitted to determine its credit by selection of years included those so reconstructed. Furthermore, the credit should be 100 percent of the average for the 3 selected years, not 75 percent as proposed by Secretary Snyder, nor 85 percent as contained in H. R. 9827.

We very definitely feel that, with respect to any taxable year ending in 1950 at least, a provision should be included in the law which will eliminate any chance for the imposition of a penalty tax under section 102. This penalty tax, as you know, is imposed upon a corporation which accumulates earnings and profits beyond the reasonable needs of the business. In the present situation wherein it was announced, as was done in section 701 (a) of the Revenue Act of 1950, that Congress intended to enact an excess profits tax retroactively, it seems harsh indeed to permit the imposition of a penalty for accumulation. A board of directors of a corporation during 1950 would be derelict of its duty if it did not accumulate more earnings than it normally would, to be certain of having sufficient funds at hand to pay any retroactively imposed tax. It could never know how high such a tax would be. Perhaps it is not the intention of the Commissioner of Internal Revenue to impose any section 102 tax in 1950, but it would be helpful to him and beyond doubt wise to provide in the statute that such penalty shall not be asserted this year.

While I have not discussed this matter with my clients, I am sure that they are unanimously opposed to the provision included in H. R. 9827 which would deny section 117 (j) losses in determining earnings subject to the excess profits tax.

Section 117 (j), as you know, permits a corporation to deduct in full business property losses but gives capital-gains treatment to profits realized on the sale or exchange of such property.

In the Revenue Act of 1950 this committee and Congress rejected an attempt on the part of the Treasury to revise this section so as to in effect eliminate losses as deductible by declaring them to be capital and not operating. The present proposed change in this section is but another attempt to accomplish the same thing, viz, make such property losses nondeductible insofar as the excess profits tax is concerned. The same reasons obtain for not making such a change.

Congress, in devising the war tax law of 1942, recognized that to encourage industrial efficiency for production, it would be wise to stimulate change-overs from obsolete to up-to-date machinery, equipment, and buildings by giving taxpayers making such change-overs at losses or gains favorable tax treatment. The same reasons which prompted passage of section 117 (j) originally exist today when the country must eliminate inefficient structures and install the most up-to-date obtainable to permit the greatest possible contribution to industrial production. Elimination of the loss deduction in computing excess profits income and thus exacting an excess profits tax on such loss will retard the discard of old and installation of new efficient structures. This will hinder, not help the defense armament program.

The CHAIRMAN. I will ask the reporter to insert in the record at this point a memorandum in support of exemption of vermiculite mines from the excess profits tax, submitted by the Board of Trade Building, Chicago, Ill.

(The memorandum referred to is as follows:)

MEMORANDUM OF JOHN H. BISHOP IN SUPPORT OF EXEMPTION OF VERMICULITE MINES FROM EXCESS PROFITS TAX IN BEHALF OF BOARD OF TRADE BUILDING, CHICAGO, ILL.

I. HISTORY OF EXCESS PROFITS TAX LEGISLATION FOR VERMICULITE

In 1943, the War Production Board classified vermiculite as a mineral necessary for the war effort. Thereafter it was included in the Revenue Act of 1943 with other strategic minerals, and income from the mining of it was exempted from excess profits taxes. The exemption so granted remained in effect until the Excess Profits Tax Act was repealed.

II. WAR USES OF VERMICULITE

When vermiculite was classified in 1943 as a mineral essential to the war effort, it was being used principally for high-temperature cements, insulation, and sound-deadening for gun compartments in airplanes, ship decking, roof decking, and for insulation and construction of Government buildings.

Since the end of World War II, it has not only maintained the position which it had during the war but it has extended its use in many additional and important phases of the rearmament program. We list below some of the more important ones:

1. Underground insulation for steam lines

Vermiculite is the principal ingredient for what is known as the Z-Crete system of insulating underground steam lines. It has been used extensively on all types of Army and Navy installations. Some of the jobs that have been completed are the following: The Thirty-sixth Street Airport, Miami, Fla.; Raritan Arsenal, Metuchen, N. J.; Training Aids Building, Camp Springs, Md.; shop buildings at the Engineer School, Fort Belvoir, Va.; fire stations at Walter Reed Hospital, Washington, D. C.; barracks and mess hall, Vint Hall Farms Station, Warrenton, Va.; Washington National Airport, Gravelly Point, Va.; Veterans' Administration Hospital, Manchester, N. H.; gymnasium and theater at Westover Field, Chicopee Falls, Mass.; Pentagon Building, Washington, D. C.; Limestone Army Air Base, Limestone, Maine; Signal Depot, Lexington, Ky.; Navy work at Treasure Island, San Francisco, Calif.; air bases at Duluth, Minn.; Fargo, N. Dak., and Riverdale, N. Dak.

Z-Crete insulation has been specified for the Air Force development at Tullahoma, Tenn., and for the veterans' hospital at Pittsburgh, Pa.

More than 30,000 feet of underground steam piping are being insulated with this material at the Army installation at Anchorage, Alaska. A special vermiculite expanding plant has been constructed in Alaska to take care of the present and future work that is expected from Army installations and from Government housing.

Z-Crete insulation has been installed in approximately 100 housing projects in the past 3 years and on numerous industrial and utility installations. It is estimated that the expansion of industrial and utility facilities in the rearmament program and the need for additional Army camps and housing will require quantities substantially in excess of the amount furnished in the past.

2. Precast chimneys for Army camps, atomic energy installations, and other Government buildings

Because vermiculite is fireproof and indestructible, it has been used in the manufacture of chimneys for Army camps, Atomic Energy Commission structures, and other Government installations in place of steel stacks that were formerly used.

Chimneys manufactured from vermiculite have been installed in the Atomic Energy Commission projects in Salt Lake City, Utah; Pocatello, Idaho; Anchorage, Alaska; Oak Ridge, Tenn.; Fort Leonard Wood, Camp Atterbury, Camp Edwards, and Camp Pickett. Government contracts for this type of insulation now existing are DA–23–037–AV–15 and 16.

Fifth Army headquarters in Chicago have advised the manufacturers of this type chimney that they will be required to furnish vermiculite chimneys to all camps and forts under Fifth Army jurisdiction. It is expected that First, Second, and Third Army headquarters will standardize on this type of product.

It is estimated that requirements for this type of installation will far exceed the vermiculite that has been allocated for this use in the past.

3. Antisweat coating in holds of ships

The Bureau of Ships and Docks, under its release of October 1, 1943, 52–V–19 (Int.) has specified vermiculite as an antisweat coating for naval vessels. This material is now the recognized standard product for this use.

4. Rail joint packing compound

Railroads are now using substantial quantities of vermiculite compounded with heavy lubricating oil and inhibitors for rail joint packing. In a period of national emergency, this is important in maintaining our transportation system.

5. Fireproofing of steel

Vermiculite, in combination with gypsum, is being widely used for the fireproofing of steel beams and columns. Underwriters laboratories have given the material a 4-hour fire rating. This type of fireproofing reduces approximately 90 percent the weight of the fireproofing material. A 35-story building, by using vermiculite fireproofing, saved 1,880 tons of structural steel, on approximately 30 percent of the amount originally estimated.

In addition to the fireproofing qualities, vermiculite is used for plaster, roof decks, floor fill, and other construction uses. Because of its light weight, it results in substantial reductions in steel requirements. When is a critical item, as at present, any reduction in its use is of prime importance to the war effort. Since vermiculite contributes materially to that reduction, its importance in the saving of steel cannot be overemphasized.

6. High-temperature cements

Vermiculite is the principal ingredient in high-temperature cements that are used in the insulation of blast furnices and in oil refineries. In the former, it is believed to be the only practical material available for the purpose. It is of particular importance in the oil industry because it can be shipped to distant points in concentrated form and there converted into the insulation that is required for refinery construction. The obvious effect is a material saving in shipping space.

7. Building construction

During the last war vermiculite was used in large quantities for insulated and fireproofed roof decks on Government buildings. Notable examples are the Pentagon Building, Washington, D. C., the small arms plant at St. Louis, Mo., and the Velox national supply depot at Velox, Wash.

It is presently being used for the same purpose on Government installations. It is also being manufactured into a roof tile. This tile has gained wide acceptance because it combines structural strength, insulation, fireproofing, and acoustical properties.

Vermiculite is used as a plaster aggregate, for light-weight concrete aggregate and for insulation for all types of structures. The latter is of prime importance in that it permits substantial savings on fuel consumption.

8. Agricultural uses

Vermiculite aggregates and vermiculite insulation are generally the only materials available in small farm communities where they are used to build and insulate all types of farm structures. This contributes to the economical production of food.

It is also being used by practically all large fertilizer manufacturers as a fertilizer conditioner.

Other uses contributory to the rearmament program might be given. It is believed unnecessary. The mineral has made for itself a place in the war economy of this country that cannot be taken over by any other known mineral. From the mere listing of the uses above, it is apparent that in almost every instance the use is one which is peculiar to the mineral itself and which would be wholly lost if an adequate supply were not maintained. There are no known substitutes for this material in the principal war uses above described.

III. EFFECT OF EXEMPTION PROVISIONS OF THE REVENUE ACT

Under the exemption provisions of the last excess profits tax law, the vermiculite industry was able to supply the war needs of the country. From 1943 to 1946 tonnage mined increased about 90 percent. It is a fair assumption that a substantial part of this increase was attributable to the excess profits tax exemption.

Since the end of the war, the vermiculite industry has continued to grow. While we have not been able to compile figures from all the operating mines, we can illustrate the growth from the records of the principal producer. From April 1, 1946, to March 31, 1950, this mining company spent over $1,500,000 for the expansion and improvement of production and operating facilities. This resulted in increased tonnages and increased earnings. Production increased from about 86,000 tons in 1946 to approximately 169,000 tons in 1949. Profits increased from $217,000 in 1946 to $541,000 in 1949. Income taxes paid increased from $82,000 in 1946 to $203,000 in 1949.

If the earnings over these years had been subjected to a normal tax of 45 percent and an excess profits tax at the rate of 75 percent, it is a safe assumption that expansion of production and operating facilities could not have gone forward on the scale that was actually accomplished.

From the records of the past war period, it is believed safe to assume that there will be a substantial increase in the demand for vermiculite as a result of the present rearmament program. The mines are now operating at peak capacity and the economy is absorbing the entire output of the mines. It is not possible to stockpile any amount of the mineral under present conditions. If the industry is to keep pace with the war effort and supply the anticipated increase in demand, it will have to have funds available to procure the needed additional facilities. This it cannot do if it must face a normal tax of 45 percent and an excess profits tax at the rate of 75 percent.

The loss of revenue from the granting of the exemption will be small. The principal producers of vermiculite are engaged in two activities—the mining of ore and the manufacture and sale of finished products. Income from the two activities is about equally divided—for example, the records of one of the larger companies show 49 percent of income from mining in 1949 and 51 percent from the sale of expanded products and other materials; in 1950 the ratio was 54 percent from mining and 46 percent from the sale of expanded products and other materials. The exemption would apply then to only about one-half of the income of the vermiculite miners. Since the total income of all miners is small, the loss of revenue could not be a material one. It is believed that this loss of revenue from the exemption would be more than offset by additional normal taxes that would result from increased production and increased sales of expanded material and other products that would undoubtedly follow from continued growth of the industry. Certainly, if the growth equaled that of the last war, or that of the postwar period, receipts from normal taxes would far exceed the loss of revenue that would result from exemption of the industry from excess profits taxes on mining.

IV. CONCLUSION

In conclusion, we respectfully request that the mining of vermiculite be granted exemption of excess profits taxes in the revenue act under consideration, because—

(1) It would be in keeping with the precedent established in World War II.

(2) It would be in furtherance of the objects of the Strategic Minerals Act.

(3) It would encourage development and additional production to meet war needs.

(4) It would follow the recommendation of the American Mining Congress.

(5) It would result in substantial savings of critical items, such as steel, fuel, and transportation facilities.

(6) It would not materially affect revenue collections.

(The following material was submitted for the record:)

STATEMENT BY RALPH W. HARDY, DIRECTOR OF GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF BROADCASTERS

The National Association of Broadcasters is a trade association whose members are engaged in all forms of broadcasting—amplitude modulation, frequency modulation, and television. The association has a membership of approximately 1,500.

By the very nature of their service functions, broadcasters are deeply conscious of the swift pace of national and world events. They understand the implications of leadership inherent in this country's role in the family of nations. Being practical businessmen in a highly competitive area, they are urgently aware of the relationship between costs and services. Broadcasters do not oppose necessary procedures on the part of Government to levy taxes to meet the heavy costs of the defense program. On the contrary, they would prefer to see their Government achieve as nearly as possible a pay-as-you-go basis of operation. The factors involved in arriving at an equitable distribution of the heavy tax load are of great concern to the members of this industry, and it is with regard to these factors as they pertain to broadcasting in all of its aspects that we seek to lay before your committee a current and accurate picture.

We do not represent ourselves as being tax experts. However, our own close review of our industry and its obvious tax problems leads us to express great sympathy for the joint staff and this committee as they proceed to recommend to the Congress excess profits tax legislation that will answer the many compelling diversities in American business in a fair manner and at the same time be serviceable from an administrative point of view and still produce the needed revenue. We can understand and appreciate the sentiments that have been expressed by leaders in both Houses of Congress and the Treasury viewing with concern the many problems that will arise with excess profits taxes.

Broadcasting as an industry offers a prime example of the tremendous difficulties encountered in the application of excess profits tax principles. Presumably the concept of an excess profits tax is that it shall absorb that portion of business profits which is in excess of the normal level of profits for individual business units. The underlying assumption is that such excess profits result from emergency or wartime factors, external to the business unit, rather than from normal economic conditions and normal management leadership. Therefore, it becomes essential that a fair and legitimate measurement of "normal level of profits" be established. Otherwise, such a tax burdens corporate achievements as based upon management and entrepreneurial ability. There is considerable difficulty—even during ordinary times—in establishing any formula which accurately and justly measures the normal profits of individual firms. The plight of the broadcaster arises out of the fact that due to constant technological development coupled with unusual regulation by the Government, there is, to all intents and purposes, no "normal time," and, consequently, no "normal profit" period. To see this, let us examine the make-up of the industry, particularizing on the three major segments, AM, FM, and TV.

As this country entered World War II there were in operation, licensed by the Government, 882 standard broadcast (AM) stations. There were 48 FM (frequency modulation) stations on the air, and 1 commercial television station. During World War II, the Federal Communications Commission, the broadcast licensing arm of the Government, froze all applications for additional radio facilities so the growth picture became static. This Government freeze ended on August 7, 1945, and during the intervening period to December 31, 1949, the number of AM stations jumped to 2,086, an increase of 137 percent. FM stations increased from 48 to 732, or 15 times as many as were on the air before the war.

The television picture is even more extreme than sound broadcasting. Whereas in 1941 there was only 1 commercial TV station in operation, on December 31,

1949, there were 97. Respecting television and its normal growth picture, another artificial brake was applied and the natural expansion movement distorted by a freeze order on television licenses issued by the FCC on September 30, 1948. Since that date there have been no further television license applications processed by the Commission. These, then, are the facts pertaining to growth. There are additional factors, however, having a bearing on this unusual state of affairs, and I invite your consideration of them.

Without burdening the committee with technical details, permit me to point out that frequency modulation presented a new form of sound broadcasting, designed in the words of its proponents, including members of the Federal Communications Commission, to eventually supplant the standard or amplitude modulation method of sound broadcasting. With the FCC urging them to action, many broadcasters already operating AM transmitters undertook to pioneer FM, paying its losses out of their AM earnings. Some indication of the extent of this joint operation is seen in the fact that of the 732 FM stations on the air as of December 31, 1949, 614 or 84 percent were functioning in connection with a standard AM station. The profit picture of these broadcast corporations would not in any sense be normal during this extended developmental period.

Let us take next the case of the 58 percent of the present standard AM stations which came into being with the end of the FCC freeze at the termination of World War II. A substantial number of these new licenses were granted for communities that previously had not enjoyed a local radio outlet. Others made it possible to expand into a desirable diversity the number of individual program services available to a community or region. In the process of the return of the normal environment of competitive forces in the postwar years and the establishing of these new broadcast stations, a period of losses or abnormally low earnings characterized most of the stations in this category. Any base period selected during the past 5 years would manifestly be discriminatory to this important part of the industry. It should be borne in mind that the general rule of procedure for broadcasters having both AM and FM is to continue them under a common corporate entity.

To bring the broad industry picture into full focus, let us now add the television problem. As in the case of FM, television transmitting service was undertaken largely by broadcasters who already were in the AM broadcasting business, and in many cases were also broadcasting FM. In a few instances television stations were launched as distinct corporations without any relationship to an AM or FM operation. During the base period suggested by the Treasury, it was not an uncommon experience to see television operators together together engaging in friendly rivalry matching experience to see who could claim the distinction of losing money at a greater rate than the others. The operating losses were staggering and they were carried either by siphoning off earnings from sound broadcasting or by heavy investments of risk capital put forward in the faith that this new industry could be launched successfully. The problem of applying excess profits taxes to television operations is perhaps as serious and extreme as any that you will consider.

There is a tendency to group industries of a somewhat similar functional type together to arrive at bases for studies showing percentage returns on net worth and for tax computations. To combine radio and television broadcasting with the broad field of communications, including the vast public utilities operating in this area, would be completely unrealistic and would not take into account the many distinguishing conditions and factors already outlined that have a direct bearing on the equities of taxation pertaining to broadcasters.

There is still another important consideration worthy of your attention. In petitioning you for review of the peculiar problems incident to our industry, we have in mind the object that no legislation will be recommended by this committee of the Senate that will in any way impair the maintenance and growth of a strong and efficient system of communication that has unequalled speed, power, and effectiveness in reaching the masses of the American citizenry in peace, in emergency, and in war with messages and directives of the Government as well as the tremendously vital morale sustaining services. In the report on American civil defense plans transmitted by the Honorable Stuart Symington, Chairman of the National Security Resources Board to the President, State and community planners are told "The nerve system of civil defense is communications. * * * Communications plans at the local level should embrace all forms of communications including * * * AM, FM, and TV. * * * Broadcasting stations (including television) should be utilized as an important medium to inform the public of its responsibility in civil defense. Through broadcastng

stations, timely civil defense informational and educational material can be quickly presented to a maximum audience with a minimum number of persons required to prepare and disseminate the information."

On July 21, 1950, at the outbreak of the Korean troubles, Dr. John R. Steelman, the assistant to the President, requested that immediate steps be taken by the National Association of Broadcasters, "to organize the entire broadcasting industry in some manner in which it would be instantly available to the Government as required." This organization of the broadcasting industry has been accomplished and the broadcasters have pledged themselves to render all-out service to their country in contributing skills and facilities to meet every challenge.

The period ahead is filled with many uncertainties. For the broadcaster it does not look like a boom. On the contrary, it has ominous indications of hardships and stresses. Serious problems of equipment maintenance, receiving set manufacturing and distribution, manpower and material shortages are already on the horizon. Hanging over all this is the completely baffling influence of constant new inventions in the field of electronics that periodically and unpredictably shake the structure of the industry to its foundations. To this picture add the sizable ingredient of Government regulation through decisions and directives of the Federal Communications Commission, and you have the principle sources of tensions that plague broadcasters in their view of the present as well as of things to come.

The earnest hope of the members of this industry is that your committee will be able to produce an effective tax bill that will meet the urgent needs of the Government and, being free from administrative snares and inequities, will permit radio and television broadcasting to sustain themselves and grow to fill their great role in our national life in rendering vital public service.

The broadcasters are convinced that their case is not only unique, but is one of commanding merit.

KENT-COFFEY MANUFACTURING CO.,
Lenoir, N. C., December 5, 1950.

COMMITTEE ON FINANCE,
United States Senate,
Senate Office Building, Washington, D. C.

GENTLEMEN: I Harold F. Coffey, president of the Kent-Coffey Manufacturing Co. of Lenoir, N. C., submit herewith the following facts and figures setting forth this company's predicament should there be enacted an excess profits tax using an average earnings or invested capital credit, without providing relief for such cases as ours in which plant expansion during the base period has resulted in loss in production and net earnings.

By way of qualification, I would like to state that I have been with the company since its organization, beginning as a factory workman and serving in various capacities, including that of executive vice president and sales manager for more than 25 years prior to 1943. Since my father's death in 1943, I have served as president.

GENERAL BUSINESS EXPANSION

Ibelieve your committee will find that there was a general expansion of plant facilities following World War II and that this company, rather than being an exception, followed the general trend in this particular. Likewise, I believe you will find that there was considerable equity and borrowed capital employed to finance this expansion, all of which was employed with the anticipation of realizing increased earnings from such expansions to retire these obligations. In our case, it was largely borrowed capital, and without an adequate credit for earnings for the year 1949, it would have been better to have made no plant expansion.

ORIGIN AND HISTORY

This company is a manufacturer of wood bedroom furniture and began business in 1907 with a paid capital of $33,800.

By consistently plowing back its profits, after income taxes, into plant expansion to take care of the increased demand for its product, the company is enjoying an increased volume of sales, which for the 10 months ended September 30, 1950, exceeded $4,000,000. As the result of its plant expansion, the company

estimates its annual volume of sales will exceed $6,000,000. The company's sales are widely distributed in the United States, Canada, Mexico, and Hawaii. At September 30, 1950, the company had 596 employees at its factory location, and 27 commission salesmen, a total personnel of 623.

Although the foregoing sales volume is stated in millions which looks big to us, when compared with industry as a whole, we are definitely in the small corporation class. I assume that you have already been furnished figures showing that it was the small corporation that was hardest hit in the previous excess profits tax for the reason that they did not have the comparable credit; either by earnings or invested capital with the large corporations.

This Company's Predicament

In the light of the enactment of an excess profits tax, using the period 1946-49 as the basis for a credit, this company finds itself in this predicament:

1. During the base period years 1946–49, and to September 30, 1950, this company made the following expansion of its plant and equipment:

Fiscal year ended Nov. 30, 1947	$54,434.10
Fiscal year ended Nov. 30, 1948	124,412.90
Twenty-two months ended Sept. 30, 1950	848,973.65
Total plant expansion to Sept. 30, 1950	1,027,820.65
Plant and equipment Nov. 30, 1946	520,064.47
Total plant and equipment Sept. 30, 1950, as shown exhibit A	1,547,885.12

You will notice by the foregoing that the major plant expansion extended over a 22-month period to September 30, 1950, and in the event the year 1949 is used as the last year of the base period, this period of expansion then extended 10 months beyond the base period. In making this expansion, it was necessary to demolish a large area of wooden buildings and replace them with modern, standard mill construction, consisting of brick walls, steel beams, and standard 5-inch factory flooring. The productive floor space was increased to 383,751 square feet, an increase of approximately 104,000 square feet. Included in this expansion was the installation of new and modern machinery, labor-saving devices, conveyorized equipment, and a system of quality control which, together with the increased productive floor area should produce an annual earnings credit considerably in excess of any shown in the base period years.

2. Of the 22-month period of plant construction and renovation, the 13 months ended May 30, 1950, was the most affected by the interruption of the expansion program, and in this 13-month period, the company sustained an actual loss of $30,287.88. The management was confronted with the choice of closing the plant down completely and concentrating all efforts on building for a period of 6 to 8 months, or of building the plant around the workmen and suffering a consequent loss in the production of goods during the construction period. The latter course was chosen, resulting in the dollar loss just stated. To close down completely for such an extended period would have entailed disruption of the plant organization and the permanent loss of skilled workmen, requiring years to train new personnel to the degree of skill and efficiency existing at the time of the interruption. Likewise, with no product available for sale, contact with the customer would have been lost and the sales force disbanded, making necessary a long uphill pull to reactivate a selling organization and regain anything approaching a normal status in the trade.

3. By referring to exhibit B you will note that the company had net earnings before income taxes for the proposed base period of years as follows:

Fiscal year ended Nov. 30, 1946	$338,938.41
Fiscal year ended Nov. 30, 1947	559,865.12
Fiscal year ended Nov. 30, 1948	737,813.97
Fiscal year ended Nov. 30, 1949	174,635.40
Total	1,811,253.30
Average	452,813.32

An average earnings of $452,813.32 would be a severe handicap to this company as it would not reflect the substantial and consistent growth during the base period, and above all, it would not reflect the profits that can be earned with the

new and modern plant with increased productive floor space and improved facilities.

The plant expansion was practically completed by May 30, 1950. For the 4 months of June, July, August, and September, 1950, the company realized a net profit of $231,181 which, when placed on an annual basis would result in a net profit of $693,543. This figure, although an index of the effect of the plant expansion, is inadequate, for the reasons that the full effect of the expansion was not felt in all four of the months stated, and the production for this period was at a rising material and labor cost, whereas, the orders were taken several months previous and at prices in effect on and prior to June 5, 1950.

Since writing the foregoing, H. R. 9827 has become available, and specific reference is made to section 442, abnormalities during base period, shown at page 57 of the bill. We have carefully examined this section and have applied it to our situation and find that it affords us no relief whatsoever, for the reason that an industry-wide index of earnings is used instead of that of our own, which is much more, as can be seen by referring to exhibits A and B attached, where it will be noted that this company earned an average of approximately 44 percent on its net worth for the years 1946–48.

The bill proposes a credit on invested capital at 12 percent, which in our case would produce a credit less than any one of the year's earnings, and, consequently, the invested-capital method affords us no relief.

CONCLUSION

We strongly urge, first, that the substituted earnings during the construction period—in our case the year 1949—be based on each corporation's own experience and not that of the industry-wide average; and, second, that the growth formula be applied after having substituted such constructive earnings for the period of construction. Only by these means can companies such as ours, whose earnings were materially reduced during the period of expansion, be allowed an earnings credit comparable to those companies whose earnings were not interrupted by plant expansion. Even such a credit would allow nothing for the increased capacity as the result of plant expansion.

We hope your committee will see fit to enact into law such provisions as the foregoing that will afford relief merited by the conditions heretofore outlined.

Respectfully submitted,

KENT-COFFEY MANUFACTURING CO.,
By HAROLD F. COFFEY, *President.*

EXHIBIT A.—*Kent-Coffey Manufacturing Co., comparative balance sheets*

	Fiscal year, Nov. 30, 1946	Fiscal year, Nov. 30, 1947	Fiscal year, Nov. 30, 1948	Fiscal year, Nov. 30, 1949	To Sept. 30, 1950
Assets:					
Cash	$50, 727. 37	$56, 813. 68	$192, 830. 05	$76, 709. 83	$175, 586. 79
Accounts receivable	296, 254. 36	373, 375. 93	537, 209. 56	390, 387. 45	655, 026. 31
Notes receivable			5, 000. 00		
Inventories	486, 185. 41	648, 804. 14	710, 803. 46	505, 928. 10	732, 361. 03
Cash value life insurance	30, 787. 50	36, 013. 25	41, 922. 15	48, 071. 10	48, 071. 10
Plant and equipment	520, 064. 47	574, 498. 57	698, 911. 47	1, 219, 330. 93	1, 547, 885. 12
Prepaid expense	4, 145. 49	18, 178. 13	14, 775. 62	35, 215. 16	67, 327. 15
Stock in other corporations	26, 000. 00	26, 000. 00	26, 000. 00	72, 000. 00	72, 000. 00
Total assets	1, 414, 164. 60	1, 733, 683. 70	2, 227, 452. 31	2, 347, 642. 57	3, 298, 257. 50
Liabilities:					
Accounts payable	48, 153. 22	43, 346. 10	43, 785. 31	79, 300. 38	188, 053. 78
Notes payable	125, 000. 00		5, 000. 00	200, 000. 00	735, 000. 00
Accruals	122, 956. 34	288, 401. 11	376, 219. 29	146, 709. 44	274, 006. 73
Reserve for depreciation	185, 917. 71	202, 257. 22	225, 737. 54	259, 981. 19	307, 481. 19
Preferred stock	30, 000. 00				
Common stock	400, 000. 00	400, 000. 00	400, 000. 00	400, 000. 00	400, 000. 00
Surplus	502, 137. 33	799, 679. 27	1, 176, 710. 17	1, 261, 651. 56	1, 393, 715. 80
Total liabilities	1, 414, 164. 60	1, 733, 683. 70	2, 227, 452. 31	2, 347, 642. 57	3, 298, 257. 50

EXHIBIT B.—*Kent-Coffey Manufacturing Co. analysis of net profit and surplus*

	Fiscal year, Nov. 30, 1946	Fiscal year, Nov. 30, 1947	Fiscal year, Nov. 30, 1948	Fiscal year, Nov. 30, 1949	To Sept. 30, 1950
Net profits, 5 months				$209, 843. 42	
Net loss, 7 months				−35, 208. 02	
Net profits:					
6 months					$4, 920. 14
4 months					231, 181. 00
Fiscal years	$338, 938. 41	$559, 865. 62	$737, 813. 97		
Net profit for period	338, 938. 41	559, 865. 62	737, 813. 97	174, 635. 40	236, 101. 14
Less income taxes accrued	150, 572. 90	232, 815. 35	307, 180. 24	66, 511. 53	98, 501. 40
Net addition to surplus	188, 365. 51	327, 050. 27	430, 633. 73	108, 123. 87	137, 599. 74
Beginning surplus	344, 020. 57	502, 137. 33	799, 679. 27	1, 176, 710. 17	1, 261, 651. 56
Additions:					
Including cash value life insurance	6, 719. 25	5, 225. 75	5, 908. 90	6, 148. 95	
Miscellaneous adjustments		1. 62	146. 52	1, 671. 77	180. 00
Total	539, 105. 33	834, 414. 97	1, 236, 368. 42	1, 292, 654. 76	1, 399, 431. 30
Deductions:					
Life-insurance premiums	5, 468. 00	9, 610. 70	7, 094 95	7, 003. 20	5, 715. 50
Preferred stock retired	1, 875. 00				
Preferred stock dividend	5, 625. 00	1, 125. 00			
Common stock dividend	24, 000. 00	24, 000. 00	48, 000. 00	24, 000. 00	
Miscellaneous adjustments			4, 563. 30		
End surplus balance	502, 137. 33	799, 679. 27	1, 176, 710. 17	1, 261, 651. 56	1, 393, 715. 80

STATISTICAL

Volume of sales	$3, 303, 333. 36	$4, 111, 755. 42	$5, 205, 113. 72	$3, 745, 881. 20	$4, 111, 976. 65
Net return on net profit after taxes ......percent..	5. 7	7. 9	8. 3	2. 9	3. 3
Invested capital ......do....	20. 21	27. 26	27. 31	6. 51	7. 67

PARENTS' INSTITUTE, INC.,
New York 17, N. Y., December 6, 1950.

Senator WALTER F. GEORGE,
Senate Finance Committee, Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: We are greatly distressed, on studying the excess profits tax bill (H. R. 9827) to find that, because of circumstance peculiar to our company, we would have virtually no excess profits tax credit on the income method and very little on the invested capital method.

This company is a moderate-sized publishing company which publishes Parents' Magazine and Varsity (a young man's magazine).

In 1946 we launched Varsity and incurred heavy losses through 1949. In 1947 we liquidated certain publishing subsidiaries and Parents' Institute, Inc., sustained substantial losses from such liquidation. These two things together more than canceled the profits we made from Parents' Magazine. Therefore, on the income basis we would have practically no excess profits credit under the provisions of the bill.

On the invested capital basis we would have a negligible credit, because like most other small publishing firms, we have a low capitalization.

With Varsity now practically at a break-even points and with the results on Parents' Magazine more profitable (due to increased efficiency and despite decreased advertising paging) we apparently face the prospect of having virtually all our present normal income subject to excess profits taxes.

We sincerely believe that it is not the intent of Congress so to tax normal income. Since none of our present income can possibly be deemed "defense or war-swollen" we must respectfully protest the provision in the proposed tax bill which would cause such an unfair situation.

The practical effect of H. R. 9827 is to subject all our normal earnings to excess profits tax.

Specifically, we urge that the following provisions be retained from the Excess Profit Tax Act of World War II, namely—

(*a*) The growth formula, and

(*b*) The definition of base period (so as to allow for the inclusion of fiscal periods instead of placing everyone on calendar periods).

We also recommend that—

(*a*) Losses sustained in development of new products (in our case a new magazine) be eliminated from the base period.

(*b*) Nonrecurring losses sustained in liquidation of subsidiaries be eliminated from the base period.

(*c*) The relief provisions, replacing old section 722, be amended specifically to include problems such as ours.

(*d*) A Special Relief Board be created to handle the unusual type of case, such as ours, which is certain to be subjected to the maximum over-all tax, 67 percent in H. R. 9827, and where the income is not the result of the defense or war economy.

We sincerely trust this letter will have your most serious consideration.

Respectfully yours,

GEORGE J. HECHT, *President.*

RICHMOND, VA., *December 7, 1950.*

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

MY DEAR MR. CHAIRMAN: To avoid taking the time of your hard-pressed committee by personal appearance, I am writing this letter to invite attention to a defect in H. R. 9827, which I believe resulted from accidental oversight and which can easily be corrected by the amendment suggested below.

The World War II excess profits law recognized the fact that fire and casualty insurance companies were required by law to set aside reserves which accounted for and absorbed a substantial portion of their equity capital, especially in the case of casualty companies. Accordingly that law included an express provision (sec. 723-B in the case of mutual companies) which provided that 50 percent of the average of reserves required by law should be included in equity capital. Of course, voluntary reserves, not required by law, were not included in equity capital.

Under the proposed law (due, I believe, to oversight) no distinction is made between voluntary reserves on the one hand and reserves required by law on the other hand. To correct this manifest injustice I suggest the following amendment:

Page 42, section 437 (c), line 15, amend the sentence beginning with the words "in the case of" so as to read as follows:

"In the case of an insurance company, its reserves, other than reserves required by law, shall be treated as liabilities and not as assets; provided further that 50 per centum of the average of its reserves required by law, computed as of the beginning and ending of the taxable year, shall be treated as assets and added to, and treated as part of, its equity capital."

Since I have informally discussed this matter with Mr. Stam and he is familiar with the situation, I am handing him a copy of this letter. Since this letter is being dictated and transcribed here in Washington, it is on plain paper rather than on my regular letterhead.

Respectfully yours,

JOHN J. WICKER, Jr.,
Attorney at law.

BOYLE, WHEELER, GRESHAM & DAVIS,
San Antonio, Tex., December 5, 1950.

In re Heckett Engineering, Inc.

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

DEAR SENATOR GEORGE: I respectfully urge your thoughtful consideration of an extremely serious problem which faces the above-named corporation in connection with the proposed excess profits tax.

In the attached letter to the Office of the Tax Legislative Counsel, Treasury Department, I have set forth the problem in full, closing with a suggested solution. Stated very briefly and simply, the problem and suggesed solution are as follows:

Heckett Engineering, Inc., recovers clear steel from the past and current slag and refuse discard of steel mills; its machinery and processes are patented and it is the only corporation in the United States which renders this unique service. The company began operations just before World War II, and made the excellent contribution of saving for the war effort hundreds of thousands of tons of clear steel. After the war, but long before the present emergency arose, there existed not only the opportunity but the urgent demand for broad expansion of the company's recovery operations. Such demand arose primarily because this source of scrap steel was new and economical, and the steel companies were consequently anxious to see it utilized to the fullest. The present preparedness effort, or armaments program, will not materially increase this demand, simply because the steel business is already operating at top capacity, and has been for the last several years. To illustrate the opportunity for expansion which lies before Heckett Engineering, Inc., the company now gives full or partial service to 6 mills, while there are over 60 steel concerns in the United States today. The consequent demand is tremendous.

Heckett Engineering, Inc., started with a relatively small amount of capital, and has used its profits to bring the company to its present level of activity. It now has long-range plans for continued expansion, and would like to go forward with these plans. However, the proposed excess profits tax has no provision which would prevent additional profits from expansion being treated as excess profits. Obviously these additional profits are not excess profits, but are normal profits, since they will arise only as a result of normal expansion, and not as a result of of the preparedness effort. It seems to me that it is wholly unfair for the new law to contain no provision which would permit this company (and other corporations similarly situated) to expand normally, without having all its additional profits classified as excess profits. This places an extremely heavy burden on precisely those corporations which should be encouraged most; namely, the innovators and the growing corporations. Heckett Engineering, Inc., operates under complicated patents covering a process which originated in Europe and which was brought to this country by Mr. E. H. Heckett in 1939. This recovery process is a great contribution to our economy, and assuredly it should not be stifled by a deficient or ill-conceived excess profits tax.

Hackett Engineering, Inc., is not asking for special consideration, but merely seeks some equitable provision in the law which will recognize that its additional profits from normal expansion are not excess profits and will not be so treated. The large established corporations of this country, on whom a fair share of the burden of new taxes should in all justice fall, will not be faced with this problem. Because they have been operating for the last several years at top capacity, and will therefore (unless we have uncontrolled inflation) have average earnings in the future not materially greater than their average earnings for 1946–49, the net effect of H. R. 9827 on these large established corporations will be that they will pay a so-called excess profits tax of 75 percent on only 15 percent of their normal profits, whereas Heckett Engineering, Inc., and similar fast-growing corporations will soon find themselves paying the 75 percent excess profits tax on the bulk of their normal profits. Such legislation as this is not only inequitable but it is distinctly harmful to our economy. There is no supportable excuse for failing to include in whatever new law is enacted a provision which will give fair treatment to growing corporations by recognizing that their additional profits, from normal expansion, are not excess profits.

As a solution to this problem, it is suggested that a growing corporation be permitted to establish from its actual experience during the years 1946–49 the average rate of profit earned in relation to its fixed operating assets. This ratio of profits to assets would then be used as the measure of the corporation's normal earnings (and consequently its excess profits credit) in any given taxable year. Thus, if a corporation should grow and develop by increasing its investment in fixed operating assets, it would be permitted to earn its established rate of profit thereon. Such a provision would be fair, administratively practical, and would discourage price inflation.

I have had a good many years of experience, both with the Treasury Department and in private tax practice. I realize that the prime purpose of a revenue bill is to raise that desired revenue. However, I speak with impartial conviction when I say that an excess profits tax bill which taxes the additional earnings of a growing corporation as excess profits, and fails to recognize and make allowance for the fact that such additional earnings are normal profits and not excess profits, not only spreads the tax burden unevenly and unfairly, but operates as an active deterrent to the normal growth and expansion of those corporations

which, for the support of our economy in general and the support of the preparedness effort in particular, most deserve congressional encouragement.

Very truly yours,

CLAIBORNE B. GREGORY.

BOYLE, WHEELER, GRESHAM & DAVIS,
San Antonio, Tex., November 9, 1950.

Re Heckett Engineering, Inc.

OFFICE OF THE TAX LEGISLATIVE COUNSEL,
United States Treasury Department, Washington 25, D. C.

GENTLEMEN: I respectfully urge your thoughtful consideration of an extremely serious tax problem which faces the above-named corporation. The business of this concern is unique: It consists of recovering free steel from the waste of steel furnaces through the application of patented processes. There is no other concern in America operating under these patents. The service rendered by this corporation is, as we shall see, in addition to its normal economic importance, vital to the long-range preparedness program on which our country is now embarked.

The problem which I wish to present for your consideration is occasioned by the probability of a new excess profits tax. The achievement of a fair and equitable solution constitutes a challenge to the wisdom and skill of those who have the responsibility of working out a tax measure which will raise the necessary revenue without crippling the preparedness effort or distributing the tax burden unevenly.

EARLY HISTORY

In 1927, Mr. Eric H. Heckett, at that time a citizen and resident of Holland, became interested in the application of the magnetic separating principle to the recovery of the metallics contained in the slag and refuse of steel mills, and shortly thereafter began constructing and operating recovery plants. By 1938 these recovery operations had assumed considerable proportions, but it was also at this time that Hitler began his extension of control over Europe. Thereupon, Mr. Heckett abandoned his recovery operations in Europe and came to America, where he immediately undertook an intensive study of the means and methods whereby the steel-recovery operation conducted in Europe could be adapted to the use of the American steel industry. Mr. Heckett came to America on a visitor's permit, but the potentialities of his contribution to the steel industry in this country were enormous. By a special act of Congress, dated June 17, 1940, he became a resident of the United States outside the immigration quota of the Netherlands, and became a naturalized citizen in June of 1945.

Up to as late as 1940, no serious effort had been made in the United States to recover free steel from the slag and refuse cast off by steel furnaces. Over the years, enormous slag pits and refuse dumps had accumulated near our steel mills, but the potentialities of metallic recovery from the materials that go into these slag pits had never been really recognized by American steel makers. While this accumulation represented tremendous waste, the failure to meet the problem lay specifically in the fact that up to 1940 there had always been, with the possible exception of the World War I period, a plentiful supply of steel scrap in America. Though some of the steel mills were conscious of the loss of steel through their slag and refuse, they did not attempt to recover it since no methods existed for economical recovery and for preparing it to such quality that it could be utilized in the furnaces.

It was at this time that Mr. E. H. Heckett came forward with plans and methods which would mean the recovery of millions of tons of steel from this waste material, in a quality readily usable in the steel furnaces.

When, with the outbreak of World War II, a desperate need for scrap arose, Mr. Heckett had his first two plants in operation. These plants had not only been used to iron out all kinks that are unavoidable in new methods, but were already delivering substantial quantities of steel to two mills and were accordingly ready for the task Mr. Heckett was then called upon by the War Production Board to undertake.

HECKETT ENGINEERING, INC.

(a) Formation of the corporation

To bridge the gap between European hand production and American assembly line methods, from the standpoint of utilizing the magnetic separating and cleaning process, was a difficult undertaking. At first the task seemed to pre-

sent insurmountable problems, but the result of experimental operations at a midwest plant of one of the country's largest steel concerns demonstrated the possibilities of the magnetic method. Thereupon, on April 26, 1939, Mr. Heckett organized Holland Engineering Co. an Ohio corporation, and on September 9, 1939, he applied for patents on the magnetic separating machinery and process. Two basic patents were granted to Mr. Heckett, one on November 25, 1941, and the other on July 4, 1944. Contracts were let for the construction of the intricate separating machine (see attached drawing marked "Exhibit A"). Demand for installation of recovery operations promptly outstripped the ability of the corporation to comply. The first recovery operation began at the South Chicago plant of Republic Steel Corp. in December 1939.

On August 10, 1940, Mr. Heckett organized Heckett Engineering, Inc. (hereinafter called Heckett Engineering), an Ohio corporation with principal offices in Butler, Pa., of which corporation he is now president and principal stockholder. Heckett Engineering conducted parallel activities with Holland Engineering Co., until the latter was dissolved in late 1941 and its assets transferred to Heckett Engineering. Heckett Engineering has free use of the patents issued to Mr. Heckett, but pays no royalties whatsoever.

(*b*) *Nature of the business*

Heckett Engineering does not sell or lease its machinery to the steel mills. Instead, it contracts with the mills to effect a recovery operation at a given site within each individual mill. To do this, the corporation brings its own machinery and its own crew onto the mill property as a semipermanent installation. To describe these recovery operations in detail in this letter would lead too far, but a short outline of the methods might be important. The mill waste in which most of the steel losses occur are the slags and refuse from the steel making furnaces. The hot slag runs out of the open hearth at the time of tapping the steel flow into the steel ladle and overflows from this ladle into big slag thimbles placed alongside the steel ladle. These slag thimbles are taken to the Heckett Engineering pits while the slag is still molten or at least semimolten. The refuse is the material that accumulates on the open hearth floor from spillings during the process of tapping, pouring and filling, and in moving the ingot molds. This material is brought to the Heckett Engineering plant in cold stage and dumped into separate pits at their plant location.

From there on Heckett Engineering takes over, and performs all the duties of recovery and preparing the usable materials, especially the free steel and the high manganese bearing slags, and then disposes of the worthless remaining waste. These useful materials are then loaded by Heckett Engineering into cars put on their siding by the mill and the materials go back into the furnaces immediately.

All this work is done partly by very big cranes, draglines, lifting magnets, bulldozers, hauling equipment, etc., and partly, or mostly, by the special equipment designed and patented by Mr. Heckett for this purpose. One of these pieces is shown on the enclosed drawing; this is called the separator. All slag and steel which is not big enough to be easily detected visually and which needs no cutting and breaking for use in the furnaces, passes through these separators. Very strong specially designed magnetic fields are created within this machine and every single piece passes through this field and is separated from non-steel-bearing materials. Practically all pieces containing steel, down to pieces of of one-quarter inch, are thus recovered, screened according to their size and then removed to huge cleaning installations where all the impurities adhering to the steel are removed. The loading of the manganese-bearing slag, for use in the blast furnaces where the manganese is recovered, is a separate, but in these times of manganese scarcity, a most important operation.

The recovery operations comprise both the handling of slag and refuse from the current operations of the steel mills and the processing of slag and refuse which has accumulated over the years in old dump heaps and slag pits.

HISTORY OF OPERATIONS DURING WORLD WAR II

In the spring of 1941, the United States was put on an emergency footing. At that time Heckert Engineering and Holland Engineering Co. (which was dissolved that same year) together had contracts with only two steel companies for recovery of free steel. In April of 1941 the War Production Board requested that the recovery operations of Heckett Engineering be expanded to certain specific mill sites. Heckett Engineering had not sufficient funds with which to

make this expansion, so consequently the Heckett Corp. was formed in August 1941 and was made the agent of the Defense Plants Corporation (a Government-owned corporation) for the purpose of purchasing the necessary heavy equipment to expand operations to the mill sites indicated. This equipment was duly purchased for Defense Plants Corporation and the latter then retired the equipment to the Heckett Corp. During the war years, Heckett Engineering did not expand at all. In fact, it had only one recovery operation in 1943, only one recovery operation in 1944, and only one full recovery operation in 1945. Meanwhile, the Heckett Corp. operated six recovery installations in 1943, six in 1944, and eight in 1945.

As indicated, the Heckett Corp. was formed largely to carry out recovery operations as directed by Defense Plants Corporation. The operations produced sizable recovery of free steel, but resulted in losses each year. In 1944 and in 1945 losses were considerable. These losses were mainly due to the fact that during the extreme scrap shortage in World War II the plants mostly affected were those that were not "integrated"; this means they had no blast furnaces and accordingly no pig iron of their own. Consequently these plants were dependent on allocation of pig iron and had to use a much higher percentage of scrap in their charge than integrated mills. It was in these mills that the War Production Board asked Mr. Heckett to operate and to recover the steel, mostly from their existing dumps, irrespective of whether this was economical or not. The steel production of most of these nonintegrated mills was small, in fact too small to keep Heckett's esuipment occupied, and the dumps were partly so situated that a well planned earth moving operation was impossible. At the end of the war, the recovery operations conducted by the Heckett Corp. were terminated as soon as possible. Only one of these operations was taken over by Heckett Engineering when the Heckett Corp. was merged into the former in late 1947. The other operations were not taken over because they were not profitable and would not have been undertaken at all except for the exigencies of war and the wishes of Defense Plants Corporation. Such operations were not the type of operations that Heckett Engineering would have undertaken as a part of normal growth and expansion. It is thus apparent not only that Heckett Engineering did not grow or expand at all during the war years, but that the expansion and growth of the Heckett Corp. was of such abnormal character that it was discontinued almost completely as soon as the demands of war ceased.

Prior to World War II, steel scrap had been readily available to the steel mills in this country. However, at the close of World War II this was no longer the situation. There were several reasons for this. First, there had been a tremendous increase in the productive capacity of steel mills, and at the close of the war there arose a vast demand for steel products for civilian use. This fact kept the steel mills producing at capacity. Second, the ordinary source of scrap is scrapped machinery and other equipment, which, however, in the postwar period enjoys a much longer life than before the war. This is illustrated by the present and past average life of the automobile, which always has been a principal source of scrap metal. Third, since scrap is nothing but used machines, tools, tanks, guns, etc., into the manufacture of which goes new steel the cycle of returning scrap was interrupted due to the fact that the bulk of all goods made from steel during the war had been taken overseas and thus irrevocably lost to the American economy. In addition to these three reasons indicating why scrap metal is not as easily available today as it was prior to World War II, with the result that steel mills are tremendously anxious for all the free steel which can be recovered from slag and refuse, there is another very important reason why the mills are anxious to have recovery operations installed at their mills; this is the simple reason that steel recovered by Heckett Engineering is made available to the steel mills at approximately one-half the price, or less, of steel scrap from other sources.

THE EXCESS PROFITS TAX PROBLEM

As disclosed by the above history, war in Europe led almost directly to the appearance of the magnetic recovery process in the United States. Three corporations were formed to put this process to work: Holland Engineering Co., Heckett Engineering Inc., and the Heckett Corp. As we have seen, Holland Eingineering Co. terminated its activities and was absorbed by Heckett Engineering in 1941. Heckett Engineering itself came into existence in August 1940, but had achieved little or no growth when it came to a standstill upon the formation of the Heckett Corp. This latter concern was organized for the purpose of carrying out the

expansion desired by the Defense Plants Corporation. It is thus apparent that before Holland Engineering Co., or its successor, Heckett Engineering, could even get under way with their normal growth and expansion, the Heckett Corp. was formed to carry out all the expansion that subsequently occurred during the war years in this specialized field of industrial activity.

During the war years, the activity of Heckett Engineering dwindled down to only one operation in 1943, only one operation in 1944, and only one operation in 1945. Meanwhile, the activities of the Heckett Corp. were expanding to carry out the wishes of Defense Plants Corporation. The guiding factor in these expanded activithies was, of course, the needs of the war effort. The additional recovery operations which were undertaken were not considered from the standpoint of economic soundness. It was simply a case of the Government wanting the job done, and the corporation doing it. By 1945, the Heckett Corp. had eight different recovery operations in progress, but with the termination of the war all these operations, except one, were discontinued as quickly as possible. They were discontinued because they were not contracts which the corporation would have entered into as a part of normal growth and development. On the contrary, they were contracts dictated by the exigencies of the war situation. They were transient and profitless operations. For each year of wartime operation, the Heckett Corp. reported losses. It is thus apparent that Heckett Engineering never really began its normal growth and development prior to the end of World War II, and was therefore, at that time, for all practical purposes, still a new corporation, with its real growth and development period yet to come.

Since the end of World War II, Heckett Engineering has made big strides in developing its business; practically all profits have remained in the corporation and have been utilized constantly to add additional plants. At the moment of this writing, Heckett operates plants at 10 American steel mills, having built up its operations gradually since the end of the war to this figure. Long-range plans for further expansion have been laid long ago, quite independent of the present emergency, and the possibility of the expansion is practically unlimited since there are some 60 odd steel mills in the country, of which at least 40 offer an opportunity for economical and substantial recovery. In order to accelerate this expansion, Heckett Engineering will require substantial amounts of additional borrowed or invested capital, and efforts in this direction are under way. (The success or failure of these efforts will no doubt turn largely on how such corporations as Heckett Engineering are treated under the proposed excess profits tax.) It must be repeated at this point that these recovery operations must be handled in each individual mill, as it is not possible to transport the material from one location to another; accordingly, each steel mill requires a separate operating unit.

The contracts of Heckett Engineering with the steel mills are practically all based on fixed prices, independent of the price of scrap in the open market. It is for this reason that increased profits of Heckett Engineering in the ensuing years would be solely based on growth and expansion of their operations, and on more efficient methods, and would be in no way the consequence of increased prices for its product.

The basic theory of the old excess profits tax was to tax profits which were "more than usual or normal" for the particular corporation concerned for the particular year involved. Presumably the new tax will be premised upon the same theory. This means that in any year for which an excess profits tax is to be paid the profit taxed will not include the profit which is usual or normal for the corporation in that year. Heckett Engineering is now in the midst of a period of normal growth and development. Since the close of World War II it has made good progress, and it is clear that major expansion and growth will take place during the next several years. The corporation conducts a unique and vital activity. To meet the clearly foreseeable demands of the steel industry, substantial expansion is inevitable. Such expansion would take place regardless of the present preparedness program, largely because the corporation provides the steel industry with an article (i. e., free steel) which has become essential to them whether there is a preparedness program or not, at a price far below any other source. As a matter of fact, this expansion would probably take place more rapidly in the absence of a preparedness program for the simple reason that the tremendous quantities of machinery necessary install additional recovery operations would be more readily available to Heckett Engineering if there were no defense program in progress. Under these circumstances, it would obviously be both inaccurate and inequitable to say that the usual or normal profits of Heckett Engineering during the

development years ahead would be no more than its earnings during a past year, or no more than the average of several past years. In order faithfully to apply the basic theory of the excess profits tax (i. e., that only profits which are "more than usual or normal" for the year in question shall be taxed) to the case of Heckett Engineering, consideration must certainly be given to the fact that during the immediate years ahead this corporation's usual and normal profits, regardless of the preparedness program, will be considerably in excess of its earnings during past years.

If the old excess profits tax law is not skillfully and thoroughly altered to give effective and liberal consideration to this problem of a normally growing corporation, Heckett Engineering would be faced with the fact that any expansion beyond its scale of operations for 1949, even though this expansion were obviously normal growth and development, would produce profits subject in their entirety to the excess profits tax. Such a situation is scarcely encouraging to a new and growing corporation. Instead of going ahead with its plans to borrow the additional capital necessary to finance the tremendous machinery purchases required for expansion, the corporation would be bound to hesitate. Moreover, the financing necessary to the expansion (whether additional borrowed capital or additional invested capital) would be immeasurably more difficult, perhaps impossible. And yet there must be expansion. Neither the steel industry nor the country can afford to do less than see this source of free steel exploited to the fullest. Thus it is not to the interest of anyone that a corporation such as Heckett Engineering should be discriminated against under the new law. On the contrary, it is vitally important that a wise and fair solution to the problem be found. Heckett Engineering is an innovator, rendering a unique service. It is a new and growing corporation. As the General Counsel of the United States Treasury stated in 1943, the newcomers and the innovators are the very businesses that need encouragement most. They cannot be neglected or forgotten.

I am well aware of the so-called growth formula of the old excess profits tax law. I am also aware of the so-called 2-year push-back relief provision in section 722. These provisions demonstrate that those who prepared the old law were aware of some of the problems I have discussed in this letter, but the provisions fall far short of providing a fair and adequate solution. Furthermore, Heckett Engineering would find no relief in resorting to the invested capital method of computing its excess profits credit, for the fairly obvious reason that while substantial investment is required to provide necessary operating equipment, the bulk of the corporation's earning power is directly traceable to the patented separator and separating process.

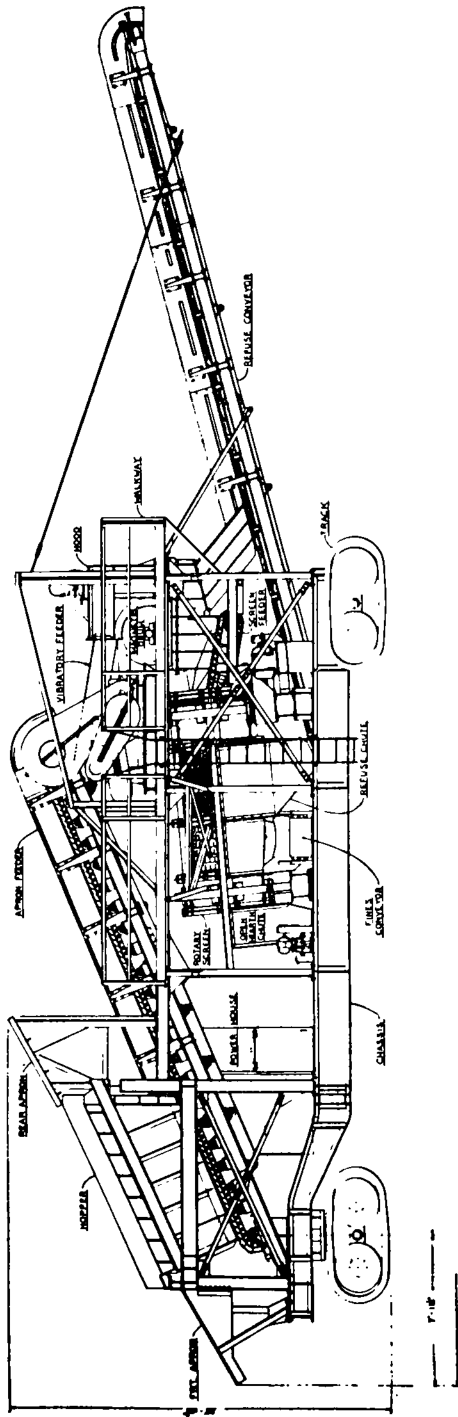
I am convinced that if there is, on the part of the Treasury Department and on the part of Congress, a full appreciation and complete understanding of the serious situation which faces corporations such as Heckett Engineering, a wise, equitable and workable solution will be forthcoming. Consequently, the principal purpose of this letter is to present the full and accurate facts, and to make the problem as clear as possible. Nevertheless, because specific recommendations are often helpful to those charged with the responsibility of finding a solution, I would like to make two brief suggestions which may at least point the way to a fair and workable answer to the problem I have discussed:

(1) My principal suggestion is to offer, for new and growing corporations, an alternative to the old average earnings and invested capital methods of computing the excess profits credit. Using Heckett Engineering as an example, I have demonstrated how both these old methods produce inequitable and stifling results, the average earnings method because it makes no adequate allowance for normal growth and the invested capital method because the bulk of Heckett Engineering's income is derived from patented processes for the use of which it pays no royalties.

The alternative I suggest is to permit the corporation to establish from its actual earnings during the years 1946–49 the average rate of profit earned in relation to its fixed operating assets. This ratio of profits to assets is then used as the measure of the corporation's normal earnings, and consequently its excess profits credit, in any given taxable year. Thus, if a corporation should grow and develop by increasing its investment in fixed operating assets it would be permitted to earn its established rate of profit thereon, but if it should increase the price of its product, and thereby increase its rate of profit, the resulting excess in profits would be fully subject to the excess profits tax.

Under this alternative, Heckett Engineering, and other growing corporations, could go ahead and expand, and be subject only to the normal tax and surtax

EXHIBIT A



on additional profits resulting from such expansion; but if the corporation increased the price of its product excess profits would result and would be fully subject to the excess profits tax. In this way, normal profits are protected from the tax while excessive profits are clearly subject to the tax. I believe, if serious reflection is given to this proposed alternative, it will be found to be a most equitable method and thoroughly workable from an administrative standpoint. The formula meets the needs of growing corporations, and it also will fit the case of new corporations. For the latter, the permissible rate of profit would be computed by reference to the average rate in comparable industry.

Finally, it should not be overlooked that the proposed formula would, in the great majority of cases, permit the corporation to compute its full excess profits tax credit at the time it prepares its tax return and pays its tax, thereby avoiding the undesirable (both from the standpoint of the taxpayer and the Government) recourse of postoperative adjustment through some agency such as the Excess Profits Tax Council.

(2) As stated above, my principal suggestion is the alternative method which I have described in the foregoing paragraph. However, if there are compelling reasons why the old excess profits tax law should be followed more closely, I suggest that in all fairness a corporation which was formed during World War II or within 3 years prior thereto should be regarded under the new law as a new corporation; that where a corporation was in a growth and development period during 1946–49 it should be given a minimum of 4 years after 1949 during which the computation of its normal earnings (and consequently its excess profits credit) should take into consideration the profit it would have earned as a result of normal growth and development, in the absence of a preparedness program; and that the measure of yearly increase in earnings due to normal growth and development should be the average rate of increase in earnings actually experienced during the years 1946–49, or a specific percentage of such average rate.

Respectfully submitted.

CLAIBORNE B. GREGORY.

The CHAIRMAN. The committee will recess until 10 o'clock tomorrow.

(Whereupon, at 5:30 p. m., the committee recessed to reconvene on Thursday, December 7, 1950, at 10 a. m.)

EXCESS PROFITS TAX ON CORPORATIONS, 1950

THURSDAY, DECEMBER 7, 1950

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

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

Present: Senators George, Connally, Hoey, Kerr, Myers, Millikin, Taft, Butler, Brewster, and Martin.

Also present: Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation; and Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will please be in order.

Mr. Reporter, please enter in the record of today's proceedings a statement by Mr. Ralph W. Button representing the National Retail Dry Goods Association, on the excess-profits tax. This statement is submitted by Mr. John C. Hazen, of Washington, in lieu of the appearance of Mr. Button, who is scheduled for tomorrow.

(The statement of Ralph W. Button is as follows:)

STATEMENT OF RALPH W. BUTTON, REPRESENTING THE NATIONAL RETAIL DRY GOODS ASSOCIATION

I am Ralph W. Button, assistant secretary, Allied Stores Corp. I am chairman of the taxation committee of the National Retail Dry Goods Association. The National Retail Dry Goods Association is a voluntary organization that is registered under the Lobbying Act. The association's registered agent in Washington is John C. Hazen. The NRDGA is composed of approximately 7,000 department and specialty stores throughout the United States. The annual sales of the members of this association exceed $10,000,000,000.

The present pressure for an excess profits tax is understandable. But the public demand for such a tax stems from a misunderstanding as to the actual application of such a tax on profits. It is believed by many that such a tax siphons off excess profits directly resulting from the national defense program and that it is a tax on big business. World War II experience proved this premise to be false. Statistics show that in 1944 three-fifths of the corporations paying excess profits tax were in the small category.

We are all well aware of the weaknesses inherent in any system of excess profits taxation. Our objections to an excess profits tax are these:

1. An excess profits tax is inflationary.

It encourages waste and extravagance. It provides no incentive to reduce expenses. An excess profits tax is an invitation to imprudent spending on the part of business management. A tax which leaves 15 cents or 20 cents out of every dollar of profit results in some actions becoming prudent which under other circumstances would be frowned upon.

2. An excess profits tax discourages growth.

The best curb on inflation is production and more production. Greater production can only be obtained through expansion of production facilities. Excess profits taxation provides little incentive or opportunity for a business to expand. Siphoning off profits, which would otherwise be reinvested in

plant expansion, especially curtails the growth and expansion of small and new businesses.

3. An equitable excess profits tax law cannot be written.

It is physically impossible to devise a measurement of normal profits which would fit every business. An excess profits tax involves the determination of some kind of a base point as a criterion for when profits become excessive. The difficulty of finding an equitable base point applicable to all industry is evidenced by the many and varied proposals which have already been made.

An excess profits tax favors the established company and penalizes the new and expanding company. It favors the marginal producer as against the efficiently operated producer.

4. An excess profits tax creates administrative burdens on both the Government and the taxpayer.

Because of the inequities directly inherent in excess profits taxation, it is necessary to enact relief provisions designed to iron out these inequities. The net result is protracted litigation and prolonged discussions and arguments between the taxpayer and Government lasting for a great many years. The last relief case arising under the excess profits law of World War I was just settled a few years ago. There are many thousands of relief cases still pending from World War II and it will be many years before they are finally settled.

Present world conditions necessitate continuing large military expenditures for probably many years to come. We should face this fact realistically and develop a tax program which will produce the amount of revenue needed and at the same time, in some measure, preserve the economic system that has made this country great.

Therefore, in lieu of an excess profits tax, we recommend the following program:

1. (*a*) The corporate normal income tax rate be set at 20 percent.

(*b*) The corporate surtax of 18 percent be applicable to all net income above $25,000.

2. Enact a corporate defense tax, the rate to be varied in accordance with the need for revenue.

It is recognized that taxation of corporations cannot produce the revenue to finance a 60-billion-dollar budget. It becomes necessary to seek additional revenue sources. Therefore, we recommend that the individual income taxes be increased as follows:

1. The personal exemption of $600 be reduced to $500.

2. The surtax rates on personal income be increased 3 percentage points in all brackets.

An important element of our tax structure is excise taxes. Financing the national defense program on a pay-as-we-go basis may require a revision of the entire list of excise taxes. Others are proposing a uniform across-the-board manufacturers' excise tax. We are opposed to a general manufacturers' excise tax for the following reasons:

1. It is a hidden tax. We are convinced that all taxes should be exposed. Our people should know what taxes they are paying.

2. Manufacturers' excise taxes are inflationary. A 5-percent manufacturers' excise tax by the time the taxed product passes through all the channels of distribution becomes a much higher percentage.

If the revenue needs are such as require the imposition of a general uniform excise tax, then we favor a general sales tax on the end use of products and services.

Section 701 of the Revenue Act of 1950 provides for the submission of a bill providing for an excess profits tax. In view of this requirement, and in the event that an excess profits tax is inevitable, then we recommend that excess profits be determined in accordance with the following basic principles.

1. The normal profits of a corporation should be determined either by the use of the average earnings method or the invested capital method, whichever method produces the lesser tax. This procedure was followed in the last excess profits tax law.

2. Average earnings method:

(*a*) The base period should consist, initially, of the years 1946, 1947, 1948, and 1949. The taxpayer should be given the right to elect as his base period either—

(i) The average of any 3 of these 4 years, or

(ii) An average of the 4 years adjusted for price increases between the base period and the taxable year.

(*b*) There should be no percentage reduction of the average base period net income.

(*c*) The base period net income should be adjusted for additions or capital reductions in capital subsequent to the base period. The percentage addition or reduction of capital to be used by a taxpayer should be the average rate of earnings on invested capital of the taxpayer during the base period selected by the taxpayer.

(*d*) Capital should include capital stock, borrowed capital, capital or paid-in surplus, and surplus reserves.

(*e*) The normal tax and surtax should be permitted as a deduction in determining the excess profits tax net income.

3. Invested capital:

(*a*) Invested capital should consist of equity capital, 100 percent of the borrowed capital, capital or paid-in surplus, surplus reserves and accumulated earnings and profits.

(*b*) Retained earnings subsequent to the base period should be permitted to increase the capital base.

(*c*) A deficit in accumulated earnings and profits should be considered as zero in the determination of invested capital.

(*d*) The invested capital credit rate should be, initially, the average earning rate of the taxpayer during the base period on its invested capital. The rate should be in no event less than 10 percent.

A flat rate of credit should be used for all taxpayers. There should be no declining scale.

4. Specific exemption: We favor a specific exemption of $10,000 for all corporations.

5. Excess profits tax rate: There should be one flat rate applied to excess profits. An over-all ceiling should be provided for the combined normal tax, surtax, and excess profits tax not in excess of 60 percent.

6. Excess profits adjustments: Section 711, as amended, of the last excess profits tax law provided for the exclusion of certain types of income. It is recommended that a like provision be included in any new excess profits tax law.

7. Excess profits tax relief provisions: Section 722 of the previous excess profits tax law was designed to cover special situations deserving of relief. However, the application and administration of this section put an unfair burden on the taxpayer to prove the measure of relief to which it was entitled. It appears highly desirable that objective standards and procedures under them for determining the amount of relief in most situations be set forth in detail in the proposed revenue act.

8. We are confident that the remaining provisions of the latest excess profits tax law will be included in the proposed act with such modifications as previous experience has shown are necessary.

Involuntary liquidation and replacement of inventory

It is recommended that section 22 (d) (6) of the Internal Revenue Code be continued as a permanent feature of our tax structure. Unstable world conditions and our own national defense program will undoubtedly cause dislocations in matériel resources. LIFO users will be compelled to liquidate involuntarily their inventories below a normal operating level. Continuation of this provision appears highly desirable in view of present day conditions.

Economy in Government

It is most essential that we keep our military operating at a high level of efficiency. This will take a tremendous amount of money. All of us must pull in our belts another notch, including our Federal Government. All governmental expenditures must be closely strutinized in order to eliminate waste and extravagance. The elimination of nonessential programs will take courage and intestinal fortitude. The tax burden in the years ahead will weigh heavily on the shoulders of the American people. Let us not add to that burden any more than is absolutely necessary.

Coordination and control of noncombatant military expenditures

I have said that we must keep our military operating at a high level of efficiency. I am sure that there are very few, if any, civilians who are in a position to measure the need of the military for such things as planes, guns, tanks, ammunition, and the host of other things that may be classified as combat material. But in

the field of noncombatant material there is an opportunity to coordinate the purchasing and manufacture of matériel in this area with the production of civilian goods and supplies. Also, I believe, that there can be some control exercised over the expenditure of taxpayers' money in the purchase of matériel falling into this classification. Believe me, we want our military to be well supplied with everything they need. We are not trying to be penny wise and pound foolish. War is wasteful no matter how you figure it.

It is recommended that a civilian committee be appointed to work with and assist the Defense Department in the coordination and control of noncombatant military expenditures.

We are well aware of the dangers that lie ahead. Our survival in the field of economics as well as on the battlefield depends on the policies we adopt now. The vast amount of revenue to be raised over the next few years require the adoption of sound taxation policies. A tax policy that will not stifle completely the incentive to produce, save, and expand. Our opposition to an excess profits tax is founded on the sincere belief that such a tax will result in economic suicide, a result much hoped for by peoples holding ideologies foreign to our own.

The CHAIRMAN. Also for the record the statement of the Tufted Textile Manufacturers Association submitted by Mr. Henry C. Ball, the executive vice president, on the excess profits tax.

(The statement of Henry C. Ball, executive vice president of the Tufted Textile Manufacturers Association, is as follows:)

TUFTED TEXTILE MANUFACTURERS ASSOCIATION,
Dalton, Ga., December 1, 1950.

To: Hon. Walter F. George, Chairman, United States Senate Finance Committee, Washington, D. C.

From: Tufted Textile Manufacturers Association, Henry C. Ball, executive vice president, post office box 256, Dalton, Ga.

Subject: Petition on proposed Excess Profits Tax Act.

The tufted textile industry is comparatively a new industry and one which has only in recent years been converted from a home-and-hand industry to a machine-and-production-line industry, with expensive and new types of production machinery each year being produced which it is necessary for the factories to install to stay abreast of the times and competitive in their manufacturing cost.

The tufted industry is composed of approximately 200 manufacturers, the large majority being located in the Southern States. However, there are tufting factories in the New England States, Illinois, California, Texas, Oklahoma, and Indiana. The direct machine employment is approximately 15,000 persons and approximately 25,000 persons derive their main livelihood directly or indirectly from the tufted industry. Ninety-eight percent of the production is of cotton fibers and the industry manufactures principally tufted bedspreads; rugs, small and room size; bathmats; tufted robes; housecoats; jackets; and novelties.

Our industry is hopeful that it will not be necessary to impose an excess profits tax at this time. The industry has had very unprofitable years and in many cases severe losses during the period from 1947 through 1950.

Most tufting manufacturing experienced a severe loss during the first 6 months of the calendar year. This is due to the fact that our products are largely sold for fall use and Christmas selling and we have practically no spring and summer season to speak of. In most cases, goods sold during the first 6 months of the year are sold at a loss in order to keep our labor together so it will be available when our regular season begins.

Should an excess profits tax have to be imposed, we believe it should become effective January 1, 1951, so that our industry will be given the opportunity to recoup the exceedingly severe losses of the first half of 1950.

The tufted textile industry is a very small industry which started about 1925 as a homecraft work. It reached its peak in 1933 as a homecraft industry when the first chenille tufting machine was invented.

About this time multineedle machines were developed employing from two to four needles. During the past 3 years loom-type machines using from 120 to 300 needles have been developed which now produce chenille or tufted yard goods in quantities.

Since 1933 the development of chenille tufting machines has been rapid and the experience of most manufacturers has been that of continual replacement

and development of new machines because of the continuous obsoletion which prevails. This is brought about because of constant style and texture changes which are required as style trends change. Also from the fact that new designs and textures can only be created in a good many instances by perfecting different type machines. This is entirely different than other textile lines where the same machines can be employed for many years and new patterns can constantly be created without replacing the basic machinery as is true to a great extent in the chenille tufting industry.

The industry has experienced many growing pains such as—

1. Changing from a homecraft to a factory manufacturing business, which made it necessary to plow back any profits into newer machines, equipment, and adequate buildings.
2. Rising cost of plant equipment, labor, and raw materials, which creates more competitive problems and make it more difficult for our young struggling tufted industry to survive.
3. The history of practically every plant has been from a homecraft industry which required practically no investment except inventory, to present-day needs for factory facilities, and the industry has not been able to establish large capital investments comparable to other industries.
4. The trend of the industry's products—namely, chenille bedspreads, chenille house and beach robes and coats, rugs, and bath mats—has been so variable and unpredictable that even profit or loss periods of operations have never been obtainable.
5. We have seen many instances in the past where the investment or base period provisions of excess profits were not applicable for determining fair tax burdens, and the relief provisions of section 722 offered the tufted industry practically no relief.
6. The tufted chenille industry is a segment of the cotton textile industry that uses entirely different equipment and methods of operation. The industry has had very unprofitable years during the proposed base period years due to the inventory losses sustained. This was due to the declining prices of sheetings and yarns from the high of 1946 to the low of June 1950.

   Serious and cutthroat competition has plagued the industry since 1947 because of an excessive number of factories created during the OPA period of the middle '40's.

In view of the above peculiar circumstances we trust that careful consideration be given the industry in establishing a reasonable tax burden.

The Excess Profits Tax Acts of 1940, 1941, and 1942 recognized the difficulties of avoiding the creation of many hardships of various types and endeavored to provide relief through the provisions of section 722 of the Internal Revenue Code. The rigid base period provisions made necessary the broad relief provisions of section 722. It seemed to promise much, but actually gave little relief and that only to a few. As a practical matter, it was almost impossible to administer.

It appears to us that equitable relief in most instances can and should be given through explicit provisions and these suggestions are made with the thought that, if they are adopted, there will be relatively few cases that will come under section 722 and as to those prompt action can be taken.

A relief provision should be provided that can be interpreted more easily than section 722 of the last excess profits tax law. It should be fair to the taxpayer. It should not place the hardship that the above-mentioned section did on all concerned in that it required an unusually long period to administer.

We urge that the following provisions be included in any Excess Profits Tax Act:

1. A flexible base, giving the taxpayer the right to select (1) average earnings during 3 years, selected by the taxpayer, in the period 1946–49 (including in the case of fiscal-year taxpayers the first four fiscal years beginning after August 31, 1945); (2) 90 percent of the average of any 2 years of that period; or (3) 80 percent of any 1 year during that period.
2. To this average earnings base there should be added (as is true in the invested capital method) a proper percentage of any increase in average capital and undistributed earnings existing in any taxable year over the average of the invested capital and accumulated earnings existing in the selected base period year or years.
3. Many of the former difficulties will be avoided and some of the provisions of the last law can be dropped, including the 75 percent provision in

section 713 (e), and there would likely be fewer instances requiring the use of section 711, if the above suggestions are followed.

4. Corporations should have the right to obtain a credit based on invested capital, the percentage to be on a realistic basis. Recognition should also be given to the depreciated purchasing power of our present dollar and the need of the rate of earnings to attract equity capital.

5. The taxpayer should be given a specific exemption of $25,000, which can be carried over each year as a part of an unused credit. This will give needed relief to small business and to the new struggling enterprise at time of great need. $25,000 is the amount relieved from the surtax, and for the same reasons which prompted that exemption this sum should be freed from the impact of the excess profits tax. This should apply in the use of either method.

6. The excess profits tax rate should not exceed 60 percent, with an over-all limitation of a total on all taxable income of 80 percent of the excess profits tax rate.

7. In calculating the over-all maximum limitation, the tax on long-term capital gains should be limited to the statutory 25 percent and the maximum limitation should be applied on other incomes.

8. To section 711 (f) should be added "and refunds of State and other taxes paid for prior years and interest thereon."

Corporations which suffered losses during the 4 years preceding the enactment of an excess profits tax should be permitted to carry forward the balance of losses in those preceding years, to the years covered by the new excess profits tax, in order to recover from such losses sustained and to put such corporations on a more equitable basis.

A growth formula should be provided to take care of the natural growth that small corporations in a comparatively new industry usually have, by reason of the normal increase in sales volume.

The new act should terminate on December 31, 1952, or sooner, by concurrent resolution of the two Houses of the Congress.

We believe such a law as we suggest will help increase production and lead to higher tax receipts than would be true under a law fixing too high a tax rate and subjecting thousands of corporate taxpayers to injustices and inequities. An excess profits tax so high that it will encourage extravagance and indifference might well reduce the anticipated normal tax and surtax receipts.

This industry is greatly in need of additional capital to provide for its change from a homecraft to a machine industry. The Excess Profits Tax Acts of 1940, 1941, and 1942 took away a great portion of the capital of this industry which was sorely needed (1) for purchasing new equipment; (2) for working capital to finance operations in an inflated economy; (3) to cushion losses sustained during the deflation in textile prices from 1947 to June 1950; (4) to provide for the normal growth of the industry as well as the development of new products; (5) to maintain employment during the spring and summer off-seasons; and (6) to finance the increasing volume of sales necessary to meet competition and to provide reasonable prices demanded by the consumer for its products.

This being an industry composed of small manufacturers, it is unable to obtain new capital in the manner employed by large corporations. It must depend on the retention of its profits as a source of additional capital required to stay in business and meet the competition within and without the industry.

Respectfully yours,

HENRY C. BALL,
Executive Vice President.

The CHAIRMAN. Also statement from the National Association of Bank Auditors and Comptrollers on certain aspects of the excess profits tax in relation to banking.

(The statement submitted by National Association of Bank Auditors and Comptrollers is as follows:)

STATEMENT OF NATIONAL ASSOCIATION OF BANK AUDITORS AND COMPTROLLERS

There are several important, well-known, and widely appreciated objections to an excess profits tax applied to any business or industry. These objections are fully applicable to the banking industry, yet, if an excess profits tax must be

adopted, recognition should be given to the fact that the banking industry has certain characteristics which require special consideration, provided that a private competitive banking system is to be permitted to exist and to operate in a sound and conservative manner.

The characteristics of the banking industry which require special consideration in connection with an excess profits tax are: (1) the normally low rate of earnings on invested capital, (2) the relatively high, but steadily decreasing, amount of partially tax exempt income included in total earnings, (3) the usual stability of earnings and dividend payments, and (4) the relative ease of liquidating or merging banks in order to realize the book value of the stockholders' equity.

The available statistics compiled by the Federal Reserve Board, although possibly requiring some adjustments for this purpose in connection with reserves, recoveries, and profits, indicate that all member banks earned 7.6 percent, after taxes, on total capital accounts in 1949, country member banks earned 8.8 percent, and New York City member banks earned 4.8 percent. Total capital accounts were highest in relation to total deposits in the New York City banks, amounting to 10.1 percent of deposits. In all members banks, capital accounts were 7.6 percent of deposits; in country banks they were 7.3 percent of deposits. Dividend payments were at the rate of 3.5 percent on total capital accounts for all member banks and for New York City banks, and were at the rate of 3 percent for country banks. These figures show that banks with low capital accounts earn a higher rate of return on capital, but they pay out a smaller proportion of earnings in dividends in order to strengthen their capital ratio. Obviously, and particularly if we are facing a national emergency, it is highly desirable that the capital of the banking system be further expanded. An excess profits tax would reduce or eliminate this source of expansion of capital.

An excess profits tax with provisions similar to those in effect in 1940–45 would not only restrict bank earnings but would bring an actual reduction in earnings as compared with 1946–50 in a large number of intermediate-size banks. The principal reason for this latter effect is that the income from partially tax-exempt Treasury securities (exempt from normal tax and excess profits tax) has been an important contributor to total net earnings, but this type of income has been steadily declining and is not replaceable. The amount of partially tax-exempt bonds outstanding was $24.0 billion on June 30, 1944. Through maturities, the amount was reduced $18.1 billion by June 30, 1947. During this period, however, the commercial banks were able to maintain their holdings at about $13.0 billion by acquiring bonds from other holders and in this manner, obtained an exempt position from the excess profits tax of 1940–45. Since June 30, 1947, the amount of partially tax-exempt bonds outstanding has fallen to $11.0 billion and bank holdings are now down to approximately $8.6 billion. By the end of 1951, the amount outstanding will be reduced to $7.5 billion and by March 15, 1955, to $3.5 billion. There will be a similar sharp contraction in bank holdings of these bonds, and their income will presumably be replaced with fully taxable income, subject to high rates of tax.

Because of the record of stability of dividend payments, which stockholders expect and which banks believe is necessary and appropriate for the industry, there would be considerable reluctance on the part of banks to decrease dividend payments if earnings declined as a result of excess profits taxes. The result would be that smaller additions would be made to capital, but in many cases dividends would have to be reduced or passed. In either event, it would be more difficult for the banking system to obtain needed new capital—through retained earnings or sale of stock.

The market prices of actively traded bank stocks, now for the most part at discounts of 10 to 30 percent from stated book values, would very likely decline further earnings decreased and especially if dividends are reduced or passed. Under present circumstances, bank earnings have been inadequate to bring market values up to a par with book values. This has made it difficult to obtain new capital through the sale of additional stock. An excess profits tax, bringing a decline in earnings and dividends, would greatly increase the difficulty of raising capital in this manner.

A probable effect of a further decline in the market prices of bank stocks in relation to book values would be an acceleration of the trend of liquidation and merger, whereby stockholders of the merged bank receive the book value of their shares, but at the broad social cost of reducing the total capital of the banking system and at the further cost of diminished competition and service. If a private competitive banking system is desired, further pressure toward

mergers should not be brought by an excess profits tax, which would reduce earnings and thereby give further encouragement to the withdrawal of capital from the system.

In addition to the foregoing which are of a basic nature, there are two unusual current circumstances which also require special consideration in an excess profits tax applying to the banking industry. These are (1) the reserve for bad debts, established generally on a taxable basis under the Commissioner's Mimeograph No. 6209 in 1947–49, mainly, which would reduce the base earnings for excess profits tax purposes; and (2) the reduction in Federal Deposit Insurance Corporation assessments, which becomes effective in 1950 or 1951. In both instances, the effect is that earnings in the base years are reduced and are not comparable, with respect to those important items of expense, with the earnings of subsequent years. An additional penalty would thereby be imposed on the banking industry unless special consideration is given to these matters.

To give the banking industry equitable treatment, as required in order to strengthen or at least maintain the capital investment in the industry, the fundamental requirement is that the base years' earnings, or the earnings base on the invested capital alternative, be comparable with the earnings in years when an excess profits tax is in effect. This is especially essential in the banking industry because, as previously pointed out, there has been an unavoidable change in the tax status of a high proportion of bank earnings. If proper allowance is not made for this circumstance, net earnings after taxes in the years subject to excess profits taxes would in many cases be lower than net earnings after taxes in the base period.

The following proposals would overcome this obvious inconsistency and would establish as fair a base as possible for determining "excess profits."

COMPUTATION OF EXCESS PROFITS TAX NET INCOME

A. Make the following adjustments to net income as defined in section 21 (a) of the Internal Revenue Code. (This is the same figure as reported on line 34 of Form 1120 for the calendar year 1949.)

1. Reduce the deduction made for reserve for bad debts in the year or years of the base period to an amount not in excess of the deduction in the taxable year subject to excess profits tax.
2. Reduce the deduction made for Federal Deposit Insurance Corporation assessment in the base period by the same proportion by which the assessment is reduced in the taxable year.
3. Eliminate (a) capital gains and (b) dividends received from domestic corporations, from the base period and from the taxable year.
4. Permit the elimination of abnormal deductions during the base period.
5. Eliminate the deduction for the net operating loss deduction.

B. Deduct applicable normal tax and surtax from the net income of the base period (as adjusted in A, above) at the tax rate or rates which were then in effect.

C. Deduct applicable normal tax and surtax from the net income of the taxable year, after first adjusting this net income for capital gains and for dividends received from domestic corporations as in A (3), above.

DETERMINATION OF THE AMOUNT OF EXCESS PROFITS TAX

A. Under the average-earnings method. Determine the difference between net income after normal and surtax in the base period (as adjusted in B, above), and net income after normal tax and surtax in the taxable year (as adjusted in C, above). Apply the tax to the excess.

B. Under the invested capital method. Determine the rate or rates of net income after normal tax and surtax in the base period (as adjusted in B, above) to the average invested capital in the corresponding year or years of the base period. Permit the earning of this rate (or a minimum rate of 6 percent) in the taxable year on the average invested capital of the taxable year. Apply the tax to the excess.

DETERMINATION OF EXCESS PROFITS TAX BASE

The base period should be any one year, selected by the taxpayer, from the years 1946 to 1949, or the years 1947 to 1950, depending on whether the tax is imposed for 1950. Base period earnings should be allowed 100 percent as a credit in computing excess profits tax. The full 100 percent of invested capital should be allowed in computing the base under the invested capital method.

The CHAIRMAN. Mr. Hardman, have a seat right there, sir. Mr. Hardman, you are from Commerce, Ga.?

Mr. HARDMAN. Yes, sir.

The CHAIRMAN. And you are here representing the American Cotton Manufacturers' Institute?

Mr. HARDMAN. Yes, sir.

The CHAIRMAN. The committee will be very glad to hear you at this time.

Mr. HARDMAN. Thank you, sir.

The CHAIRMAN. Do you wish to complete your statement before any Senator asks you questions?

Mr. HARDMAN. I would like to complete the statement.

The CHAIRMAN. All right.

STATEMENT OF LAMARTINE G. HARDMAN, JR., OF COMMERCE, GA., REPRESENTING THE AMERICAN COTTON MANUFACTURERS' INSTITUTE, INC., ACCOMPANIED BY JAMES L. RANKIN

Mr. HARDMAN. Mr. Chairman and gentlemen of the committee, my name is Lamartine G. Hardman, Jr. I am president and treasurer of Harmony Grove Cotton Mills, located in Commerce, Ga. Our company was organized by my father and others as a community enterprise in 1893 and in the same corporate form it has operated in the same town for 57 years. We employ about 450 persons. The company is owned by about 100 shareholders. About 95 percent of all of the stock is owned by the families of the original shareholders.

I am appearing today for the American Cotton Manufacturers Institute, Charlotte, N. C., which is the central trade association for the entire cotton manufacturing industry and serves as its spokesman in matters of general and national interest. I desire to file with the committee a statement.

The CHAIRMAN. You may do so.

Mr. HARDMAN. Mr. James L. Rankin, who has assisted in the preparation of our statement, is with me and I am asking for permission to have him sit with me and to assist in answering questions which might be asked by the committee.

The CHAIRMAN. Yes, sir; that is agreeable.

Mr. HARDMAN. We believe there is no sound justification for a corporation excess profits tax of the World War II type. We believe the following criticisms of the former excess profits tax law are generally recognized as being justified. It hampered growth and expansion, especially of small companies and new industries; it led to waste and inefficiency; it encouraged extravagances and indifference; it led to increased costs, which to a large degree offset the increase in tax revenue produced by the excess profits tax levies; it proved to be extremely difficult to administer.

However, in view of the fact that the committee is considering a corporation excess profits tax law, we are suggesting that if any such law is to be adopted it should contain the following provisions:

1. Base period earnings credit: The Treasury Department and the House Ways and Means Committee have agreed that the 4 years 1946–49 are the most acceptable base period, and that each taxpayer should be allowed to use for credit purposes the average earnings of the best 3 years.

Any tax imposed should be limited to war profits as distinguished from so-called excess profits.

The privilege to use the average of the best 3 years tends to alleviate inequities if the taxpayer had one bad year. However, it does not give equitable treatment if there were two or more poor years out of the four. In order to take care of these situations and still protect the tax revenue, we recommend that each taxpayer be given the right to a credit of 100 percent of the average earnings of any 3 years during that period, 90 percent of the average earnings of any 2 years, or 80 percent of the earnings of any 1 year.

We disagree with the provisions in the House bill providing that the credit shall be only 85 percent of the 3-year average. We fell the credit should be more than 100 percent of the 3-year average because of natural growth. If the credit is only 85 percent, it means that an excess profits tax is to be imposed on 15 percent of the normal earnings in addition to those earnings which may be regarded as excess.

On page 5 of the report filed by the Ways and Means Committee, we find a statement that certain adjustments under the World War II Tax Act "were considerably less liberal." In at least one respect, under the former excess profits tax law, corporations were given more favorable form of treatment than would result from a credit limited to 85 percent of the 3-year average. Take the case of a corporation whose total income for its three best years was $300,000 and for the fourth year $40,000. Under the former law, the fourth-year income would be reconstructed at $75,000, and this added to the $300,000 earnings for 3 years would give a total of $375,000, or an average yearly earning of $93,750. On the 95-percent basis of the old law, the credit would be $89,062.50. On the terms outlined in H. R. 9827, the credit will be only $85,000. The disparity will be greater if the lowest year in the four was more than 75 percent of the average of the three best years.

The House bill provides an additional credit of 12 percent on the increase in equity capital, including accumulated earnings. This will be helpful to almost all corporations.

The members of the committee are reminded that the additional specific exemption of $10,000 has been removed, and the only relief given to allow for normal growth is the 12 percent on the increase in net worth.

2. Invested-capital credit: We believe that H. R. 9827 makes fair provisions for many taxpayers who determine their excess profits credits on the basis of invested capital, and who do not have any consolidation or acquisition problems.

3. Treatment of capital gains and losses: We think well of the provisions in H. R. 9827 excluding capital gains and capital losses from income in both the base-period years and in the excess profits tax years.

4. Effective date: We believe that the new law should become effective on January 1, 1951, and not earlier. Business usually is conducted on the basis of long forward buying, selling, and other commitments. Many cotton mills sell for periods as long as 6 months ahead and therefore to a great degree the influence of the national defense program will not reflect higher earnings until 1951. A large portion of the increased earnings of many corporations in the second half of 1950 would have come in any event. By reason of the mathematical form in which the act is made effective as of July 1, 1950, a tax necessarily

will be imposed upon those profits which were earned in the first half of the year, as well as those earned during the second half.

Any retroactive tax is bad. Many companies in 1949 and early in 1950 made plans for capital improvements and a large increase in the 1950 tax bill may hamper those plans and result in need to borrow funds to carry out those plans and to pay the taxes.

5. Termination date: We feel that any excess profits tax law should be temporary and should not be in force for longer than those special conditions which some think justify such a law. Therefore, we urge that the new act should terminate under its own provisions on December 31, 1952, or sooner, by a concurrent resolution of the two Houses of Congress.

We believe such a law as we suggest will help increase production and lead to higher tax receipts than would be true under a law fixing too high a tax rate and subjecting many corporate taxpayers to injustices and inequities.

Increased corporate taxes in a real sense are paid by the individuals who are shareholders. These shareholders are doubly assessed for income taxes—the normal tax and surtax paid by the companies and the individual taxes based on dividends. Each of these taxes has been increased by the Revenue Act of 1950. If an excess profits tax is now to be added, the individual shareholders are being subjected to "triple jeopardy."

Thank you, sir.

The CHAIRMAN. Any questions, gentlemen?

Mr. Hardman, in the cotton textile industry, was 1946 a good or a bad year?

Mr. HARDMAN. 1946 was fairly good.

The CHAIRMAN. And then 1947 and 1948?

Mr. HARDMAN. Were the better years, better than 1946; 1949 was not as good.

The CHAIRMAN. 1949 was not so good?

Mr. HARDMAN. 1949 was lower, I would say.

The CHAIRMAN. You suggest a termination date to the act. I believe the Secretary of the Treasury in his statement before the House Ways and Means Committee indicated that he would have no objection to a reasonable termination date. I think I am correct in that.

Mr. RANKIN. I heard him say that; yes, sir.

The CHAIRMAN. There would, of course, be some additional reason for a termination date of the act, particularly when the act is framed under considerable pressure, and hardship situations may arise that nobody could have contemplated, of course, at this time, so that if there is some reasonable time at which the act can be reviewed, it might be reassuring somewhat to general business.

If there are no further questions, Mr. Hardman, we thank you for your appearance and we will incorporate your supplementary statement in the record.

Mr. HARDMAN. Thank you, sir.

(The statement submitted by Mr. Hardman is as follows:)

STATEMENT OF LAMARTINE G. HARDMAN, JR., OF COMMERCE, GA., REPRESENTING THE AMERICAN COTTON MANUFACTURERS INSTITUTE, INC.

My name is Lamartine G. Hardman, Jr. I am president and treasurer of Harmony Grove Cotton Mills, located in Commerce, Ga. Our company was organized by my father and others as a community enterprise in 1893 and in

the same corporate form it has operated in the same town for 57 years. We make cotton sheeting for the bag trade and narrow and wide cotton drills for the garment and converting trades. We employ about 450 persons. The company is owned by about 100 shareholders. About 95 percent of all of the stock is owned by the families of the original shareholders. Our town is 70 miles northeast of Atlanta and is between Athens and Gainesville.

I am appearing today for the American Cotton Manufacturers Institute, Inc., Charlotte, N. C., which is the central trade association for the entire cotton-manufacturing industry and serves as its spokesman in matters of general and national interest. The industry is one of the country's largest, providing direct employment to more than 500,000 people and having a production output valued in the primary market at more than $6,000,000,000 per year. Its scope of operations extends over many States in all sections of the Union, and it is especially important throughout the area extending from Maine to Texas.

The industry units are numerous, being about 1,000 in number. The size of each unit is small, the largest owning less than 4 percent of the industry's spindleage. It is, and for a long time has been, distinctive as the most competitive and individualistic of the country's major manufacturing industries, and for that reason represents to the maximum degree the spirit of free business enterprise. The member mills of the American Cotton Manufacturers Institute, Inc., are distributed throughout the industry's entire area and operate approximately 85 percent of the industry's total spindles.

We believe there is no sound justification for a corporation excess profits tax of the World War II type. We believe the following criticisms of the former excess profits tax law are generally recognized as being justified. It hampered growth and expansion, especially of small companies and new industries; it led to waste and inefficiency; it encouraged extravagances and indifference; it led to increased costs, which to a large degree offset the increase in tax revenue produced by the excess profits tax levies; it proved to be extremely difficult to administer.

However, in view of the fact that the committee is considering a form of a corporation excess profits tax law, we are suggesting that if any such law is to be adopted, it should contain the following provisions:

1. Base period earnings credit

The Treasury Department and the House Ways and Means Committee have agreed that the 4 years 1946–49 are the most acceptable base period, and that each taxpayer should be allowed to use for credit purposes the average earnings of the best 3 years.

Any tax imposed should be limited to war profits as distinguished from so-called excess profits. Each year many companies and also many entire industries show increases in volume with corresponding increases in net earnings. We wish to dwell somewhat at length upon one cause for this, namely, the influence of population changes. Between 1940 and 1950 our national population increased from 131,669,275 to 150,697,361, or about 14½ percent. This rise in population brings increase in the total volume of business to many companies. During the last decade the increases exceeded 20 percent in 10 States, namely, California, Arizona, Florida, Nevada, Oregon, Washington, Maryland, Virginia, Michigan, and Texas, the highest being 53.3 percent in California. In each of these States, and also in sections of many other States where there was large movement of people from cities to suburban areas, many companies in a normal and natural way have benefited from very substantial increase in the volume of business done. Among these are merchants serving local communities; factories whose output traditionally has been sold in one or in a few States; dairies; public utility companies; transportation companies; jobbers. The movement of the population has created the need for new houses with consequent increase in volume of business to those who build and to those who furnish materials for new construction and also to those who deal in house furniture and equipment. Many more similar instances could be detailed.

The privilege to use the average of the best 3 years tends to alleviate inequities if the taxpayer had one bad year. However, it does not give equitable treatment if there were two or more poor years out of the four. In order to take care of these situations and still protect the tax revenue, we recommend that each taxpayer be given the right to a credit of 100 percent of the average earnings of any three years during that period, 90 percent of the average earnings of any two years, or 80 percent of the earnings of any one year.

We disagree with the provisions in the House bill providing that the credit shall be only 85 percent of the 3-year average. We feel the credit should be more than 100 percent of the 3-year average because of natural growth. If the credit is only 85 percent, it means that an excess profits tax is to be imposed on 15 percent of the normal earnings in addition to those earnings which may be regarded as excess.

On page 5 of the report filed by the Ways and Means Committee, we find a statement that certain adjustments under the World War II Tax Act "were considerably less liberal." In at least one respect under the former excess profits tax law, corporations were given more favorable form of treatment than would result from a credit limited to 85 percent of the 3-year average. Take the case of a corporation whose total income for its three best years was $300,000 and for the fourth year $40,000. Under the former law, the fourth year income would be reconstructed at $75,000, and this added to the $300,000 earnings for 3 years would give a total of $375,000 or an average yearly earnings of $93,750. On the 95 percent basis of the old law, the credit would be $89,062.50. On the terms outlined in H. R. 9827, the credit will be only $85,000. The disparity will be greater if the lowest year in the four was more than 75 percent of the average of the three best years.

The House bill provides an additional credit of 12 percent on the increase in equity capital, including accumulated earnings. This will be helpful to almost all corporations.

The members of the committee are reminded that the additional specific exemption of $10,000 has been removed, and the only relief given to allow for normal growth is the 12 percent on the increase in net worth.

2. Invested capital credit

We believe tht H. R. 9827 makes fair provisions for many taxpayers who may elect to procure their excess profits credits on the basis of invested capital, and who do not have any consolidation or acquisition problems.

3. Treatment of capital gains and losses

We think well of the provisions in H. R. 9827 excluding capital gains and capital losses from income in both the base period years and in the excess profits tax years.

4. Effective date

We believe that the new law should become effective on January 1, 1951, and not earlier. Business usually is conducted on the basis of long forward buying, selling, and other commitments. Many cotton mills sell for periods as long as 6 month ahead and therefore to a great degree the influence of the national defense program will not reflect higher earnings until 1951. A large portion of the increased earnings of many corporations in the second half of 1950 would have come in any event. By reason of the mathematical form in which the act is made effective as of July 1, 1950, a tax necessarily will be imposed upon those profits which were earned in the first half of the year as well as those earned during the second half.

Any retroactive tax is bad. Many companies in 1949 and early in 1950 made plans for capital improvements and a large increase in the 1950 tax bill may hamper those plans and result in need to borrow funds to carry out those plans and to pay the taxes.

5. Termination date

We feel that any excess profits tax law should be temporary and should not be in force for longer than those special conditions which some think justify such a law. Therefore, we urge that the new act should terminate under its own provisions on December 31, 1952, or sooner, by a concurrent resolution of the two Houses of Congress. In his testimony before the Ways and Means Committee, Mr. Snyder testified that he has no objection to fixing a termination date. Such a provision will give the Congress full opportunity to see how a difficult act works out in practice, and Congress can then decide by affirmative action what kind of an excess profits tax, if any, should be enacted.

6. Specific relief provisions

One of the surest lessons taught from the experiences under the former law was that specific section should provide for relief in deserving cases rather than require taxpayers to seek relief through anything like section 722 of the old law. For that reason we are pleased to note those provisions in H. R.

9827 which try to provide for protection against a number of abnormalities, growth problems, and the peculiar situations in connection with utilities, railroads, and those industries in which depletion and development are large factors. However, there are probably still a number of cases for which general relief should be given through an improved form of section 722.

Specifically, we feel that the provisions of "the 2-year push-back rule" should be clarified. In considering problems arising under section 722 (b), in all pertinent situations, the volume of business and other relevant factors during the post base period should be considered. A rule of reason should be established with respect to the problem of agreeing that increased production realized in, say, the year 1951 could have been sold at least during some portions of the base period years.

There are probably other specific suggestions which others could make out of their experiences under the old law.

We believe such a law as we suggest will help increase production and lead to higher tax receipts than would be true under a law fixing too high a tax rate and subjecting many corporate taxpayers to injustices and inequities.

Increased corporate taxes in a real sense are paid by the individuals who are shareholders. These shareholders are doubly assessed for income taxes: The normal tax and surtax paid by the companies and the individual taxes based on dividends. Each of these taxes has been increased by the Revenue Act of 1950. If an excess profits tax is now to be added, the individual shareholders are being subjected to triple jeopardy.

The CHAIRMAN. Robert Ramspeck. Come around, Mr. Ramspeck.

I am advised that Mr. Oakes of the Pennsylvania Power & Light Co. wished to appear just after the appearance of Mr. Hulcey. I assume that is correct.

Mr. Ramspeck, we will be very glad to hear you on this excess profits tax matter.

STATEMENT OF ROBERT RAMSPECK, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION

Mr. RAMSPECK. Thank you, Mr. Chairman.

My name is Robert Ramspeck. I am executive vice president of the Air Transport Association, which has as its members practically all of the certificated scheduled airlines of the United States. The opportunity given to the airlines to study the effect of the excess profits tax measure now under consideration has, of course, been limited, but even our brief consideration of the matter has made it clear that the earnings permitted to the airline industry under that proposal are inadequate to permit the industry to recover its financial strength and continue its growth in the interest of the commerce of the United States and the national defense.

Theoretically, H. R. 9827 gives to the industry three alternative methods of computing the tax, but as a practical matter the industry only has one. The average earnings base cannot be used by the airlines because the airlines lost about $20,000,000 during the prescribed base period. The ordinary invested capital base cannot be used because in financing the rebuilding of the industry after the war it was necessary to finance heavily with debt, which is not adequately recognized under that method of computation. The only basis on which the industry can compute the tax is that provided for public utilities, in which the entire investment is recognized and a return of 5 percent is provided. A 5 percent return on investment has long been held by the Civil Aeronautics Board as insufficient to finance the industry and keep it in a financially sound condition. Thus, the effect of the law on the industry will be to tax away a large portion

of income deemed by the regulatory agency as not merely reasonable, but actually essential to its continued financial health.

The airlines are now and have been under heavy public pressure to grow—to expand and modernize their fleets. It is well established in both theory and practice that the military forces rely upon the airlines to provide air transport capacity for military purposes in time of emergency. Prior to World War II, military plans were carefully made for the utilization of airlines in the event of war. Those plans were carried out, and even more drastic additions were made to them after the critical need for air transport in that war was discovered. In May of 1942 the Government requisitioned 168 aircraft which the airlines then had on order, and took approximately 175 aircraft which were then in operation. The airline fleet was thus reduced to 183 aircraft during the year 1942. Airline executives, flight crews, and mechanics were taken in large numbers to provide air transport service for the Government.

The last war proved the value of air transport to the military. Consequently, attention has been given almost constantly since the war ended to the provision of air transport capacity for military purposes in the event of another similar emergency. In all of the studies made of this subject by Government agencies a large portion of the fleet of the commercial airlines has been regarded in effect as a part of the available military transport fleet.

The CHAIRMAN. Have the commercial planes been used in this?

Mr. RAMSPECK. Yes, sir. I mention that later.

These studies have revealed that notwithstanding the anticipated utilization of a portion of the commercial fleet, a deficit in air transport capacity is to be expected. Those responsible for mobilization planning for the Government have been, and are now, considering methods by which this deficit can be made up. For some time it has been made plain to the airlines that, in order to meet this national defense problem, they were required to develop their commercial business and the size of their fleets as rapidly as possible. The airlines have made good progress in carrying out this responsibility, the fleet having increased since the end of the war from about 350 twin-engine airplanes to over 1,000—a little less than half of which are four-engine transports. Thus, the fleet was increased not only in numbers, but also in quality and military usefulness.

Senator KERR. What would you say the capacity has been increased, Mr. Ramspeck?

Mr. RAMSPECK. It has been increased, I think, 10 times in capacity, Senator.

Senator KERR. That comes by reason of the larger carrying capacity on the one hand and the greater speed on the other?

Mr. RAMSPECK. That is correct, Senator.

Senator KERR. What part of your expansion was financed by borrowed capital?

Mr. RAMSPECK. I think slightly over 50 percent, Senator.

Senator KERR. You are aware of the fact that the House bill makes provision for credit on borrowed money.

Mr. RAMSPECK. Yes, sir.

Senator KERR. 133⅓ percent of whatever the interest charges on the borrowed capital are.

The CHAIRMAN. The interest rate.

Mr. RAMSPECK. Senator, that is true, but our interest rates are pretty low.

Senator KERR. What are the interest rates? What would they be?

Mr. RAMSPECK. Well, there are some of them as low as 2 percent.

Senator KERR. Would they average about three, do you think?

Mr. RAMSPECK. I think so.

Senator KERR. Well, if it averaged about 3 and they let you make 13⅓ percent, that would be 1 percent on that investment that they would let you make; would they not?

Mr. RAMSPECK. I am not too good at mental arithmetic, Senator. I will take your word for it.

Senator KERR. What do you suppose their indebtedness is?

Mr. RAMSPECK. The indebtedness of the airlines?

Senator KERR. Yes.

Mr. RAMSPECK. I would say somewhere around $350,000,000.

Senator KERR. About $350,000,000, and 1 percent on that would be three and a half million.

Mr. RAMSPECK. Yes, sir.

Senator KERR. Of course, you would have to pay a normal tax on that and that would leave about a million and three-quarters a year. It would not take you over a couple hundred years to retire that indebtedness.

Mr. RAMSPECK. It would take a good while, Senator.

Senator KERR. How much expansion do you think they would do if that were the limit of what they were permitted to have as a return with which to recover losses and retire?

Mr. RAMSPECK. I do not think they would expand any on that, Senator.

Senator KERR. You do not think that would be sufficient to entice them?

Mr. RAMSPECK. No, sir.

Senator KERR. All right. I do not think it would be sufficient to entice anybody, but I am still looking for one that might be an exception to the rule.

Mr. RAMSPECK. It is a good thing that this was done. As soon as the war in Korea began, the military forces called upon the airlines to provide aircraft for emergency airlift to Korea. Forty-three four-engine transports were requested, and were promptly provided, with four crews apiece. That constituted about 10 percent of the four-engine fleet. After these aircraft had been in military service for about 3 months a portion of them were returned to the airlines for reintroduction into their commercial service. Very recently, however, additional demands have been made on the airlines to return these same aircraft for use for the same purpose. Thus, the employment of the civil airline fleet as a direct auxiliary to military operations is not just talk.

The airlines are being counted upon to expand their fleets further. They have on order at the present time 168 additional aircraft, for which they will be required to pay in the neighborhood of $136,000,000. This bill would require us to attempt to finance this development on the basis of a 5-percent return on investment. We do not believe it can be done.

In making special provision for regulated public utilities the Ways and Means Committee in its report stated:

> Your committee also believes that where industries are regulated by other governmental bodies providing only a fair rate of return, it is undesirable to consider profits allowed by such regulated bodies as excessive for purposes of an excess profits tax. The 5- and 6-percent rates of return provided for in this minimum credit will be approximately the average rates of return customarily allowed for the regulated industries in question.

We think that the principle enunciated by the committee in that statement is completely sound, but in applying it to the air transport industry the committee failed to recognize the rates of return which the Civil Aeronautics Board has considered essential for the industry, between 8 and 10 percent.

The airlines were not treated as favorably as were the gas and electric utilities, which obviously involve far less risk to investors than do airlines. The airlines were given the same treatment as were the railroads, notwithstanding the differences between airline and railroad operation which require greater returns for airlines in order to maintain them in a sound financial position. The railroads are much older. They do not operate internationally. Experience has shown that their equipment is not subject to requisition for military purposes. Their equipment is not subject to such rapid obsolescence. Members of the committee who are familiar with the two forms of transportation could undoubtedly state other elements in which the risk to the air transport investor is greater than that to the investor in railroad securities.

In addition, the establishment of the same rate of return for railroads and airlines fails to recognize one fundamental difference between the two industries—that is, the airlines do about three times as much business with a dollar of investment as do the railroads. For example, in the case of a railroad and an airline each with an investment of $1,000,000, the railroad would do $350,000 worth of business during the year and the airline would do about $1,000,000. Thus, the railroad would be entitled under this bill to a profit of $50,000 on $350,000 gross business, while the airline would be entitled to $50,000 of profit on $1,000,000 of gross business. Thus, by treating railroads and airlines alike, airlines are made the victims of serious discrimination.

We hope that the committee will give attention to solution of the airlines' problems under this bill. Our first recommendation is that the bill be amended to include a provision to the effect that compensation received from the United States for the transportation of mail by aircraft should be excluded from the income subject to the excess profits tax. We believe this amendment to be the simplest and most effective way of insuring a proper return to the airlines. We believe it is proper to exclude mail pay from income subject to the excess profits tax, since it is the means by which the Board, in the last analysis. determines the earnings which the airlines will be permitted to make.

In the event that the committee does not adopt this recommendation, we recommend that the bill be appropriately amended to substitute for the 5 percent rate of return provided for air transport regulated by the Civil Aeronautics Board, the percentage of return recognized by that Board.

I have a longer statement, Mr. Chariman, which supports in detail the conclusions I have stated here. I would appreciate it if the committee would receive this longer statement for the record.

The CHAIRMAN. You may file it for the record.

Mr. RAMSPECK. Thank you, sir.

The CHAIRMAN. It will be incorporated.

(The statement submitted by Mr. Ramspeck is as follows:)

STATEMENT OF ROBERT RAMSPECK, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA

This statement is presented by the Air Transport Association of America on behalf of its membership, which includes substantially all of the United States flag airlines certificated by the Civil Aeronautics Board and operating scheduled services.

I. Summary of airline industry position

The effect of H. R. 9827 would be to limit to 5 percent after normal taxes the earnings which the airlines would be permitted to make. The imposition of such a tax upon the air-transport industry of the United States at this time would be a severe blow to the defense program of this country. It is well established in both theory and practice that the military forces rely upon the airlines to provide air-transport capacity for military purposes in time of emergency. It is well-established military policy that the airlines should be encouraged to acquire through private financing the largest fleet of effective transports that they can justify economically. The airlines have made some progress in carrying out this policy, notwithstanding a financial history which is far from attractive for private investors. An excess profits tax which would permit the airlines to earn only 5 percent would make it impossible, not only for the airlines to recoup severe losses incurred since the war but even to make the return on investment which has been considered by the Government as necessary in order for them to finance the transport relied upon by the military. If this committee reports an excess profits tax bill, we recommend that special provisions be made to permit the airlines to earn enough money to buy the additional transports on which the military is relying. These are our conclusions in general. It will be the purpose of the remainder of the statement to support them in detail.

II. The reasons why it is not in the public interest to impose an excess profits tax on the airline industry at the level prescribed in H. R. 9827

There are three principal reasons why it would be contrary to the public interest to limit the earnings of the scheduled airlines to 5 percent after normal income taxes.

1. The airline industry, far from earning excessive profits, has never had a period of normal earnings, is not yet well-established from a financial viewpoint, and needs a period of earnings higher than 5 percent to continue the growth demanded of it by the needs of the national defense and the commerce of the United States.

The condition of the airline industry during the period from its inception in 1926 to the enactment of the Civil Aeronautics Act in 1938 can best be described as chaotic. Airline companies emerged on the scene and disappeared, either through bankruptcy or consolidations and mergers with other companies. The Government had no clearly defined policy with reference to air transportation, and the provisions and requirements of the statutes covering the carriage of air mail were constantly changing. As a consequence, by 1938 many of the remaining airline companies were on the verge of bankruptcy, and approximately half of the industry's capital had been lost.

In 1938, Congress passed the Civil Aeronautics Act. This act embodies virtually all of the features of a public utility regulatory statute, but has one very important addition. It contains a directive to the Civil Aeronautics Board to fix and determine a mail rate for each individual carrier sufficient, together with other revenues of the carrier, to enable that carrier, under honest, economical, and efficient management, "to maintain and continue the development of air transportation to the extent and of the character and quality required for the commerce of the United States, the Postal Service, and the national defense."

As a result of the comprehensive safety and economic regulation provided by the Civil Aeronautics Act, economic conditions improved in the industry during the years immediately following. This can be seen from an examination of the net income, after taxes and fixed charges, of the industry for the years 1938 through 1941. The following table indicates the net income figure (or loss) of each of the years in question and the approximate net investment on which it was based:

Year	Income	Investment	Return
			Percent
1938	[1]$1,653,000	$36,032,000	
1939	3,682,000	45,994,000	8.7
1940	4,637,000	71,285,000	7.0
1941	4,183,000	86,656,000	4.6

[1] Loss.

The impact of World War II on the industry was drastic. The war found the industry in the process of progressing from the 2-engine DC–3 to the 4-engine DC–4 and Constellation, a process which ordinarily would be expected to take approximately 5 years. Any such plans had to be abandoned immediately, and those new airplanes went to the military.

Instead of proceeding to build up the industry, the airlines were required to tear it down. To mention only a few of the most important results of the war, it meant loss of approximately 168 aircraft on order; the requisitioning by the Government of approximately 175 aircraft then in operation (reducing the fleet operated during the year 1942 to an average of 183 aircraft); and the loss to the military services of approximately half of the airline executives and half of the flight crews. The airlines were required by the War Department to suspend service on routes aggregating about 8,500 route-miles, or about 20 percent of their total route mileage, and to reduce service on the remainder to the point where the limited number of remaining aircraft would provide the most essential service. International operations in the Atlantic and the Pacific, except on the basis of contracts with the War and Navy Departments, ceased entirely.

In addition to the above measures, a passenger and cargo priority system was established to make certain that the reduced airline capacity would be reserved for the most essential traffic. The airline industry was the only one of the transport industries which was subjected to this type of control.

In the spring of 1942, all of the airlines entered into contracts with the War and Navy Departments for the variety of services, including ferrying military aircraft; the modification, repair, and overhaul of military aircraft, engines, and other equipment; pilot training; the operation of passenger- and cargo-transport services over most of the world; the emergency movement of troops; transportation of wounded for treatment; construction of airports; and the establishment of airways.

By reason of the intense utilization of existing equipment, the high load factors experienced, the very heavy mail loads carried, and the wage and price freeze in effect during the war years, the industry made reasonable profits during the years 1942 through 1945. The following table shows the net income, after taxes and fixed charges, and the total investment during that period:

Year	Income	Investment	Return
			Percent
1942	$14,119,000	$122,121,000	11.5
1943	12,226,000	154,368,000	7.8
1944	17,489,000	187,719,000	9.0
1945	21,194,000	248,703,000	8.4

The average percent of return on investment for the above period was approximately 9.3 percent, which, as will be seen later, was an inadequate return to provide for things to come.

All of the forces which stimulate growth in the transportation industry had been at work during the war years, but they had been forcibly confined by Gov-

ernment action. With the end of the war, these forces literally burst upon the air lines. The airlines were faced with the necessity of rebuilding in a short time an industry which had been 20 years in the development, and this rebuilding had to be done under circumstances which could hardly have been more unfavorable.

Surplus DC–3's and DC–4's had to be purchased or leased from the Government, overhauled and rebuilt to meet Civil Aeronautics Administration specifications, and equipped with passenger interiors before they could be put into service. This was an expensive way to obtain new aircraft—particularly since these aircraft were to be used only as stopgaps for several years until the manufacturers could fill the airlines' orders for DC–6's and Constellations, and the two-engine Martins and Convairs, which the airlines needed to replace the obsolete DC–3's and DC–4's. A major part of the transition from the DC–3 to the DC–4, to the DC–6, Constellation, Martin, and Convair was accomplished in the years 1946 through 1948.

In addition to the tremendous cost of the new aircraft, and of training personnel to use and service them, the airlines were forced to bear heavy grounding costs, in connection with this new equipment, as its use on the line showed need for modification and adjustments.

Moreover, the industry was actively engaged in developing new routes which the Board had previously certificated, the progress on which had been interrupted by the war. The international services were rebuilt and greatly expanded.

In short, the period 1946–48 was a period of unparalled growth. It was also a period of unparalleled industry losses. The investment of the domestic trunk lines grew from approximately $187,000,000 in 1944 to approximately $484,000,000 in 1948. In addition to raising capital for this purpose, the industry had to finance net losses during the years 1946 through 1948 of approximately $30,000,000. In 1946, the domestic airlines lost $5,626,000; in 1947, $20,242,000; and in 1948, $4,996,000. Consequently, the industry experienced a great increase in long-term debt, from approximately $147,000 in 1944 to approximately $172,000,000 in 1948.[1]

In the year 1949, the industry finally managed to realize net earnings, the domestic trunk lines realizing earnings of approximately 2.75 percent, and all of the certificated airlines, including the international carriers and the feeder lines, earning approximately 3.5 percent on the total investment. Estimates for 1950 indicate that a slightly larger percentage of profit can be expected.

There you have the airline financial record up to now, consisting as it does of three abnormal periods: First, the recovery from bankruptcy under the Civil Aeronautics Act; second, the war years; and, third, the years since the war when the industry was in the process of rebuilding. Possibly the industry is now entering a period of financial stability which will permit a consolidation of airline progress. It s equally possible that the industry is not entering such a period. The development of new transports, powered with jet engines, has come forward rapidly since the war, and we hesitate to forecast when it will be necessary for the United States industry to adopt this advanced type of aircraft and again go through the throes of a reequipment program.

Our experience with the airlift to Korea makes us wonder whether the next few years will be stable ones for air transport. As soon as the Korean War broke out, the military called upon us for 10 percent of our fleet of four-engine aircraft, and got them—and still has most of them. What similar incidents lie ahead we cannot anticipate.

But one fact is clear. The industry now is, and will continue to be, under heavy pressure from the Military Establishment to increase its fleet of aircraft in order to make up the present serious deficit in air transport for defense purposes. Speaking of the role of the airlines in a national emergency, the Honorable Dan A. Kimball, Under Secretary of the Navy, stated in a speech on October 17, 1950: "I think there is a clear lesson to be learned in connection with commercial air transportation as it relates to military emergencies. We have learned to count upon our airlines as a source of planes for emergency use."

In a speech on September 21, 1950, the Honorable Thomas K. Finletter, Secretary of the Air Force, in speaking of the requirement for air-transport planes in a time of emergency, stated in part: "When we add these figures together

[1] The above figures are from Civil Aeronautics Board reports. A much larger loss for the period 1946 through 1948 appears in the testimony of Secretary Snyder before the House Ways and Means Committee. The latter figure undoubtedly also includes air carriers other than the domestic scheduled airlines, which were used in our computation.

and take into consideration our capacities as of the present time, including not only the military planes available but a practicable percentage of the civilian airlines which might be taken over in the event of war we find a very substantial deficit."

The Air Coordinating Committee, the top civil aviation committee of the Federal Government, which includes representatives of the Department of Defense, has also recognized the reliance placed upon the commercial airlines as a supplement to military aviation and the present deficit in air transport. A release of the Air Coordinating Committee, dated October 25, 1950, states in part: "Delos W. Rentzel, Chairman of the Air Coordinating Committee, announced today that the Air Coordinating Committee had agreed that transport aircraft and replacement of parts for civil aviation should be produced on an equal priority with similar military equipment."

Thus, it is incumbent on the airlines, in addition to undertaking the specialized services and functions performed for the military services during World War II, to increase as rapidly as possible their fleets and personnel so that they will be in a position to assist the Department of Defense in meeting the serious deficit in air-transport capacity and at the same time avoid, as far as possible, the drastic curtailment of services available to support the civilian economy.

The purchase of new aircraft and the training of the necessary personnel to operate them are almost incredibly expensive projects. $30,000,000 of losses suffered, and $172,000,000 of debt acquired, during the postwar years are proof of that fact. Unless the industry is to be saddled with even greater amounts of long-term indebtedness., or resort to Government financing, it must be permitted earnings sufficient to build up the necessary reserves of capital and to attract investors willing to participate as stockholders in the industry. To apply to the airlines an excess profits tax computed on the basis of H. R. 9827, would make it impossible for the airlines to retain earnings sufficient to accomplish those objectives.

As will be demonstrated below, the general effect of H. R. 9827 is to limit the airlines to earnings of 5 percent on their investment. There are several reasons why a return of that amount would be completely inadequate for the air transport industry.

In the first place, as we have seen above, the industry earned approximately 9.3 percent after taxes and fixed charges, during the years 1942–45. However, this amount was completely inadequate to cover the rebuilding which the industry had to undertake, and the growth which it accomplished, during the postwar period 1946–48. Because of the unparalleled losses attributable to that rebuilding and growth, the industry's long-term debt increased from approximately $147,000 in 1944 to approximately $172,000.000 in 1948.

Turning now to the second reason, by the Civil Aeronautics Act of 1938, the Congress created the Civil Aeronautics Board and made it the Federal agency responsible to see to it that the airline industry is economically sound and develops as required to meet the present and future needs of the commerce of this country and of our national defense. The Board also was directed by that act to take those needs into account in determining the mail compensation to be paid to the airlines. In the exercise of its expert judgment, the Board has consistently held that a return of 8 to 10 percent on airline investment is essential to the maintenance of a sound industry. The Board's conclusion with respect to a rate of return are based on an evaluation of profits required in order to attract sound private investment into the industry.

There is nothing in the record of the hearings on H. R. 9827, either before the House Ways and Means Committee, or this committee, to indicate that the determination by the Board of the earnings which the airlines should be permitted is in error. In our opinion, the Board's determination on this subject is correct. That being the case, it is, on the face of it, unwise and even dangerous from the viewpoint of our defense effort for the Congress to pass an excess profits tax statute which would cut substantially in half the amount of earnings which the Civil Aeronautics Board has determined that the industry must have in order to maintain its proper growth.

2. The Civil Aeronautics Board has been given the duty by the Congress to see to it that the airlines earn a reasonable profit. Unless the excess profits tax law is so drawn as to recognize as normal the rate of return permitted by the Civil Aeronautics Board, conflict will inevitably result between the Civil Aeronautics Board and the Bureau of Internal Revenue.

Under the Civil Aeronautics Act, the Congress imposed upon the Civil Aeronautics Board the duty of establishing rates for the transportation of persons, prop-

erty, and mail, which are fair and reasonable and which will enable the individual airlines to maintain and continue the development of air transportation as required by the national defense and the commerce of the United States. Under the administrative machinery established by the Congress in the Civil Aeronautics Act, unreasonable profits have not existed and cannot develop.

The Board's control over the airlines is far greater than the control which most regulatory bodies exercise over the public utilities which they regulate. The typical regulatory agency establishes the rate which the utility may charge the public. This may or may not control profits of that utility, due to the fact that a rate reduction may, because of a great increase in the volume of business, result in more, rather than less, earnings. The Civil Aeronautics Board not only has the power to determine the rates charged by the airlines for the transportation of persons or property, but also to establish the mail revenue which each airline receives. Generally speaking, this is done on an individual carrier basis and takes into account all revenues of the carrier from other sources. The determination of mail pay is the means by which the Board, in the last analysis, determines the earnings which the carrier will be permitted to make.

The close and continuing scrutiny to which the Board subjects airline profits is amply illustrated in actions taken by the Board during the years 1942–45 when the airlines had net income. As the result of such action, the industry's average mail rate per ton-mile decreased from $1.08 in 1942 to 50.5 cents in 1945. Passenger fares were reduced from approximately 5.3 cents per mile to approximately 5 cents per mile.

As a consequence of the above reductions, the carriers' revenue per revenue ton-mile showed the following decrease after 1942: 1943, $1.17; 1944, $1.11; 1945, $1.03.

As stated above, the Civil Aeronautics Board has consistently held that a return of 8 to 10 percent, after taxes, on airline investment is essential to the maintenance of a sound airline industry and its development to the extent required by the national defense and the commerce of the United States. However, if H. R. 9827 is enacted into law, the Bureau of Internal Revenue would permit the airlines to earn only 5 percent on their investment. Thus, we would have the anomalous situation wherein two Federal agencies would be in direct conflict regarding the earnings which an industry would be permitted to retain.

Section 446 of H. R. 9827 is an obvious recognition by the House of Representatives that regulated public utilities should have special treatment under the excess profits tax law. In fact, the report of the Ways and Means Committee on H. R. 9827 states in part:

> "* * * Your committee also believes that where industries are regulated by other governmental bodies providing only a fair rate of return, it is undesirable to consider profits allowed by such regulated bodies as excessive for purposes of an excess profits tax. The 5 and 6 percent rates of return provided for in this minimum credit will be approximately the average rates of return customarily allowed for the regulated industries in question."

It is respectfully submitted that the Ways and Means Committee is in error in its belief that the Civil Aeronautics Board regards earnings of 5 percent as adequate. As stated above, the Board actually has taken the position that earnings of 8 to 10 percent, after taxes, are necessary.

3. A tax statute which limits airline and railroad earnings to 5 percent on investment will discriminate against the airlines and in favor of their principal competitors, the railroads.

Under section 446 of H. R. 9827, the 5-percent limitation applies not only to the airlines, but also to the railroads. Such a limitation would discriminate against the airlines and in favor of the railroads. The total assets of the scheduled airlines, including the international airlines, is but a fraction of the assets of the railroads. In 1948, the latest year for which data are available, the class I railroads had 27.5 billion dollars invested in property and equipment, as depreciated. The scheduled airlines, including the international airlines, had assets amounting to but 705 million dollars. It is obvious, therefore, that any excess profits tax credit based on percentage of investment would discriminate against the airlines.

Airline investments can also be compared with those of the railroads in still another sense. Before World War II the airlines were able to earn more than $1 in revenues for each $1 of investment. At the same time, class I railroads were able to earn less than 20 cents for every $1 invested. In the postwar period this relative position was maintained, and in 1949, for example, the airlines were

able to earn approximately 97 cents with each $1 of investment, as compared with the railroads' ability to earn approximately 35 cents for each $1 of investment.

This means that a hypothetical railroad with a total investment of $1,000,000 would gross approximately $350,000, and a hypothetical airline with an investment of a similar amount, would gross almost $1,000,000. Under the excess profits tax law, both would be permitted to retain earnings of approximately $50,000, although the revenues of the airline were almost triple those of the railroad.

Thus, the airlines would be required to conduct a large and growing business on a margin of profit which would be dangerously small, while the railroads, due to their larger investment and slower turn-over, could do business with a comfortable margin. Any tax law which produces such a result is obviously unsound.

In this memorandum, it has been stated that the effect of H. R. 9827 would be to limit airline earnings to 5 percent on investment. This would be the result of the application to the industry of section 446 of the bill. We are not unmindful of the fact that the airlines would have two alternative methods of computing their credit under the excess profits tax, namely, the average earnings method (section 435) and the invested capital method (section 436). While limitations of time have not permitted us to conduct extensive research on this subject, preliminary examination indicates that, generally speaking, the credit available to the airlines under either of these alternative methods would be less than that produced by section 446 (the regulated public utility credit).

Insofar as the average earnings method is concerned, table 7 submitted to the Ways and Means Committee by Secretary Snyder, as an attachment to his statement, reveals that of all of the industrial groups listed in that table, air transportation is unique in that it is the only industry which sustained a loss for the period 1946–49. According to the Treasury Department's figures, the air transportation industry suffered a loss of $7,000,000 during that period. The figures for the individual years are as follows: 1946, $23,000,000 (loss); 1947, $40,000,000 (loss); 1948, $4,000,000 (net income before taxes); 1949, $31,000,000 (net income before taxes); average for the 4 years, $7,000,000 (loss).

According to table 7, the average for the three best years is $4,000,000 (net income before taxes). This figure, of course, represents the total income for the entire air transport industry, not for any one company in the industry. Under H. R. 9827 only 85 percent of the average of the three best years ($4,000,000) is taken into account in determining the base period earnings credit. Thus, the total credit for the entire air transport industry would be $3,400,000.

Obviously, the air transport industry would not use the average earnings base for computing the excess profits tax.

Insofar as the invested capital method is concerned, the airlines, generally speaking, have a comparatively small capital investment. Although the rates of permissible return on investment are larger in H. R. 9827 than under the former excess profits tax law, the resulting credit would be less, generally speaking, than the credit computed under section 446.

III. A summary of the provisions which should be incorporated by the Senate Finance Committee in H. R. 9827 in order to permit the airlines to realize sufficient earnings to permit the industry to grow as required by the national defense and the commerce of the United States

It has been demonstrated above that the effect of H. R. 9827 would be to limit to 5 percent after normal taxes the earnings which the airlines would be permitted to make, and that such a limitation would prevent them from maintaining the growth required by the national defense and the commerce of the United States.

We have two alternative suggestions to make as to how this deficiency in the bill should be remedied.

1. There should be included in the bill a provision to the effect that compensation received from the United States for the transportation of mail by aircraft shall be excluded from the income subject to the excess profits tax.

We urge that the bill be amended to provide that compensation received by the airlines for the transportation of mail by aircraft shall be excluded from income subject to the excess profits tax. To apply an excess profits tax to mail pay would be to take away a portion of what the Board considers necessary for the carrier to retain in the operation of its business, and would seriously interfere with the administration of the Civil Aeronautics Act. This exclusion should be incorporated in the section of the bill defining income subject to the excess profits tax, rather than in a general exemption section, such as section 727 of the former excess profits tax law.

2. In the alternative, the bill should be appropriately amended to implement the principle recognized by the Ways and Means Committee of the House that it is undesirable to consider profits allowed by the regulatory body as excessive for the purposes of an excess profits tax.

As stated above, the Ways and Means Committee provided for a permissible return of 5 percent on airline investment on the assumption that a 5-percent rate of return is approximately the average rate of return customarily allowed the airlines by the Civil Aeronautics Board. While the principle recognized by the Ways and Means Committee is correct, the percentage figure which it selected, unfortunately, is incorrect. It is therefore urged that this committee correctly implement the principle recognized by the House of Representatives by amending section 446 of H. R. 9827 to substitute for the 5-percent rate of return provided thereunder for air transportation regulated by the Civil Aeronautics Board, the percentage of return recognized by that Board.

Mr. RAMSPECK. If further confirmation is needed with respect to the utilization of airlines in the national defense we would refer the committee to the Air Forces, and if additional data with respect to the financial needs of the industry is required, we would suggest that the committee consult with the Civil Aeronautics Board.

The CHAIRMAN. Any questions by any member of the committee?

Senator BREWSTER. You spoke of the $350,000,000 debt. What is the amount of the equity investment?

Mr. RAMSPECK. The total investment, including the debt?

Senator BREWSTER. No; outside your equity.

Mr. RAMSPECK. It is about the same amount, Senator. The debt is slightly over 50 percent of the total. That was due, Senator, as I am sure you realize, having been on the committee that investigated the financial condition of the airlines, to the fact that we were losing money and we could not get money through the equity capital.

Senator BREWSTER. What shocks me is this is the first time I realize the airlines industry was worried about excess profits. All I had heard about was excess losses.

Mr. RAMSPECK. Yes, sir; that is about all we had. We never had any normal earnings.

Senator BREWSTER. That is why it is very encouraging. The only difference you do not point out about the railroads and other utilities is that you are in a different position in that you have a formidable Government guaranty. We paid you something like over $100,000,000 last year, for carrying the mails.

Mr. RAMSPECK. Yes, sir.

Senator BREWSTER. And I do not think you contend that it is all earned?

Mr. RAMSPECK. It is not all compensatory mail pay. Some of it is subsidy.

Senator BREWSTER. We are now having quite an expensive investigation as to how to divide your compensation and your subsidy.

Mr. RAMSPECK. Yes, sir.

Senator BREWSTER. Which you are in sympathy with. Does not the Civil Aeronautics through that medium, the moment that is determined, simply by eliminating your subsidy, solve the problem of excess profits?

Mr. RAMSPECK. Yes, sir. You will recall, Senator, I am sure, that during the last war they reduced the pay they provided to the airlines in order to reduce that profit.

Senator BREWSTER. Yes, because of the war stimulus.

Mr. RAMSPECK. We think they went too far, and that brought about part of our trouble right after the war, but they did drastically reduce the payments. The mail rate went down from about $1.50, I think it was, per ton-mile to 50 cents.

Senator BREWSTER. Would it not also help a great deal if we would stop subsidizing foreign airlines by the indirect method of supplying them with the capital with which they build our competition?

Mr. RAMSPECK. There is certainly a big question there, Senator.

Senator KERR. You say the airlines have about a thousand planes, Mr. Ramspeck?

Mr. RAMSPECK. Yes, sir; they are operating now about a thousand planes.

Senator KERR. And about half of those are twin-engine?

Mr. RAMSPECK. Slightly less than half; about 450.

Senator KERR. No; twin engines.

Mr. RAMSPECK. 550 twin engines, approximately.

Senator KERR. What is the capacity of those?

Mr. RAMSPECK. They run from 21 seats to 40.

Senator KERR. The twin engines?

Mr. RAMSPECK. Yes, sir.

Senator KERR. And the four-engined have an average of about 50?

Mr. RAMSPECK. I think they would probably average a little higher than that. Some of them have as many as 78 seats on them, using this coach service.

Senator KERR. In other words, you have got enough, then, if a situation should develop over here on the right flank of the United Nations forces where they were unable to extricate themselves, if there was a place to land you have got the ships that could set down there and pick up the entire contingent that is there, and bring them out?

Mr. RAMSPECK. I think we could, Senator. We could carry a lot of people in those airplanes.

Senator KERR. If you have got a thousand that average about 35 capacity each, you could bring 35,000 out at one load?

Mr. RAMSPECK. Yes, sir.

The CHAIRMAN. No further questions, Mr. Ramspeck. We thank you.

Mr. RAMSPECK. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. John Hessey. Come forward, Mr. Hessey, and identify yourself.

STATEMENT OF JOHN H. HESSEY, CHAIRMAN, NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS, WASHINGTON, D. C.

Mr. HESSEY. My name is John H. Hessey. I am chairman of the Public Service Commission of Maryland. I am appearing here today on behalf of the National Association of Railroad and Utilities Commissioners with respect to the excess profits tax bill.

We have heretofore passed a resolution with respect to this matter and adopted a statement which has been filed, and I would like to have that made a part of the record, as well as the statement which I shall present this morning.

The CHAIRMAN. Yes, sir; you may file it with the reporter and it will be incorporated.

(The statement referred to is as follows:)

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS, WASHINGTON, D. C.—REPORT OF THE SPECIAL COMMITTEE ON EXCESS PROFITS TAX

The National Association of Railroad and Utilities Commissioners, commonly referred to as NARUC, is an association of the regulatory commissions of this country who are empowered to regulate, inter alia, the rates charged to the public by the gas, electric, communication, steam heating and transportation public utilities serving the American public. The issuance of securities, the determination of reasonable earnings and the adequacy of service rendered to consumers are also among the matters which these commissions are generally empowered to regulate.

I

Our appearance before Congress is in respect to the proposals to enact an excess profits tax. We understand the current need which Congress faces to raise revenues by taxation, and the difficulties of that task; and our viewpoint is certainly not in opposition to the endeavor of Congress to recover through taxation any excess profits that arise out of the country's defense program or war effort.

However, so far as regulated public utilities are concerned, their normal regulated peacetime earnings, and the normal regulated earnings required to attract and support the large amounts of new capital needed for their vitally essential expansion programs, are not excess profits and should not be reduced by a tax designed to siphon away excess profits arising from the defense or war program. Utilities must have sufficient earnings to maintain their credit. If an excess profits tax should be adopted that does not recognize this need for adequate utility earnings, regulation of utilities by the commissions will be seriously handicapped and the ability of utilities to meet the demand for service and make their vital contribution to the defense program may be dangerously impaired.

Our day-to-day work has provided us with an intimate grasp of the facts concerning this vital segment of the country's economy. We believe that the proposals to levy an excess profits tax on regulated utilities in any of the forms so far publicly proposed or as legislated during World War II would interfere with the functions and obligations of regulatory commissions and would affect the public interest adversely to a substantial degree.

Specifically, the excess profits tax proposals made so far or used heretofore do not recognize that—

(*a*) the earnings of utilities are already under constant review and are closely regulated down to reasonable returns:

(*b*) the need for those reasonable earnings is vital to the maintenance of utility credit and the ability to attract capital;

(*c*) the ability to attract capital is particularly important now because of the huge construction programs which are currently in progress by nearly all utilities in their race to meet the Nation's demand for peacetime and also wartime service;

(*d*) the excess profits tax proposals (or the law heretofore in effect) would result in taxing away a substantial part of reasonable and necessary nonwar earnings of public utilities; and

(*e*) the remaining earnings would generally be insufficient to support credit of utilities and attract the vitally needed new capital.

The proposed tax law therefore needs to be so framed that utilities will not be required to pay excess profits taxes when they are not earning more than the reasonable return prescribed for them by regulatory commissions.

Our point is not that excess profits from defense or war business should be untaxed. Rather we contend that only true defense or wartime excess profits should be taxed, and that in the case of public utilities the standards followed under law by the commissions in regulating rates and earnings constitute the proper measure for distinguishing "normal and reasonable profits" from "excess profits made during or from war business." In making these points we understand and presume that Congress intends to reach normal earnings with the normal and surtax rate, and that it does not intend to levy an additional tax on normal earnings in an effort to recapture war profits.

Experience with the last excess profits tax law and our knowledge that a similar new law would have a far more drastic effect upon the industry than it had during World War II prompts the request that our views be considered.

II

There are fundamental characteristics and facts that govern the public utility situation; and if an excess profits formula is imposed which does not take into account these characteristics, the result is both unjust and unnecessarily injurious.

(1) The first of these characteristics is that the rates of utilities are regulated under law so that there should be no excessive earnings on the property devoted to the public service. One resulting fact is that rates cannot be increased by utility companies at will as, for instance, when a war boom or other boom period would permit higher prices. Another is that utility earnings, with rare exceptions, do not rise in boom periods as do profits in unregulated business. Nor can utilities amass out of earnings the funds neded to pay for large construction projects.

We hold therefore that only when a utility earns on the applicable rate base in excess of the rate of return (after income taxes and other expenses) specified by the regulatory commission having jurisdiction, can it have any excess profits.

We also believe that a standard based upon the average earnings of a preceding period will not meet the facts (or the needs) of the public utility situation, even as a matter of theory, particularly when as in recent years there has occurred a large growth in the amount of property devoted to the public service.

(2) The second of these fundamental characteristics is that utilities must attract and use large amounts of additional capital to obtain increases in their business and earnings—much more so in relation to their volume of business than any other industry of which we have knowledge. From $3 to $5 of capital is required for every dollar of gross business done, and for reasons of economy, and lower cost to their customers, the public utilities use borrowed money (bonds, chiefly) for a large part of their total capitalizations. Approximately 35 to 55 percent is generally in that form, and these proportions are much larger than in unregulated businesses.

The expansion in the amount of property required to keep up with the public's need for utility service is several times as large now as it was before or during World War II, and the need for new investment capital now is tremendous in comparison with the previous periods. To illustrate, one example may be drawn from the regulated electric power business, which is now spending for new facilities about $3,000,000,000 a year. This is nearly six times the prewar rate, and is twice as much per year as was spent in all the war years 1942–45 together. A broader example may be drawn from the record of securities sold for "new money" purposes (as distinguished from refunding) by all utilities, excluding railroads. The present rate of securities sold is over 40 times the rate for 1939, and 8 times the defense years 1940–41, and almost 5 times per year the entire amount raised in that manner for the entire war period. The greater need for new stock financing is evidenced by the fact that, in 1949, 129 times as much was sold as in 1939, and 25 times as much as in the defense years 1940–41, and nearly 8 times as much in 1 year as in all the 4 war years. We must bear in mind in 1940 there were substantially greater plant reserves and, hence, not as great a need for plant expansion.

The additional capital needed to expand utility facilities in the years immediately ahead to serve increasing demands including those of the defense program will probably be as large and possibly larger than the new capital requirements of the recent postwar years. Any tax law which redefines a part of closely controlled normal earnings as excess profits, and taxes them away, tends to cripple the utility industry's ability to raise the huge sums of new capital required to finish construction programs now under way and to undertake the necessary new construction. It is this point which concerns us so much.

Therefore any standard for differentiating between normal earnings and excess war profits based upon invested capital will not meet the needs of the utility situation if it fails to meet two tests:

(*a*) If the invested capital permitted by the tax law is less than the total actual invested capital utilized (for instance, if there is a disallowance of 50 percent of the debt capitalization as heretofore), and

(*b*) If the rate of return permitted on rate base will not provide earnings after all taxes which are adequate to maintain the utility's credit and enable it to attract large amounts of new investment capital.

III

We believe that the general forms of excess profits tax laws so far proposed or hitherto used would have the effect of confiscating substantial portions of necessary normal or reasonable profits, with the resulting adverse effects mentioned.

We believe that normal or reasonable earnings of public utilities should, for the purposes of a war or defense period excess profits tax law, be synonymous with the term "allowable" or "fair" earnings used by the regulatory commissions in the exercise of their supervision under law. The points at which the regulated reasonable earnings of utilities differ from the general formulas of the excess profits tax law previously in effect or so far proposed, and which cause the discrimination against regulated utilities are these in the main:

(1) A reasonable price (i. e., rate) for utility service has repeatedly been held to include a reasonable return upon the property devoted to the public service after all expenses (other than interest) including income taxes. On the other hand, the return on invested capital provided under the excess profits tax law (in the form proposed or heretofore in effect) is before allowing for income taxes and the cost or value of the capital employed in rendering service to the public for regulatory purposes is not synonymous with the tax basis of the taxpayer's capital investment.

(2) Utility regulation allows for the changes from time to time in the amount of the investment and the amount of earnings constituting a fair or necessary return thereon. Consequently any wartime excess profits tax formula which seeks to define normal earnings in terms of an average of several previous years (still less, only 75 to 85 percent thereof) is irreconcilable with the facts upon which regulatory commissions are required by law to, and actually do, regulate the reasonableness of utility rates and utility earnings to meet actual current conditions.

(3) Utility regulation provides for a reasonable return on all capital expenditures of the utility whereas the excess profits law previously in effect or proposed requires elimination of a portion of the capital invested (such as 50 percent of borrowed capital, or additions during the taxable year, or so-called inadmissible assets) and allows a rate of return so low that resulting earning after taxes will not in fact maintain credit or attract necessary capital. The 5 percent return before normal and surtaxes of 45 percent, which has been proposed before Congress, would be disastrous; and even a 5 percent return after taxes would be inadequate to support the credit of the utility industry.

Our calculations show that with the standards of the 1945 law (and proposed in the recent O'Mahoney-Connally amendment) the point at which an excess profits tax becomes payable under the invested capital method for the typically sized utility is at about 3⅓ to 3¾ percent rate of return on its property devoted to public service. We believe that the same general level would be produced by the recent proposals. We are quite certain that such returns are so much below what is necessary to keep utilities functioning properly that only severe damage can result. The currently huge needs for new capital is the factor which would crystallize the harm, a factor which was not operative in anything like the same degree when the previous excess profits tax law was in force.

The future results under the average earnings method cannot be summarized so succinctly; but the earnings record in what would now be a base period (the postwar years) is a subnormal one for utilities in that much growth of their capital investment has taken (and is taking) place from the levels on which those earnings were derived. The facts and needs of the utility situation actually compelled us to grant many rate increases during the postwar years. A redefinition of a part of those earnings as being excess profits would indeed be anomalous.

IV

It is our belief, and judgment, that there should not be excess profits in the utility industry at any time; that regulatory bodies are generally charged with, and seek to secure, the prevention of excessive profits; that in fact they do accomplish the prevention of such excessive profits. We therefore believe that any tax law which seeks to distinguish normal earnings from excess profits should take into account the fact that an existing and competent machinery of regulatory commissions is, and for many years has been, in operation for the identical purpose (among others) of making such measurements and further to order preventive adjustments in the selling prices of utility services when necessary.

The regulatory bodies have many guides enunciated by the courts, such as the opinion of the Supreme Court in the Bluefield Water Works & Improvement Co. case, in their determination of reasonable earnings:

"What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will premit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

We submit the fact that regulatory bodies are competent to so regulate utility selling prices, and in fact they do so regulate them, as to prevent excess profits under the Bluefield or other applicable court decisions which are the law of the land.

Persuasive evidence of the result is the following record of prices charged in the electric and gas industries:

The average price paid for all electric power served by the electric utilities was 2.16 cents per kilowatt-hour in 1939; it was 1.86 cents per kilowatt-hour in 1949. (Source: Edison Electric Institute Statistical Bulletin No. 17, p. 29.)

The Bureau of Labor index for retail prices of electricity was 96.3 in 1939 and 90.1 in 1949.

The average price paid for manufactured gas was 99.3 cents per million cubic feet in 1939, and 113.1 cents per million cubic feet in 1949. The average price of natural gas was 33.2 cents in 1939 and 35.1 cents in 1949, per million cubic feet. (Source: Computed from American Gas Association's Gas Facts, 1949; tables 72 and 88, pp. 104, 122.)

The Bureau of Labor index for retail price of gas was 101.1 in 1939 and 103.1 in 1949.

These price trends are in sharp variance with the prices of nearly al unregulated products and services, particularly since the beginning or end of World War II, when sharply increased levels of wage rates and material costs developed. The articles and services comprising the Bureau of Labor's Cost of Living Index were 70 percent higher in 1949 than 1939; the Bureau's Wholesale Commodity Price Index is 100 percent higher. This is positive indication that public utilities have through regulation been held to profits that in no way could be termed excess profits.

V

We respectfully urge that the concept of excess profits for public utilities is essentially inimical to the concept of regulation by statutory commissions; and that assuming Congress does not intend to levy a tax on normal earnings except through the normal and surtax rate, the applicability of a wartime excess profits tax to public utilities is open to serious question. Regulatory commissions should be continued in their duty and their right to determine what constitutes excessive profits in each case, and have conclusively proven that they may be relied upon to discharge their duty to prevent excessive profits by regulating the selling prices of public utility services.

Acceptance of this proposition would be desirable both as a matter of equity and as a matter of practicality in regulatory administration. Nor, as we understand it, would recognition of the unique characteristics of the utility industry involve departure from the principle of recognizing unique circumstances which Congress has followed for many years—in some cases since 1913. Insurance companies, mutual savings banks, commercial banks (as to capital gains and losses), shipping companies, companies affected by depletion allowances (mining and as a matter of practically in regulatory administration. Nor, as we undercharacteristics recognized in our income tax laws.

Most importantly, this proposition would avoid a most difficult regulatory problem. Both the need and the requirement under the law to allow reasonable earnings after taxes, will remain if a war or defense excess profits tax is levied. The large increases in rates which are involved under a tax formula which

requires $6 to $7 of additional revenue to be collected from the public in order to produce $1 of earnings to the utility after tax would obviously present our commissions with unmanageable problems. It would make it mandatory from a legal standpoint for the regulatory commissions to increase the rates charged by almost every public utility in this Nation, which would mean increases in gas rates, water rates, electric rates, bus and railroad fares, and many other rates, which will certainly tend to increase the already dangerous inflationary trend, a trend which has thus far been resisted to a greater degree by the public utilities than by any other group.

VI

If Congress nevertheless decides to apply a war or defense excess profits tax to public utilities, we urge that it is necessary in the public interest that Congress endeavor to bring the definition of normal reasonable earnings for purposes of the excess profits tax law into practical conformity with the basis by which those earnings are judged by the regulatory commissions. In other words, the point at which an excess profits tax becomes payable must be sufficiently high to preserve the ability of public utilities to secure the capital they need to render services vital to the public and the defense effort.

We recognize the practical difficulties of introducing into tax legislation the regulatory concepts of "rate base," "rate of return," and "reasonable operating expenses" as such, and we recognize that no other formula in lieu thereof will produce exact equality. The following suggestions are, however, pragmatic substitutes:

(*a*) Some help can be achieved if the definitions themselves are altered. "Invested capital" should recognize all capital, including capital added during the taxable year, as contrasted with the former exclusion of 50 percent of debt capital and the exclusion of "inadmissible assets." The definition of "average earnings" might be altered from the form hitherto used to that of the earnings in a selected base year plus 6 to 7 percent after taxes of the additional capital employed since the close of the base year. The selection of a base year or years under the average-earnings formula should recognize that the years 1946–49 inclusive were years of subnormal earnings in relation to the present investment in utility properties. The average earnings of those years would not be sufficient to pay the interest on the presently outstanding bonds and a reasonable dividend on the presently outstanding stocks. Higher earnings than the average of 1946–49 are required because of the large increase in capitalization in each of the years 1946, 1947, 1948, 1949, and the lag of such capitalization becoming fully productive. As said, further large capital investments are required. In our judgment the calendar year 1950 constitutes the most representative and equitable year. It has as yet been little affected by war business, particularly so for public utilities. The pre-Korean period in any event is no earlier than the year ending June 30, 1950. We would therefore recommend 1950 as the base year. Even the use of the year 1950 must provide for specific relief in those cases where earnings were subnormal.

For both the invested-capital and the average-earnings approach, normal and surtaxes should be deducted before determining excess war profits; and the percentage returns on capital should be taken to mean "after all taxes including income and excess profits taxes." The percentage return should be related to the approximate cost of acquiring large amounts of new capital. Variance in the rate of return arises from the differences in the rate base adopted by a commission, as well as for the character of the utility for which the rate is fixed. In some States there is of necessity a variance in required rate of return because of legal provisions with respect to rate base.

These suggestions would apply the same definitions to both regulated and unregulated forms of business.

(*b*) Congress might prefer, however, to avoid the difficulties of drafting definitions applying to both regulated and unregulated businesses, and could do so by including in the proposed law a provision designed specifically to cover the utilities. In such event, we urge that the law provide that the excess profits tax not impinge upon the level of utility earnings prevailing in the year 1950, which is the period immediately prior to the time at which war or defense activity began to affect business returns. Further, the law should give adequate recognition to the normal regulated earnings necessary to support the large amounts of additional capital the utilities will have to attract and use in expanding their properties to take care of the public demands for their services and for defense production in the years ahead.

These suggestions have varying merits and shortcomings, and at best they bridge only imperfectly the differences between tax formulas and the formulas of commission regulation. We therefore incline to the conviction that an excess profit stax is by its nature not fitted to the facts of the public utility situation.

A RESOLUTION OF THE NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS RELATING TO EXCESS PROFITS TAXES

Whereas the executive committee of this association established a special committee on excess profits taxes under the chairmanship of the Honorable Justus F. Craemer, of California; and

Whereas that committee and a subcommittee of that committee under the chairmanship of the Honorable John H. Hessey of the Maryland commission has made a comprehensive study of the effect of excess profits taxation upon regulated utilities and has prepared a report on this matter which has been submitted herewith at this convention; and

Whereas the special excess profits tax committee has unanimously adopted this report: Now, therefore, be it

Resolved, That the National Association of Railroad and Utilities Commissioners adopts this report and authorizes the Honorable John H. Hessey, the Honorable H. Lester Hooker, and the legal representatives of this association to appear on behalf of the association before any committee of Congress at any hearings which may be hereafter held upon legislation pertaining to excess profits taxes for the purpose of presenting the views of the association as contained in the committee report.

This the 15th day of November 1950.

Mr. HESSEY. Now, our main points are these, sir. First, the earnings of utilities are already under constant review by competent regulatory commissions operating under law. There should not be excess profits in the regulated utility industry at any time. We are charged with and seek to secure the prevention of excess profits, and we believe, of course, that in the main we do that which we are required to do.

Now, of course, I would say there could not be any more persuasive evidence than if we take and analyze one or two industries and we look and see that the price of gas in 1949 is only 2 percent more than that in 1939, and that the price of electricity in 1949 is 6 percent less than it was in 1939.

All we have to do is to compare that with the Bureau of Labor index for the over-all cost of living, and we find that that was 70 percent higher in 1949 than in 1939, and the wholesale commodity price index was 100 percent higher. Therefore, we feel that we endeavor, in the main, to do a good job.

Now, secondly, on the other hand, when earnings are so closely regulated as to prevent unreasonable earnings at any time, it becomes a vital matter in the interest of adequate service to the public that utilities be permitted to earn the amounts to which they are entitled under regulation.

This vital need is not merely a matter of logic or justice; it is a matter of supporting the credit of the utilities so that they can obtain the new capital they need to support these service-producing facilities demanded of them by public needs, and by the needs of the defense program.

Thirdly, it is necessary for them to maintain proper earnings. They are expending today tremendously great amounts of capital. Their capital improvements are considerably higher, many times higher than they were in prewar years, and the same thing applies for the amount of the security sold. It is so tremendously in excess of what it was at any previous time that it is almost unbelievable, and it is necessary if

they are to do the work that they have to do, that the commissions allow them to earn a rate of return which will support the money that they have to secure either by way of debt capital or equity capital.

Fourth, the various proposals so far made in respect to an excess profits tax, or the laws enforced during World War II, will not permit the utilities to earn the requisite amounts required by the practical needs of the case unless their present rates are increased appreciably. The proposals in question redefine substantial portions of existing normal and necessary earnings as being excessive, and tax them away. Our calculations show that the excess profits tax formulas heretofore used produce returns which are so much below what is now necessary to keep utilities functioning properly that only severe damage can result.

With the facts and needs of the utility situation actually compelling us to grant many rate increases during the postwar years, then we find ourselves again confronted with the same thing that we have already had.

Fifth, our viewpoint is not that excess profits from defense or war business should go untaxed. But we contend that for the regulated utility industries, which we know intimately, a utility makes excess profits only when its earns, after all taxes, more than the allowable rate of return upon the rate base as specified by the regulatory commission having jurisdiction. We believe that the customary forms of "average earnings" or "invested capital" measurements heretofore used or proposed will not meet the needs of the case.

Senator MILLIKIN. Would you mind repeating that last sentence?

Mr. HESSEY. We believe that the customary forms of "average earnings" or "invested capital" measurements heretofore used or proposed will not meet the needs of the case.

Senator MILLIKIN. Used by whom?

Mr. HESSEY. In the law, and as to how the law was. The rate of return, for instance, where you would have 50 percent rate of return under the old law, that they would not meet the needs of the case. We have a different situation here.

We respectfully urge that the concept of excess profits for public utilities is inimical to the concept of regulation by statutory commissions, and that the applicability of an excess profits tax to regulated utilities at all is seriously open to question.

The association's statement urges that if Congress nevertheless decides to apply a war or defense excess profits tax to public utilities, then Congress should endeavor to bring the definition of normal reasonable earnings for purposes of an excess profits tax law into practical conformity with the basis by which those earnings are judged by the regulatory commissions. In other words, the point of entry at which an excess profits tax becomes payable must be sufficient to preserve the ability of the utilities to secure the capital they need to render services vital to the public and the defense effort (see NARUC committee report, pp. 11 and 12).

Since my appearance before the House Ways and Means Committee, a proposal has been made by that body, in the form of House bill 9827. This proposal makes progress in giving recognition to the practical problems about which I have been speaking. But that recognition, in section 446, contains one proposition which may substantially

vitiate the intended solution, and if adopted may make a possibly insoluble muddle of regulation by the various State and Federal regulatory commissions.

Section 446 would define the point of entry of the excess profits tax, that is, the "excess profits credit," as the sum of the normal and surtax plus 6 percent of the following: (*a*) borrowed capital, and (*b*) "adjusted equity capital." It is the definition of adjusted equity capital that concerns the commissions.

Now, "adjusted equity capital" is defined not as the actual equity capital in use by the utility. If that were done, then I would say it would probably be all right. I have read the comments of Secretary Snyder on the bill which was presented, and I read this statement where he says:

It would permit them—

that is, the utilities—

to receive before the application of any profits tax a net return after income taxes of 6 percent on their total investment including capital stock, reinvested earnings and borrowed capital.

That, in my judgment, is not what the bill provides. If that is what the bill provides, I think I would be satisfied from the commissions' standpoint, but it does not so provide.

The CHAIRMAN. What does the commission consider when it fixes its rates?

Mr. HESSEY. Of course, the commissions have to determine a rate base which is the fair value of the property which is used and useful in the public service.

The CHAIRMAN. Under this House bill they do not take that determination?

Mr. HESSEY. No, they do not take that determination. They tie it in with the income tax law, which means we are not going to have to revalue. We do not do that.

It means that the Treasury Department would have to take every physical facility that every utility has and revalue it in accordance with the terms set forth in here, which is a colossal task.

The CHAIRMAN. I suspect, and I pointed out the first day of the hearing, that what would be taken was simply your tax reports, rather than the book values or rather than the values which you, as a regulatory body, fix the rates.

Mr. HESSEY. We now come to the fact that we suggest a definition or suggest a statement to be included in lieu of the equity capital that is defined in the bill.

Senator KERR. There is a provision in the bill that fixes it so that the tax valuation figure would be the one used rather than either the fair value or the book value.

Mr. HESSEY. I am afraid I did not get the very first part of that question. I heard the last of it.

Senator KERR. Would it be possible to interpret this bill to mean that the base would have to be computed in terms of the assessed valuation of the properties in part instead of either the fair value or the book value as determined by the books of the utility?

Mr. HESSEY. I do not think that that is in this bill. I cannot find it in any way, shape, or form.

It seems to me that this leaves this matter right with the Treasury Department, and I was going to comment that if the Treasury Department takes the same position that it has taken with respect to section 722 of the previous law under which there are perhaps 15,000 open claims today involving perhaps $4,500,000,000, we would find ourselves in somewhat of a similar position with the utilities.

The utilities have all had, when they appeared before the commissions—of course, their properties are valued and appraised, and there the fair value is determined, that is, from the commission's standpoint, and we must allow a rate of return based upon the fair value of their property used and useful by and to the public. They are entitled to that.

They are using it for the public, and if you take any of it away, then what does it mean? If you take it away in taxes, we have got to give them back an amount which would be sufficient to put into their coffers a rate of return which we would allow.

The CHAIRMAN. What is the provision which you suggest?

Mr. HESSEY. The phrase in section 446, page 73, with which you are familiar, should read this way:

(A) The average outstanding common and preferred capital stock accounts and the capital and surplus accounts for such taxable year, as recorded on the corporate books of account if maintained in accordance with systems of accounts prescribed by an appropriate regulatory body.

In other words, we do not have to allow it to their whim as to what they put on, but it must be as prescribed by a regulatory body. Now, that is what we suggest.

Senator MILLIKIN. Taking the whole field of controlled utilities, there are all kinds of utilities. What is the range of fair return, from what percent to what percent?

Mr. HESSEY. That varies according to different commissions in different States.

Senator MILLIKIN. I understand that.

Mr. HESSEY. It varies, of course, in industries, it varies as to whether the industry is a large or small industry.

Senator MILLIKIN. I understand that. What is the range, from what to what?

Mr. HESSEY. I would say from 5½ to 7½.

Senator MILLIKIN. Thank you very much.

Senator BREWSTER. What is the proportion of debt to equity in the whole structure?

Mr. HESSEY. That depends. Of course, in the telephone industry, that is all capital, I mean equity capital. Understand, I can only talk about those companies which are under my jurisdiction and which I know somewhat intimately.

All of the structure of our Chesapeake & Potomac Telephone Co. of Baltimore City is represented by capital stock, all of which, of course, is owned by the A. T. & T.

Senator TAFT. The Bell Co. is 50——

Mr. HESSEY. Yes, but our local company has 100 percent equity capital. When it comes to our Consolidated Gas, Electric Light & Power Co., there is a ratio there. I do not know that I can give you it exactly, but it is somewhere between 45 and 55 percent.

Senator BREWSTER. Does it generally run about 50–50?

Mr. HESSEY. I would say so, in that neighborhood, 45 to 50.

Senator MILLIKIN. How fast has that increased in recent years? Did it not used to be about 30?

Mr. HESSEY. I think it has gone up slightly. It has not increased with us too much.

Now, of course, I cannot give you the whole national picture at once when you come over here on such short notice, you understand, but it has increased slightly.

Now, I would like to make one further comment with respect to it. The House bill passed Tuesday results in taking away from certain utilities earnings which State commissions have already adjudged, after thorough investigation, to be both reasonable and necessary. Also, it allows no flexibility, so that utilities cannot, under the bill, be allowed to earn a greater return even though such return is, in the opinion of the regulatory body, absolutely essential to enable the utility to attract future capital needed in the interest of the public and the defense program.

Now, I say that because the bill limits it to 6 percent. I am not quarreling about percentage, do not misunderstand me. I am not here to quarrel about the excess tax bill, as such. I am not here to quarrel about percentage. I am here to say that when a regulatory body allows them a return and is required by law to allow that return, that the utility ought to be permitted to earn it before it starts to pay its excess profits tax.

I do not want you to misunderstand my position at all, sir. I would like to emphasize by saying it is the duty of all the members of our association to regulate rates charged by the public utilities under our jurisdiction; and necessarily we are interested in any law which would apparently make it necessary for us to increase the rates to our citizens.

Under the previous bill as proposed by Secretary Snyder, I had a calculation made of only our two companies as to what we would have to pay, what additional rates would have to be granted if they were permitted to earn a 6-percent return, and I found that in our State alone it exceeded $20,000,000.

We have one sixty-fifth of the population. If you use that as a basis over the Nation, it would be $1,324,000,000. If you used the 48 States, that is slightly less than a billion. That is only two companies. We have other companies operating in Maryland, and I think that rate increases would be tremendously higher, and I, for one, would hate to think of the unfair and unjust criticism that would be heaped upon the heads of the commissioners if they have to raise the rates any more.

They have had to do it a couple of times for most companies since the war, to keep pace with what has been going on, and I hate to think what would be heaped upon our heads if we now have to increase this rate because of an excess profits tax bill.

Senator MILLIKIN. Are there any cases where the utility exceeds the allowed fair rate of return?

Mr. HESSEY. I would say that we have——

Senator MILLIKIN. There are bound to be some.

Mr. HESSEY. Once in a while; yes. Not as a general rule. You see, they are all required to file annual reports with us. Those reports are examined very carefully after the first of the year as soon as they are presented, and if there is any indication that there is going to be a

greater rate of return than what we consider a fair rate of return, then we either set the matter down for hearing or enter into negotiations where the rates are sometimes voluntarily reduced.

Senator MILLIKIN. Taking all utilities, you do not believe there is any substantial overrun on the allowed rate of return?

Mr. HESSEY. No, sir. I want you to understand I am speaking, of course, for the State regulatory bodies. I am not here in behalf of Federal bodies, railroads, or anything of that kind. I do not think that I would have that power.

I am speaking about the State regulatory bodies.

Senator KERR. The calculation you gave us there of $1 billion increase in rates, as I understand it, is based on the bill that was not introduced and is not before us?

Mr. HESSEY. That is correct.

Senator KERR. What estimate, if any, do you have with reference to increases that would be required under the terms of the bill which is before us?

Mr. HESSEY. If the income-tax department would accept the previous returns which have been accepted for proper rates of depreciation, and would not attempt to determine the value of their property based on a sale of the property or gain in the sale of it as they propose to do, there would not be, probably not have to be any increases except very slight ones, but it is this provision which leaves the door wide open so that at any time the Internal Revenue Bureau or Department can come in and question any and every figure that they have and revalue their own property in spite of what the commissions have done and in spite of the fact also that depreciation has been charged for years. They can still question it.

Senator KERR. If they were permitted to do that, would that not result in interminable confusion?

Mr. HESSEY. That is what I say, sir. That is the reason I used that word "muddle." I do not know what else you would call it. It is confused and a muddle, whatever it may be.

Senator MILLIKIN. As a practical matter, would not the tax-collection authorities, except if there were some flagrant cases, have to accept the judgment of the commissioners? In other words, I have some vague memory that the Congress at one time authorized a valuation of the railroads. When they finally got through with that valuation, it was of utterly no use because the whole picture changed.

Now, the Bureau of Internal Revenue is not set up, and I doubt whether the Congress will set it up, to revalue every regulated business in this country, although there are fellows who like to overreach their power, and I cannot say that this would not pop into someone's head to build up that kind of a bureau, but at the present time as a practical matter would they not be compelled to accept the views of the various regulatory bodies?

Mr. HESSEY. The answer to that is this: As a legal matter the answer would be "No." As a practical matter, they might in many cases accept it; yes.

However, let me just take this illustration. On March 1, 1913, they had property which cost them $500,000. It is now 37 years later.

Under the rule of the Treasury Department, we would have to depreciate that property by a certain percentage over that period of years.

Assuming we depreciated it 2 percent a year, that has depreciated 74 percent, so we carry it on our books at $125,000. Anybody with a grain of sense knows today that you could not reproduce that facility for $125,000.

Senator MILLIKIN. You mean as depreciated?

Mr. HESSEY. Even as depreciated.

Senator MILLIKIN. I mean as depreciated in fact.

Mr. HESSEY. As depreciated in fact, and we must allow on the fair value of that property if it is $250,000, so you have taken off $125,000 on that item alone.

I want to avoid any semblance of confusion. I am not here objecting to anything in the way of the excess profits tax law as such. I do say that all we want them to do is to earn a rate of return which we have to give them, no matter what you do.

You can put all the excess profits tax on you want to, but as soon as you put it on, then we have got to give them a fair return even if it is necessary to raise the rates to pay that excess profits tax. That is what I am saying.

Senator BREWSTER. You made quite a study of this situation, did you not?

Mr. HESSEY. Well, I do not know. I do not like to claim I made any great study on it.

Senator BREWSTER. Is there an estimate of what this bill would cost on the 1950 earnings?

Mr. HESSEY. Oh, there is no possible way to figure out what that would be, no possible way.

Senator BREWSTER. If there is not, how do you know it is going to hurt you?

Mr. HESSEY. I did not say it would hurt me. All I said is the possibilities are here for the Department to make it hurt if they choose to come in and revalue all of their property on the basis for determining gain upon sale or exchange. That is what I am saying.

Senator BREWSTER. You fear, then, the administrative actions?

Mr. HESSEY. The possibilities are there; yes, sir.

Senator BREWSTER. If we are going to deny them all the power, we will have to stop Government. There is always the possibility of administrative abuse or lack of discretion.

In your own case, you could ruin every utility in this country by your regulations. We have to trust you. Why will you not trust the Bureau?

Mr. HESSEY. I do have, Senator, some instances where up to now some of the companies are still having some open questions with the Bureau over the very thing that I am talking about.

Senator BREWSTER. I hold no brief for any branch of the administration—you do come down to a question of exercise of honest discretion.

Mr. HESSEY. I agree with you. What we say with respect to that——

Senator MILLIKIN. Have you not proposed that you shall accept the valuations of the Commissions?

Mr. HESSEY. No, I do not use it in that language.

Senator MILLIKIN. Does it come to that?

Mr. HESSEY. No. If you say that, of course not that any commissions would, but there are 48 commissions and they look at it in differ-

ent lights, but we all have to establish a rate base. Some allow it on the fair value of the property, some allow it on the capital invested in the company.

Senator MILLIKIN. What is your proposal?

Mr. HESSEY. I will read it again:

> The average outstanding common and preferred capital stock accounts and the capital and surplus accounts for such taxable year, as recorded on the corporate books of account if maintained in accordance with system of accounts prescribed by an appropriate regulatory body.

Senator MILLIKIN. Does that meet the usual practice among the regulating bodies?

Mr. HESSEY. Yes. You see in all their national reports the commissions usually——

Senator MILLIKIN. In what respect, if any, does that differ from the usual method of the utility commission in establishing fair rates?

Mr. HESSEY. It does not differ very much. We talk about the value of capital, the value of property is almost the same thing. The amount of capital and the value of property may sometimes be different. There are certain times you will refuse to allow things that the companies want to allow.

In our last telephone company case, they wanted us to allow them $2,000,000 for capital, working capital, and we refused to do it on the theory, of course, that they had considerable more than that of the Government's tax money at all times which they were using as working capital. We were not going to make rate payers pay a greater return on something they were not required to put up themselves but just are holding from the Government. Many other little things come into it that we consider when we determine a national rate base.

Senator TAFT. The fundamental difference, of course, is the question of excess profits tax is supposed to get the excess profits of corporations, and in the case of utilities it does not get the excess profits, it is passed on by definition, by law, to the consumers themselves. Therefore it does not carry out the purpose of an excess profits tax on other corporations.

Mr. HESSEY. Provided the point of entry of that excess profits tax comes before the allowance of a reasonable return.

Senator TAFT. Yes.

Mr. HESSEY. If it comes after that then, of course, I believe that the company should pay it.

Senator TAFT. I see.

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

If not, we thank you for your contribution.

Senator CONNALLY. Mr. Chairman, I have a constituent here who was here all day yesterday and who has got to leave today. He will only take 3 or 4 minutes. I will be glad if the committee would hear him at this time so that he can fill his other appointments. He is Mr. J. B. Thomas.

The CHAIRMAN. Come forward, Mr. Thomas. We will be glad to hear you now. Just have a seat, Mr. Thomas, and identify yourself for the record.

STATEMENT OF J. B. THOMAS, PRESIDENT AND GENERAL MANAGER OF TEXAS ELECTRIC SERVICE CO., FORT WORTH, TEX.

Mr. THOMAS. My name is J. B. Thomas, of Fort Worth, Tex. I am president and general manager of Texas Electric Service Co.

The CHAIRMAN. All right, Mr. Thomas, you may proceed.

Mr. THOMAS. I very much appreciate that and am grateful.

My company, by reason of a rapid increase in its capital the last 4 years——

Senator CONNALLY. Let's have order, Mr. Chairman, in the room. We cannot hear.

The CHAIRMAN. Please let us have order in the room.

Mr. THOMAS. My company, by reason of a rapid increase in its capital in the last 4 years, namely, 130 percent, or $40,000,000, and the prospect of a continuing growth of the same order, will be hard put to be able to attract under the provisions of the bill as presented, the additional capital required for necessary expansion. We are very hopeful that section 446, which is so necessary to utilities, particularly those with a growth factor, will be so amended that the adjusted equity capital will, where the books of a utility are kept in accordance with proper and uniform systems of accounts, be defined to include the sum of the capital-stock accounts, both common and preferred, and the surplus accounts, as compared to the definitions now contained in section 437 and 446.

An amendment is to be presented by Mr. Whiting later, in which I wholly concur and a copy of which I will attach.

We realize the necessity of additional taxation and expect to bear our fair proportion, but must be able to attract the additional capital which we must have for keeping up with the requirements of the defense effort and of natural growth.

In my company's service area there is produced over 14 percent of all the crude oil of the United States, and I have to reach to purchase it and to send it to market. We are deeply concerned and the results of the proposed legislation do not indicate that we can keep that necessary amount to attract capital.

My statement before the Ways and Means Committee of the House, presented on November 22, and in the record of that hearing, sets out the crippling effect of the Treasury proposal as applied to our company, namely, a rate of additional earnings on required capital far too low to attract such capital, or else to require extremely large rate increases, which may be of the order of $6,000,000 a year in the case of my company initially and to grow.

The House bill, as passed, is more realistic and may be made tenable with the amendments suggested, although fundamentally the 6 percent return on total capital which might be reached is not an adequate one in the hazards of my growing territory.

There is one particular thing not intended, I am sure, in which the act as passed by the House will likely be construed to discriminate in section 446, the section relating to the excess profits tax credit for regulated public utilities, against the utilities in the States of Texas, Iowa, Minnesoa, Florida, Mississippi, and South Dakota; this by reason of the fact that in these States regulation has been delegated by their legislatures to the various cities and towns instead of to a

State commission. Much of our income lies outside the area of such towns exercising regulation.

Such regulation is practical and effective as to the over-all operations of the utility but does not in many cases fall precisely within the requirements of the language of section 446 of H. R. 9827.

Senator CONNALLY. Let me ask you right there. Your complaint is that with regard to these particular States which do not have a State regulatory body but delegate the authority to the municipalities, that they would be discriminated against in this bill?

Mr. THOMAS. And not have the advantages of section 446.

Senator TAFT. Why is that? There is some language about State political subdivisions, and so forth.

Mr. THOMAS. There is some language but not such, sir, as assure that we would get that credit.

May I go along a moment and suggest an amendment which will bring out the discussion.

A similar situation existed some 8 years ago with respect to tax credits on certain classes of utility preferred stock, and was effectively met by regulation of the Internal Revenue Department. We feel that section 446 should be amended to use virtually identical language as used in the Internal Revenue Bureau regulation, section 29.26–5, to avoid similar discriminations here. We suggest that section 446 be so amended.

The electric utilities in the State of Texas and the other States do not seek to avoid their fair and proportionate share of necessary taxes under this Act, but rightfully insist they be allowed the full credits as expressed in section 446 and as allowed such utilties in the other 42 States.

The suggested amendment is brief and is attached hereto. I read as follows:

Subsection (d) of section 446 was amended to read as follows:

> For the purposes of this subchapter the term "regulated public utility" means a corporatoin described in subsection (c) substantially all of whose excess profits net income for the taxable year is derived from sources described in subsection (c).

We propose to amend that by striking out the subection (c) and inserting—

> as described in subparagraphs (1) (A), (1) (B), (2), (3) (A), and (3) (B) of subsection (c) and such terms shall include the corporation part of the gross income of which is derived from such sources at rates which are not so regulated if such corporation establishes to the satisfaction of the Commissioner (a) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region, in one or more States, and (b) that the regulation to which it is subject in part of its operating territory is effective to control rates within the unregulated territory so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

Senator MILLIKIN. Is there a difference between the charges you make in unregulated areas as contrasted with regulated areas? Do you charge more in the unregulated areas?

Mr. THOMAS. No, sir, for they are the same throughout. We have our scale of rates for sizes of towns, and our power rates are general across the territory, and the rate level is the same. Its character is determined by the cities that exercise their regulatory privileges.

Senator MILLIKIN. I see.

Mr. THOMAS. But as the act is written in 446, my tax counsel and others tell me that we would not technically be entitled to the advantages of section 446, which is very necessary. We therefore suggest this language which the Internal Revenue Bureau itself used in connection with the preferred-stock credit I referred to, and which has been interpreted to fit our various situations for some 8 years.

Senator CONNALLY. Your tax counsel advises that you would not be eligible to 446 because all of the companies in that area are not regulated?

Mr. THOMAS. That is right. And all of our business, each company's business, is not regulated. Therefore, it does not meet the technical qualifications.

Senator TAFT. Is it not the fact that where municipalities regulate instead of the State, part of the territory is not covered by any regulation and that rules out 446?

Mr. THOMAS. That, I think, is the principal thing. Of course, the method of legislation inherently leaves gaps. Some cities may not elect—although the rates will be filed with them and satisfactory, they may not elect to take any formal action, in some cases have not, which again would prevent us from having the advantages of 446.

Senator MILLIKIN. Mr. Chairman, may I ask Mr. Stam a question?

The CHAIRMAN. Yes.

Senator MILLIKIN. Has this matter been considered, Mr. Stam?

Mr. STAM. I do not think it was the intention to exclude the type of utility that this gentleman has in mind. I think the reason that amendment was made on the floor was mainly in connection with the transportation by pipeline of these oil and gas companies, and the thought was that substantially all of their income had to come from that activity.

Senator MILLIKIN. Would there be any objection to a clarifying amendment?

Mr. STAM. I do not think so, and we are working on that problem now.

Senator TAFT. Mr. Stam, has this bill been reprinted with the amendments made on the floor? This does not have that amendment in it. It is different from what was read.

Mr. THOMAS. The print of December 5 does not contain it.

Mr. STAM. Yes, we have it with the amendments made on the floor.

Senator TAFT. May we have those distributed rather than the original House bill?

The CHAIRMAN. I do not think we have them.

Mr. STAM. Yes, they just came in.

The CHAIRMAN. Suppose you have the clerk distribute them.

Mr. STAM. We have sent for them now.

Senator CONNALLY. Let me ask you, Mr. Stam, are you familiar with the internal revenue regulation of 8 years ago which the witness refers to, which he says he is satisfied now if that is put into practice?

Mr. STAM. Not too familiar. We have been looking up this particular problem. It has been brought to our attention and we are working on it now.

Mr. THOMAS. We do not think it is intentional, sir, but it would be tragic to have it go through without it, and the language I suggested has been used in connection with the preferred stock.

The CHAIRMAN. Thank you very much.

Mr. THOMAS. Thank you for the opportunity of appearing.

(The suggested amendments submitted by Mr. Thomas are as follows:)

SUGGESTED AMENDMENTS TO H. R. 9827

Subsection (d) of section 446 of H. R. 9827 (printing of December 1, 1950), was amended in the House to read as follows:

"For the purposes of this subchapter the term 'regulated public utility' means a corporation described in subsection (c) substantially all of whose excess profits net income for the taxable year is derived from sources described in subsection (c)."

We suggest subsection (d) be further amended to avoid discrimination against utilities in the States of Texas, Iowa, Minnesota, Florida, Mississippi, and South Dakota.

In this subsection (d) strike out the word "subsection c" at the end thereof and insert "subparagraphs (1) (A), 1 (B), 2, 3 (A) and 3 (B) of subsection (c) and such term shall include a corporation part of the gross income of which is derived from such sources at rates which are not so regulated if such corporation establishes to the satisfaction of the Commissioner (a) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region, in one or more states, and (b) that the regulation to which it is subject in part of its operating territory is effective to control rates within the unregulated territory so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory."

"(A) The adjusted equity capital for such taxable year (as defined in Section 437 (b), *or where regulated corporate books of account are maintained the sum of the capital stock accounts (both common capital stock and preferred capital stock) and surplus accounts (both capital surplus and earned surplus)*, and

(Italicized portion is amendment proposed to section 446 (b) (2) (A) H. R. 9827.)

New subsection to section 446:

"(e) As used in this section the term 'regulated corporate books of account' means the books of the regulated utility when kept under a uniform system of accounts which confirms with the accounting principles contained in the Uniform System of Accounts prescribed for Public Utilities and Licensees and for Natural Gas Companies by the Federal Power Commission.

The CHAIRMAN. Mr. Justin Whiting. Please identify yourself for the record.

STATEMENT OF JUSTIN R. WHITING, PRESIDENT, CONSUMERS POWER CO., JACKSON, MICH.

Mr. WHITING. My name is Justin R. Whiting.

I have filed a statement with the clerk of the committee, but in order to save time, if I may, I would like to have that understood as going in the record and I will brief my remarks and follow the general line of the statement.

The CHAIRMAN. You may proceed. The reporter will place the full brief in the record.

Mr. WHITING. I reside at Jackson, Mich. I am president of the Consumers Power Co., and electrict and gas utility that operates in the State of Michigan, and chairman of the tax committee of the board of directors of the Edison Electric Institute. The Edison Institute is a trade organization representing some 80 percent of the electric utilities in this country.

We have filed certain recommendations with your legislative experts, and later with the Ways and Means Committee, in combina-

tion with the American Gas Association, which will be given by the succeeding witness.

In view of the questions asked Mr. Hessey this morning, I am going to go over my first four points rather briefly. They are all in the statement. Then I will come to matters under discussion with Mr. Hessey.

My statement at first points out the importance of this industry. Let me say that in 1954, or at present rather, this industry from point of investment is the third largest industry in the United States, only exceeded by agriculture and the railroads.

Senator KERR. Now in that reference do you include only the electric industry, Mr. Whiting, or do you refer both to electric and gas?

Mr. WHITING. I am confining my remarks, Senator Kerr, principally to the electric industry. Mr. Hulcey from Texas will deal with the gas.

We think we are pretty vital to the national economy and the defense effort because in 1944 this country manufactured 50 percent more munitions than the Axis nations. This country manufactured 45 percent of the munitions of all belligerent nations. It is interesting to note at that same time the electric industry of this country represented 42.2 percent of the world production of electric energy.

Senator KERR. That is in terms of output?

Mr. WHITING. Yes, sir.

I point that out to show you that we believe we are essential to the war effort and to the national economy.

I have indicated our large investment. But when you come to our net earnings, we are small. In 1940–45, the income after taxes of the electric utilities of this country only amounted to 4.9 percent of the income of all other corporations.

Senator CONNALLY. How is that?

Mr. WHITING. 4.9 percent, Senator, net income left after taxes of all the utilities, excluding transportation and communications.

Senator KERR. You mean of all corporations, utility and otherwise?

Mr. WHITING. That is right.

I mention that because when we talk about this tax problem it does not bulk as large from our income as it does from our investment.

Another thing. In order to build all this plant, we only turn our capital once in 3½ or 4 years, and in order to build it, our capital structure is necessarily large in debt.

I have some graphs attached to my statement. I am going to put them up here.

There is one there now you can see. The stock and surplus is 51 percent. The long-term debt of the utilities is 49, almost 50 percent. Whereas when you come to the manufacturing industry, they are 88 percent stock and 12 percent debt.

I mention that because it has a very profound influence in the equitable dealing with debt under invested capital.

If you turn to the——

Senator MILLIKIN. The difference you have stated perhaps represents a difference in the degree of risk.

Mr. WHITING. Yes. And let me say, Senator Millikin, on that, because I am going to come down to talk about common equity, these companies are set up roughly on this basis: 50 percent debt; let us

say 20 to 25 percent preferred, and the balance equity capital, or what you call risk capital.

Senator MILLIKIN. Yes.

Mr. WHITING. That is historic in the development of the utilities of this country. So when I say "risk" I mean risk because you have got bonds ahead of it and you have got preferred ahead of it, and the market on the risk capital which we are all trying to build up is very sensitive. I do not know anything more timid in the face of an excess profits tax than the investment in risk capital of a utility.

Senator MILLIKIN. I think it should also be mentioned that you also have a monopoly, which decreases risk.

Mr. WHITING. That is right.

Senator TAFT. Your point is that the risk for the whole company is less but the risk for the stockholders balancing against that is larger because of having put debt ahead of it?

Mr. WHITING. That is precisely right, Senator Taft.

Senator MARTIN. Mr. Chairman, I am not just quite sure about this. In this 50–50 division, in the debt side, does that include the preferred stock?

Mr. WHITING. No; we include preferred stock in the equity.

Senator MARTIN. Then we still have about 25 percent common stock, 25 percent preferred, and then 50 percent bonds, is that right?

Mr. WHITING. That is right. But I would say that of recent years, under the pressure of regulation, that we have increased the common equity and reduced the preferred. In my own company our common is now something in the neighborhood of 34 percent.

Senator MARTIN. Then that 34 percent is really the risk capital?

Mr. WHITING. That is real risk.

Senator MARTIN. Yes; that is the real risk.

Mr. WHITING. Yes, sir.

Senator MILLIKIN. How much dividends do you pay on your preferred?

Mr. WHITING. $4.50 and $4.52.

Senator MILLIKIN. And what price is your preferred carried at on the market?

Mr. WHITING. It is selling currently at about 110.

Senator MARTIN. That makes a yield of about 3.

Mr. WHITING. No; it is a yield of more than that I think. It is closer to 4, Senator.

Senator MARTIN. The dividend is 4½. I see. It would be closer to 4.

Mr. WHITING. Yes.

Senator MARTIN. Now what dividend have you been paying on the common?

Mr. WHITING. We paid a $2 dividend on the common stock since the day the excess profits tax went off, and I hope to goodness we do not have to reduce it.

Senator MARTIN. What percentage would that be on the risk capital? You say $2 a share. What percentage is that on risk capital?

Senator MILLIKIN. What is your market?

Mr. WHITING. The yield basis at present, if that is what you mean——

Senator MARTIN. Yes.

Mr. WHITING (continuing). Is about 7.15. Let me say to you that we had 500,000 shares of stock in the works that we would have sold for

$33, and when Korea happened and the threat of the excess profits tax occurred, we sold it at 28, or $2,000,000 less. That is a very concrete illustration of what this thing does to us in the way of finance.

Senator MILLIKIN. How widely spread is your stock?

Mr. WHITING. We have 28,000 shareholders, Senator Millikin, and we have acquired 12,000 of them since 1946.

Senator MILLIKIN. What is the average holding?

Mr. WHITING. Well, I do not know that I can answer that. It is small. We undertake to do that.

I want to say to you, and I am going to come to it, that all of these stocks are sold on prospectuses under the regulation of the Securities and Exchange Commission, in which the value of our assets and our earnings are reflected in accordance with the accounts kept as prescribed by the Federal Power Commission. That is the vital thing that I want to get to, but I will have a few words of explanation.

Senator MARTIN. Mr. Chairman, before he leaves that. Do you have any group of what we would call extremely large stockholders in your equity capital?

Mr. WHITING. Yes. The educational institutions from the colleges of Massachusetts across the Nation to the colleges of California have invested in our stocks. The insurance companies also.

Senator MARTIN. Then how about individuals? Do you have any individuals who have large holdings?

Mr. WHITING. Not too large. We do have, I think I would say, four or five, but none of them hold 1 percent of the business. We have many individual stockholders, and like all corporations we have more women than we do men.

Senator MARTIN. Yes.

Now what percentage is owned in your own individual company by colleges and other institutions where they are holding it for their endowment?

Mr. WHITING. I hate to give you that percentage because I just do not know. If it is important to you, I will be glad to mail it to you.

Senator MARTIN. No; it is not important. What I am getting at is so many people think that these corporations and utilities are owned by rich individuals. What I am trying to get at is that is not the case.

Mr. WHITTING. Let me say this to you: That the utilities, including the telephone companies and the railroads, so far as the best estimate I can get, have about 5,000,000 stockholders. But if you will take the indirect ownership through everybody that has a life insurance policy, or the people who buy these present-day investment trusts, and the like of that, I suspect that figure would go up very much.

Senator MARTIN. What I am trying to get at, Mr. Chairman, a few years ago, 30 or 40 years ago, our large railroads had individuals with several million dollar holdings in the equity capital, but that has changed in the years considerably.

Mr. WHITING. Well, when our stock came out from under the holding company, we had 16,000 shareholders, and subsequent selling to little fellows has brought that figure up to 28,000.

Senator MARTIN. Thank you.

Mr. WHITING. That [indicating] shows what Commissioner Hessey said to you on the witness stand. You can see how the price of electricity has gone down, gas only slightly up, and the other index is as much as over 200 percent.

Now I think that is a very graphic demonstration of what the regulatory commissions of this country have done.

We do not have excess profits. And to refer to my own company, if you will excuse me, we have had one electric rate increase in 28 years, and it took me 2½ years to get it, and it will only be reflected in 10 months of this year, and that is not in the base period.

Senator MILLIKIN. How much of your distributable earnings do you keep for plant?

Mr. WHITING. We like to distribute, Senator Millikin, 75 percent. The industry has gone up on that basis.

I would like to take a minute to tell you why that is so.

You know this utility business is not a static business, and if we are going to keep it virile, it has to grow. And the only way we can keep abreast of it is to take the pitcher to the well. I have sold $30,000,000 worth of stock this year because I wanted to improve our equity capital. But we cannot do it unless we have earnings, and if we do not have earnings, we will pay an unreasonable price for our stock, and then we will stop selling stock, and we will do the thing we should not do; we will go to bonds, if we keep up with the efforts. Gas and electric utility companies have spent nine billion two in the last 3 years, and it looks as though we ought to spend more than that in the next 3.

Senator MILLIKIN. Mr. Chairman, may I ask Mr. Stam a question?

The CHAIRMAN. Yes.

Senator MILLIKIN. A while ago, Mr. Stam, I asked a question designed to find out how much revenue it is intended to get from all of these utility people of all kinds. Have you any figure on that?

Mr. STAM. We do not have the figure, Senator Millikin. If you accept the House bill, that was adopted with 6 percent minimum. Of course, some of the revenue from the utilities would be very small under the House bill, but if you did not have that 6 percent minimum, of course, you would get much more revenue than you would otherwise.

Senator MILLIKIN. If you exempted all utilities, would there be a lot of horror cases of companies that might be called utilities that would be put in position to gouge, make excessive profits?

Mr. STAM. Well, there might be some situations where the return was up to 8 or 9 percent in some cases. You see, you do not have a uniform system throughout the country. The rates range anywhere from 5 or 4 up to about 9, the return.

Senator MILLIKIN. You do not have uniform rates of interest throughout the country, either. I can remember when in Colorado 12 percent was the normal banking rate of interest. It is not true now. In New England 6 percent was the top, and New England banks got rich by sending deposits out to Colorado and getting 12 percent.

All I am trying to say is I imagine there has been some flattening-out in interest over the country, but there is still a difference in interest rates over the country.

Mr. STAM. That is right, but I think when the utilities came before our technical group and discussed this problem, I believe they indicated that about the average rate was around 6 percent.

Mr. WHITING. You just have the chart up there, Mr. Stam. The average rate for the base period is 6.33 percent. That does not mean they are all that amount. Some of them may be a little over, and some of them run as low as 4½ to 5 percent.

Senator MILLIKIN. What I am getting at, Mr. Stam, I am just tossing a speculative idea around in my head: Would there be a lot of horror cases of utilities earning too much in wartime if you exempt them all completely?

Mr. STAM. I think you have got to divide your utility groups. I mean you have got your electric group, and I do not think you would find too much problem there, but you might have some in these other groups. You got your railroad groups, and you got these other groups that might earn a lot more than they have been in the past, and the question is, if it gets up beyond what you might feel to be a normal return, should it be subject to the excess profits tax. I mean that is the problem that you are faced with.

See, some of these companies, quite a few of them, have not been earning very much, particularly in the base period. If because of the stimulation of the war, the rates go up beyond what you might feel to be a reasonable return, why, then there might be some question as to whether or not you would want to impose an excess profits tax on that excess. I think that is the approach that the House bill took, although the question of the rate, of course, is still a matter of consideration.

The CHAIRMAN. Is there a Treasury representative here? I am sure there is.

Please have the Treasury supply the estimated revenues under the House bill from the utilities as a whole and broken down in separate classifications.

Senator TAFT. They must have made those calculations when they figured the yield of the tax.

The CHAIRMAN. They must have figured them. Please furnish those to the committee so they may go into the record.

(The information referred to is as follows:)

Public utilities—estimated excess profits tax liabilities[1] under general rule and sec. 446 of H. R. 9827[2]

[Millions of dollars]

	Estimated tax		Decrease due to sec. 446
	Under general rule	Under sec. 446	
Transportation:			
Railroads, airlines, street railways and busses, pipelines, etc. (regulated)[3]	105.0	45.0	60.0
Other	15.0	15.0	
Total transportation	120.0	60.0	60.0
Communications:			
Telephone, telegraph, etc. (regulated)	5.0	2.5	2.5
Other	5.0	5.0	
Total communications	10.0	7.5	2.5
Other public utilities: Gas, electric, water, etc. (regulated)	65.0	25.0	40.0
Grand total:			
Regulated	175.0	72.5	102.5
Not regulated	20.0	20.0	
Total	195.0	92.5	102.5

[1] At levels of income estimated for the calendar year 1951. (The level of corporation profits in 1951 is estimated to be $40,000,000,000, Department of Commerce basis.)
[2] As passed by the House of Representatives.
[3] As defined in H. R. 9827.

Source: Office of the Secretary of the Treasury, Office of the Technical Staff, Dec. 11, 1950.

Mr. WHITING. May I proceed, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. WHITING. The witness Ramspeck read from the report of the Ways and Means Committee on this section 446, which is fresh in your minds, and I will not take time to refer to it.

Mr. Hessey referred to the statement of Secretary Snyder to the same subject. A reading of those shows that the Ways and Means Committee report and Mr. Snyder indicate that the utilities will be exempted, and thus permitted to earn what the regulatory bodies give them. But I can assure you that is not the case.

I want to take just a little time to get the record straight. If anybody wants to interrupt me at any point in the discussion, do not hesitate to do so, but I want to be just as understanding as I know how. It is a complicated situation, and I would like to make it clear if it is possible for me to do so.

Now let me say to you at the outset, and I think you have to understand this, that the utilities of this country are regulated on several different bases. The one that Commissioner Hessey referred to was present fair value. That is what they use in Maryland. There are numerous States that use present fair value, and that is a judgment figure when they get all through considering all the elements.

Other States use original cost, and original cost is defined in the Federal Power Act that adopted this uniform system of accounts as the cost of the property to the person first devoting it to public use. We in the industry have come to call that the aboriginal costs, because it takes us back to the Indians, but it goes way back to when a lot of these small companies were begun, a lot less than we could buy them for. But we did buy them, and there is always three things that happen when these large companies took over the smaller companies and paid a larger price.

My own observation has been this: They always improved the service, they reduced the rates, and they increased the wages. I think that is another good commentary on our regulation in this country.

Another one: Your own State, Senator Taft, of Ohio, uses reproduction costs new less depreciation. Some other States use that.

Senator KERR. Do you have a tabulation of the formula used in the various States?

Mr. WHITING. No. It is the Federal Power Commission report, and I will send it to the committee. Shall I send it to the clerk of the committee?

Senator KERR. I think it would be very helpful if that were in the record, Mr. Chairman.

The CHAIRMAN. All right. Please supply that to the clerk.

Mr. WHITING. We will supply that.

(The information referred to is as follows:)

TABLE B.—*Method of rate base determination generally applied, electric and gas utilities*

[Statement reflects method given greatest weight or preference as a standard for measuring fair value and is not necessarily the method universally applied]

State or Territory	Method applied	Treatment of depreciation in determining rate base
Alabama	Prudent investment	Balance in reserve deducted.
Arizona	do	
Arkansas	do	
California	Reasonable historical cost [1]	Not deducted. Sinking fund applied.[2]
Colorado	All elements considered	Balance in reserve deducted.
Connecticut		
District of Columbia	Original cost	Do.[3]
Georgia	All elements considered	
Idaho	Original cost	Straight line deducted.
Illinois		
Indiana		Deducted.[4]
Kansas	Fair value	Balance in reserve deducted.[5]
Kentucky		
Louisiana	Prudent investment	Not deducted.[6]
Maine		
Maryland	Fair value, 1923 plus net additions [7]	Increase over 1923 deducted.
Massachusetts	Prudent investment	Balance in reserve deducted.
Michigan	Original cost	Balance in reserve deducted if reasonable.
Missouri	do	Not deducted.[8]
Montana	Fair value	Straight line deducted.
Nevada	Prudent investment	Balance in reserve deducted.
New Hampshire	All elements considered	Reserve requirement deducted.
New Jersey	do	Straight line deducted.
New Mexico	Original cost adjusted [9]	Do.
New York	Original cost	Do.
North Carolina	All elements considered	Do.
North Dakota	Prudent investment [10]	Balance in reserve deducted.
Ohio	Reproduction cost [10]	Observed depreciation deducted.
Oklahoma	Original cost	Straight line deducted.
Oregon	do	Straight line deducted. Sinking fund not deducted.
Pennsylvania	Fair value	
Rhode Island		
South Carolina	Fair value	
Tennessee	Prudent investment	Balance in reserve deducted.
Texas [11]		
Utah	Prudent investment	Straight line deducted. Sinking fund not deducted.
Vermont		
Virginia	Fair value	Balance in reserve deducted.
Washington	Original cost	Straight line deducted.
West Virginia	All elements considered	Reserve requirement deducted.[12]
Wisconsin	Fair value	Straight line deducted.
Wyoming		
Hawaii	Prudent investment	Do.
Puerto Rico	do.[13]	Deducted.[4]

[1] Land at present market value.
[2] If depreciated rate base is used, prime consideration is given to the balance in the reserve.
[3] Tested by reserve requirement study.
[4] Balance in reserve or amount determined by inspection.
[5] When book value or original cost is used to determine the rate base.
[6] Treated as a trust fund with earnings deducted from allowable gross earnings.
[7] Applied in rate case decided Dec. 30, 1946.
[8] Annual charge to operation reduced by an amount determined by computing interest at 3 percent on all balances in the depreciation reserve account.
[9] Five to 10 percent is added for reproduction value.
[10] Prescribed by statute.
[11] Commission regulation of gas utilities only.
[12] Based on inspection and company's experience.
[13] Original cost or reasonable historical cost.

Mr. WHITING. Now, the Federal Power Commision sitting here in Washington fixes certain rates, and it does it on original costs, and allows rates, dependent on the case, all the way from 5½ up to 7 percent. But that original cost is reflected in the books of account, and it is reflected because the books of account have to be kept in accordance with the uniform system of accounts that was adopted by the Federal Power Commission. Most of the States have adopted the same uniform system of accounts.

So we get down in our accounting in the utility business today, in the electric utility business, where our books reflect the original cost, less a percentage of 1 percent. We have amortized it out since 1937 when this uniform system of accounts was adopted.

So let me say to you that when we talk about our books of account, do not get the idea that we have got some books that are not regulated, and do not get the idea that you have to leave it to someone else as was suggested when we were talking about the Bureau. These accounts are regulated. They are kept in accordance with the uniform system, and the Federal Power Commission uses them pretty generally in establishing its rate base to allow this rate of return.

They are also accepted by the Securities and Exchange Commission when we prepare a prospectus that goes out to the public, upon the faith and credit of which all our securities are acquired.

Now, when you look at the present bill—well, before I leave that, I want to just take time to read you a quotation by Justice Douglas in the Hope Gas case, because while you have all these different theories of rate-making, you have one concept upon which they all agree, and that is the crux of the recommendation that we make here.

I want to read it to you. This may be found at the top of page 5 of my statement, and it is quoted from 320 United States Code 590. It reads:

> The rate-making process under the act—

and he was referring to the Federal Power Act—

> i. e., the fixing of just and reasonable rates—involves a balancing of the investor and the consumer interests.
>
> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock (citing cases). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital.

Now that is the vital thing that we are concerned with in the formulation of an equitable tax as applied to utilities. We made this recommendation before the Ways and Means Committee. They adopted it as to the 6 percent, but when they came to establish the base upon which they would compute the 6 percent, that is where I think there is confusion.

I want to address myself to that for a few moments, because under the terms of this act you have to take the income tax cost of the property to arrive at that base. Now, that income tax cost was put in by the Congress for the purpose of establishing costs to be used in the event you sold the property so as to determine what your capital gain was. I want to tell you that it is not an easy thing to determine, and

that, I think, is what Commissioner Hesey meant when he said you would get into a muddle or confusion.

I have had the experience of having the determination of costs in the sale of property drag on for several years, and I will say to you frankly no one knows what it is until the Commissioners agree to it.

But there are a few things that I want to just point out briefly, and I cannot take the time to go into detail. I do not believe I am qualified to go into all the ramifications of it anyway, but I want to hit the high spots of one or two things.

For instance, there are different methods of depreciation as applied in the income tax law, and as applied in our regulatory regulations. I will say to you that so far as getting close to the depreciation as it affects values, that the regulatory regulation is more practical, and the one in the income tax law is theoretical because that is a group of straightline depreciations allowed on certain properties.

Now, another thing. In the last World War, the utilities and business were given the right to acclerate depreciation. I want to tell you, it was a port in a storm for us to build the plant that we needed. It permitted us to write the depreciation off over 60 months, or 5 years, and I think it was given to us for the precise purpose of enabling us to build the plant. But if you take this tax cost, we have got to take that all out, and all those plants that we built during the war would go out and would not be in this base. But they are in the base in the State regulation, and they are good plants, and we knew when we built them they would be good for 25 years, they were not good for only 5 years.

So, under the regulation we have depreciated them in the normal course.

Senator KERR. They were needed in the defense effort, too, were they not?

Mr. WHITING. They sure were. That is why 42.2 percent of the world production of electric energy was here.

Senator KERR. And you are going to have to provide a similar expansion now, are you not?

Mr. WHITING. I have never seen the necessity more great.

Senator KERR. Is it possible that such a provision now with reference to the expansion that is necessary before you in the months and years ahead would meet a part of the needs that you have in this matter?

Mr. WHITING. It helps, Senator Millikin. It is in the bill you adopted.

Senator KERR. I hope now you and I will understand each other. We are pretty close together here in reference to many of the things you are talking about, but you could not be further away with reference to the identity. I am sure I am highly complimented, but neither the distinguished Senator from Colorado nor I——

Mr. WHITING. I remember now; it is Senator Kerr.

Senator KERR. Yes.

Mr. WHITING. I am just naturally complimentary.

Did I answer your question?

Senator KERR. You not only did, but you identified the viewpoint.

Mr. WHITING. Thank you

Another item that goes into this tax cost is tax-free reorganization. You know when you go out to buy a small utility plant, and the people that own it want to sell it, they do not want to pay taxes on it. They

do no want to pay capital gains taxes on it. So Congress, when taxes used to be 11 percent, and we thought they really amounted to something, put in these tax-free reorganizations. That allowed the man to take securities in the new enterprise without paying the tax, and he could hold it. But under this definition, we have got to go back to the predecessor costs in all those tax-free reorganizations.

Then we have indirect costs of capital, which used to be different in our State regulations than they are under the income tax law. Of recent years, we have had a rule under our accounting that brings them pretty close together, but the sum total of those different items that I have referred to materially reduces tax cost.

Now, no one would object to that for the purpose for which it was intended, to arrive at tax cost to impose capital gains tax; but when you undertake to take that as a criteria upon which this industry shall be entitled to earn 6 percent, there may be some companies of recent organization, mostly cash, that have not gone through these different transactions that I have spoken of that might come out pretty well. But the rank and file of the utilties, electric utility companies, I believe would be materially hurt. I would be very much interested if the Treasury Department can give you a report, as the chairman has requested, that will show with any degree of accuracy what the utilities of this country will have to pay on the excess profits tax in this bill as written. I would be very curious to have included in that the Consumers Power Co., because I do not know myself.

Senator MILLIKIN. What is your solution?

Mr. WHITING. My solution is that you go back to the recommendation that we talked about before the Ways and Means Committee, and what I expect they had in mind when they wrote the report, because it reads that way. It is attached to my statement, and I am going to read it because it is pretty simple. It is:

> The adjusted equity capital for such taxable year, as defined in section 437 (b), or where regulated corporate books of account are maintained the sum of the capital stock accounts (both common capital stock and preferred capital stock) and surplus accounts (both capital surplus and earned surplus).

Then, in section 446, would be this definition:

> As used in this section, the term "regulated corporate books of account" means the books of the regulated utility when kept under a uniform system of accounts which conforms with the accounting principles contained in the Uniform System of Accounts prescribed for public utilities and licensees and for natural gas companies by the Federal Power Commission.

That, Senator, is just one department of the Government accepting the regulation and the vigilance of the other part.

It has this great advantage: It is the thing that I said a minute ago is the base for our sale of securities, that we go to our citizens with the request to put their savings in our industry. I do not see how it could be said to be prejudicial. All it does is to preserve the ability of these companies that are such an essential necessity, and a part of our defense effort.

I had in my statement a reference to the possibility of increasing the allowance for debt because of our high debt structure. That I pass over with a word, and leave with the statement.

It is simply that if the allowance that you have given for a company that has not only 12 percent debt is reasonable, then one that has got 49 perhaps ought to have more.

Then the other one that I speak of. I noticed the committee says that they have given only 85 percent of the average earnings during the base period because we are in an unusually high state of business, and it will not be retained. Well, I would like to tell you—of course, I am not a prophet, but I do not believe the business we have had in the Consumers Power Co. from 1946 to 1949 is going to recede. We have been trying to keep up with the growth in population in this country. We have added twenty-odd-thousand electric customers every year, and they are in homes, and they are not going to go off the line. My company is 39 percent residential.

So when it comes to industry, why, high labor costs have just forced mechanization so that every utility man that will come before you will tell you that ever since 1946 we have been working at the drafting board, and with engineers, to build to keep pace with this great requirement in this country. I do not believe it is going off. We have built the plants to take care of it. Other departments of the Government think we are behind the eight ball in what we are building now. We think we are coming along all right, and we will if you give us an equitable excess profits tax.

Senator TAFT. How does this amendment differ from that proposed by Mr. Hessey? You referred to the Federal Power Commission. That is only applicable to utilities, to begin with, is it not?

Mr. WHITING. Yes.

Senator TAFT. To electric utilities?

Mr. WHITING. It is applicable to electric and gas utilities.

Senator KERR. Natural gas.

Mr. WHITING. Natural gas.

Senator TAFT. And this refers to that, whereas I think his committee had a system of accounts prescribed by the State commission.

Mr. WHITING. Well, mine includes those.

The way that happened was this: The Federal Power Commission established these uniform systems of accounts. Then the association, represented by Mr. Hessey, the National Association of Railroad Utility Commissioners, collaborated with them, and they went back to the States and substantially all the States——

Senator TAFT. All the States have adopted this uniform system?

Mr. WHITING. Yes. So when I speak of one, I speak of all.

Senator TAFT. I see.

Mr. WHITING. In closing, let me say that I realize this bill was put together in a hurry. As a matter of fact, I marvel at how well it is done in the short time it took to do it. But it does seem to me there was an oversight, if I can believe the statement of the committee, in the way the bill was drawn—and I am not criticizing anybody on that, because I think it was a splendid job to do it as fast as they did it.

Another thing, I want to leave with you just a word of appreciation of the public duty that members of this committee have. We, of the industry, are sensible of that. We do not want to do anything that is going to, in any way, hamper you in doing the right job. But I do want to plead with you, in closing: If you do the right job, please be equitable to the utilities, so that we can do the job in the effort, whatever may come, of doing what you expect us to do, and which we would like to do.

Senator TAFT. Mr. Whiting, is it not also true that this change would prevent discrimination between utilities?

In other words, the rule in the present House bill would not hurt some utilities at all?

Mr. WHITING. That is right.

Senator TAFT. Others, it would put on a substantially different basis from the first group?

Mr. WHITING. I think that is a clear comment.

We, in the industry, had a great deal of discussion as to how we could formulate some criteria to make the point of inception of an excess profits tax. I, for myself, thought if we maintained the dividends that we have maintained the last 4 years, that that was vital; but the more we discussed it, the more it seemed to us that if we anchored it to the books of account as kept under a strict regulation and limited it to the historic percentage of 6, that that was about a fair solution of the problem as we could see.

I would like to say, in conclusion, that if you do that, you are still going to get some excess profit taxes from the utilities, in my judgment.

The CHAIRMAN. Thank you very much, Mr. Whiting, for your appearance and your contribution.

Mr. WHITING. Thank you.

(The prepared statements submitted by Mr. Whiting read in full, as follows:)

STATEMENT OF JUSTIN R. WHITING, PRESIDENT OF CONSUMERS POWER CO. AND CHAIRMAN OF TAX COMMITTEE OF BOARD OF DIRECTORS OF THE EDISON ELECTRIC INSTITUTE

My name is Justin R. Whiting. I reside at Jackson, Mich. I am president of Consumers Power Co., an electric and gas utility operating in Michigan. Edison Electric Institute is a trade organization representing some 80 percent of the investor-owned, taxpaying electric utilities of this country. Our original recommendations first made to your legislative experts and representatives of the Treasury and later presented to the Ways and Means Committee were joined in by the American Gas Association.

There are four fundamental facts in regard to this industry which cannot be disputed.

First, as to the importance of the industry. In money invested, these electric and gas utilities are our third largest industry being exceeded only by agriculture, first, and railroads, second. Aside from contributing to our high standard of living, they are a vital necessity to national defense.

For instance, in 1944, the peak year of our war effort, the United States was producing 50 percent more munitions than the combined axis countries and accounted by itself for nearly 45 percent of the total armament output of all the belligerent nations.

It is estimated that during the same year, the United States produced 42.2 percent of the world production of electric energy.

Since the war, during 1946–49 we have expended for new plants 9.2 billions of dollars, 5½ billions of which came from new capital sold to the public. In the next 3 years we must spend larger sums.

From an income point of view, this industry is relatively of much lesser importance because of the slow turn-over of capital and limited earnings under regulations. In the period of 1940–45, the net income after taxes of all utilities, excluding transportation and communications, was less than 4.9 percent of such net income of all corporations. The level of utility earnings declined, while the earnings of other corporations increased as shown on chart 2. This demonstrates that 85 percent of base period earnings is inequitable as applied to utilities.

Our mass production in this country is essential. It is dependent on electric power. If an inequitable tax so far as these companies are concerned is adopted

and their earnings depleted then their ability to finance at reasonable cost would be lost and their essential construction severely hampered. This would be tragic. We must keep these companies able to perform their necessary part in the national defense.

Second, the electric utility industry differs from manufacturing industries in general by the fact that it has long-term debt of nearly 50 percent of its capital, whereas manufacturing industry has a debt of only 12 percent. This is shown graphically on chart 3. The result is that the treatment of debt capital which may be equitable for manufacturing industry, is not equitable for utility companies.

Third, the price of electricity has gone down from 1939, whereas the price of practically everything else has gone up, in some cases over 200 percent. This is graphically shown on chart 4

Fourth, the electric utility industry is a regulated industry not making any abnormal or excess earnings and it never will owing to the vigilance of the State and Federal regulatory commissions. This is shown graphically on chart 1, showing that in the base period of 1946–49 the average earnings were only 6.3 percent of invested capital as shown by the books of account. This does not mean 6.3 percent on a tax cost basis of assets. It is 6.3 percent on all capital represented by indebtedness, capital stock and surplus, all as shown on the corporate books of account kept in accordance wtih the uniform system of accounts established by the Federal Power Commission, and numerous State authorities and recognized by the SEC in the sale of securities.

We do not ask the right to make or retain any excess or abnormal profits. We ask that we be allowed to keep enough earnings to preserve our credit and enable us to raise the necessary new capital, if possible, by common stock. Everyone familiar with the investment market knows that this industry pays out about 75 percent of its earnings in dividends. This established practice is vital for the sale of our securities. Any decrease in earnings which would affect our ability to pay the conservative dividends we have maintained since World War II and the repeal of the last excess profits tax, would be a deadly blow to our credit.

Many witnesses testified to all this before the Ways and Means Committee. The committee decided to include a special provision for regulated utilities that specified the 6 percent rate which we had requested. However, section 446 of H. R. 9827, as written, does not accomplish what the committee evidently intended by their report on the bill.

The following quotation is from page 26 of the report.

"The effect of this minimum credit for certain public utilities is to give assurance that an excess profits tax will not be imposed until after the regulated industries earn a rate of return of 5 percent or 6 percent after paying corporate normal taxes and surtaxes. Your committee believes that this is appropriate in view of the fact that the profits of these industries in the base period years were held down well below the profits earned by unregulated industries. Moreover, there is considerable evidence that rate adjustments for these industries lagged considerably behind increases in their costs of doing business. Your committee also believes that where industries are regulated by other governmental bodies providing only a fair rate of return, it is undesirable to consider profits allowed by such regulated bodies as excessive for purposes of an excess profits tax. The 5 and 6 percent rates of return provided for in this minimum credit will be approximately the average rates of return customarily allowed for the regulated industries in question."

Secretary Snyder labors under the same misapprehension, as to the effect of the bill as written, because he said to you at page 6 of his written statement as follows:

"This bill would allow public utilities regulated by State authorities an alternative credit. It would permit them to receive (before the application of any profits tax) a net return after income taxes of 6 percent of their total investment, including capital stock, reinvested earnings and borrowed capital. In the case of utilities subject to Federal regulation, notably railroads and other interstate carriers, the corresponding tax-free return is set at 5 percent."

Let's get the record straight. This section 446 as written will not preserve to utilities the normal earnings granted them by regulatory authorities because it provides for 6 percent on adjusted tax cost of assets instead of 6 percent of the total outstanding borrowed capital, capital stock and surplus as reflected on the corporation books of account. With many companies this tax base is substantially less than the capital account.

A brief explanation will clarify our special problem. State and Federal agencies use numerous different bases on which they allow a rate of return in fixing reasonable rates. Some use "present fair value" others "original cost" (which means the cost of the person first devoting the property to public use); some use "reproduction cost new less depreciation," others "prudent investment" and the Federal Power Commission uses "original cost." No regulatory authorities that I can find have ever used income tax cost upon which to establish a reasonable utility rate. The rates of return vary all the way from 5½ percent up to 7 percent dependent in a large degree on the method used in arriving at the base. Naturally, if present fair value is used as the base, the rate of return applied is not as great as when original cost is used. The Federal Power Commission has applied a return on original cost of 5½, 6, and 6½ percent dependent upon the facts of the case. Taking an over-all view of this rate-making procedure, there is one concept upon which all authorities agree whatever process they may use in arriving at the end result. This concept is well expressed by Mr. Justice Douglas in the case of *Federal Power Commission* v. *Hope Natural Gas Company* (320 U. S. 590). Wherein at page 603 he says:

"The rate-making process under the act, i. e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests.

"From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock (citing cases). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital. * * *"

The adjusted tax cost of assets in many instances results in quite a different figure. This difference is caused principally by (*a*) different methods of figuring depreciation; (*b*) the remedial accelerated depreciation given corporations during World War II concerning facilities for national defense; (*c*) the treatment of tax-free reorganizations, particularly those under supplement R, which was a provision designed to facilitate the integration and reorganization of holding-company systems; (*d*) the different theories as to the treatment of certain indirect construction costs, etc. All of these items have to be adjusted in order to arrive at a tax cost that is proper for the purpose for which it was intended, viz, arriving at the capital gain in case of the sale of the property. No one ever intended that this tax cost should be a proper rate base upon which a utility should be entitled to make fair rate of return, nor should be used in a prospectus for use in the sale of securities. Our investors buy and sell our securities relying on our property and earnings shown on our regulated books of account.

After mature consideration the electric and gas industries decided to recommend the formula of 6 percent on the outstanding borrowed capital, capital stock, and surplus as reflected on their regulated books of account as the best and simplest formula of obtaining the desired result, which was simply to preserve enough earnings to maintain the credit of the industry. If you look at chart 1, you will see that the average earnings of electric utilities during the years 1946–49 was 6.3 percent of the book capital. Consequently, we thought that 6 percent of the book capital was the absolute minimum which was necessary to maintain our credit. Many people in the industry thought it should be greater because they are being allowed a greater percent. The telephone industry have asked for 7½ percent. The 6 percent, in my judgment, is a minimum figure for the electric and gas industries. I have attached to my statement two brief amendments to section 446 which, in my judgment, would make the law conform to what the majority of the Ways and Means Committee said it meant as well as what Secretary Snyder said it means.

Now, gentlemen, what we desire is a result, and we do not care particularly about the method. We only want to keep the necessary earnings in order to preserve our credit and enable the electric utilities to perform their function in the war economy. This can be accomplished by the method I have already pointed out. Some relief might be made by a special provision relating to regulated utilities in:

(A) The "average-earnings method," by allowing 100 percent instead of 85 percent of the base-period earnings as provided in section 435 (a) (1) (A) of the House bill.

The reason given by the committee at page 5 of their report for reducing these earnings to 85 percent is that the period 1946 to 1949 is referred to as: "of

unusual business prosperity which to a substantial degree was built on the deferred demands, the accumulated savings of World War II, and large postwar defense expenditures. Since this unprecedented level of business activity could hardly have been expected to continue permanently, the use of the income of the years 1946 through 1949, without adjustment, would produce a general overstatement of the taxpayers' earning capacity in the absence of hostilities in Korea or a large program of military expenditures. For this reason your committee believes that a 15-percent cut-back in average base-period income is a moderate adjustment."

This, I submit, does not apply to the electric utilities. 39 percent of my company's business is in the domestic classification namely to householders. We have been taking on twenty-odd-thousand electric customers each year during this period in order to keep pace with our increase in population. Large expenditures in electric facilities and generating units have been required notwithstanding Korea. Other departments of Government have been concerned with our keeping abreast with the tremendous growth in the country. Labor costs have forced mechanization of industry. We do not look upon the business of 1946 to 1949 of a level that will not be maintained. We believe it is normal and we should not expect it to decline. We may be called upon to do more in the years that lie immediately ahead but, in my judgment, we will not recede from the 1946–49 level. This it seems to me will clearly justify an amendment of this provision authorizing 100 percent of the earning of the base period.

(B) The "Invested capital method" by allowing a larger credit for debt. If corporations generally which have only 12 percent of long-term debt are entitled to a capital credit equal to one-third of the interest on borrowed capital not to exceed an amount equal to 3 percent of average borrowed capital then an industry that has 50 percent of its capital in borrowed debt, appears to be entitled to a higher credit.

I wish to file with the clerk for printing in the record the statements of Mr. Harold Quinton, executive vice president of the Southern California Edison Co. and of Mr. Adrian M. Massie, executive vice president of the New York Trust Co.

(The statements referred to above follow this statement.)

In closing, may I say that I appreciate the great burden that is cast on the members of this committee to do a public service at this time. We do not want to be understood as in any way hindering this committee or the Congress in doing a good job in the present circumstances. By the same token may I plead with you to give the electric utilities equitable treatment so that in any eventuality we may do all that is expected of us and that we are so anxious to do.

PROPOSED AMENDMENTS

"(A) The adjust equity capital for such taxable year (as defined in section 437 (b), *or where regulated corporate books of account are maintained the sum of the capital stock accounts (both common capital stock and preferred capital stock) and surplus accounts (both capital surplus and earned surplus)*, and

(Italic portion is amendment proposed to section 446 (b) (2) (A) of H. R. 9827.)

New subsection to section 446:

"(e) As used in this section the term "regulated corporate books of account" means the books of the regulated utility when kept under a uniform system of accounts which conforms with the accounting principles contained in the uniform system of accounts prescribed for public utilities and licensees and for Natural Gas Co. by the Federal Power Commission.

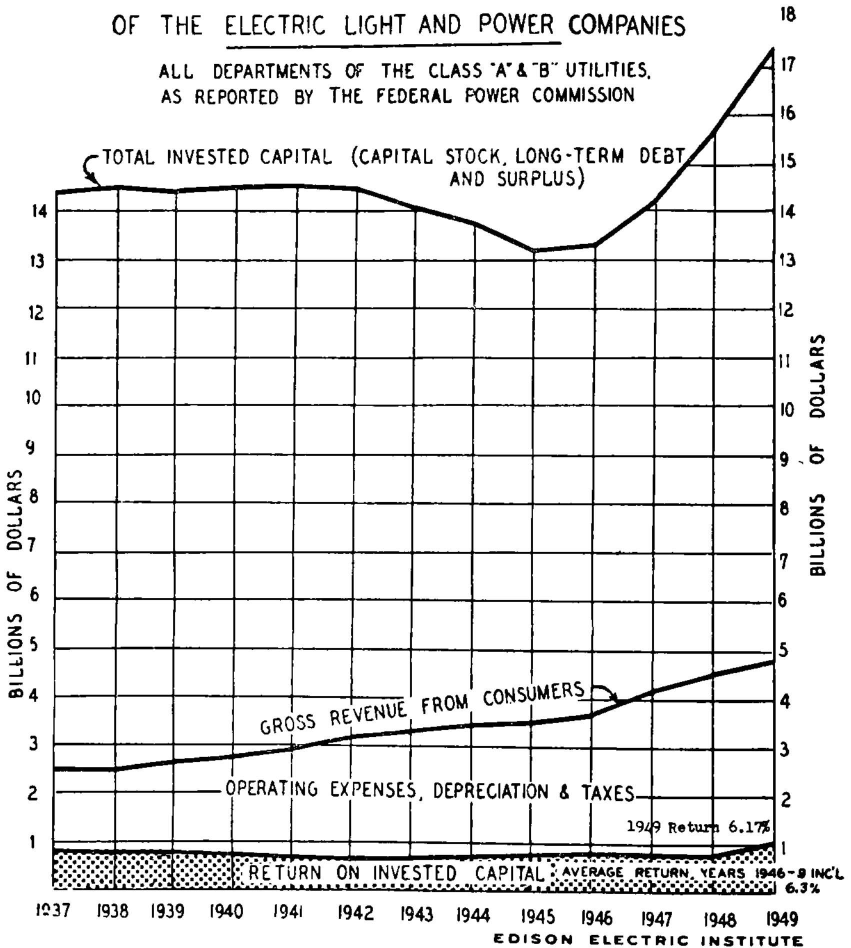


CHART I
REVENUE FROM CONSUMERS
AND RETURN ON INVESTED CAPITAL,
OF THE ELECTRIC LIGHT AND POWER COMPANIES
ALL DEPARTMENTS OF THE CLASS "A" & "B" UTILITIES,
AS REPORTED BY THE FEDERAL POWER COMMISSION
TOTAL INVESTED CAPITAL (CAPITAL STOCK, LONG-TERM DEBT AND SURPLUS)
GROSS REVENUE FROM CONSUMERS
OPERATING EXPENSES, DEPRECIATION & TAXES
1949 Return 6.17%
RETURN ON INVESTED CAPITAL
AVERAGE RETURN, YEARS 1946-9 INC'L 6.3%
BILLIONS OF DOLLARS
BILLIONS OF DOLLARS
1 2 3 4 5 6 7 8 9 10 11 12 13 14
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18
1937 1938 1939 1940 1941 1942 1943 1944 1945 1946 1947 1948 1949
EDISON ELECTRIC INSTITUTE

CHART II

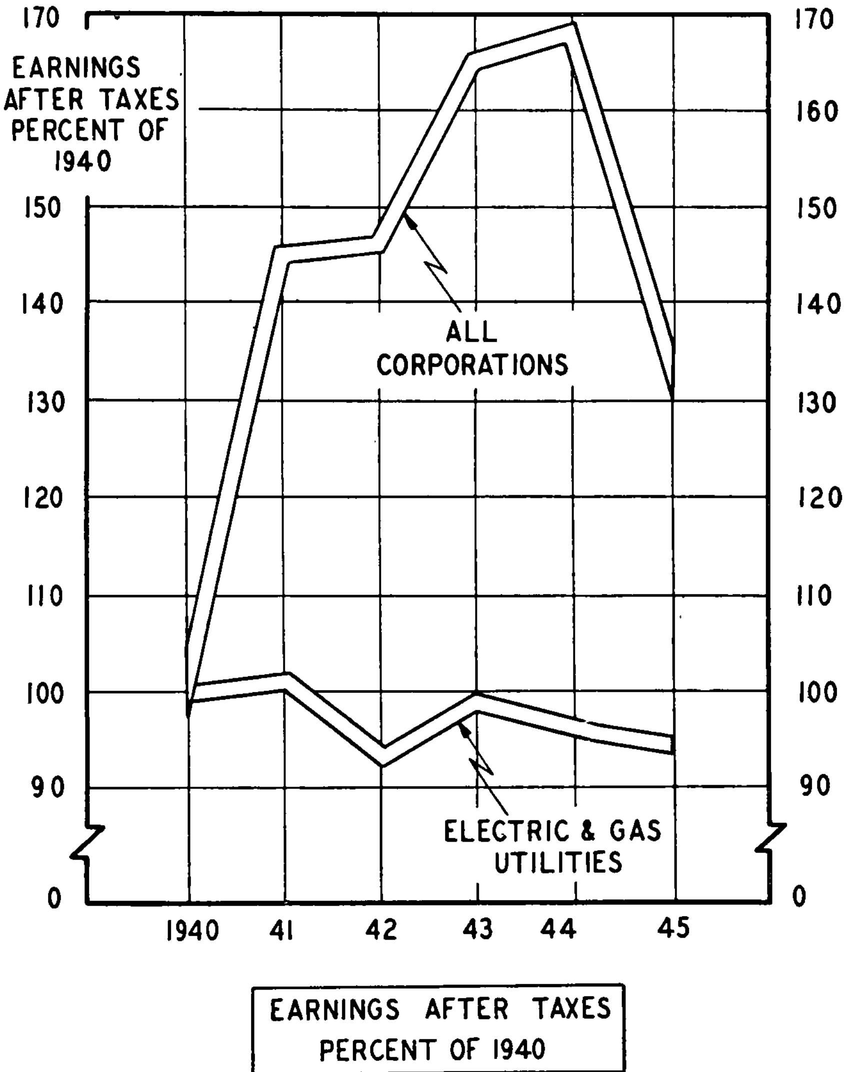


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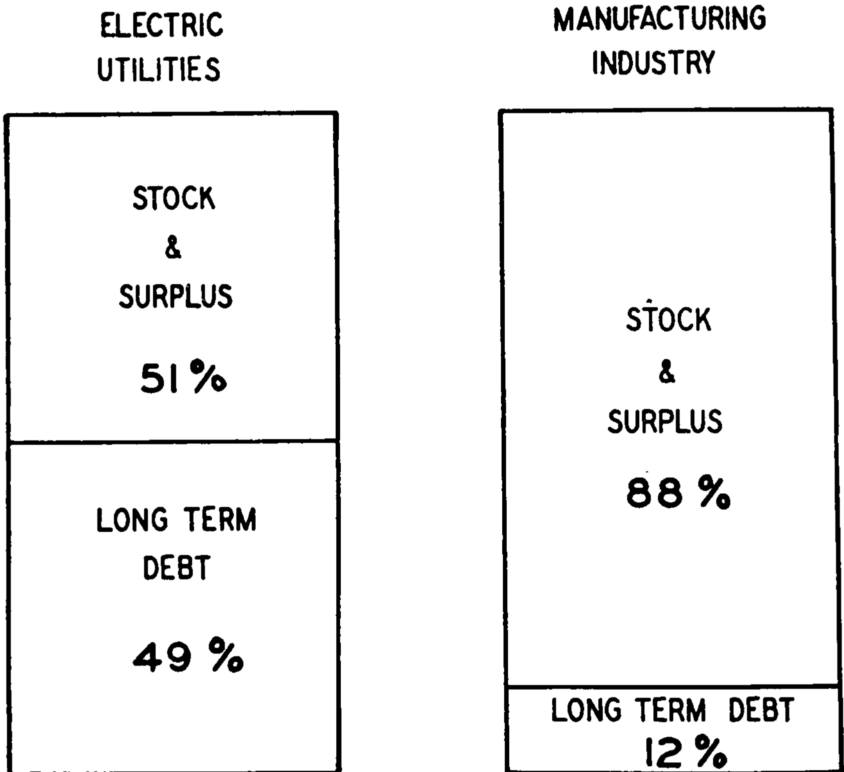
CHART III

PENALTIES FOR DEBT DISCRIMINATE AGAINST UTILITIES

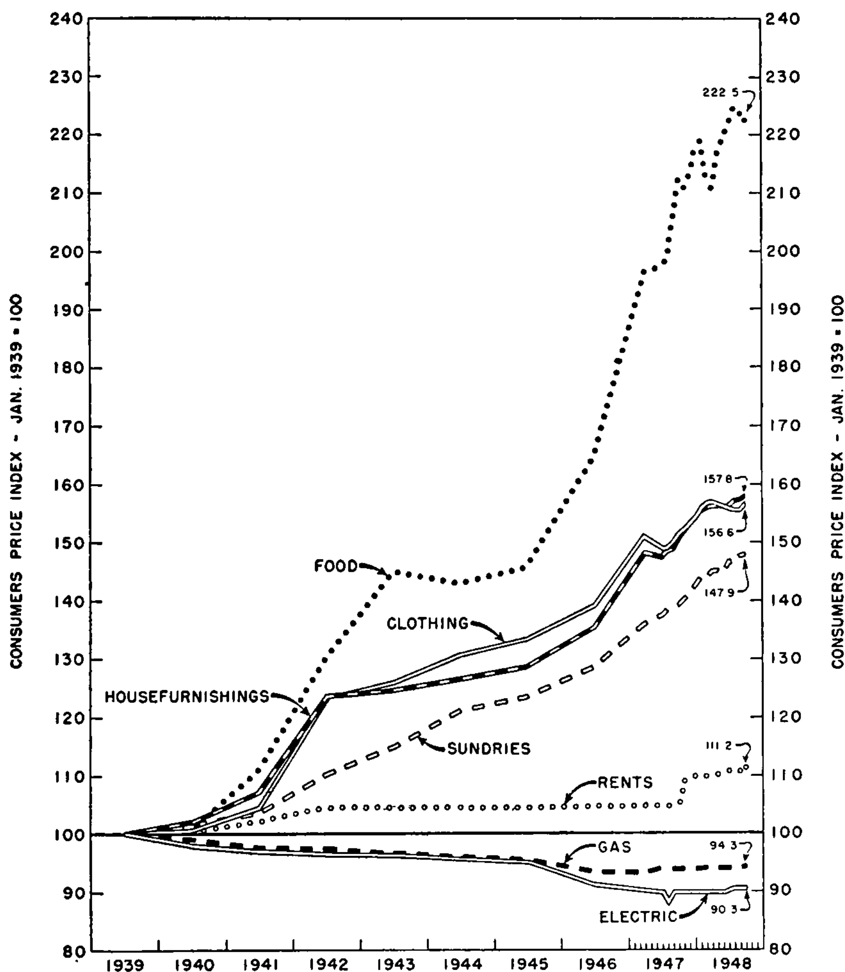


CAPITALIZATION RATIOS

ELECTRIC UTILITIES VS MANUFACTURING

CHART IV

UPWARD TREND IN THE MAJOR COST-OF-LIVING ITEMS VS GAS AND ELECTRICITY



STATEMENT BY HAROLD QUINTON, EXECUTIVE VICE PRESIDENT, SOUTHERN CALIFORNIA EDISON CO., ON BEHALF OF THE REGULATED PRIVATE ELECTRIC UTILITIES

Gentlemen, we are here today seeking some special provisions for regulated industries in any excess profits tax law that may be enacted. We seek this in the interests of avoiding serious injury to and discrimination against our regulated private electric companies.

Two points cover the basic and fundamental public policies, public duties, and financial and physical conditions under which we operate.

First, our net income is regulated by Federal, State, or local regulatory commissions. This has been said before but what does it mean? It means that the index of electric and gas utility rates has been held to 97 percent of 1935–39 levels while costs of living and all other significant indexes have climbed to levels of 165 to 246 percent of the levels of 1935–39. It means that we have not contributed to inflation. Quite the contrary. Our material and labor costs have risen with all other price indexes; but unlike unregulated industry, we have not followed these operating cost increases with increases for our services. That is what regulation means.

An erroneous impression prevails that the utilities have substantially increased their rate of profits in recent years. In our two industries alone, the gas and electric industries, we have constructed in 1946–49 more than 9.2 billion dollars of new plant. We would indeed be in a sorry condition if we had not earned any profits on that new plant, and therefore our total dollars of profits must, of course, be greater. Our electric industry reported a total of approximately $887,000,000 in earnings in the year 1945, with a total average capital investment of $13,545,000,000, or a return of 6.55 percent. At the end of 1949 we had combined earnings in our industry of $1,021,750,000, but a total average investment in the industry of $16,550,000,000, and our return had declined to 6.17 percent. That is what regulation means. Stated in another way, under regulation, we have earned only 4.48 percent on the billions of dollars of new capital which we put in our business since 1945. I know of no unregulated industry that can point to any such record. Were those regulated earnings of 6.17 percent and 4.48 percent normal, or subnormal, or excessive?

Now, our second point: The utilities require a much larger amount of plant and properties and, therefore, a much larger amount of capital investment in their business in relation to their gross sales or gross revenue than most unregulated industries.

All manufacturing industries had a plant investment of $67,000,000,000 in 1949 and reported sales of $155,000,000,000, or sales of 2.3 times plant investment. Now, by contrast with such sales of many times plant investment, the electric and gas utilities have plant investment of three to five times their sales. The interest and dividends paid for the use of capital funds for the construction of such enormous amounts of plant is therefore, also, many times greater in relation to sales than in other industries. Such costs of money represent approximately 15 percent of the selling price of our commodity to our consumers. By contrast, the cost of money is less than 3 percent of the selling price of the products of all manufacturing industries.

Such abnormal amount of plant investment, involving such a high proportion of the total cost of service to the consumer, is the most unique physical feature of the electric and gas utility business.

From these two basic and fundamental circumstances, first, regulation, and second, abnormality of capital, all of our other unique characteristics and problems evolve.

Third, it is estimated that an additional 9½ billion dollars will be spent for new construction in the three years 1950, 1951, and 1952 by the electric and gas industries. The utilities must be constantly in the market seeking new capital money. By contrast, other industries may require new capital only a few times in the life of the enterprise.

Fourth, the electric, gas, and water utilities sold 58.6 percent of the total securities issued by all industry for new money in the fiscal year ended June 30, 1949. They accounted for approximately 18 percent of the total expenditures for new plant and equipment of all industry. The higher ratio of securities sold by the utilities compared with the ratio of expenditures by the utilities, is accounted for by the fact that unregulated industry can accumulate, through its higher profits returns, a much greater part of their construction requirements than the regulated industries are permitted to do.

In this respect the Maryland Public Service Commission has said:

"The amount that public utilities are allowed to earn is limited to a fair return. They are not permitted to make a charge which will produce a greater return. They have no method of recoupment when earnings under existing rates amount to less than a fair return. They cannot amass out of earnings capital with which to make large expenditures for plant additions. That must come from places other than earnings and cannot be secured when the rate of return is insufficient to attract capital."

Our earnings are now normal and regulated industries are in no position to pay any additional tax, whether it be an excess profits tax or any other kind of tax unless it can be passed along to the consumer. Actually, the increase in normal and surtax rates from 38 to 45 percent has already nullified some rate increases.

Fifth, it is reported that Secretary Snyder, in his appearance before your committee on November 15, stated that the President, in proposing his $4,000,000,000 excess profits tax levy, had three objectives, and I quote from a newspaper report: "First, to contribute to meeting the increased cost of defense; second, to help check inflationary pressures and enable the Government to maintain a strong financial position; and, third, to tax the high profits resulting from the defense program."

On the first point, we are already making a relatively greater contribution to meeting the increased cost of defense than unregulated industry. Our Federal taxes on income are 7½ percent of our total sales, compared with Federal income taxes of 3⅛ percent of total sales of all industry. We are, and have been for a long time, contributing a relatively greater portion to the increased cost of defense, and to all other Federal governmental costs, than other industries.

The President's second objective is to help check inflationary pressures and enable the Government to maintain a strong financial position. There would be no inflation in this country today if all other industries and labor had maintained the price levels that we have maintained.

And the President's reported third objective is to tax the high profits resulting from the defense program. We have shown here that we not only have not increased our profits during the years 1946 to 1949, but we have actually experienced a decline in profits. Secretary Snyder's suggestions would effect reductions on the average of 25 percent in the earnings available for common stock on many companies and seriously affect dividends on common stock.

We have made, and are making, a relatively higher contribution to the financial requirements of our armament programs than other industries. We have certainly not contributed to inflation, and we certainly are not realizing high profits from the defense program or any other source. Accordingly, insofar as these three objectives of the President are concerned, we have met them. And any discriminating excess profits tax against our industry could only serve to defeat them.

Representatives of the regulated electric and gas utility industries have prepared some recommendations for the consideration of this committee and the Congress which would relieve in part the discriminating effect of an excess profits tax law against these industries, and which reflect and take cognizance of their unique characteristics resulting from regulation, and resulting from their extremely high capital investment in relation to sales. These recommendations are designed to conform the orthodox statutory average earnings method and the orthodox invested capital method of computing the excess profits tax to these unique characteristics. They are seven in number. In the interests of time I will discuss here only the first and seventh points.

Recommendation 1

1. Under any method of determining excess profits net income, deduction should be allowed for normal tax and surtax in ascertaining excess profits net income.

The normal income which the utilities are permitted to earn under regulation is the final figure after the deduction of operating expenses, including the corporation's normal and surtaxes. If such result is, say, a 6½-percent return, or $65,000 on a capital investment of $1,000,000, and the normal and surtaxes are not then allowed as a deduction in arriving at the excess profits tax net income, then a tax will be computed on such $65,000 plus the normal and surtax and the return on the company's $1,000,000 of capital will inevitably be reduced below 6½ percent. This is equally true if the starting rate of return is only 6 percent. It is impossible, in the case of a regulated utility whose net income is determined under regulation after deduction of the normal and surtaxes—it is im-

possible to avoid classification of some of its normal profits as excess profits if the normal taxes and surtaxes are not deducted in determining the excess profits net income.

Recommendation 7

7. In the case of public utilities, the excess profits credit for any taxable year shall be not less than the aggregate of the normal tax and surtax plus an amount not less than 6 percent of the total of outstanding borrowed capital, capital stock, and surplus, as reflected on the corporate books of accounts, averaged for the beginning and end of the taxable year, with a corresponding adjustment to excess profits net income for interest on borrowed capital.

Our seventh point is designed to fix a ceiling on the excess profits taxes which will nevertheless be incurred by many of our companies in spite of the relief that would result from enactment of the preceding six recommendations. As a further effort to meet this condition, our seventh simple provision was designed and is recommended to fix a point of earnings below which excess profits taxes will not be incurred. We ask in that provision that we be permitted to earn, after all of our charges and expenses, including the normal tax and surtax—that we be permitted to earn not less than 6 percent on our total outstanding capital stock, borrowed capital, and surplus, as reflected on our books of accounts, average for the beginning and end of the year with, of course, a corresponding adjustment to excess profits tax net income for interest on borrowed capital, and for normal tax and surtax. We believe that a fair and decent and reasonable rate of return on our capital actually invested in our business, should be 7 percent and that such percentage should be the point below which we would not be subjected to any excess profits tax.

It will be noted that we use the term "capital actually invested in our business," and we mean capital stock, borrowed capital, and surplus as reflected in our books, not the statutory definition of "invested capital." Such capital actually invested in our business is the basis of determination of our regulated net income, and such regulated net income is the basis of our whole financial policy, financial structure, and financial expansion. We have recognized in our points 1 to 6 the propriety of the use of the orthodox statutory concept of invested capital as a method of calculation of an excess profits tax where it does not nullify these basic circumstances of our business. But here in point 7 we submit for your consideration the proposition that, notwithstanding technical Treasury concepts, if the result of their application is to reach into and tax away regulated normal profits at excess profits tax rates, then there should, and must, be some proviso such as our No. 7 here proposed which will limit the degree of the injury and the degree of discrimination which results from such technical concepts. The fact remains that we must stay in business; we must perform our construction programs, and they must not be stopped by words and terms, however fixed such words or terms may have become in our taxing statutes of the past. It is the discrimination of the past which we are here trying to overcome.

Our case, gentlemen, is just that simple. The substance of our first six recommendations, and of the ceiling provision on excess profits taxes which is contained in our seventh recommendation, is that we may be allowed to earn only a fair, decent, reasonable, and necessary return on the capital actually invested in our industries.

We thank you for this opportunity to appear before you and stand ready to supply any supporting material or other data bearing on our industries which you may desire in your considerations.

Statement of Adrian M. Massie

My name is Adrian M. Massie. I am executive vice president of the New York Trust Co., 100 Broadway, New York City. For 30 years I have been engaged in the investment of trust funds.

As a trustee of Columbia University I am a member of the investment advisory committee which handles the endowment fund. I am on the investment committees of seven insurance companies.

Increased low-cost production is the most pressing need in the country today, to meet the requirements of our defense program and to offset the effects of the monetary inflation which exists.

The nature of our mass-production machine methods requires the availability of huge quantities of low-cost electricity and gas at proper locations.

The electric and gas industry, recognizing the vital role it plays in activating all industry, has planned and is executing a huge expansion program.

To finance this expansion, the industry must attract large amounts of additional capital—much more so in relation to the volume of business than any other industry—namely, three to five dollars of capital for every dollar of gross business.

Capital investment in the industry has accelerated in recent years. The regulated electric power business is now spending for new facilities about $3,000,000,000 a year. This is nearly six times the prewar rate and is nearly twice as much per year as was spent in all the war years 1942–45 together.

To assure the success of this huge volume of financing, the regulatory bodies have recently found it necessary to increase rates for the first time in many years. It was recognized by these bodies that the attraction of new capital in a competitive market requires an adequate amount of earnings. They knew that the investor required and was entitled to receive a fair rate of return on the capital used in the enterprise.

For 1949 the industry rate of return was 6.17 and is running at about the same rate for 1950.

On the equity portion of the capital used in the enterprises, the rate of return for 1949 was about 8.6 percent.

The industry has a far greater proportion of debt than any other industry and a very considerable amount of preferred stock, thus effecting a high pyramid on a small common-stock equity position.

This common-stock equity position, representing the base on which the entire industry rests, is so important and is so vulnerable to the effects of taxation that a few facts must be recorded for clarification. I will use the figures for the electric utility industry, but the facts show the argument is equally valid for the gas industry.

The privately owned electric utility companies had a common-stock equity position at the end of 1949 made up as follows:

Common stock	$4, 623, 000, 000
Premium	239, 000, 000
Capital surplus	355, 000, 000
Earned surplus	1, 197, 000, 000
Total	6, 414, 000, 000

The earnings after all costs, interest on the debt, and preferred dividends amount to $653,775,000. Out of this sum $449,453,000 was paid out in common dividends and the balance of $204,322,000 was retained in the business.

These were the earnings which the regulatory bodies allowed in order to maintain the credit of the companies involved.

I submit that this common equity capital of $6,414,000,000 and the applicable earnings of $653,775,000 are the keystone of the expansion not only of the electric utilities but also of all industry which cannot expand without more electric energy.

In levying an excess profits tax, the Congress expects to obtain substantial revenue but to leave unaffected the incentive and ability to expand.

It is obvious that if the entire earnings available for common stock were siphoned off by the tax the industry would collapse.

It is equally obvious that if the sum siphoned off was equal to the amount retained in the business, namely $204,322,000, dividends would have to be cut immediately and the prices of the securities would drop. It would be impossible to finance the required expansion.

This paucity of earning power available for additional taxes is due to the fact that we are dealing with a regulated industry where the regulatory bodies have already taken action to provide a reasonable rate of return but with no excessive earnings.

This is a situation which from a financial standpoint is both marginal and sensitive. In an industry with 50 percent of its capitalization in debt, with debt still expanding, with the earnings available for common stock just enough to support that equity and maintain the credit of the industry, such earnings are marginal not only to the industry itself but to all industry.

Any invasion of these equity earnings by any form of taxes which cannot be passed on through increased rates will in my judgment have far-reaching adverse effects completely out of all proportion to the amount of the revenue received.

The CHAIRMAN. Mr. D. A. Hulcy. Mr. Hulcy, you may be seated and identify yourself, please, for the record.

STATEMENT OF D. A. HULCY, PRESIDENT, LONE STAR GAS CO., DALLAS, TEX.

Mr. HULCY. My name is D. A. Hulcy. I live at Dallas, Tex. I am president of the Lone Star Gas Co., a natural-gas company operating in northern Texas and in southern Oklahoma.

We operate in excess of 6,000 miles of main transmission lines and serve some 550,000 customers in that area.

I am also president of the American Gas Association, which is the trade association for the American gas industry, including among its members gas utility companies serving more than 90 percent of the gas customers of the country. Also included in our membership is the manufacturers of gas equipment and appliances, and other persons that are interested in the industry.

Now, Mr. Chairman, it will not be my purpose to make a technical discussion of the bill passed by the House but to give some general information, and also to call your attention to the fact that I have filed with the committee a report covering these matters. But if I can just highlight some of that, perhaps I can save the time of the committee. I have prepared some charts in large form here which I think may give the members a little bit better understanding of what I am trying to talk about than perhaps if I were to say it myself.

The CHAIRMAN. Would you like the extended brief put in the record?

Mr. HULCY. Yes; I would.

The CHAIRMAN. Furnish that to the reporter, please.

Mr. HULCY. Thank you, sir.

I would like to call your attention to the fact that the American gas industry, with its 175,000 employees, serves 22,000,000 homes and 2,000,000 factories and commercial establishments through a system of pipelines that exceeds in mileage the railroad trunk-line mileage of the country. The truth of the matter is our pipelines are in excess of 364,000 miles.

The gas industry is important to many people. A high percentage of the entire population is dependent to a greater or a lesser degree on this industry.

I would like to make clear in the beginning that the gas industry is willing and anxious to do its part in the defense effort of our country. We realize the needs and certainly we do not want to be short in that.

Now the so-called excess profits type of a tax, from the discussion you heard this morning with reference to public-utility companies, I think that it does discriminate against them unless the characteristics of the utility business—and I speak particularly now of the gas industry—unless those are taken into account, that we do have basic differences between our industry and other types of business.

First I would like to have chart No. 1, which shows that a strong gas industry is vital to the defense and the well-being of our people.

The gas industry has always played an important part in all of the affairs and the economy of our country. The total heat energy supplied from natural resources in the United States, as shown on chart 1, shows that in 1939 natural gas furnished 11.7 percent. In

1949 that has increased to 19.4 percent, and at the present time natural gas is furnishing more than 20 percent of the entire requirements. During this 10-year period the heat energy supplied by natural gas has increased 130 percent. So I think that it does show that we are playing an important part in the over-all economy of the country.

Also on chart 1 we show that dwelling units have increased 24 percent and that residential customers served by the gas industry have increased 34 percent, or at a greater rate.

Also chart 2 will show that the industrial gas sales are in keeping with the Federal Reserve Board Index of Industrial Production.

Now it will be noticed that immediately after the war we were below the index. Well, that was caused by our inability to secure materials in order to expand our facilities. But our facilities have now been expanded, and it will be shown that the deliveries of industrial gas are in keeping with the index referred to above.

Now one of the principal problems that we have in the gas industry is that we must attract large amounts of capital. We are now in the midst of the greatest expansion and development period in the whole history of the industry. There is a really big job ahead of us to keep up with the demand for service. The requirement is for capital and for more capital. Of course it goes without saying that if we are going to attract this capital we must have earnings to support it.

Now chart No. 3 shows the growth picture of the gas industry, that the total assets of our industry in 1945, at the end of the war, were 5.7 billions of dollars. At December 1, this year, or at the present time, they have increased to 8.7 billions of dollars, and it is estimated from a survey that at December 31, 1954, they will have increased to 10.2 billions of dollars, or in this 10-year period since the end of the war that we will almost have doubled the total assets. So that does show, I think, clearly the great need that we have had to attract new capital.

I know just with reference to our own company, which, as I said, operates in Texas and in southern Oklahoma, when the war was over our total debt was $8,375,000. That was only about 20 percent of our total capital structure. Today our debt is $85,000,000, and the ratio of debt to the total capital structure is about 51 percent. That shows the great requirement that has come about through the growth in our part of the country and that we have made every effort to do it.

The CHAIRMAN. What was the ratio at the end of the war?

Mr. HULCY. About 20 percent.

The CHAIRMAN. Now it has gone up to 51?

Mr. HULCY. Yes, sir. In other words, the total debt has increased from $8,375,00 to $85,000,000.

Senator MILLIKIN. Have you testified as to what you are paying on your securities?

Mr. HULCY. On what, Senator?

Senator MILLIKIN. On the securities. Have you testified as to that?

Mr. HULCY. The interest rate. No, sir; I have not.

Senator MILLIKIN. Are you coming to that?

Mr. HULCY. I am not, but I will be very happy to mention that, sir. The weighted rate, that, is a combination of installment bank loan

notes and of private borrowings from a major insurance company—it is 25-year money. It was just concluded in June of this last year. The rate to the banks, with maturities beginning in the third year and going through the tenth year, was 2.5 percent, and the payments for the loan to the insurance company, the maturity starting in the eleventh year and going through the twenty-fifth year, was 3 percent. The weighted rate, I believe, was about 2.91.

Senator MILLIKAN. What do you pay on your equity?

Mr. HULCY. On our equities we are paying at the present time a dividend of $1.20 a share.

Senator MILLIKIN. What is it selling for a share?

Mr. HULCY. Shares are selling now—they are down a few points the last few days, but in round figures, Senator, it has been about $25. So we have just been selling slightly under 5-percent basis. We have not issued any equities because our ratio of equities had always been high. So now in round figures it is about 51 percent of debt and 49 of equities.

Now I would like to call your attention to the fact that the gas industry investment pattern does differ from that of industry in general. As shown on chart No. 4, it requires an investment of right at $4 for every dollar of annual gross revenue, whereas for many industries, like the retail business, or the wholesale business, you will find those ranging anywhere from 29 cents per dollar of investment on up, and I think with the public utility business generally in the higher brackets.

Also the debt characteristics for our industry naturally have to be a little high. I think, as shown on chart No. 5—I believe that shows that our industry does require large amounts of capital. As I said, necessarily the percentage of debt will be relatively high.

Now we just have no choice about this matter because if we are going to meet the needs and the requirements not only for defense but for the industrial growth of our country, we are going to have to provide money in relatively large sums. This chart does show, compared with other industries, that our debt ratio is about 51 percent compared with others.

Then, too, I think it should be called to your attention that there is a lot of people, of course, a large segment of the entire population, that has a stake in the soundness of the utility industry. I made the statement a little earlier that we served about 22,000,000 residential customers. Now on the ratio of the population to customers that would mean that we are serving approximately 100,000,000 out of the 150,000,000 people of this country. So they have a very definite stake in the type of service that we are able to render.

Then there are the different financial institutions that have an interest in the investment and hold securities of the industry, and as shown on chart No. 6, the life-insurance companies have some 25 percent of their total security holding made up of utility securities. Now that is exclusive of railroads.

After taking the Governments out, it means that about 50 percent of their total securities owned are securities of the utility companies.

Senator CONNALLY. Mr. Chairman, I have just had an emergency call to the floor, and I apologize but I will have to leave. I want to apologize to Mr. Hulcy.

Mr. HULCY. It is all right, Senator.

Senator CONNALLY. I am interested in his testimony. Mr. Hulcy is well known to me as an outstanding citizen down there, and I am sure the committee will give heed to his suggestions and his testimony.

I apologize, sir. I have to go; but you heard the bell ring there, and they are calling me to the floor.

Mr. HULCY. I know just how that is, Senator. And I thank you for the kind words you were good enough to say. I appreciate it. Thank you, Senator.

The gas industry earnings, as has been pointed out by other witnesses here, are regulated by public authority. I think it goes without saying that the regulation has been effective.

I was interested in the exhibit sponsored by Secretary Snyder before the Ways and Means Committee, and particularly in connection with the charts which he submitted, showing that corporation earnings, that is, that the rate they were going in the second or third quarter, I believe, was some $37,000,000,000 before taxes. He did give information on the rates of return being earned on the net worth of different industries both before and after taxes. For industrials generally I think it was shown to be before taxes some 19 percent on the net worth and after taxes some 13 percent. I think by referring to that you will find that for the public utility business other than railroads and communications that it was only 6.7 percent applicable to the entire utility industry. So that I think that rate on its face does show that regulation has been effective.

Then, as shown by chart 7, certainly I think it shows clearly that the gas industry has not contributed to the increased cost of living. It will be noticed there that the general index shows a figure in excess of 170 percent, and that the gas service cost based on a comparable level is only 103.7.

I might add that those increases that have come about have come about generally just recently with the increased cost of operation. In most instances those have been on the manufactured gas product.

I know with reference to our own company we had a reduction in residential service and commercial service in 1942 of some 13 percent, and it will be noticed from the chart until just recently we had been holding our own, or just slightly under the 100 percent figure.

So I think that it does show clearly, gentlemen, that regulation has been effective and utilities have not been making an excess profit or having excess earnings.

Senator MILLIKIN. What percentage of your distributable income do you keep in the business for expansion?

Mr. HULCY. I think the average for the gas industry is about 65 percent. In our own case we have not quite that high due to the fact that we have had such great requirement for capital. Frankly, we have held down a little bit on the distribution.

Senator KERR. I do not believe you understood his question.

Senator MILLIKIN. Of the income that is available for distribution, what percentage do you keep in the business for expansion?

Mr. HULCY. I thought you meant was what we paid out. We pay out about 65 percent and keep about 35 percent on the average.

Senator MILLIKIN. Thirty-five.

Mr. HULCY. Yes, sir. So I did misunderstand you.

Thank you, Senator Kerr.

The CHAIRMAN. And you paid out a little more?

Mr. HULCY. No, sir, we have paid out a little less because we have had no need to hold the money to take care of our fixed capital additions.

The CHAIRMAN. I see.

Mr. HULCY. So, gentlemen, I would just like to leave the general thought with you here and say that in summary the gas industry is the type of an industry that does not lend itself readily to the kind of treatment and excess profits that is included, say, in the excess profits tax that was applicable during World War II.

Now I was very interested in the statement that Mr. Whiting made to you with reference to the statement on the equity capital as shown on the corporate books. Of course, I am well familiar with all of the problems of which he mentions, because I know from our own experience where we had acquired going utility properties back in the earlier years that it was necessary, for tax purposes, of course, for us to step into the shoes of the predecessor owners. From a tax point of view we were allowed depreciation on the original cost when first dedicated to public service—that is, under the set-up on our books—because we had acquired securities and to say, thereby, we stepped into the shoes of the predecessor owners.

We did have in 1942 in our company a reorganization to qualify for exemption under the Holding Company Act to put many companies together. Just as a matter of information, in getting rid of excess costs of securities we had at that time about four millions in surplus, the adjusted balance sheet at December 31, 1942. After doing all of the things required by the Securities and Exchange Commission in the keeping of classification of accounts prescribed by the Federal Power Commission, we wound up that year with zero earned surplus and had some 3½ millions of these excess costs to write off in the future because we just did not have enough surplus to do it. But that, of course, has been disposed of before now.

But I do feel that it is important that some of these things be taken into account because if they are not, there will be many of the utility companies earning a great deal less than allowed us by regulatory bodies, that is, public authority.

I will say, too, that even if that is corrected there will be considerable amount of excess profits taxes paid by utility companies.

Now in many instances they have some operations that are not regarded as public service. I mean by that profits from merchandising and things of that sort. Also, it might be interest earnings from securities that are held. Of course, that would not just come altogether under that. But certainly I would say this: That as I understand H. R. 9827, as I understand it, and if the base is the taxable base, then I will say to you gentlemen there will be material amounts, sizable sums, that will be paid out as excess profits taxes.

Of course, as I see the problem, it gets back to this: We are confronted with the absolute necessity of continuing to raise large sums of money, and if we are going to be able to do that, we are going to have to be able to make a showing on earnings that will justify people in lending us some money, or else buying our equity securities.

Then again, as was brought out by the Chairman of the NARUC, and others, gentlemen, there is only one place for the money to come from for a public-utility company, and that is from the customer. If we are going to have largely increased taxes over and above, then, just as the Commissioner said, I think it would be necessary, of course, to come along, and to have increased rates to provide for it.

One other thing I think is particularly applicable to our business that should be taken into account: In the construction of properties, there is a lag, a material lag, in earnings behind the construction period. Senator Kerr, right up in Oklahoma, I think you perhaps know that we are just extending facilities to Idabell, to Broken Bow, to Antlers. That is a brand-new project. I think they are having the celebration there this evening about the gas being turned on.

From the business, of course, you know it will be a good period of time before the business is fully developed in those towns to where it would be paying a rate of return on the investment there. So that is the lag that comes in the utility business, I think perhaps particularly the gas business. So all of those things I think have to be taken into account in permitting us to do the kind of a job that we should.

Now I think, gentlemen, that pretty well summarizes my views about it, and thank you very much for the opportunity of appearing before you.

The CHAIRMAN. Thank you very much for your appearance.

(The statement submitted by Mr. Hulcy reads in full as follows:)

STATEMENT OF D. A. HULCY, PRESIDENT, LONE STAR GAS CO.; PRESIDENT, AMERICAN GAS ASSOCIATION, INC.

I am D. A. Hulcy, president, Lone Star Gas Co., Dallas, Tex. My company serves natural gas in 379 communities in northern Texas and southern Oklahoma where approximately 550,000 customers depend on us almost entirely for their fuel for cooking, water heating, house heating, and industrial purposes, and to a lesser degree for many other services such as refrigeration and air conditioning.

The American gas industry with its 175,000 employees serves 22,000,000 homes and 2,000,000 factories, commercial establishments, and other customers through a system of pipes that exceeds in mileage the railroad trunk-line mileage of the country. In taking care of the demands now being made upon it, it will, in all likelihood, be serving an additional 5,000,000 customers before the present world emergency passes. Practically the entire population of the United States is dependent, to a greater or lesser degree, on this industry and has a direct stake in its ability to meet its expanding requirements.

Over 5,000,000 homes, industries, and commercial establishments use liquefied petroleum gases delivered in containers. This has been one of the fastest growing postwar industries in the country. Except for the small part my own company plays in this business, I do not presume to speak for it, however.

At the present time I am president of the American Gas Association which is the trade association for the American gas industry, including among its members gas utility companies serving more than 90 percent of the gas customers of the country, manufacturers of gas equipment and gas-consuming appliances, and individuals and others interested in the industry.

The gas industry is willing and anxious to do its part in the tremendous defense effort before the country. It asks only that consideration be given to certain inherent factors so that its ability to give material aid to the defense effort and to adequately serve the millions of citizens dependent on it shall not be impaired. The so-called excess profits tax discriminates heavily against, and by its nature should not be applied to, our industry. If such a tax is to be enacted, however, we ask that this discrimination be reduced to a minimum.

I. A strong gas industry is vital to defense and to the well-being of our people

The gas industry has always played an important part in the economy of our country and that part is becoming increasingly more important. In 1939, for example, 11.7 percent of the total heat energy supplied from natural resources

in the United States was supplied by natural gas (chart I). By 1949 this percentage had increased to 19.4 percent and at the present time is well over 20 percent. From 1940 to 1950 there was an increase of 24 percent in the number of dwelling units in the United States (chart I) but the number of domestic gas customers increased from about 16,000,000 to 22,000,000, or 34 percent. Industry has come to rely heavily on gas. We were handicapped during the last war by restrictions which made it impossible to expand as rapidly as we should but as those handicaps are being removed, the sale of gas for industrial purposes is following very closely the Federal Reserve Board Index of Industrial Production (chart II).

II. The gas industry must attract large amounts of capital

The gas industry is in the middle of the greatest and most rapid expansion in its history and has a big job to keep pace with the demands for service made upon it. Since the end of World War II $3,000,000,000 have been invested in new plant facilities and equipment. During the next 4 years at least an additional $1,500,000,000 will be required. At the beginning of 1945 the total assets of the gas industry were 5.7 billions of dollars (chart III). By 1954 it is estimated that this will reach 10.2 billion dollars, thus almost doubling in the 10-year period. Failure to give credit in excess profits calculations for fixed capital added at such a high rate after the base year will certainly result in drastically curtailing our ability to expand our facilities and to make a creditable contribution to the defense effort.

This plant expansion requires new capital, much of which must come from the sale of new securities. New capital requires earnings out of which to pay interest and dividends sufficient to induce investors to buy new securities. To sell new securities advantageously a reasonable record of payment of interest and dividends on securities already issued and outstanding must be demonstrated. Additional taxes, of course, bite into earnings, bring about uncertainties, and hamper us in raising the large amounts of capital required for plant expansion.

III. The gas industry investment pattern differs from that of industry in general

Turn-over of investment in the gas industry is very slow as compared to other industries (chart IV). In 1947, assets of the gas industry were almost $4 for every $1 of revenue. A dollar invested in the average manufacturing plant turned over almost twice a year while one invested in the average gas utility turned over only once in about 4 years. This means not only that large amounts of capital must be raised for the gas business but also that earnings are relatively stable and would have to vary over a wide range to be termed "excessive."

By reason of the long-life nature of assets of the gas industry it is both desirable and necessary to raise capital through a high percentage of funded debt (chart V). This practice is of direct benefit to the users of our service by reason of the lower resulting cost of money. Not to recognize the full amount of the debt in computing an excess profits tax results in discrimination against our industry and puts a burden on our ability to finance. It also results in a wider fluctuation in the amount of earnings on which the tax is computed and thus introduces an element of instability which reflects itself in our ability to finance with junior securities.

Again by virtue of the long-life characteristics of gas plant and the nature of our business, there is a greater lag than in most industries between the time when gas plant investment must be made and earnings are sufficient to pay a return thereon. One of the largest utilities of the country finds that this lag is 18 months. One of the new pipeline companies beginning under more favorable conditions than most of them has found this lag to be 4 years. This lag adds to the difficulty of financing capital additions from within and forces us into the security markets. If earnings are reduced by the imposition of an excess profits tax, this lag will be materially lengthened.

The gas industry is already heavily taxed and has consistently borne its full share of government costs. The taxes per dollar of revenue are several times those for many other industries. Investors watch closely the trend of taxation and quickly reflect in the prices they are willing to pay for our securities any change, particularly where change affects earnings and cannot be readily overcome.

A large segment of our population has a direct stake in the ability of the gas utilities to render adequate service and to expand, by reason of their ownership of gas company securities. In increasing amounts have these securities come into the hands of the general public. The little man is an important factor. Almost

25 percent of the securities owned by the life insurance companies of this country are utility company securities (chart VI). In 1949 over $9,000,000,000 of the assets of the insurance companies, held in trust for the benefit of millions of policyholders, were utility company securities.

IV. Gas industry earnings are regulated by public authorities

The gas industry is a regulated industry and as such is not permitted to experience excessive earnings. Local, State, and Federal regulation has been very effective in containing earnings of the gas companies to a modest and fairly stable level but has been reasonably alert to the necessity of fixing rates that will allow the companies to attract the necessary capital. By its very nature regulation responds slowly in increasing rates. If an excess profits tax were to be imposed at this time it would hit the gas companies directly, and with little chance of quick relief, and would seriously impair their ability to continue to render adequate service.

Regulatory authorities, after thorough and generally protracted investigations, would doubtless find that companies need higher rates in order to attract necessary new capital after paying any taxes applied as was the last excess profits tax. Such increases in rates, however, would be several times the amount of the tax.

The gas industry has a very commendable record of holding down its rates (chart VII). While the cost of living as of June 1950 was 170.2 compared to 1935–39, the index of gas rates is only 103.7. Until recently the industry was able to show a declining index. It absorbed the inflationary costs of material and labor, increased taxes, and a portion of its plant expansion and still lived on steadily lowered rates. The heavy costs of operation during the past few years, however, have made necessary a number of increases in rates. Under the terms of an excess profits tax such as existed before, a large portion of these increased earnings, which are absolutely necessary to allow the gas utilities to live, will be taken away in the form of taxes.

V. Gas industry characteristics should be considered if any type of excess profits tax is instituted

Recently the gas industry joined with the electric industry in a presentation to the staff members of your Joint Committee on Internal Taxation and of the Treasury Department. A copy of the statement presented at that time and labeled "The Impact of an Excess Profits Tax on the Gas and Electric Utility Industries" is presented herewith. I shall not repeat what was said there but would like to amplify one point.

Point 8 of that presentation asks for adequate relief provisions but is not specific. One of the relief provisions I would like particularly to stress is that provided by section 735 of the Internal Revenue Code (as amended by the Revenue Act of 1943) which gave partial relief to natural gas companies who, in the war effort, depleted their resources at an excessive rate. This provision aided materially in preserving the soundness of our companies and gave sufficient encouragement to a search for new natural gas reserves to make possible the great expansion which has taken place since the war. I understand that another witness will discuss this matter in detail.

In summary, the gas industry does not, in my opinion, lend itself to the kind of treatment which any form of a so-called excess profits tax will impose. It is regulated by public authorities to a very high degree and has little chance to make any excess profits. It has need for continuing large amounts of capital if it is to perform its obligations to national defense and to the public. Anything which interferes with the free flow of that capital jeopardizes the carrying out of those obligations.

The gas industry has always carried, and now wants to carry, its full share of the defense burden. If your committee concludes to recommend an excess profits tax we ask that you so shape its provisions as not to endanger our ability to meet our obligations

CHARTS AND TABLES CONCERNING EXCESS-PROFITS TAXES

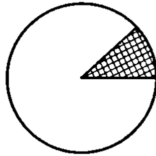
CHART 1

THE GROWTH PICTURE OF THE GAS INDUSTRY

ITS CONTINUED GROWTH ESSENTIAL TO GENERAL WELL-BEING

AN INCREASINGLY IMPORTANT ENERGY SOURCE

1939

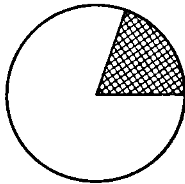


TOTAL ENERGY SUPPLY OF U.S.
22,683 TRILLION Btu

NATURAL GAS
2,663 TRILLION Btu
11.7% OF TOTAL

1949

A LARGER PIE - A LARGER SLICE

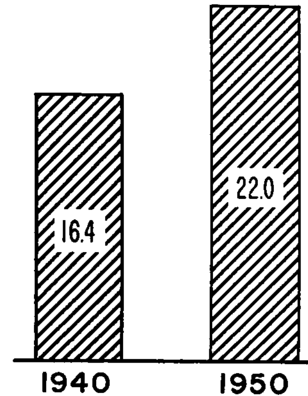


TOTAL ENERGY SUPPLY OF U.S.
31,786 TRILLION Btu

NATURAL GAS
6,181 TRILLION Btu
19.4% OF TOTAL

ALTHOUGH TOTAL DWELLING UNITS HAVE INCREASED ONLY 24% DOMESTIC GAS USERS HAVE INCREASED BY 34%

MILLIONS OF DOMESTIC UTILITY GAS USERS



Annual supply of energy from mineral fuels and water power in the United States, 1939–49

[Trillions of British thermal units]

	Total [1]	Natural gas [1]	Percent natural gas to total [1]		Total [1]	Natural gas [1]	Percent natural gas to total [1]
1939	22, 683	2, 663	11.7	1945	32, 552	4, 213	12.9
1940	25, 216	2, 860	11.3	1946	31, 839	4, 333	13.6
1941	27, 288	3, 024	11.1	1947	35, 674	4, 926	13.8
1942	29, 331	3, 282	11.2	1948	36, 635	5, 534	15.1
1943	30, 791	3, 671	11.9	1949	31, 786	6, 181	19.4
1944	33, 176	3, 989	12.0				

[1] Source: Department of the Interior, Bureau of Mines, Coal—Bituminous and Lignite (reprint from Minerals Yearbook, 1949).

Growth in dwelling units and domestic utility gas users, United States, 1940–50

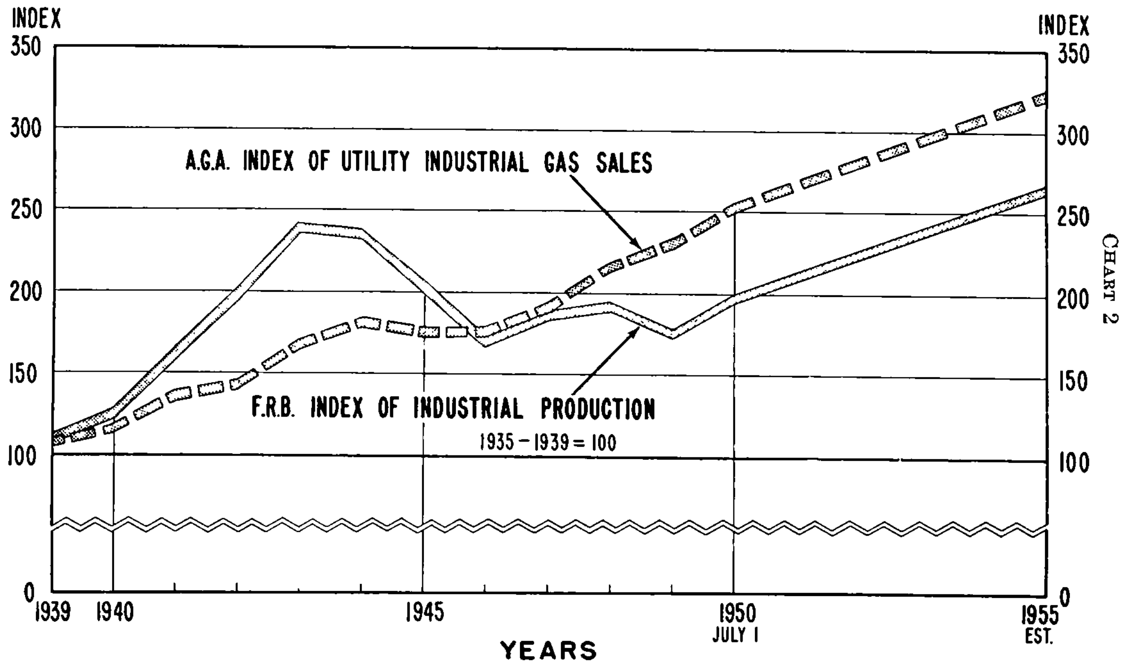
	Dwelling units [1]	Domestic utility gas users [2]
1940	37, 325, 500	16, 435, 000
1950	46, 151, 200	21, 962, 000
Increase (percent)	23.6	33.6

[1] Source: Department of Commerce, Bureau of the Census, 1950 Census of Housing, Release Series HC-1' No. 50.

[2] Source: American Gas Association, Gas Facts, 1949. Certain statistics are derived from published data, and do not appear in the same form in this volume.

CHART 2

EXPANSION OF INDUSTRIAL GAS SALES REQUIRED TO MEET GENERAL INDUSTRIAL GROWTH



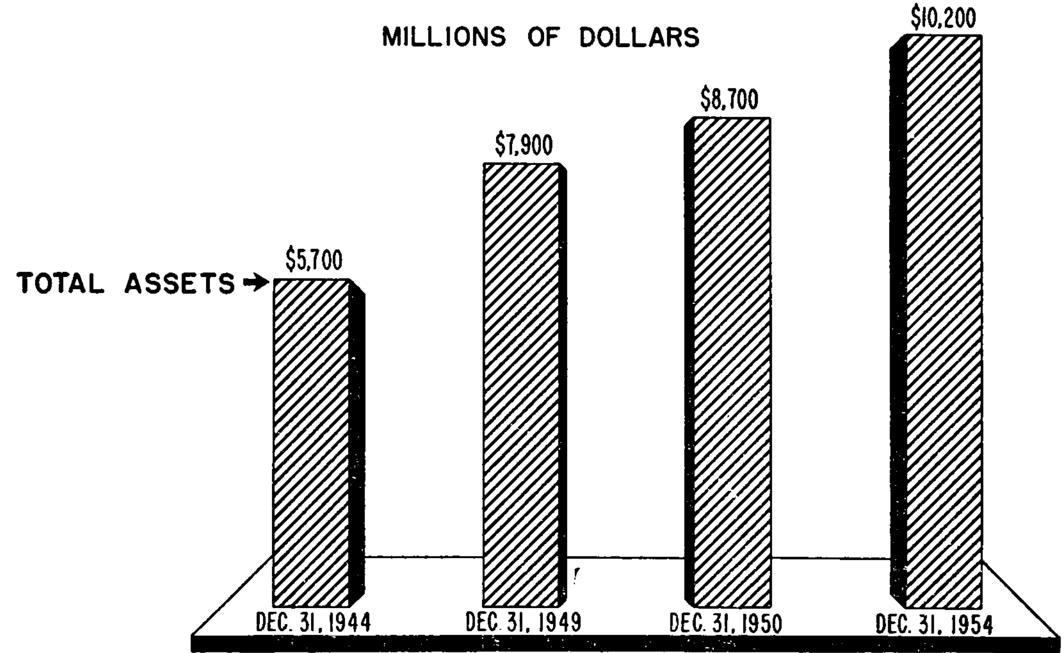
Comparison of indexes of industrial production and utility gas sales to industrial consumers, United States, 1939–55

[1935–39=100]

	Index of industrial production [1]	Index of utility gas sales to industrial consumers [2]		Index of industrial production [1]	Index of utility gas sales to industrial consumers [2]
1939	109	107	1946	170	177
1940	125	116	1947	187	192
1941	162	137	1948	192	217
1942	199	143	1949	176	230
1943	239	168	June 30, 1950	198	254
1944	235	182	1955 [3]	265	323
1945	203	176			

[1] Source: Federal Reserve Board Bulletin, October 1950.
[2] Source: American Gas Association, Gas Facts, 1949. Certain statistics are derived from published data and do not appear in the same form in this volume.
[3] Estimates for 1955 based on prediction of Gross National Product of 350 in 1955, made by Leon Keyserling of the Council of Economic Advisers.

CHART 3



Total assets and construction expenditures, gas utility industry, United States, 1944–54

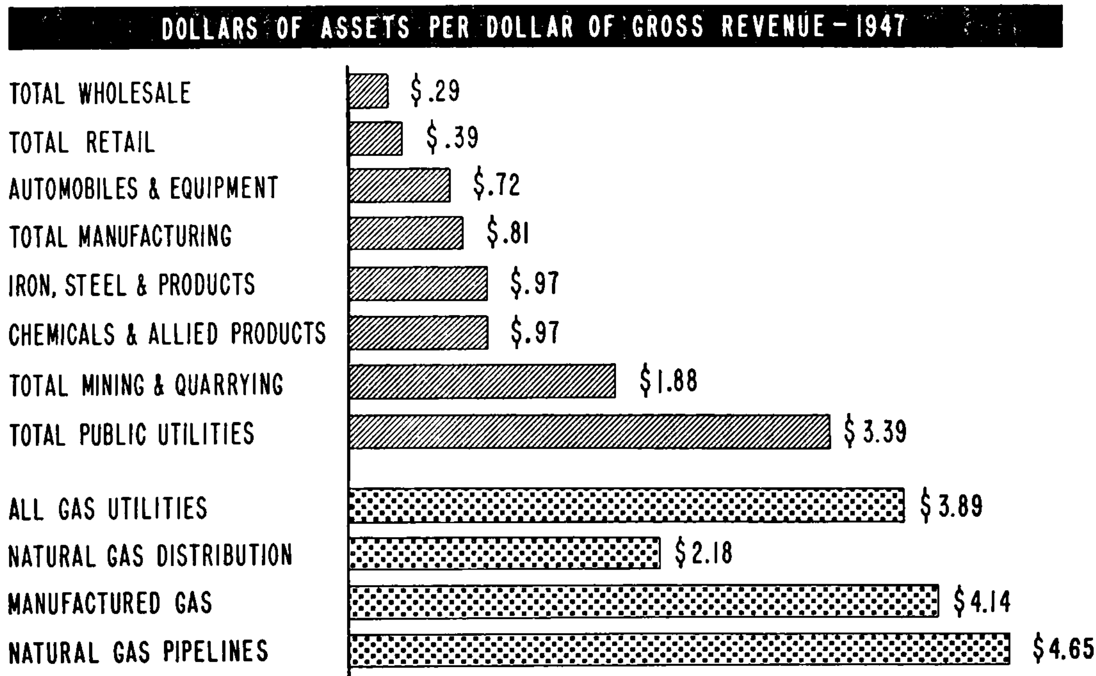
[Millions of dollars]

	Total assets (Dec. 31) [1]	Construction expenditures [1]
1944	$5,700	$162
1945	(2)	160
1946	(2)	810
1947	(2)	758
1948	(2)	770
1949	7,900	959
1950	$8,700	$1,066
1951	(2)	[3] 981
1952	(2)	[3] 428
1953	(2)	[3] 333
1954	10,200	[3] 327

[1] Source: American Gas Association, Gas Facts, 1949. Certain statistics are derived from published data and do not appear in the same form in this volume.
[2] Not computed for these years.
[3] Based on a survey of the industry made in 1949. Estimates for last 3 years probably understated by an unknown amount, because of necessary omission of data for pipelines and distributors not yet organized.

CHART 4

THE GAS INDUSTRY REQUIRES HEAVY INVESTMENT PER DOLLAR OF REVENUE



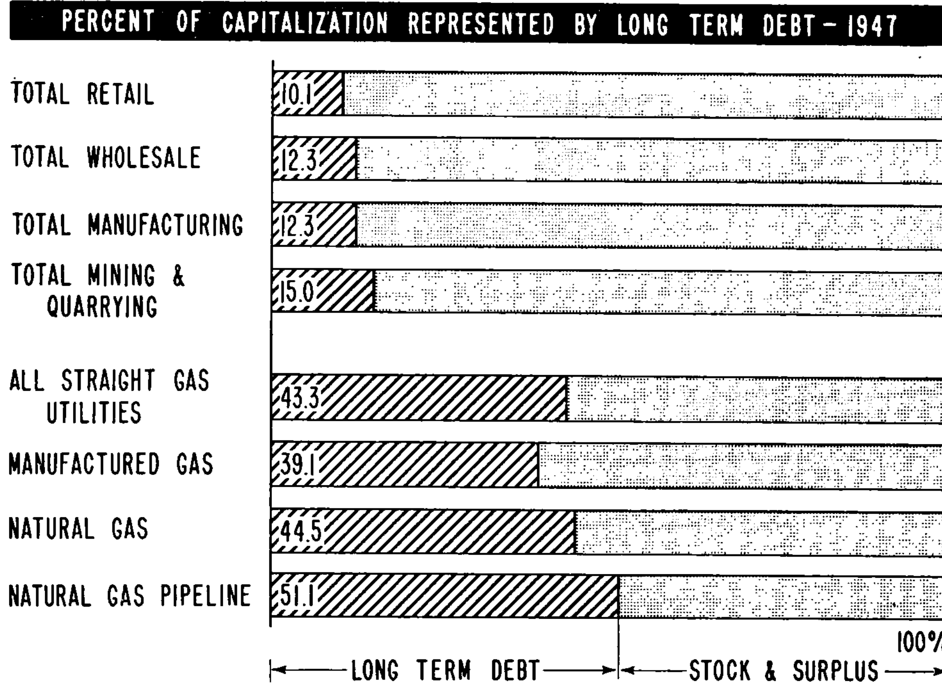
Dollars of assets required to produce $1 of gross revenue, gas utilities, and other business groups, 1947

	Dollars of assets [1]
Total wholesale	$0.29
Total retail	.39
Automobiles and equipment	.72
Total manufacturing	.81
Iron, steel, and products	.97
Chemicals and allied products	.97
Total mining and quarrying	1.88
Total public utilities	3.39
All gas utilities	3.89
Natural-gas distribution	2.18
Manufactured gas	4.14
Natural-gas pipelines	4.05

[1] Sources: American Gas Association, Gas Facts, 1949 (certain statistics are derived from published data and do not appear in the same form in this volume); Treasury Department, Bureau of Internal Revenue, Statistics of Income, pt. 2, 1939–45; Press Service release S–1051 (1946); Press Service release S–2449 (1947).

CHART 5

DEBT CHARACTERISTICS OF THE GAS INDUSTRY



Long-term indebtedness as a proportion of total capitalization, gas utilities and other business groups, 1947

	Percentage of long term debt [1]
Total retail	10.1
Total wholesale	12.3
Total manufacturing	12.3
Total mining and quarrying	15.0
All straight gas utilities [2]	43.3
Manufactured gas	39.1
Natural gas	44.5
Natural-gas pipelines	51.1

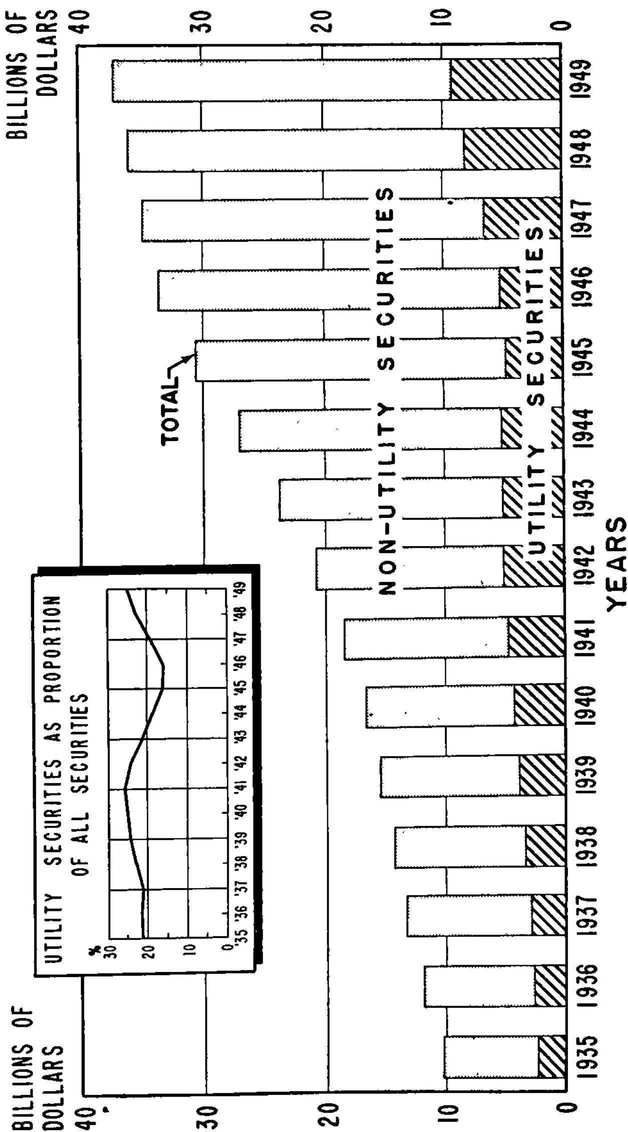
[1] Sources: American Gas Association, Gas Facts, 1949 (certain statistics are derived from published data and do not appear in the same form in this volume); Treasury Department, Bureau of Internal Revenue, Statistics of Income, pt. 2, 1939–45; Press Service release S–2440 (1947).

[2] Excludes gas utilities also distributing electricity, to avoid necessarily arbitrary segregaion of capitalization between utility services.

CHART 6

SMALL SAVERS HAVE A VITAL STAKE IN CONTINUED FINANCIAL HEALTH OF THE UTILITY INDUSTRY

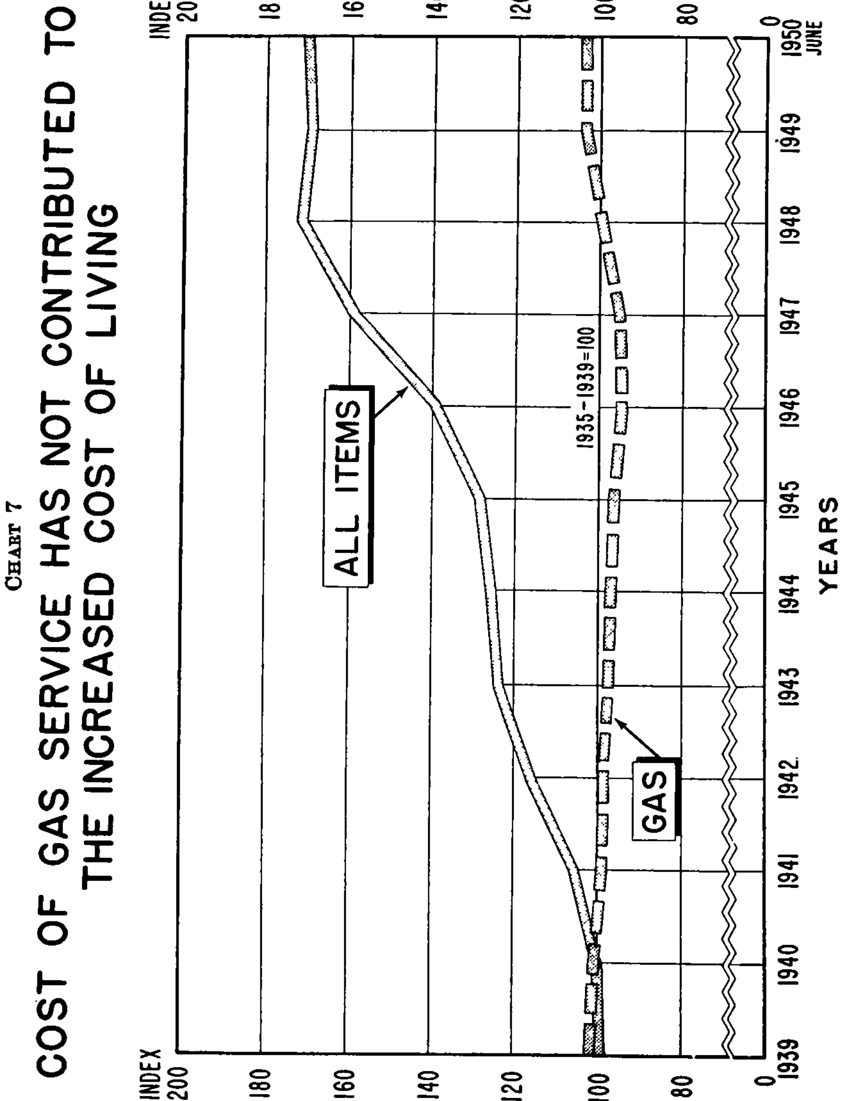
LIFE INSURANCE COMPANIES—THE REPOSITORIES OF ACCUMULATED SAVINGS OF MILLIONS OF AMERICANS—HAVE LARGE INVESTMENTS IN UTILITY SECURITIES



Life-insurance-company holdings of utility securities, as contrasted to total security holdings, 1935–49

	Utility securities [1]	All securities [1]	Utility securities as percent of total		Utility securities [1]	All securities [1]	Utility securities as percent of total
	Millions	*Millions*	*Percent*		*Millions*	*Millions*	*Percent*
1935	$2,171	$10,209	21.3	1943	$5,060	$23,718	21.3
1936	2,563	11,897	21.5	1944	5,099	27,099	18.8
1937	2,823	13,328	21.2	1945	4,948	30,653	16.1
1938	3,277	14,397	22.8	1946	5,373	33,488	16.0
1939	3,774	15,537	24.3	1947	6,650	34,926	19.0
1940	4,197	16,800	25.0	1948	8,289	36,125	22.9
1941	4,774	18,571	25.7	1949	9,314	37,397	24.9
1942	5,043	20,809	24.2				

[1] Source: Life Insurance Institute of America, Record of Life Insurance Investments, 1949.



Index of consumer prices, gas and all items, 1939–50

[1935–39=100]

	Gas service [1]	All items [1]		Gas service [1]	All items [1]
1939	101.3	99.4	1945	96.4	128.4
1940	100.3	100.2	1946	94.7	139.3
1941	99.3	105.2	1947	95.7	159.2
1942	99.0	116.5	1948	99.2	171.2
1943	97.9	123.6	1949	103.1	169.1
1944	97.1	125.5	June 1950	103.7	170.2

[1] Source: Department of Labor, Bureau of Labor Statistics, Monthly Labor Review, October 1950, and other publications.

The Impact of an Excess Profits Tax on the Gas and Electric Utility Industries

It is generally understood that any congressional consideration of the enactment of a new excess profits tax law within the near future would be for the particular purpose of eliminating "war profiteering" and minimizing inflationary pressures, as distinguished from a primary purpose of imposing, by means of excess profits taxes, extraordinarily heavy additional tax burdens to produce the magnitude of revenue which might, at some future time, be needed to finance an all-out world war. If this is true particular attention is required in the drafting of such legislation to see that it serves its intended purpose and does not, in fact, result in the taxation of profits which, under normal concepts, are demonstrably not excessive.

Inasmuch as the public-utility industries, as distinguished from other industries, are comprehensively regulated (both as to rate of return on investment and as to the prices which may be charged for their products or services) by governmental regulatory bodies, it follows that the type of war profits which is intended to be recaptured by excess profits tax legislation are not and will not generally be present in the case of public utility companies.

Our committees are fully aware that all segments of the national economy must bear their share of such additional taxes as may be required to finance the defense effort and obviously the public utility industries are willing to accept their responsibility in assuming their appropriate share of the fiscal burdens arising from the present emergency.

It is incumbent upon public utilities, as well as industry in general, to assist the Congress, to the extent possible, in its efforts to determine statutory concepts of what may properly be considered "excessive or war profits," as distinguished from normal profits even though the latter are earned during a period of national emergency. To this end, our committees have carefully studied the substance and effects of the previous statutory concepts and has formulated certain recommendations which it feels would, if adopted, result in a much sounder and more equitable application of the avowed purposes of the proposed excess profits tax legislation.

RECOMMENDATIONS

For the reasons set forth above and below, it is recommended that the following essential provisions be included in any excess profits tax that may be enacted:

1. Under any method of determining excess profits net income, deduction should be allowed for normal tax and surtax in ascertaining excess profits net income.
2. Under the invested capital method of determining the excess profits credit, borrowed capital shall be included at 100 percent thereof with a corresponding adjustment to excess profits net income for interest thereon.
3. Under the invested capital method, the excess profits credit shall not be less than 6 percent of the invested capital.
4. Under either invested capital method or the average earnings method there shall be allowed a credit at an incentive rate on all capital additions, whether equity, borrowed, or retained earnings made during the first excess profits tax year and all years subsequent thereto.
5. Under the average earnings method of determining the excess profits credit, there shall be added to the credit otherwise determined not less than

6 percent of all net capital additions whether equity, borrowed, or retained earnings added during the last 2 years of the base period and all subsequent years prior to the first excess profits tax year.

6. Under the invested capital method of determining excess profits net income, interest on borrowed capital added back to normal tax net income to obtain excess profits net income, shall be reduced by the percentage used in excluding inadmissible assets.

7. The penalty rate on consolidated return reporting shall be eliminated.

8. Adequate relief provisions shall be enacted in excess profits tax law to relieve hardship, remove inequities, and relief situations that are not covered by the usual statutory provisions:

The basic problem in applying the proposed tax is to determine what constitutes excessive earnings, war profits, or excess profits.

In the case of public utilities, it is well established by public policy that excess earnings or profits begin when such earnings exceed an amount determined by State and Federal regulatory agencies to be fair and equitable. There is danger to the public interest in superimposing new regulation of earnigs of utilities in the form of tax legislation which conflicts with well-established regulatory methods and procedure, especially if such legislation by fixing limits which do not fully recognize existing customs and practices adversely affects the ability of the industry to meet the constantly expanding capital requirements necessary to maintain adequate public service.[1]

Therefore, the following simple provision is necessary to fix a point below which excess profits do not occur:

"In the case of public utilities, the excess-profits credit for any taxable year shall be not less than the aggregate of the normal tax and surtax plus an amount not less than 6 percent of the total of outstanding borrowed capital, capital stock and surplus, as reflected on the corporate books of accounts, averaged for the beginning and end of the taxable year, with a corresponding adjustment to excess-profits net income for interest on borrowed capital."

REASONS FOR RECOMMENDATIONS

Before explaining in detail the recommendations, our committees believe that some observations on the general financial position of the utilities are necessary.

The public-utility industries are not static or declining industries. They are industries that are still experiencing a tremendous growth. This growth is not alone a matter of choice but is one of compulsion, since franchise requirements obligate utilities to provide service for the constantly growing number of customers who want such service in increasing amounts. Furthermore, utilities are vitally essential to the defense effort and their operating efficiency and financial stability must be maintained if the defense effort is not to be impaired.

The expansion program of the gas and electric utilities is absorbing large sums of money. As an example, gas and electric utility companies spent 9.2 billion dollars for new construction during 1946–49. Some of this money came from the internal operations of the utility business itself, depreciation, retained earnings, etc. But 5.5 billion dollars of new capital had to be obtained through the sale of 3.8 billion dollars of long-term debt and 1.7 billion dollars of stock.

In the next 3 years it is estimated that an additional 9.5 billion dollars will be spent for new construction. Of this amount, internal sources will supply approximately one-third, but the other two-thirds must be raised through the investment of new capital.

Utilities are obviously going heavily into debt to finance their construction program. The long-term debt of the electric utilities increased 2.4 billion dollars from 1946 to 1949 and the portion that debt is to the total investment has risen from 46 percent in 1946 to 49 percent in 1949.

This brief review emphasizes the urgent need of public-utility industries for new capital. It also indicates that these industries have reached the point where larger amounts of equity capital must be secured if the industries are not to become top-heavy with debt. Long experience has demonstrated that the way to induce investors to buy utility stock is through a satisfactory earnings record and a fair return on their investment.

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[1] See appendix 1, p. 11.

1. Deduction of income tax

The earnings of nearly all utilities are under the jurisdiction of regulatory commissions. In determining normal earnings, the commissions generally have allowed utilities to charge their customers enough to cover their expenses, pay their taxes including income tax, and provide a fair return on their investments.

An excess profits tax may of itself deny a fair return to a utility. The following example explains why. Assume that $1,000,000 in the form of capital stock has been invested in a utility and the regulatory commission will allow the utility to earn a 6 percent return, after taxes, on this investment or a net income of $60,000. To earn the $60,000, the utility would have to have taxable income of $109,000 if the income tax rate were 45 percent and there were no excess profits tax.

Assume now that an excess profits tax is imposed that defines "excess profits" as any income that exceeds 6 percent of the invested capital, but which does not allow the deduction of the income tax before determining "excess profits." If the excess profits tax rate were 85 percent, the net income to the nearest $1,000 of this utility, after taxes, would then be computed as follows:

Taxable income	$109,000		$109,000
Deduct 6 percent of invested capital	60,000		
"Excess profits"	49,000		
Excess profits tax at 85 percent		$42,000	
Income subject to income tax	60,000		
Income tax at 45 percent		27,000	
Deduct total taxes			69,000
Net income after taxes			40,000
Return on $1,000,000 investment (percent)			4

This illustration shows that the earned return declines from 6 percent on investment to 4 percent after the application of an excess profits tax. Such reduced return is wholly inadequate to service the capital of the utility, thus impairing its credit standing and hence its ability to raise capital for essential expansion.

Suppose the Commission, in spite of the excess profits tax, agreed that the utility should increase the price of its services to obtain a return on $60,000 after taxes. Taxable income would then have to increase to $242,000, and the utility's rates to the public would have to be substantially increased. Obviously, a large increase in the price of gas or electricity is not in the public interest, especially during a period when the Federal Government invokes economic controls to combat inflation.

2. Inclusion of 100 percent of borrowed capital

In establishing a fair return to be allowed on investment, Federal and State commissions, through the regulatory mechanism of rate base, rate of return, etc., usually do not distinguish between the form of investment, whether of bonds or stock. The fair return to the utility is established on the basis of the over-all investment. The rate of return comprehends that part of the investment will be in bonds paying a low interest rate and part in stock earning at a higher rate.

The return which the utility is permitted to earn by the regulatory agency is determined by allowing a relatively low rate of return on the total investment. If the provisions of an excess profits tax exclude part of the investment in arriving at the definition of "excess profits," the effect is to deny the utility a fair return. To demonstrate this, take a utility with an investment of $1,000,000 of which $500,000 is debt (so-called borrowed capital) with an interest rate of 3 percent. The regulatory commission allows a return of 6 percent on the total investment, or an income of $60,000 after taxes but before interest. Assume there is an excess profits tax rate of 85 percent which allows the deduction

of income tax, but which excludes one-half of the debt in the computation of "excess profits" the return of this utility is as follows:

Gross income before taxes and interest		$96,800		$96,800
Deduct interest		15,000		
Taxable income		81,800		
Income tax at 45 percent		36,800	$36,800	
Income before excess profits computation		45,000		
Add interest on one-half of debt		7,500		
Subtotal		52,500		
Deduct excess profits tax credit:				
6 percent on $500,000 of capital stock	$30,000			
6 percent on $250,000 of debt (½)	15,000			
		45,000		
"Excess profits"		7,500		
Excess profitx tax at 85 percent			6,400	
Deduct total taxes				43,200
Income after taxes but before interest				53,600
Return on $1,000,000 investment ... percent				5.4

In the computation of "excess profits," if all the debt had been included, the income before interest would have been $60,000 or a return of 6 percent on the total investment. This would have been in accord with the fair return established by the regulatory commission.

There is approximately $45,000,000,000 of long-term debt, exclusive of real-estate mortgages, outstanding for all privately owned industries. Of this amount, more than 40 percent has been issued by utilities, 30 percent by railroads and other transportation companies, and the remaining 30 percent by industrial corporations. Thus, 70 percent of the total outstanding debt has been issued by corporations subject to regulatory commissions. Therefore, the exclusion of part of long-term debt or borrowed capital, in the determination of "excess profits," results in discrimination against the regulated company.

3. Minimum rate of 6 percent on investment (capital stock, debt, and surplus)

As previously noted, utilities during the 1946–49 period raised large amounts of new capital. The gas and electric utilities obtained $5,500,000,000 of new money, of which less than one-third was in the form of capital stock. During the same period, the average return on total investment of the electric utilities was 6.3 percent. Based on this experience, an over-all return of less than 6 percent would seriously impair the ability of the utilities to obtain new capital.

With a rate of less than 6 percent applicable to invested capital, regulated companies earning less than a fair return will face the dilemma of paying excess profits taxes when a fair return has not been attained under revenues limited by regulation.

4. Incentive rate for new capital

It is evident from the 1946–49 experience that an excess profits tax must permit sufficient inducement to be offered investors if utilities are to secure the proper amounts and kind of new capital for their expansion. Because of the regulatory practice of setting return on total investment, it is not practical from a utility viewpoint, to a higher rate on new equity investment only. The excess profis tax should, therefore, permit some higher rate on all new investment than the current rate of return of approximately 6 percent.

5. Additional credit to base period earnings

The plant and equipment of a utility are large, complex and expensive. The planning and construction of this plant is time-consuming and it is not unusual for 2 to 3 years to elapse between the start of a project and its completion. During the construction period, substantial expenditures are made for the new plant. But not until the project is finished will it become an asset that produces income. A long period between construction expenditures and the time when income is earned thereon is characteristic of the utility industry.

An excess profits tax that does not give weight to the lag of earnings behind construction expenditures will work a serious hardship on a utility. To illustrate, suppose an excess profits tax is enacted that first allows the deduction of income tax and then defines "excess profits" as any income in excess of the average earnings of a base period of several years immediately preceding the year of enactment. Two years before the excess profits tax is enacted, a utility with an equity investment of $1,000,000 and average earnings of $60,000 after income tax starts the construction of a plant costing $250,000. Construction proceeds continuously, so that the utility gradually invests $250,000 over the 2-year construction period. The construction has been financed through bank loans, and just prior to completion the loans are refinanced into capital stock.

The first year of operation of the new plant is also the first year of the excess profits tax, and the fair return on the new investment in the plant is 6 percent, or $15,000. Before income tax at a rate of 45 percent, the return of $15,000 is equivalent to $27,000. The return on the total investment of $1,250,000 for regulatory purposes is $75,000. If no adjustment is provided by the excess profits tax for the increased earnings resulting from the investment of $250,000, the return of this utility would be as follows:

Taxable income			$136,000
From old investment	$109,000		
From new investment	27,000		
Total	136,000		
Income tax at 45 percent	61,000	$61,000	
Fair return on total investment	75,000		
Deduct average earnings of base period	60,000		
"Excess profits"	15,000		
Excess profits tax at 85 percent		13,000	
Deduct total tax			74,000
Net income after taxes			62,000
Return on $1,250,000 percent			5.0

In this instance, the average earnings of the base period years should be increased by the return on the investment added in the 2 years prior to the enactment of the excess profits tax. The utility, which in fact had no "excess profits" would then earn its fair return of $75,000, or 6 percent on its investment.

6. Additional inadmissible adjustment to invested-capital method

Invested capital, including borrowed capital, is properly reduced by an inadmissible asset factor before computing the excess profits credit. Where borrowed capital is a component of invested capital, the interest on such borrowed capital is added to the income which is subjected to excess profits tax. Therefore, in order to have a consistent result, the inadmissible asset factor should be applied to the interest on borrowed capital and the sum thereof deducted from excess profits net income to avoid a distortion of excess profits tax.

Under the prior excess profits tax law corporations having large amounts of inadmissible assets were penalized by the requirement that 50 percent of the interest on borrowed capital be added back to income, whereas the borrowed capital retained in invested capital was greatly reduced by the inadmissible asset percentage. The inclusion of 50 percent of borrowed capital in invested capital under that law actually increased the tax liability of some taxpayers. The inclusion of 100 percent of borrowed capital in invested capital, without the adjustment proposed here, would further aggravate this inequity. It is now proposed that only the interest on the portion of the borrowed capital finally retained in invested capital should be added back to income.

7. Elimination of penalty on consolidated returns

The necessity for permitting the filing of consolidated returns where an excess profits tax is imposed has been fully reviewed by Congress and provision for consolidated returns made part of every previous excess profits law. Where an excess profits tax is imposed, with its high tax rate, the determination of the true income of the entire enterprise, which the affiliated group of corporations com-

prise, is of paramount importance. Recourse to consolidated return reporting is practically forced on the taxpayer and no real election is afforded as to separate or consolidated returns. Therefore, the existing penalty should be removed since the penalty is in effect an additional tax imposed by the excess profits tax law.

Submitted by:

J. FRENCH ROBINSON,
Chairman, National Defense Committee, American Gas Association.
JUSTIN R. WHITING,
Chairman, Special Tax Committee of the Board of Directors of the Edison Electric Institute.

APPENDIX I

Maryland Public Service Commission, Case No. 4979, Order No. 45940, April 7, 1949 (78 PUR, NS, p. 481):

"The amount that public utilities are allowed to earn is limited to a fair return. They are not permitted to make a charge which will produce a greater return. They have no method of recoupment when earnings under existing rates amount to less than a fair return. They cannot amass out of earnings capital with which to make large expenditures for plant additions. That must come from places other than earnings and cannot be secured when the rate of return is insufficient to attract capital."

National Association of Railroad and Utility Commissioners, Report of the Special Committee on Excess Profits Tax, 1944, NARUC Proceedings (pp. 420, 424):

"The excess profits tax is not what its name connotes. * * * The result is that we have some public utilities paying an excess profits tax when they are not earning a fair return on the money invested in their properties."

Frank A. Newton, before the Public Service Commission of South Carolina, June 21, 1944:

"The payment by a utility of a Federal excess profits tax does not demonstrate that the earnings of the utility are excessive. * * * The difficulty lies in the fact that regulated public utilities, so far as the excess profits tax is concerned, have been put under the same tax umbrella as industries unregulated as to their prices."

Harold V. Bozell, before House Committee on Ways and Means, October 18, 1943 (Revenue Revision of 1943 Hearings, exhibit A):

"The first step to be taken in placing taxations of public utilities on a sound basis is to work out a method of computation which would be in line with the method of computing a fair rate of return for utilities so that excess profits taxes will not be assessed against earnings which are not in fact excess profits."

The CHAIRMAN. I believe Mr. Oakes was carried down from the top. We will call you at this time, Mr. Oakes.

Mr. OAKES. Thank you, Mr. Chairman.

The CHAIRMAN. You may be seated. Will you please identify yourself for the record?

STATEMENT OF CHARLES E. OAKES, PRESIDENT, PENNSYLVANIA POWER & LIGHT CO.

Mr. OAKES. My name is Charles E. Oakes and I am president of the Pennsylvania Power & Light Co.

Pennsylvania Power & Light Co., an independent public utility owned by 70,000 stockholders, serves over 500,000 customers in central eastern Pennsylvania and is regulated as to rates, earnings, security issues, and accounting by the Pennsylvania Public Utility Commission, and as to accounting and certain physical activities by the Federal Power Commission.

My appearance before your committee is with full realization of the national need for the imposition and adoption of taxes which will

meet the current situation. Pennsylvania Power & Light Co. (Pennsylvania) expects and is ready at all times to carry its just share of the tax burden. However, unless there be provided in the adoption of an excess profits tax provisions which fairly recognize the peculiar circumstances which apply to regulated public utilities such as Pennsylvania, future expansion may be retarded to the detriment of its customers and the over-all economy of the area it serves.

Pennsylvania has under way a $210,000,000 expansion program to meet the growing power needs of its service area for civilian and defense purposes. To finance this program requires the raising of large amounts of new capital. To secure such capital net earnings after taxes must be sufficient to attract investors.

Like other regulated utilities, Pennsylvania's earnings after taxes have been restricted by the Pennsylvania Public Utility Commission to what is considered normal earnings. Under such limitations, it is not possible for Pennsylvania to amass from its operations sufficient money to meet any substantial part of the construction cost of its expansion program. Consequently the needed funds must come largely from investors who will invest their money only when they are satisfied that earnings after taxes are adequate and reasonably secure.

There is ample evidence that the regulatory process as applied to my company and to the industry has kept the rates for service at prewar levels, another indication that there are no excess profits in the utility field. In the case of my company, rates for industrial purposes have been held within 5 percent of prewar and are still below prewar for the home and farm user. Pennsylvania's earnings after taxes are below the point indicated by the State regulatory body as fair and reasonable.

If the entry point at which an excess profits tax becomes effective is such as to affect Pennsylvania's normal earnings, it will affect Pennsylvania's operations and is a matter of grave concern to this company.

Therefore, I have asked for this opportunity to discuss certain phases of the impact of an excess profits tax on our operations and make a few suggestions for incorporation in the act which would allow us to continue to attract the necessary capital.

Excess profits are not possible to this company: By order of the Pennsylvania Public Utility Commission in 1945, Pennsylvania's earnings after taxes are limited to 6 percent for electric, 6½ percent for gas, and 6¾ percent for steam heating on the fair value fixed in such order for such properties used and useful in the public service. The rate of return fixed was without reference to the type of capital employed in total property investment. In its order the Commission found that Pennsylvania's rates were "not unjust, unreasonable, or productive of an excessive return."

At December 31, 1942, the fair value of the company's property as fixed by the Commission stood at $220,580,000. From that date to the end of 1950, net additions at original cost totaling $125,000,000 have been made and very substantial additions will have to be made over the next several years.

As shown on chart 1, Pennsylvania's return on such fixed fair value determined at December 31, 1942, plus these net additions at original cost has not in any year since the issuance of the Commission's order,

and, giving effect to the 45-percent Federal income tax rate just imposed, will not in the foreseeable future reach the return allowed in such order.

You will notice the red figure. You will see that it is under 6 percent. In many cases it is under 5 percent.

Senator MILLIKIN. Does that come about through the fact that allowed return does not reflect the subsequent increase in operating costs?

Mr. OAKES. That is correct.

Senator MILLIKIN. In other words, you cannot keep your allowed rate current with your increasing expenses; is that correct?

Mr. OAKES. That is true. And in the latter years, in the middle of 1947 and 1948, we had very large financing costs for the expansion program which, of course, interest charges and so forth further reduced it.

The accumulated deficiency in net earnings from 1946 to 1949 under the amount allowed in such rate order is $11,745,186, an average of $2,936,297 per year. Pennsylvania will not have normal earnings even in 1950 when the allowable return will not be earned by at least $1,346,000.

The "average earnings" method would tax Pennsylvania's less than normal profits as "excess profits": The "average earnings" method of computing Pennsylvania's normal earnings, using 85 per cent of the earnings of the three best years, 1946 to 1949, would result in an earnings base so low as to lower substantially the net earnings allowable under the Pennsylvania Public Utility Commission's rate order. Using the "average earnings" of these preceding years does not meet the needs of the public utility situation, since in the postwar years a large growth in the amount of property used in the public service has taken place. The economies resulting from these postwar investments are not reflected in the earnings of the base years 1946 to 1949. And that is why we are low in those years.

In those cases where earnings are below normal, the effect is to expose these economies in subsequent years to an excess profits tax. Rate increase made necessary to meet rising cost, the effect of which is reflected only partially or not at all in the years 1946 to 1949, likewise are later exposed to taxing as excess profits.

This is the situation as it applies to Pennsylvania.

Subsequent to World War II the company began a large expansion program under which additional capital expenditures of $103,000,000 were made to the end of 1949. Not only did this investment cause a temporary decrease in our base years net income, but the ultimate earnings maturity of such investment will not have been realized until after the end of 1949.

For example, $45,000,000 was spent during the years 1946 to 1949, inclusive, in the building of a large new power plant on the Susquehanna River near Sunbury, Pa., but the plant only went into operation in December 1949. Therefore, the savings of approximately $5,000,000 in operating expenses resulting from the substitution of this highly efficient new plant for more costly sources of power were only initially realized in the year 1950, subsequent to any of the base periods suggested. Also, increasing costs forced the company in December 1949 to put into effect a rate increase to its customers of approximately $2,200,000 which was approved by the Pennsylvania Public

Utility Commission, all the earnings from which rate increase arose subsequent to the base period years. Because of these two items, the company's taxable income will increase in 1950 over any combination of average years from 1946 to 1949 approximately $6,000,000. Even if 100 percent of earnings for 1949, the maximum earnings year, is used, this $6,000,000, which represents normal profits arising wholly without reference to a war economy, would be taxed as excess profits.

Therefore, it would be my recommendation to use for the public utility industry the year 1950 as a normal year and allow 100 percent of earnings as normal and a growth element in normal earnings related to added investment made in subsequent years and appropriate recognition of the effect of authorized rate charges.

Senator MILLIKIN. Would it be practical to include only half of 1950? I was thinking not of the effect on your company, but I am thinking whether administratively it would be practical to include the first half of 1950 as part of your base, if you wish to do so.

Mr. OAKES. Of course, that would help us a great deal. As you can see, our rate of return is moving up because of these savings in the new plant. It would help a great deal.

The CHAIRMAN. Would you prefer the basis used in World War II act to the basis that is indicated in this House bill?

Mr. OAKES. No. I believe we would much prefer, of course, the House bill. The House bill has made some real progress. We think they have done a remarkably fine job in the very short time they have spent on it.

We have a case history of our own here which I think is quite pertinent.

The CHAIRMAN. I was confining my question to the one issue of determining invested capital. Did you have a fairer base in the World War II act to determine your invested capital as a regulated utility, compared to the base provided in the House bill?

Mr. OAKES. No; the House bill is better. From our point of view we could not use the invested capital method in any event, because the invested capital method as computed under the tax laws results in a much higher base than either the average earnings or the proposed new base for public utilities.

The CHAIRMAN. All right.

Mr. OAKES. Recommendation of the utility industry: An alternative method of determining the excess profits tax credit in the case of certain regulated utilities has been suggested by our industry. We ask that we be permitted to earn not less than 6 percent on our outstanding capital stock, borrowed capital, and surplus as per corporate books, after all charges and expenses including normal tax and surtax. Mr. Whiting has outlined the position of the industry to which I subscribe.

The capitalization as shown by the corporate books of the operating electric utility companies represents original cost to the companies or less. Such capitalization of the electric utilities has been reached after judicial processes before State utility commissions and before the Federal Power Commission.

As of February 21, 1950—and here I would like to show you gentlemen, if you will, a report from the Federal Power Commission that has just become available this year.

As of February 21, 1950, of the 316 filings made before the Federal Power Commission since 1937 involving all electric companies in the United States, 305 have been judicially processed and agreement in the remaining 11 cases reached.

In commenting on this situation, the Federal Power Commission states:

> It will be seen, therefore, that the reclassification and original cost program for all practical purposes has been completed, leaving only odds and ends to be cleaned up. * * * Today, the electric utility industry is substantially on an original cost basis as to plant accounting, the total amount in excess of original cost aggregating no more than 2 percent of total utility plant, and this amount is being amortized.

This is a quotation from the Federal Power Commission report just handed you.

Therefore, the capitalization as per books of electric utilities is on a very reliable basis.

Regulation of rates by municipal commissions, State commissions, and the Federal Power Commission has been one of long standing. In fact, it may be said that the price structures of the utility industry, electric, gas, telephone, water, and steam heat, are the only price structures in the entire country which have been set by judicial processes and are set up on a cost-of-service basis including the cost of money invested. Therefore, normal earnings for these industries should be left undisturbed by an excess profits tax.

In view of these facts there should be no concern whether the definition of normal earnings for the utility industry for income tax purposes should rest on cumulated filings under the income tax law or on the filings required by law by municipal commissions, State commissions, or the Federal Power Commission. Indeed, the latter is the more preferable since net income from regulated rates is the foundation on which our financial policy, corporate financial structure, and financial expansion rests.

Rate increases to compensate for excess profits are not feasible: With earnings regulated and limited generally to amounts sufficient only to attract new capital, impairment of such normal earnings by the imposition of excess profits taxes may require the utility to go before the regulatory body and ask for rate increases to restore the net earnings to the allowable amount set by Commission standards. As taxes are raised above the high point at which they now stand, prices charged the rate payer must be disproportionately raised when it becomes necessary to restore a given amount of net earnings.

For example, as shown here on chart 2, with an income tax of 38 percent it would take $1.61 collected from the customer to realize $1 of net income. With a tax of 75 percent it would be necessary to collects $4 from the customer with the Government getting $3, and with a tax rate of 85 percent the customer would pay $6.66 of which the Government would take $5.66. In effect the result is the imposition of a hidden excise tax.

Senator MILLIKIN. Give me that last figure again, please. I cannot see the chart.

Mr. OAKES. If 85 percent, the company would have to collect from the customer $6.66, of which the Government would keep $5.66 and the company a dollar to restore the net earnings to reach the regulated amount.

Increase in the rates charged the consumer of this order would be impractical and present regulatory problems impossible of solution.

It would seem obvious that under the concept of Commission regulation the "point of entry" of an excess profits tax should not occur until the normal profit of allowable net earnings under utility commission rate orders has been exceeded.

Pennsylvania Power & Light Co. must be permitted to retain normal profits, to successfully finance its construction program: To finance this company's construction program as shown by chart 3 from 1946 to 1949 of 103 million dollars, 68.5 million dollars was raised through the sale of securities. Of this amount, 40 million dollars was by debt, 15 million dollars by preferred stock, and 13.5 million dollars by common stock. The remainder of 34.5 million dollars came from retained earnings and reserves, of which retained earnings was 11 million dollars for the 4-year period, or only 10 percent of the total required. Our construction program, based on a war-alerted economy, for the 5 years ending 1954, will require 107 million dollars, of which 51 million dollars must be raised by security sales.

Senator MARTIN. Where will the other part come from?

Mr. OAKES. The difference comes from reserves, such as depreciation reserves, and amortization reserves after the earnings which we do not distribute but retain and invest. That amounts, as you will see, to $56,000,000.

The increased net earnings resulting from its 1946 to 1949 construction program are absolutely necessary to support the securities issued to raise money to pay for such program. If, through an excess profits tax law, the company is deprived of such normal earnings, the matter of raising the $51,000,000 to pay for its $107,000,000 1950 to 1954 program becomes of grave concern.

Under an excess profits tax law such as proposed by Secretary Snyder before the House Ways and Means Committee, Pennsylvania's earnings would be so reduced as to result in seriously depressing the market for the company's common stock.

As a result, grave doubt exists as to whether or not its construction program could be financed with such reduced earnings. It is most essential to the completion of such program that the company, under its present capital structure, meet its financing requirements largely through the issuance of common stock.

I may say right here that we have just sold, now in progress, $11,000,000 of new common stock to the public.

Senator MILLIKIN. What does it pay?

Mr. OAKES. It pays $1.60. We just sold it at 23, which is quite a high return, as you see. The market for our stock has also been depressed in the past 2 weeks.

Senator MARTIN. How much has your common stock fallen off in the last 6 months?

Mr. OAKES. The common stock?

Senator MARTIN. I mean the sales price.

Mr. OAKES. The sales price went down from 25½ before Korea to 22¼, and then came back, before these hearings started, to 25¼ high, and since went down yesterday to 23¼.

Senator MILLIKIN. What interest do you pay on your debt?

Mr. OAKES. Our interest on our debt averages about 2.9.

Senator MILLIKIN. And on your preferred stock?

Mr. OAKES. On preferred stock, 4½ dollars per share.

Senator MILLIKIN. What is the preferred stock selling for?

Mr. OAKES. About 109, 108.

Pennsylvania, as one element necessary to sustaining the market value for its stock, presently is paying out about 61 percent of its net earnings in dividends, and must continue to pay adequate dividends so that its equity capital market shall not be impaired. Retained earnings can contribute only a minor portion of our capital requirements.

As I have just said, retained earnings contributes only 10 percent to our capital requirements.

Relief provisions of the law, to be really effective, should be written in such a way that the taxpayer be allowed to give effect to these relief provisions in its original filing even if it is necessary to risk a disallowance later with subsequent penalties. The reason for this lies in the fact that the company must file its return and pay its taxes and report its earnings on the basis of taxes paid, and must do its financing on the basis of earnings reported. To hold out relief provisions of the possibility of refund years later, which has been our experience under sections 711 and 722, nullifies the effect of these relief provisions as the market price of equity securities is largely determined on the basis of earnings reported.

An excess profits tax law that would be fair to public utilities: Under regulation, the rates for service which this company is permitted to charge depend upon its plant investment, which in turn is related to its outstanding stock, bonds, and surplus. These rates determine the company's net income, upon which depends its dividends, which in turn determine the prices at which the company's securities are sold. Any excess profits tax which depletes net income deemed normal under regulatory determinations not only does violence to the basic concept of excess profits but completely negatives the regulatory control of earnings and seriously affects the utility's ability to meet increasing service demands and maintain low rates in the public interest.

Therefore:

(*a*) Under any excess profits tax law, the tax should be applicable only to such part of the company's earnings as are in excess of the return allowed the company by the Pennsylvania Public Utility Commission.

(*b*) In establishing any standard measure of excess profits based on earnings, due consideration should be given to:

(1) The time lag, estimated at approximately 2 years under normal conditions, between actual investment of new capital and the point at which the earnings of such investment reach a normal level.

(2) The right to use the year 1950 as a basic measurement since the early postwar earnings do not reflect the normal earnings arising from the heavy capital investments made subsequent to 1945.

(3) To the base should be added an adequate factor to allow for increased earnings arising subsequent to 1950 from additional capital investment required to meet increased demands for service arising from all sources.

(*c*) A standard measure of excess profits based on invested capital should use 100 percent of the company's investment as per corporate books. Our capitalization has been passed upon by both the Securi-

ties and Exchange Commission, and the Pennsylvania Public Utility Commission.

I would like to reiterate that I think Mr. Whiting's comments and his suggestions are pertinent, and they would also be my suggestion.

Senator MARTIN. Are you familiar with the amendment to section 446 suggested by Mr. Whiting?

Mr. OAKES. Yes, sir.

Senator MARTIN. Do you understand that this amendment suggests the substitution of books of account for a tax base concept of capital investment?

Mr. OAKES. Yes, sir, to the extent that these books of account are in fact in conformity and are in accordance with the books of account, and the principles prescribed by the Federal Power Commission.

In that case, of course, that means that only those companies who have been through the regulatory processes of having those books of accounts meet the prescription of the Federal Power Commission would be set up on this basis.

Senator MARTIN. Is that generally accepted now by the utilities as fair and equitable?

Mr. OAKES. Yes, sir. As I have just testified, more than—well, all but 11 companies in the whole United States of 305, I think the figure is, have been through this process, and the electric utilities are now reporting their balance sheets in accordance with the books of accounts prescribed by the Federal Power Commission.

Senator MARTIN. Mr. Chairman, that was an astounding statement to me. I did not have any idea there was that large a percentage that had conformed.

Mr. OAKES. The entire electric industry now keeps its accounts absolutely on the basis set up by the Federal Power Commission.

The point is, if we take 6 percent on the capitalization set up by those books, we are not taking something that the utility management, the utilities themselves have set up, but something that has been set up by judicial process in accordance with State laws and even laws passed by Congress.

Senator MARTIN. That now is beginning to be generally accepted by the investing public?

Mr. OAKES. I think the investing public rests its entire judgment of security values, not entirely, but almost entirely, on the integrity of those balance sheets reported by the Federal Power Commission.

Senator MARTIN. How many common-stock holders does the Pennsylvania Power & Light have?

Mr. OAKES. We have something over 20,000 stockholders.

Senator MATIN. What is the average holding?

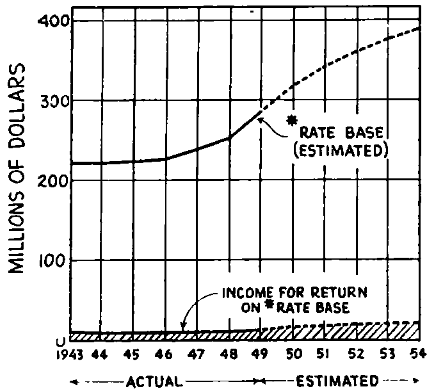
Mr. OAKES. The average holdings of our individual common-stock holders, are 65 shares. We have a stockholder, a common-stock holder, that owns more than 2 percent. That is an investment company.

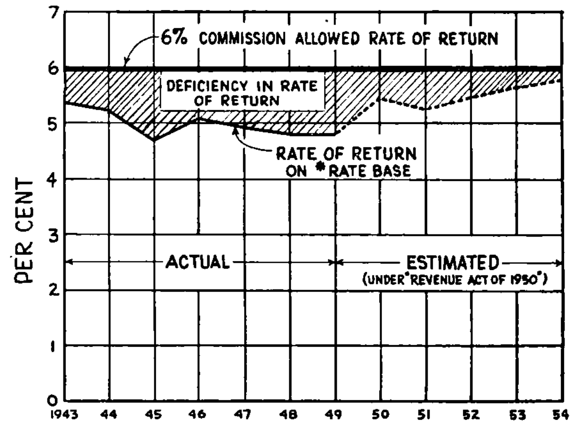
The CHAIRMAN. We thank you very much, Mr. Oakes.

Mr. OAKES. Thank you very much, gentlemen, for the opportunity to appear.

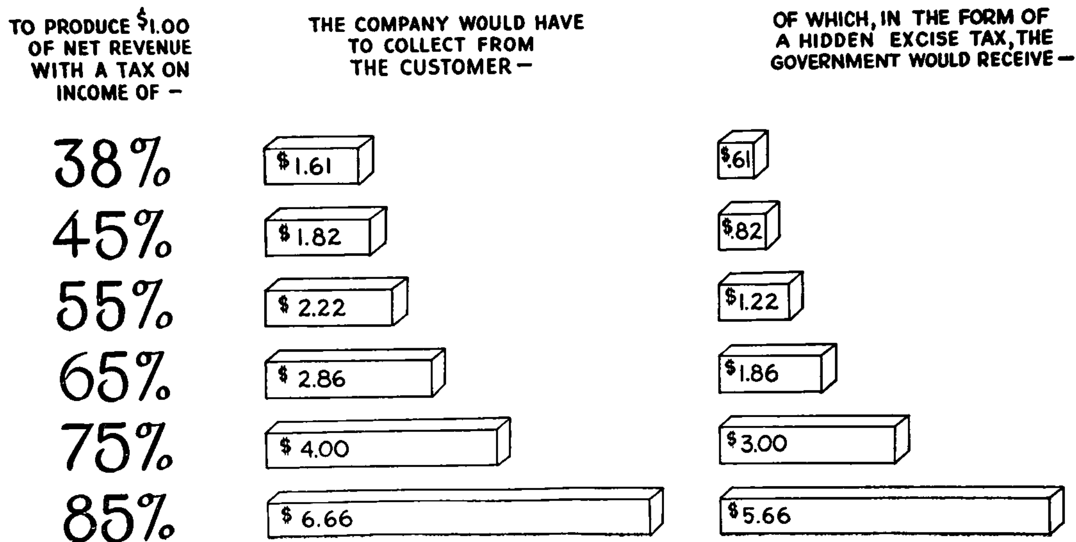
(The charts submitted by Mr. Oakes are as follows:)

PP&L CO.'S EARNINGS LIMITED BY PENNSYLVANIA PUBLIC UTILITY COMMISSION



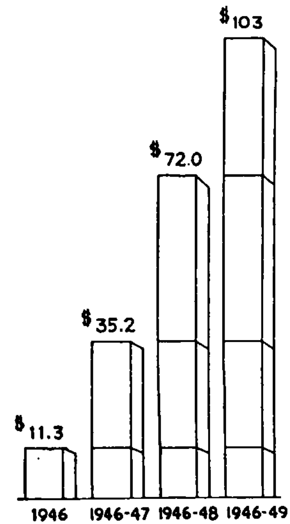


IN THE REGULATED UTILITY INDUSTRY A DISPROPORTIONATE BURDEN IS PUT ON RATE PAYERS WHEN IT BECOMES NECESSARY TO APPLY TO UTILITY COMMISSIONS FOR RATE INCREASES TO REPLACE NORMAL EARNINGS TAKEN THROUGH AN EXCESS PROFITS TAX

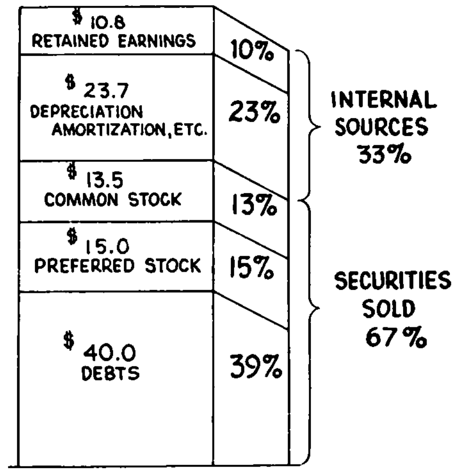


LIMITATION OF PP&L CO.'S EARNINGS UNDER COMMISSION REGULATION REQUIRES SALE OF SUBSTANTIAL AMOUNTS OF NEW SECURITIES TO INVESTORS

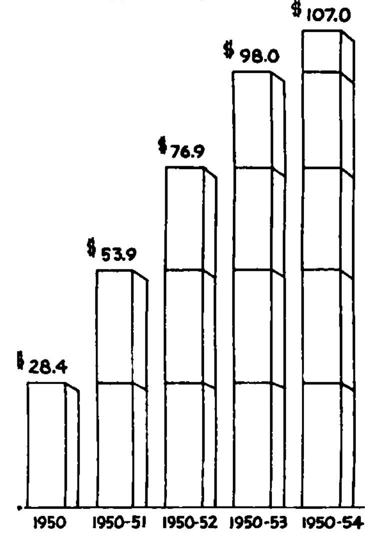
PP&L CO.'S POST-WAR EXPANSION PROGRAM (1946-49) HAS COST $103 MILLION



2/3 OF THIS $103 MILLION CAME FROM SALE OF SECURITIES



PLANNED $107 MILLION CONSTRUCTION TO MEET CIVILIAN AND DEFENSE NEEDS WILL REQUIRE SALE OF $51 MILLION NEW SECURITIES



The CHAIRMAN. Mr. George L. Buland.

Since practically all of the witnesses are dealing here with one common subject, the regulated utilities, the committee desires to hear you fully, but you might find it helpful and helpful also to the committee, by omitting the general arguments with which the committee is reasonably familiar, and giving us specific facts relating to the industry.

Mr. BULAND. I shall be very glad to take the opportunity to do that.

The CHAIRMAN. You may proceed.

STATEMENT OF GEORGE L. BULAND, REPRESENTING THE ASSOCIATION OF AMERICAN RAILROADS

Mr. BULAND. My name is George L. Buland. I am general counsel of the Southern Pacific Co., and appear here today as a representative of the Association of American Railroads.

That association is a voluntary nonprofit organization of railroads which operate more than 95 percent of the total railroad mileage of the United States, and the revenues of which are ordinarily in excess of 95 percent of the total annual railroad revenues.

Upon the assumption that an excess profits tax law would be considered by this Congress, the representatives of the railroads agreed upon certain features which, in their opinion, should be incorporated in the proposed law and authorized this presentation to be made to this committee in behalf of the industry.

The railroads have not passed collectively upon the advisability of Congress enacting an excess profits tax law at all or upon their preference as between an excess profits tax law and alternative methods of enhancing Federal revenues, and I, as their spokesman, must refrain from expressing at this time any preference in this regard.

I ask that the statement which has been filed with the clerk be printed following my verbal presentation.

The CHAIRMAN. Furnish it to the reporter, and it will be included in full.

Mr. BULAND. In taking up the excess profits tax bill before you, we must first express our appreciation for the consideration given the railroads' views by the staff of the joint committee, the Ways and Means Committee, and the House.

The bill as passed by the House has removed three instances of inequitable treatment resulting from technicalities under the former law. It expressly permits, as that law did not, the inclusion of conditional sales contracts in borrowed capital. It excludes from excess profits tax net income, income to a lessor arising solely from a lessee's obligation to pay the lessor's income and excess profits taxes. It permits an equitable apportionment of excess profits credit by the Commissioner between lessor and lessee in the case of long-term railroad leases.

Most important, the bill recognizes the principle that railroad companies, operating in a regulated industry, should be allowed to receive a fair return upon invested capital, after normal taxes and surtaxes, before being subjected to an excess profits tax. And that is a point which some of the gentlemen before me have spoken of.

The House bill differs from the proposal of the railroads in that only a 5-percent return instead of a 6-percent return upon invested

capital is allowed in computing the excess profits credit. The treatment of the railroads in this respect is less favorable than that of other regulated utilities, including pipeline companies, which are allowed a 6-percent return.

Senator MILLIKIN. What is the theory for that?

Mr. BULAND. We see no basis for this distinction. As a matter of fact, we have to pay more to get money from the investing public than do the public utilities.

Senator MILLIKIN. May I ask the staff what is the theory for the difference, Mr. Chairman?

The CHAIRMAN. Mr. Stam, what was the theory of allowing 5 percent to railroads and airlines, and 6 percent to others?

Mr. STAM. Just the committee action on it. They felt a fair return on the invested capital of railroads would be about 5 percent, and that the other companies would be subject to a little more risk, and, therefore, they thought 6 percent was more advisable. I mean that was their own action, of the committee itself. They made that decision.

Senator MILLIKIN. Did they have testimony on the difference in risk?

Mr. STAM. No; they discussed it in the executive session.

Senator KERR. I do not see how there could possibly be any relation between the risk as between railroads and airlines on the one hand, as to any favorable position with reference to the transportation companies, in comparison with other regulated utilities on the other hand.

Mr. MILLIKIN. I cannot see the slightest reason for discrimination.

Mr. BULAND. For example, the risk as weighed by the investing public, you have heard here testimony as to the common-stock prices and yields on common-stock prices in the case of public utilities. Six and one-half or seven percent, I think, were some instances given. There has been no public stock financing to any great extent in the railroad industry because investors have not been attracted because of the risk which exists.

My own company, the Southern Pacific Co., did undertake recently equity financing in an indirect way in issuing convertible debentures which were convertible into stock. Those debentures were convertible into stock at a price of $55 per share. Now the annual dividend on that stock was $5. So that provided a return of about 9 percent to the investors. I would say that about one-third of the convertible issue of $37,000,000 has now been converted. But that shows what has to be paid by a railroad company, which we think is one of the larger companies in the industry, in a growing territory, in order to attract equity capital, which is of vital importance. That is the same way in regard to other securities. We have to pay more money because the people generally regard the risk as higher. I do not think I need to elaborate that point. It is within the common knowledge of the people.

Senator MILLIKIN. I do not pretend to be qualified hardly to pass an opinion on the subject. I thought railroad securities were regarded as among the higher risk securities in the securities field.

Mr. BULAND. I think that is unquestionably the case. Certainly they should not be discriminated against.

The privately owned railroads of this country are the very backbone of our industrial economy. Their performance in the handling of war and other traffic during World War II was universally conceded to be outstanding. For them to continue to function with efficiency in the period into which we have now entered, they must have adequate earnings. Such earnings are necessary to maintain their properties, to invest a proper ratio of such earnings in additions and improvements, and to pay a return upon their securities so that new capital will be attracted.

The rates and fares charged by railroads have been regulated since before the turn of the century and, generally speaking, there can hardly be any such thing as excessive profits in the industry.

The principle of rate regulation contemplates not only the avoiding of excess rates and charges but also the permiting of reasonably compensatory charges for railroad transportation so that this important industry, clothed with the public interest and serving the most essential needs of the Nation, may function properly in the public interest. That principle is expressed in the national transportation policy declared by Congress, it is a premise upon which regulatory bodies proceed in fixing rates, and it is a fact accepted by the shipping and traveling public which must pay the charges. Congress should not enact an excess profits tax law which will impinge upon the concept of a fair return for the regulated railroad industry which Congress has itself pronounced and which is a sina qua non for the preservation and expansion of the Nation's railroad system under the free-enterprise system.

Secretary Snyder in his statement before this committee has stated that the principle of permitting a fair return to railroads and other regulated industries, after normal taxes and surtaxes, before imposing excess profits taxes is undesirable as discriminating in favor of such industries.

His criticism is not well-founded. In the first place, the incomes of the regulated industries, and particularly the railroads, during the base period were not high. In the railroad industry the average return upon net depreciated investment did not come up to a fair return, whether measured at 6 or 5 percent.

Consequently, the railroad industry as a general rule is not protected in respect of a fair return by the average-earnings method of arriving at an excess profits credit. Other industries are protected in much more than a 6 percent return by the average-earnings method. According to the figures submitted by Secretary Snyder to the Ways and Means Committee, all industry groups on the average, in the year 1947, earned 13 percent after taxes upon net worth and their earnings may well have been higher in the succeeding base period years. As against these figures as to profits, the request of the railroads for a net return of 6 percent appears modest.

In the second place, the railroads, as a regulated industry, have no opportunity to earn large sums as related to their invested capital at any time and, even if permitted in times of great economic activity to earn 6 percent, their average earnings over a period of years are bound to be less than that amount.

Finally, and most important of all, the railroads are vital as few other industries are to the welfare of this country and to its defense

in time of war and there exists a great practical interest in affording such a return to the railroads that they may function in pease and in war.

These are the reasons why the railroads should be assured a fair return. They need that protection, whereas industries outside the regulated field do not.

Now, as I say, we were gratified that the House included the railroads and the other regulated utilities in the assurance of a fair return before excess profits taxes, but there was an amendment in the House, which has been referred to, which we think is unduly limiting, which was to the effect that this fair return principle should be confined in the case of a railroad company to one whose excess profits net income is substantially all derived from transportation. "Substantially all," of course, is a very strong expression. Almost all railroads would derive a certain amount of income from incidental activities. For instance, there would be from the capital of a railroad company, the working capital, and from some reserve funds, amounts which are invested in Government securities, in the case of most companies, and there is interest derived from that.

Then there is land which is held by railroads, perhaps acquired for future use, perhaps acquired as a result of prior transactions from which rents are derived. Then, there is income from such incidental services as the dining-car and commissary service and the concessions operated in stations.

Again, railroads derive income from the rental of freight cars to other railroads and from joint facility rentals where there tracks are used by others.

Now, that is income which, though purely incidental to railroad operation, might not surely come within the definition of being income derived from transportation. So if this amendment is taken, the privilege of a fair return to the railroads might be taken away from them by this undue limitation.

Senator MILLIKIN. Mr. Chairman, may I ask Mr. Stam whether the point is good. Is it intended to reach the type of thing which the witness is describing?

Mr. STAM. I do not think it was directed at the railroads, the particular phrase he referred to, "substantially all." I think the main object back of the amendment was to be clear that in case of transportation of gas by pipeline and oil by pipeline you would be confining the exemption to a company which substantially was engaging in those activities.

Senator MILLIKIN. Could that not be cleared up as far as railroads are concerned in the report?

Mr. STAM. I think it could. You had the same problem this morning with respect to some of the electric companies.

Mr. BULAND. Rather hastily we submitted some language to take care of it, but if Mr. Stam is going to take that on as a technical problem, I do not need, I think, to go into that language.

We think the test should be in relation to the gross income of the taxpayer because the comparison is with gross income items and because also the net income from any particular source would be difficult to ascertain. Moreover, we think a definite percentage should be stated so as to eliminate difficult questions of discretion and so as to

take care of general fringe items such as I have mentioned. In the determination of what is a regulated investment company under section 361 of the Internal Revenue Code, the test is as to whether 90 percent of gross income is derived from particular sources. Again, in defining a personal holding company, section 501 of the Internal Revenue Code, the test rests upon whether 80 percent of gross income is of a particular kind. We suggest that in lieu of the amendment in the House that there be substituted the following new subsection (d) in section 446 of the House bill, viz:

For the purpose of this subchapter the term "regulated public utility" means a corporation described in subsection (c) more than 80 percent of the gross income of which for the taxable year is derived from sources described in subsection (c). For the purpose of this subsection dividends from domestic corporations which are subject to taxation under this chapter shall be excluded from gross income.

In reference to the last sentence of the suggested amendment, dividends are not included in the excess profits net income and therefore should be excluded in this computation.

Now, at this point I want to comment on a matter which is not in my statement because we had to prepare this statement very rapidly after seeing the bill.

I want to make the position of the railroads clear on this. This is the point which was also discussed this morning in regard to what invested capital base should be taken.

The railroads considered this in advance of the bill being adopted, and they came to a conclusion which was expressed in our recommendation, which was this: that the railroads preferred to have the invested capital based upon the basis which existed in World War II but with an election to those companies which had difficulties in computing under that method to use the asset approach.

Now, I am in somewhat a difficult situation because some of my railroads—and I speak here for all railroads—prefer the World War II method, while I think others would state that they prefer the asset method.

Now, on the World War II method, I want to just mention the case of my company. We did determine our invested capital under the World War II method, which was similar to the methods, of course, in the 1918 and 1921 Revenue Acts. We have a determination which has been used so far through the years to 1944, and we know what that is, and we hate very much to be cast upon a new sea of determination. But, as I say, there is this difference of viewpoint which resulted in the recommendation of a choice being given. That is the situation.

Senator KERR. Mr. Chairman, Mr. Stam would like to get some information here.

The CHAIRMAN. Mr. Stam.

Mr. STAM. I think when the railroad people appeared before the technical groups, in talking about the World War II method of computing invested capital, I think they were very much interested in at least using the basis for gain rather than the basis for loss so that they would not have to go back of March 1, 1913. Some of them felt that they were being discriminated against because when they were reorganized way back in 1890, and some of those back years, they had a very low basis, and if they could start off with March 1,

1913, they would be much better off. I believe that was in some of the recommendation.

Mr. BULAND. I think, Mr. Stam, that is correct, although I believe you would agree they said primarily they expected the World War II method to apply.

Mr. STAM. Yes.

Mr. BULAND. And certain railroads were interested in this, especially those who had been through reorganizations, as having the asset method as an alternative, and that is the position I have to state as a representative of the railroads.

I think that the entire subject should be carefully examined.

The House bill is to be commended in providing an excess profits credit, upon equity invested capital, of a minimum of 8 percent. The Revenue Act of 1940 allowed a minimum credit of 8 percent upon invested capital and, when it is considered that normal taxes and surtaxes must be paid out of the income within such credit, this is as low a rate of return as is consistent with the functioning of American business generally for those who are not so fortunate as to be able to use an average-earnings method.

We regret that the House bill does not include borrowed capital as invested capital for the purpose of determining the excess profits credit under section 436. There is no distinction in use between property provided by borrowed money or through the sale of stock or the plowing back of earnings. We think that the same return should be allowed upon all property no matter how financed.

Senator KERR. Let me ask you a question.

Mr. BULAND. Yes.

Senator KERR. You are familiar with the general provisions of the House bill?

Mr. BULAND. Yes, sir.

Senator KERR. About allowing 133 percent, I believe, or 135 percent of the interest rate?

Mr. BULAND. 133 percent.

Senator KERR. 133 percent, yes. What is the average rate the railroads pay on indebtedness?

Mr. BULAND. I am going to have to make an estimate, but it would be in the neighborhood of 4 percent.

Senator KERR. That is probably a little above that which is generally paid by industry?

Mr. BULAND. I think that is right, yes.

Senator KERR. But even at the basis of 4 percent, that would mean if the railroad industry borrowed the money with which to make the necessary expansion to provide the facilities to meet the increased demand during this emergency period, that you would be permitted to earn 1⅓ percent on that invested capital——

Mr. BULAND. As compensation for the risk and to provide eventually for the repayment of those obligations.

Senator KERR. And that would be subject to the normal tax rate which is 45 percent at the present time. That would then leave you about two-thirds of one percent. That would take you 150 years to pay it back if you suffered no extraordinary losses.

Mr. BULAND. We do not think that is adequate, Senator.

Senator KERR. Do you think it would be possible?

Mr. BULAND. No; I do not.

Senator KERR. Do you think anybody with any money would have little enough sense to loan it to you if that was the way it was going to be paid back to them?

Mr. BULAND. Senator, we have to run the railroad, no matter what Congress does, so I——

Senator KERR. But I mean with reference to this particular provision.

Mr. BULAND. I do not think it is equitable.

Senator KERR. Do you think there is any borrower who would want to borrow, or any lender who would want to lend on that basis?

Mr. BULAND. If that is what the security was, if they did not look for further assets, they would not want to loan because they could not see where the money was coming back.

Senator KERR. That would mean, then, you would have to find other collateral in order to be able to expand.

Mr. BULAND. That is right, yes. I want to make the point the provision in the House bill departs from the fundamental principle of inclusion of borrowed capital in the base, although allowing an addition to the credit on account of interest on borrowed capital. This may work more favorably or less favorably to a taxpayer than the inclusion of borrowed capital in invested capital, but it gets away from the basic principle, which is unfortunate.

In arriving at the measure of the normal earnings of taxpayers to which excess profits taxes should not apply, there is no justification, so far as the railroad industry is concerned, in taking a standard any less than 100 percent of the average earnings during the base period, 1946 to 1949. Railroad earnings were not high but were low during these years. This was due to inability to adjust rates and fares quickly in order to provide earnings to meet the increasing costs of material and labor, the heavy maintenance expense after World War II in making up for deferred maintenance, the coal strike which occurred in 1949, and other factors.

The House bill made no provision for a deduction for maintenance which is deferred in time of national emergency because materials and labor are unavailable. We ask that such provision be made, and specific proposals are contained in the statement which is being filed.

Retroactive tax legislation is always unfortunate and, if excess profits taxes must apply to any part of 1950, we think they should not apply to income prior to October 1, 1950.

Finally, since section 201 of the House bill provides for consolidated returns for the purpose of the excess profits tax law, as indeed it must if proper tax accounting is to be obtained, the time is now ripe to correct the injustice created by the imposition of a 2 percent penalty for filing consolidated returns, and it should be eliminated.

Senator KERR. If you had a subsidiary company expanding with borrowed capital, the limit it could make would be approximately six-tenth of 1 percent on the borrowed investment capital, and the consolidated tax return penalty being 2 percent, it would succeed in getting you out of business a lot quicker even than you would be able to retire the investment if you did not have a penalty, would it not?

Mr. BULAND. That is right. And while 2 percent is getting less in relation to tax, it is getting more in relation to what is left after we pay the tax.

The CHAIRMAN. Thank you very much, Mr. Buland. The statement you have submitted will be placed in the record.

(The statement submitted by Mr. Buland reads in full as follows:)

STATEMENT OF GEORGE L. BULAND ON BEHALF OF THE ASSOCIATION OF AMERICAN RAILROADS

RAILROADS AND AN EXCESS PROFITS TAX LAW

Foreword

My name is George L. Buland. I am general counsel of the Southern Pacific Co. and appear here today as a representative of the Association of American Railroads. That association is a voluntary nonprofit organization of railroads which operate more than 95 percent of the total railroad mileage of the United States and whose revenues are ordinarily in excess of 95 percent of the total annual railroad revenues.

Upon the assumption that an excess profits tax law would be considered by this Congress, the representatives of the railroads agreed upon certain features which, in their opinion, should be incorporated in the proposed law and authorized this presentation to be made to this committee in behalf of the industry.

The railroads have not passed collectively upon the advisability of Congress enacting an excess profits tax law at all or upon their preference as between an excess profits tax law and alternative methods of enhancing Federal revenues, and I, as their spokesman, must refrain from expressing at this time any preference in this regard.

The railroads advance as meritorious all of the proposals which are included in the statement which has been filed with the clerk, and which I ask to be printed following my verbal presentation. The time allotted will not permit the development orally of each of the proposals, some of which are necessarily technical and complex. But they should all be regarded as being important and they are adequately covered in the statement.

The privately owned railroads of this country are the very backbone of our industrial economy. Their performance in the handling of war and other traffic during World War II was universally conceded to be outstanding. For them to continue to function with efficiency in the period into which we have now entered, they must have adequate earnings. Such earnings are necessary to maintain their properties, to invest a proper ratio of such earnings in additions and improvements, and to pay a return upon their securities so that new capital will be attracted.

The rates and fares charged by railroads have been regulated since before the turn of the century and, generally speaking, there can hardly be any such thing as excessive profits in the industry. However, we are not now advocating that the railroads should be exempted from excess profits taxes upon earnings which can be fairly regarded as properly subject to such taxes.

The principle of rate regulation contemplates not only the avoiding of excessive rates and charges but also the permitting of reasonably compensatory charges for railroad transportation so that this important industry, clothed with a public interest and serving the most essential needs of the Nation, may function properly in the public interest. That principle is expressed in the national transportation policy declared by Congress, it is a premise upon which regulatory bodies proceed in fixing rates, and it is a fact accepted by the shipping and traveling public which must pay the charges.

The fundamental point which we make is that Congress should not enact an excess profits tax law which will impinge upon the concept of a fair return for the regulated railroad industry which Congress has itself pronounced and which is a sine qua non for the preservation and expansion of the Nation's railroad system under the free enterprise system.

Turning to the railroads' specific proposals as listed in the table of contents of our statement, I will state very briefly what they are.

An excess profits tax law should include a proviso to the effect that, in the case of railroads subject to part I of the Interstate Commerce Act, the excess profits credit shall in no event be less than the sum of (1) 6 percent upon their outstanding invested capital and (2) normal taxes and surtaxes imposed under chapter I of the Internal Revenue Code. It seems incongruous that a regulated industry should be required to pay excess profits taxes in addition to normal taxes and surtaxes, upon income which is a part of the fair return which it is

entitled by law to earn and which, indeed, sound public policy fosters and promotes. Yet that would be the case if the World War II excess profits tax law should be applied to present conditions. For large companies, the excess profits credit was limited by the World War II law to 5 percent upon invested capital. Out of that return of 5 percent, there would have to be paid, commencing in 1951, 45 percent thereof in normal taxes and surtaxes (47 percent for railroads joining in a consolidated return), and there would remain a net return of only 55 percent of 5 percent, or 2.75 percent. This is too small an amount to provide for capital improvements or to attract new capital. Our proposal is that, in the regulated railroad industry, profits should not be regarded as excessive until a fair return has been earned after normal taxes and surtaxes.

The invested capital, upon which a return should be earned, should include all of borrowed capital, instead of only 50 percent thereof as under the World War II law. The public need for transportation facilities does not distinguish between properties paid for by borrowed money or through the sale of stock or the plowing back of earnings. The same fair return should be allowed to be earned upon all of such properties by the tax law as well as by regulating authorities. This is of vital importance to the railroads which must obtain much of their capital requirements from borrowings.

Invested capital should include indebtedness evidenced by conditional sales contracts as well as that evidenced more elaborately by notes or bonds. By a quirk of the World War II law, indebtedness evidenced by conditional sales contracts was excluded from invested capital. This quirk should not be perpetuated as it would hamper railroads in following normal financial practices in obtaining as economically as possible funds for equipment purchases.

The proposals discussed so far relate to excess profits tax credits obtained through the invested capital method. It is assumed that taxpayers will be allowed alternatively to compute their excess profits credit upon the average earnings method, that the base period will include all or a number of the years in the period 1946 to 1949, inclusive, and that some suitable provision will be made to safeguard those who had one or two bad years during this period. This is gone into more extensively in the statement, but the point which I wish to stress now is that, so far as the railroad industry is concerned, there is no iota of reason for considering that anything less than 100 percent of the earnings for the base period would afford a reasonable standard of fair and nonexcessive earnings. Railroad earnings during this period were not large but to the contrary were small. This was due to the inability to adjust rates and fares quickly in order to provide earnings to meet the increasing costs of material and labor, the heavy maintenance expense after World War II in making up for deferred maintenance, the coal strike which occurred in 1949, and other factors. Class I railroads of the United States earned collectively in 1946, 2.75 percent on their combined recorded net investment; in 1947, 3.41 percent; in 1948, 4.24 percent; and in 1949, 2.85 percent. A fair method of arriving at average earnings credit is of great importance to certain railroads which find the invested capital method of computing their excess profits credit impossible or difficult. Some of our important railroads were reorganized many years ago and a determination of their invested capital is exceedingly complex and difficult, and there is a tendency for invested capital in their cases to be depressed far below the real value of their properties since securities were issued in depression years and are valued for invested capital purposes at the depressed prices of those years.

In time of war or of national emergency it is impossible to obtain materials and labor in order to perform all of the maintenance upon railroad road and equipment which is desirable and which would have been performed if materials and labor were available. The railroads are penalized taxwise because they are prevented from securing the deductions for such postponed maintenance expenditures and the public interest is affected adversely by provision not having been made for the railroad properties to be maintained as well as would have been desired. To meet this situation it is proposed that in computing net income of any carrier there shall be allowed a deduction for the amount which a carrier shall, pursuant to Interstate Commerce Commission authorization, accrue in its accounts as a reserve to provide for the cost of maintenance and repairs which it is unable to undertake or complete in any taxable year, with provision that the amount reserved shall be invested in United States securities and that the contemplated expenditures will be made within 5 years after the termination of the emergency.

For the most part, the written statement coincides substantially with the statement which was filed October 24, 1950, in behalf of the railroads by Mr. J. Carter

Fort, general counsel of the Association of American Railroads, with Mr. Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation. There has been added a part dealing with the proposal for a deduction on account of postponed maintenance, to which I have referred briefly.

Attention is called to matters in the statement not previously mentioned; the correction of requirement, imposed by administrative authority, which applied to most railroads under the World War II law, that accumulated earnings and profits be reduced by a 30-percent reserve for past unaccrued depreciation; relief from unfair, even fantastic, results which might obtain if the World War II excess profits tax law were reenacted without change in certain lessor-lessee relations; the necessity of suitable relief provisions for exceptional cases along the lines of section 722 IRC (of the old law); permission to construct an invested capital from property valuations where it is impractical to trace invested capital; and the like. Finally, to revert to an old subject, we see neither justice nor expediency in the imposition of a 2-percent penalty for the filing of consolidated returns.

I. Special treatment of railroads called for by national transportation policy and required for national defense

The impact of an excess profits tax law upon the railroads requires special consideration in the light of the established policy of Congress with respect to transportation, and particularly with reference to the requirements of national defense during the present emergency period.

National defense depends upon the railroads. As was truly said in the course of World War II: "We might suffer military reverses and still win the war, but we cannot avoid defeat should our railroads fail" (Col. J. Monroe Johnson, Interstate Commerce Commissioner and Director of the Office of Defense Transportation, May 9, 1943). During the World War II years 1941–45 the railroads moved more than 90 percent of war freight, carried more than 97 percent of the organized troop movements, and performed more than 70 percent of all transportation services. As found by the Brookings Institution of Washington in a study conducted by it at the request of the Hoover Commission on Organization of the Executive Branch of the Government (published in October 1949 under the title "National Defense Policy"):

"There seems to be little doubt that in the predictable future the main burden of war-generated traffic will be carried by the railroads as it has in the past. For this reason alone, the system must at all times be maintained in a high state of physical and operating efficiency with sufficient flexibility to permit rapid increase in carrying capacity."

Clearly the railroads cannot be maintained in a high state of physical and operating efficiency, with the flexibility required to permit rapid increase in carrying capacity, if taxes be permitted to take away earnings the retention of which is requisite to suitable improvement and expansion of the railroad plant. It follows that the interests of national defense dictate that an excess profits tax law be so drawn as to safeguard against a crippling impact of excess profits tax exactions upon the railroad industry.

As will appear hereinafter, the railroads do not suggest that they be exempted from excess profits taxation. A strong case might be presented in support of such exemption in view of the heavy burden of normal taxes and surtaxes at the presently prevailing rates. The proposals now advanced, however, do not look beyond moderation of the effect of excess profits taxation upon the earnings of railroad companies, which cannot be expected fully to perform their essential function without the measure of protection advocated.

Special treatment of the railroad industry in an excess profits tax law is not only called for by the requirements of national defense but is justified by their status as quasi-public utilities subject to regulation in respect of virtually every aspect of their business, including their accounts, their methods of financing, and the charges they may impose for the services they render.

It is important to appreciate that from the enactment of the Transportation Act of 1920 down to the present day the system of railroad regulation has looked beyond the mere prevention of abuses. By 1920 the Congress and the country had come to the realization that under the earlier regulatory laws the carrying capacity of the railroads had not developed commensurately with the development of commerce, that great difficulty had been encountered in procuring new capital upon feasible terms, and that these factors, coupled with the untoward effect of Government operation during World War I, had brought the railroads face to face with demoralization of their income and their credit.

For these reasons, the 1920 act (41 Stat. 474), in unequivocal terms, declared an affirmative purpose to build up and foster an adequate transportation system. To this end, the carriers were placed more completely than ever under the control of the Interstate Commerce Commission. The Commission was given supervision of security issues, control of car supply and distribution, the last word as to construction of new lines and abandonment of old lines, and finally, the Commission was enjoined to so regulate rates as to afford an opportunity for the realization of a fair return. As the Supreme Court said in *The New England Divisions case* (261 U. S. 184, 189–190):

"Transportation Act, 1920, introduced into the Federal legislation a new railroad policy. [Citation omitted.] Theretofore, the effort of Congress had been directed mainly to the prevention of abuses, particularly, those arising from excessive or discriminatory rates. The 1920 act sougth to insure, also, adequate transportation service. That such was its purpose, Congress did not leave to inference. The new purpose was expressed in unequivocal language. And to attain it, new rights, new obligations, new machinery were created. The new provisions took a wide range. Prominent among them are those specially designed to secure a fair return on capital devoted to the transportation service."

The purpose and policy of the 1920 enactment were reiterated in unmistakable terms in the Transportation Act of 1940 (54 Stat. 899), which incorporated in the Interstate Commerce Act the following declaration of national transportation policy:

"It is hereby declared to be the national transportation policy of the Congress * * * to promote safe, adequate, economical, and efficient service and foster sound economic conditions in transportation * * * to the end of developing, coordinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of the commerce of the United States, of the postal service, and of the national defense."

The 1940 amendment did not represent a change, but rather a reiteration of congressional intent. Continuity of policy has characterized railroad legislation since 1920. That policy contemplates that the railroads shall not be deprived of an opportunity to earn a return adequate to sustain a sound and efficient system of transportation by rail.

In *Wisconsin R. R. Comm.* v. *C. B. & Q. R. R. Co.* (257 U. S. 563, 584 (1922)), the Supreme Court of the United States, speaking of the Transportation Act of 1920, said that "the most novel and most important feature of the act, requires the Commission so to prescribe rates as to enable the carriers as a whole, or in groups selected by the Commission, to earn an aggregate annual net railway operating income equal to a fair return on the aggregate value of the railway property used in transportation." Again, in the same case (p. 589), the Court said:

"* * * Congress in its control of its interstate commerce system is seeking in the Transportation Act to make the system adequate to the needs of the country by securing for it a reasonable compensatory return for all the work it does."

In *Dayton-Goose Creek Ry. Co.* v. *U. S.* (263 U. S. 456, 478 (1924)) it was pointed out that the new act "seeks affirmatively to build up a system of railways prepared to handle promptly all the interstate traffic of the country." "It aims," the Court added, "to give the owners of the railways an opportunity to earn enough to maintain their properties and equipment in such a state of efficiency that they can carry well this burden."

In *Texas & P. Ry. Co.* v. *Gulf, C. & S. F. Ry. Co.* (270 U. S. 266, 277 (1926)) the Court said that by the enactment of the Transportation Act of 1920:

"* * * Congress undertook to develop and maintain, for the people of the United States, an adequate railway system. It recognized that preservation of the earning capacity, and conservation of the financial resources, of individual carriers is a matter of national concern; that the property employed must be permitted to earn a reasonable return; * * *."

Considering the national transportation policy in the light of the Transportation Act of 1940, the Court said in *Seaboard Air Line R. Co.* v. *Daniel* (333 U. S. 118, 124–125 (1948)):

"Congress has long made the maintenance and development of an economical and efficient railroad system a matter of primary national concern. Its legislation must be read with this purpose in mind. In keeping with this purpose Congress has often recognized that the Nation's railroads should have sound corporate and financial structures and has taken appropriate steps to this end."

It is obvious that if the national transportation policy looking to adequate earnings and a sound financial structure be lost sight of in the enactment of an excess profits tax law, Congress might, perhaps unwittingly, stultify itself by defeat of its own avowed policy.

There is no doubt that the national transportation policy reaches beyond the confines of the mere administration of the Interstate Commerce Act. It is intended to permeate and condition all legislation directly affecting the transportation industry. *Davis* v. *Farmers Co-Op. Equity Co.* (262 U. S. 312) ; *Sou. Pac. Co.* v. *Arizona* (325 U. S. 761, 773).

In the Davis case it was held that a Minnesota statute was invalid in its application to the particular facts presented because it imposed a serious burden on interstate commerce, which unduly interfered with the policy of Congress as manifested in the Interstate Commerce Act. In the Southern Pacific case a State statute known as the Arizona train-limit law was declared unconstitutional, the Court saying of the statute that it "interposes a substantial obstruction to the national policy proclaimed by Congress, to promote adequate, economical, and efficient railway transportation service."

We respectfully suggest, therefore, that the obligation rests upon those responsible for the formulation and enactment of an excess profits tax law to take the national transportation policy into account, and to see to it that such a law be not so drawn as to deprive the railroads of an opportunity, at least, to realize, and retain for essential corporate purposes, a reasonable return upon their outstanding invested capital.

In the light of the congressional purpose and policy alluded to above, the railroads urge favorable consideration of their proposals and suggestions, which it may be well to summarize at this point.

II. Summary statement of railroad proposals and suggestions

The proposals and suggestions of the railroads with respect to an excess profits tax law hereinafter set forth are in part responsive to items listed for special consideration in a letter dated October 3, 1950, addressed to Mr. J. Carter Fort, vice president and general counsel of the Association of American Railroads, by Mr. Colin F. Stam, chief of staff of the Joint Committee on Internal Revenue Taxation, and in part they go beyond the scope of the items listed by Mr. Stam. For convenient reference a copy of Mr. Stam's letter of October 3, 1950, is attached hereto as appendix I. In summary the proposals are as follows:

(1) Provision should be made for both an invested capital base and an average earnings base for determining normal profits (item 1 of Mr. Stam's letter).

(2) There should be incorporated a proviso to the effect that in the case of railroads subject to part I of the Interstate Commerce Act the excess profits credit shall in no event be less than the sum of (*a*) normal taxes and surtaxes and (*b*) a return of 6 percent upon invested capital.

(3) The invested capital base should include 100 percent of borrowed capital.

(4) Express provision should be made for inclusion in borrowed capital of indebtedness represented by conditional sales contracts.

(5) Relief should be afforded from the requirement (imposed by the Commissioner of Internal Revenue as a condition precedent to change-over from retirement to depreciation accounting) that accumulated earnings and profits be reduced by a 30 percent reserve for past unaccrued depreciation.

(6) There should be excluded from excess profits net income constructive income to a lessor resulting from payment by the lessee of the lessor's Federal income and excess profits taxes.

(7) Suitable provision should be made for the filing of consolidated returns by lessor and lessee companies or, in the alternative, for apportionment of the combined excess profits credit between the lessor and the lessee, under regulations to be prescribed by the Commissioner of Internal Revenue.

(8) The 2-percent penalty for filing consolidated returns should be eliminated.

(9) The credit based upon earnings should be arrived at on the basis of an average for a number of years, but with suitable provision for adjusting the income of the lowest year in the base period (as, for example, substitution for that year's earnings of 75 percent of the average earnings of the other years) and for relief of the character provided by section 713 of the former law. It is also deemed essential that adjustments be provided for in arriving at excess profits net income, of the character provided by section 711 of the

former law, specifically, exclusion of dividends and of gain from the retirement of bonds and from realization of capital gains. Moreover, there should be added to the credit otherwise determined not less than 6 percent of all net capital additions, whether equity, borrowed, or retained earnings, added during the last 2 years of the base period and all subsequent years prior to the first excess profits tax year (item 2 of Mr. Stam's letter).

(10) An invested capital base to be computed generally as under the prior law, but with some modifications, should be provided. Consideration should be given to a provision which would permit a taxpayer to elect to determine its invested capital upon an asset basis along the lines provided in section 723, but using the basis for gain in determining asset values. As already stated, the base should include 100 percent of borrowed capital, and the term "borrowed capital" should be so defined as clearly to include indebtedness represented by conditional sales contracts. Earnings accumulated after July 1, 1950, should be included in the invested capital base. A return of not less than 6 percent should be allowed on invested capital (item 3 of Mr. Stam's letter).

(11) Relief provisions along the lines of section 722 should be provided, with amendments to protect the railroads in certain conditions peculiar to them, including the lag between increases in labor and material costs and the authorization of resulting rate increases. An over-all tax limitation, corresponding to the 80-percent limitation of the prior law, should be provided (item 4 of Mr. Stam's letter).

(12) Capital gains should not be included in excess profits net income (item 5 of Mr. Stam's letter).

(13) Subject to inclusion of a proviso in the case of railroads protecting from excess profits taxation a 6-percent return after normal taxes and surtaxes, the adjusted excess profits net income should be deducted in arriving at the normal and surtax base (item 6 of Mr. Stam's letter).

(14) The excess profits tax, normal and surtax, should be treated as one tax for limitation, credit, and refund purposes, the sending of 90-day letters, etc. (item 7 of Mr. Stam's letter).

(15) The railroads do not favor requiring the taxpayer to elect a credit and have the election binding for all subsequent years. In their view, the taxpayer should be permitted to use the credit which produces the lesser tax, as in the former law, and should not be bound by an election (item 8 of Mr. Stam's letter).

(16) By legislation or otherwise, the consolidated excess profits regulations should be corrected to remove the provision arbitrarily reducing surplus by elimination of so much of a subsidiary's surplus as was earned prior to acquisition of 95 percent stock ownership.

(17) Provision should be made for deduction from taxable income of reserves for deferred railroad maintenance.

Certain of the foregoing proposals and suggestions are treated at some length hereinafter. As to others, no extended comment appears necessary.

III. *Provision for both an invested capital base and an average earnings base for determining normal profits*

It is assumed that any excess profits tax law to be enacted at this time will in general follow the lines of the World War II excess profits tax law. Considering the protracted and exhaustive study which went into the formulation of the Second Revenue Act of 1940, it should be safe to assume that provision will be made for both an invested capital and an average earnings base for computing the excess profits credit, as was provided in the former law. Certainly provision for an invested capital base as an alternative to an average earnings base is essential for the protection of industries having relatively small earnings over any probable base period, and relatively high capital investment. These conditions notably characterize the railroad industry. At the same time it is recognized that in the case of a taxpayer which has established a sustained record of liberal earnings, expectations have been built up upon the basis of such earnings which are often reflected in the taxpayer's capitalization and in the market prices at which its securities have been acquired by the public. Equity therefore requires that provision be made for the alternative standard of earnings during a past period for determination of the excess profits tax credit.

Accordingly, it is the view of the railroads that normal profits should be determined upon the basis of average earnings during a suitable base period or a return upon invested capital, whichever will produce the lesser amount of excess profits tax to the taxpayer.

IV. An excess profits tax law should include a proviso to the effect that, in the case of railroads subject to part I of the Interstate Commerce Act, the excess profits credit shall not be less than the sum of (1) 6 percent upon their outstanding invested capital and (2) normal taxes and surtaxes imposed under chapter 1 of the Internal Revenue Code

With respect to an excess profits tax law to be enacted at this time, the welfare of the country, and in particular the exigencies of the prevailing emergency, require that the railroads be protected from the impact of tax exactions, in the form of excess profits taxes, below the level of a fair return upon their invested capital, after normal and surtaxes upon their taxable income. The railroads urge upon those responsible for the formulation and enactment of an excess profits tax law that at least this measure of protection is imperative in the interest of a rail transportation system adequate to meet the requirements of the economy—and in particular the imperative needs of the national defense.

The proposal here advanced on behalf of the railroads is closely akin to an amendment intended to be offered by Senator Wayne Morse with an excess profits tax law being considered by Congress for inclusion in the Revenue Act of 1950 (H. R. 8920, 81st Cong., 2d sess., Calendar No. 2380, August 31, 1950). The proposed Morse amendment reads as follows:

"With respect to regulated public utilities, the excess profits net income shall be that income, after deduction of normal and surtaxes, which exceeds 5 per centum upon the capitalization, namely, borrowed capital, equity capital, and surplus."

In simplest terms the principle involved is that regulated industries cannot, in any realistic sense, be deemed to have earned "excess profits" so long as they have failed to realize a reasonable return upon their invested capital, after taxes upon the full amount of their normal and surtax net income.

We here relate the subject to the railroads in particular, and we postulate 6 percent, rather than 5 percent, as the minimum reasonable measure of a fair return, after taxes. It is generally conceded that a return of at least 6 percent upon the depreciated value of the railroad plant is essential to realization of the ends contemplated by the national transportation policy. Indeed, Congress itself, as long ago as the enactment of the Transportation Act of 1920, recognized that 6 percent would not represent an excessive return. That such a return is conservative seems clear in the light of the well-known fact that in general unregulated industries ordinarily realize greatly in excess of 6 percent on their net worth.

It should be emphasized that no relief from payment of normal taxes and surtaxes upon all taxable net income is proposed. Nor is it proposed to relieve an individual railroad from excess profits taxes in case it should realize earnings in excess of a 6-percent return. It is proposed only that so-called excess profits taxes shall not be permitted to impinge upon the earnings of the railroads, below the level of a 6-percent return upon their invested capital after normal and surtax exactions. The conservatism and modesty of the proposal is apparent. No relief whatever is here sought with respect to normal taxes and surtaxes the effect of which would reduce a return of 6 percent, before such taxes, to something in the neighborhood of 3 percent.

If an excess profits tax law could be so drawn as to reach, in all cases, only those profits properly to be regarded as "excessive," there would be no occasion for special protection. But Congress itself, in the enactment of the World War II excess profits tax law, recognized that strict application of a statutory concept of "excess profits" would in some cases subject to tax, as excess profits, earnings which were in fact normal, or even subnormal.

Looking to a cure for flagrant inequities, relief provisions were included, such as section 722 of the Internal Revenue Code. None of those relief provisions, however, afforded the degree of protection required in the case of the railroad industry.

In peculiar degree, the railroads are obliged to look to earnings as the source of funds for capital expenditures. It is well known that by reason of the competition of subsidized forms of transportation, combined with public regulation of railroad charges for services rendered, the railroads are and for 20 years past have been unable to attract to their enterprise the investment of equity capital. Moreover, except with respect to the acquisition of unencumbered rolling equipment, borrowing is not available to the railroads, because their fixed properties are in major degree already subject to mortgage.

In the decade ending with 1940, the gross expenditures of class I railways for additions and betterments to their transportation property averaged about $275,-

000,000 annually. During the war years, 1941–45, similar expenditures were stepped up to an average of $531,000,000 a year. Nevertheless, the railroads emerged from World War II, as they had emerged from World War I, with their plant in need of extensive rehabilitation. To rehabilitate their plant, the railroads made capital expenditures in the four postwar years 1946–49 in excess of $4,000,000,000. Undoubtedly more would have been expended had excess profits taxes not reduced income available for improvements below a fair return of 6 percent. It seems clear today that more railroad income should have been left free of excess profits taxes and available for expenditures upon plant upkeep and expansion. More cars, more motive power, and in general, greater rail transportation capacity appear certain to be required to meet the exigencies of the present emergency.

In these circumstances, it is clear beyond peradventure that earnings up to the level of a fair return should be protected from governmental appropriation in the form of excess profits taxes, at (presumably) very high rates.

That in over-all result railroad charges have not been such as to admit of realization of anything approaching excess profits is attested by the record of their past earnings. As Dr. J. H. Parmelee, representing the Association of American Railroads before the Subcommittee on Domestic Land and Water Transportation of the Senate Committee on Interstate and Foreign Commerce (S. Res. 50, 81st Cong.), said on April 4, 1950:

"* * * Even in this period of high business activity, their [i. e., the railroads'] earnings are not sufficient to attract the investment of new capital needed to keep pace with national transportation needs. This condition of inadequate earnings has developed, despite consistent progress in railroad efficiency, economy, and safety, a record of conservative financing and a reduction of nearly one-third in railroad debt during the past 20 years, * * *.

"Railroads in 1949 earned only 2.91 percent on their net investment. For the 4 years since the war (1946–49), the return has averaged only 3⅓ percent. * * * Even in the prosperous year 1929, the return was less than 5¼ percent."

These data have reference to the return after payment of normal and surtaxes. They plainly show that the concept of excess profits is inapplicable in the case of most railroads.

To be sure, it is true that railroad rates are constructed and regulated on a national or group basis, and that there is a wide variation between individual railroads in both gross and net earnings. The proviso suggested for inclusion in an excess profits tax law, however, would fully recognize this. It would leave individual railroads liable for excess profits taxes in respect of earnings realized in excess of a 6 percent return after payment of normal taxes and surtaxes upon the whole of their taxable net income.

The required standard of rail transportation cannot be reached unless the normal tax and the surtax are allowed as a deduction in computing the fair return of 6 percent. This becomes clear when consideration is given to what happens in the case of an exact return of 6 percent, before deduction of income taxes. The result is as follows:

Earnings at 6 percent upon $100 of capital employed	$6.00
Interest at 4 percent on $50 of debt	2.00
Balance subject to 45 percent income tax	4.00
Income tax at 45 percent	1.80
Balance available for improvements to property, dividends, and other corporate purposes	2.20

Thus, it is seen that a 6-percent return, before taxes, on the capital employed shrinks to 4.2 percent after payment of taxes—and this in the absence of an excess profits tax. If at this point, namely, where earnings reach 6 percent before taxes, an excess profits tax be allowed to become effective, it will obviously be impossible for a railroad company to preserve out of its earnings sufficient funds to provide for adequate improvement of its plant, to say nothing of a return to its equity owners.

The example which we have just cited assumes one-half of the capital employed to be borrowed capital at an average interest rate of 4 percent. If we assume a case where all of the capital employed is equity capital, the result is even more striking. In such a case the return on capital employed, after payment of income taxes, would not be 4.2 percent but only 3.3 percent, and the application of an

excess profits tax, in addition to income taxes, would produce even more extreme and destructive results.

As was said in a report of a special committee on excess profits taxes of the National Association of Railroad and Utilities Commissioners, appointed in 1944 to consider the problem of public utilities, including railroads and other common carriers, under the then existing excess profits tax law:

"Excess profits taxes * * * are computed on income from which the normal income tax and surtax have not been deducted. These taxes are expenses and no figures represent profits until they are paid."

Over even a short period, it has been impossible to realize "excess profits" in the railroad industry. This follows from the impact of rate regulation. In the case of a regulated industry, such as the railroads, machinery is at hand for the elimination of excessive profits through the medium of rate control. Long ago the Interstate Commerce Commission was vested with authority to regulate railroad rates and charges which affect interstate commerce. The various State commissions have authority over the rates and charges for intrastate movements. Should the railroads at any time earn in excess of a fair and reasonable return on their investment, the Interstate Commerce Commission and the various State commissions would undoubtedly exercise their authority and reduce rates to a level commensurate with the realization of only a reasonable return.

It is impossible then for the railroad industry as a whole to have "excess profits," in any realistic sense of the term. The Interstate Commerce Commission and the various State commissions supervise railroad earnings closely through control of accounting procedures and requirements for periodic reports. Through control of rates and charges, they can and do adjust earnings downward at any time that such an adjustment appears to be appropriate.

It is hardly necessary to dwell upon the indispensability of rail transportation to our economic life, our political and social activities, and the defense of our Nation against foreign enemies. The railroads operate approximately 225,000 miles of privately owned highways of steel. Other forms of transportation use 375,784 miles of publicly owned intercity highways; 28,591 miles of rivers, canals, and channels constructed or improved with public funds for water transportation; and 277,000 miles of privately owned pipe lines. There is an additional public investment of $1,500,000,000 in navigation aids and airport facilities used by air carriers. With substantially less than one-third of the total investment, public and private, in transportation facilities, the railroads do almost two-thirds of the entire transportation job. It would obviously be a physical impossibility to get along without the railroads. That dependence upon other forms of transportation would not be possible was demonstrated in the World War II years 1941–45 when, as already stated, the railroads moved more than 90 percent of war freight, carried more than 97 percent of the organized troop movements, and performed more than 70 percent of all transportation services.

It is believed that a serious error was made in draining off too much railroad revenue as excess profits taxes during the war years 1942–45. Under the law then in effect, the excess profits tax bill for the class I railroads amounted to $2,000,000,000. If railroad revenues below the level of a fair return had been protected from excess profits taxation, the railroads would certainly be better prepared today for service to the Nation in the present emergency.

The proposal here presented is designed to prevent the recurrence of conditions in the railroad industry which resulted from excess profits taxation during World War II. We advocate no more than protection from taxation as "excess profits" of earnings clearly not in fact excessive, but on the contrary confined to that rate of return necessary to the preservation and needed improvement of the rail transportation plant and the effective discharge of the indispensable function of the transportation industry. Clearly this degree of protection is demanded, not alone for the benefit of the railroads but also in the interest of the economy of the country and the defense of the Nation.

That earnings below the level of a fair return, after taxes, were taken as excess profits taxes in some cases under the former law, and that the suggested proviso would appropriately meet this situation, is indicated by the hypothetical examples set out in appendix II at the end of this statement.

Legislative proposal.—Amend section 714 of the Internal Revenue Code by adding a new paragraph reading as follows:

"Provided, however, in the case of a railroad corporation subject to part I of the Interstate Commerce Act, the excess profits credit for any taxable year shall be not less than an amount equal to the sum of (1) 6 per centum of the invested capital of the taxpayer, plus (2) the taxes imposed under chapter 1 hereof for such taxable year."

V. The invested capital base should include 100 percent of borrowed capital

The exclusion of 50 percent, or any part, of borrowed capital from the invested capital base is highly prejudicial to the railroad industry. That industry has historically been compelled to resort to borrowing for more than one-half of its invested capital. This extensive resort to borrowing has resulted from the exercise of sound business judgment in resorting to the large pools of investment funds available only for lending, and has also been affected by the inability of the railroad industry in general to attract equity capital. The matter is well summed up in the report, hereinbefore referred to, of the special committee on excess profis tax of the National Association of Railroad and Utilities Commissioners, where it was said:

"The utility industry is not a static or declining industry. It is a growing industry: an industry in which new discoveries and new inventions render obsolete equipment which was standard and modern 10 or 20 years ago. It is an industry that constantly appeals for more capital. The appeals are addressed to those who want an interest in the business and to those who are satisfied with a creditor's position. Your committee on corporate finance in its 1940 report found that the most economical capitalization of public utility properties was 45 percent stock and 55 percent bonds. Public utility properties are long-lived properties for which creditor financing is appropriate in a degree dependent upon the type of the utility, the stability of the payment for service, and many other factors peculiar to each property. * * *

* * * * * * *

"* * * Further, the excess profits tax credits are not computed on true invested capital, for as to borrowed capital only 50 percent of specific kinds of borrowed capital is included. Invested capital for tax purposes will necessarily differ in amount from a commission rate base but it is unsound to start with a figure for tax computation that includes only 50 percent of specific types of borrowed capital. * * *"

These observations clearly point up the inequity to the railroads which results from the inclusion of only a part of borrowed capital in the investment base. Class I line-haul railroads at the close of 1939 had outstanding slightly more than $8,000,000,000 in stock and more than $10,500,000,000 in evidences of indebtedness, the ratio being 43 percent stock and 57 percent debt. As of the close of each of the years 1948 and 1949, outstanding stock of these railroads represented slightly less than $8,000,000,000 of stock and about $8,500,000,000 of debt, the ratio being 48 percent stock and 52 percendt debt. Clearly then, the railroads are in that category discriminated against by exclusion of debt from the investment base.

It is recognized, of course, that to the extent of inclusion of borrowed capital in the base, the interest deduction for excess profits tax purposes should be reduced accordingly.

VI. Indebtedness represented by conditional sales contracts in borrowed invested capital

Section 719 (a) (1) of the Internal Revenue Code allows indebtedness to be included in borrowed capital for excess profits credit only if evidenced by a "bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust." This classification, while including a chattel mortgage, may exclude its counterpart, the conditional sales contract. In *Consolidated Gold Acres Co.* (8 T. C. 87), affirmed by the Court of Appeals for the Tenth Circuit in *Consolidated Gold Acres Co.* v. *Commissioner of Int. Rev.* (165 F. (2d) 542), it was held that money owing on a conditional sales contract was not includible in invested capital. The distinction is purely technical, as was recognized by the court of appeals. For practical purposes, a conditional sales contract operates in much the same manner as a chattel mortgage, and for determination of the excess profits credit funds obtained from either source should be upon the same footing. The court of appeals, at pages 545–546, said:

"It is true, as pointed out by Consolidated, that in terms of liability imposed, there may be little, if any, distinction or difference between the legal relationship created by a mortgage and a conditional sales contract. Both instruments are intended to provide a measure of security for the performance of an incurred obligation, but they are not used synonymously or interchangeably to describe or define the legal relationship created thereby. Courts have generally recognized the legal difference between the two."

The discrimination against conditional sales contracts is particularly onerous in the case of the railroads, which have financed the purchase of millions of

dollars of new equipment by use of such instruments. As compared with equipment trust indentures, the proceeds of which are includible in invested capital, conditional sales contracts have the merit of simplicity and economy. The former law merely served to complicate such transactions by compelling the issuance of notes to evidence the debt. Since the debt is sufficiently evidenced by the contract itself, the law should so recognize.

Legislative proposal.—Amend code section 719 (a) (1) by omission of the word stricken and insertion of the words italized below:

"(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, *or conditional sales contract*, plus."

VII. Past unaccrued depreciation—relief from the requirement (imposed by the Commissioner of Internal Revenue as a condition precedent to change-over from retirement to depreciation accounting) that accumulated earnings and profits be reduced by a 38-percent reserve for past unaccrued depreciation

A gross injustice to most of the railroads of the country is involved here. The subject is technical and complex, but the fundamental features may be fairly stated in general terms.

Under the excess profits tax law in effect during the war years 1940–45, Congress provided that corporations might earn a specified return on all accumulated earnings and profits before the excess profits tax rates applied. This was reasonable because these earnings had been left in the business through the years, after the payment of all applicable taxes, and represented additional investment in the enterprise by the shareholder. The Commissioner of Internal Revenue, however, refused to allow certain railroads to earn a return on all their accumulated earnings and profits, as provided by statute, and required these railroads to agree to pay an excess profits tax on the return from a substantial portion of their accumulated earnings and profits as a condition upon his consent to a change by these railroads in their method of accounting for depreciation on some of their properties.

Prior to 1942 most of the railroads utilized the retirement method of depreciation accounting on roadway property. This method, like the more familiar one of straight-line depreciation, ultimately reflects in the accounts the loss due to normal wear and tear upon capital assets used in a trade or business. Unlike the straight-line depreciation method, annual charges are not made based upon the estimated life of the property; rather the book cost, less salvage, is charged against income in the year in which the asset is retired. The retirement method was sanctioned by the Interstate Commerce Commission and accepted by the Internal Revenue Bureau; the accounts of the railroads were maintained upon this basis for purposes of the Commission and for tax purposes.

In 1942 the Interstate Commerce Commission issued a general order permitting the railroads to change to straight-line depreciation accounting with respect to road properties, other than those included in the track accounts. This covered station buildings, bridges, shops, and similar items. Effective January 1, 1943, a general order of the Commission made such accounting mandatory upon the railroads. In the abnormal war years, with the critical shortage of men and materials, the retirement method would have resulted in a substantial overstatement of income, since it was impossible to make the usual replacements. Therefore, the railroads sought permission to change to straight-line depreciation for tax purposes, in order to avoid the imposition of income and excess profits taxes upon overstated income during the emergency period and to bring their tax accounting in line with their regular method of accounting as prescribed by the Interstate Commerce Commission pursuant to the Interstate Commerce Act. Under Regulations 103, section 19.41–2, the Commissioner of Internal Revenue granted permission to make this change, but subject to the proviso that the taxpayer execute an agreement consenting to sundry conditions. The ruling was as follows:

"Permission will be granted to change from retirement to depreciation accounting effective January 1, 1943, with respect to the accounts tabulated below, provided you irrevocably agree:

"(1) that a reserve for depreciation shall be computed as of December 31, 1942, on all the depreciable property included in these accounts in accordance with the summary tabulation set forth below;

"(2) that the remaining sum to be recovered through depreciation allowances shall be limited to the cost or other basis less the depreciation so accrued;

"(3) that neither the change of method nor the amount of depreciation so accrued shall have any effect on taxable net income for any year ending prior to January 1, 1943;

"(4) that the depreciation rates agreed to are subject to modification if subsequent experience indicates that revision is necessary in order to spread the cost of the assets over their remaining useful lives; such revision, however, is not to be made retroactive;

"(5) that complete depreciation accounting in accordance with all the applicable sections of the Internal Revenue Code and Regulations shall be adopted for these accounts;

"(6) that the reserve for depreciation accrued to the date of the change from retirement to depreciation accounting shall reduce accumulated earnings and profits in the determination of invested capital for excess profits tax purposes."

The railroads individually applied to the Commissioner for permission to change their accounting methods. Certain railroads received and executed agreements containing the first five clauses only; others were compelled to sign agreements containing the sixth clause.

This sixth clause provides that the accumulated earnings and profits of the taxpayer shall be reduced, in the determination of invested capital for excess profits tax purposes, by an amount representing the past unaccrued depreciation upon the road properties involved. Thus, the railroads had to agree to deduct from the earnings and profits which had been accumulated and on which taxes had been paid, the amount of straight-line depreciation which would have accrued upon the properties if the retirement method of accounting had not been followed for these properties from the date of their acquisition. (The taxpayer could compute this figure, or, in lieu of such computation, reduce its surplus by 30 percent of the book value of the properties.) The railroads which were confronted with the sixth clause protested unavailingly against this condition; practical considerations necessitated the execution of the agreement.

The retirement method of depreciation accounting, as approved by the Interstate Commerce Commission and the Bureau of Internal Revenue, clearly reflected the income of the railroads through the years. Therefore, when the railroads sought to change from one method to the other, there was in fact no occasion for a reduction of their accumulated earnings and profits. Surplus had already been reduced by the charges under the retirement method. The effect of the further reduction was to subject the earnings from the disallowed surplus to excess profits tax without any allowance for a statutory return thereon.

In reducing surplus the Commission must hold the view that the incomes of the railroads were overstated by the utilization of the retirement method, yet throughout the years he raised no question concerning this method and collected taxes upon it. In substance the Commissioner is taking an inconsistent position: If the incomes were overstated in previous years, an adjustment should be recognized for the taxes paid upon them; if they were not overstated in such years, the 30-percent deduction is certainly not justified. The former excess profits tax law recognized the need for adjustments in the case of an inconsistent position and section 734 was included for this purpose. But it will probably be argued by the Commissioner that this section does not apply to the inconsistent treatment of the earnings and profits of the railroads because it is limited to a position taken "which was not correct under the law applicable" to the prior years. It was not contemplated that any adjustment would be necessary where the income taxes were correctly reported in such prior years. In the situation with which we are dealing the prior years' returns were correct, yet an adjustment is being made for excess profits tax purposes. It will be noted that in order to prevent any contention that same statutory provision protects the railroads, the agreement contained a clause that the prior years' incomes should not be affected.

The relief the railroads seek by this proposal is limited to the proper statement of accumulated earnings and profits under any prospective excess profits tax law, a contingency not conceived of when the Commissioner of Internal Revenue imposed terms for permission to change from the retirement method to the straight line depreciation method. Additionally, the terms of the agreement provide that only 70 percent of the cost of roadway property in service at the time of this change in accounting method will ever be allowed as a tax deduction (see clause 2 of the agreement above). Thus, 30 percent of the cost of such property has never been and will never be allowed as a deduction for

tax purposes from the revenues which it produced while being worn out in active service.

The railroads might well ask for retroactive legislation covering the World War II period. Perhaps they should. Relief is here sought, however, only to the extent of a provision, in any prospective tax statute in which invested capital is a factor in determining taxable income, to the effect that the accumulated earnings and profits of the railroads shall not be arbitrarily reduced because of a change to straight-line depreciation accounting. A draft of an appropriate amendment follows:

Legislative proposal.—Amend section 718 (a) (4) of the Internal Revenue Code to read as follows:

"(4) EARNINGS AND PROFITS AT BEGINNING OF YEAR.—The accumulated earnings and profits as of the beginning of such taxable year: *Provided, however, in the case of a railroad corporation subject to the Interstate Commerce Act, the net income of which has for any prior years been computed under the retirement method of accounting in respect of any of its property, such accumulated earnings and profits shall not be reduced by any amount purporting to represent depreciation sustained on such property during such years, notwithstanding any regulation or ruling to the contrary promulgated by the Commissioner and notwithstanding what may purport to be an agreement between the Commissioner and any such railroad corporation that accumulated earnings and profits shall be so reduced.*"

VIII. Exclusion from excess profits net income of constructive income to lessor resulting from payment by the lessee of the lessor's Federal income and excess profits taxes

There is here presented an extremely anomalous situation under the former excess profits tax law—the liability of a corporation to pay excess profits tax solely because of an increase in its own income tax.

Some of the railroad systems have been developed by leasing the properties of other companies, rather than by merger or consolidation. The leases are for long periods of time, practically in perpetuity. The properties of these lessor companies form an integral part of the operations of the lessee. However, in the absence of 95 percent stock ownership by the lessee, the lessor companies are not includible in a consolidated return. In a typical lease, the lessee agrees to pay all expenses of the lessor including taxes, so that a fixed dividend may be paid by the lessor. In practical operation the stock of such leased lines resembles a bond; each year the stockholder receives a fixed dividend from the company, paid either directly or indirectly by the lessee. Although in many cases the dividend is paid directly to the stockholders of the lessor, it nevertheless constitutes income of the lessor corporation on which an income tax must be paid. Pursuant to the terms of the lease, the lessee must pay the income tax thus imposed upon the lessor.

Under the decisions of the Supreme Court in *United States* v. *Boston & Maine Railroad Co.* (279 U. S. 732), and *Old Colony Trust Company* v. *Commissioner,* (279 U. S. 716), and related cases, the income tax of the lessor, when paid by the lessee, constitutes additional income to the lessor upon which a further tax must be paid. By reason of this, such a lessor corporation may find itself subjected to an excess profits tax merely by reason of the fact that the rate of Federal income taxes has been raised.

Consider, for example, the situation as it presently exists in relation to any prior base period. The combined normal tax and surtax is now 42 percent. In the years 1946–49, such taxes were at the rate of 38 percent. A lessor company's income will, therefore, be larger in 1950 than in the base period, simply by reason of the fact that the income tax paid in its behalf by the lessee has been increased. Since its other income is identical under the lease for all years, it follows that the 4-percent increase in the tax rate will result in an "excess profit" taxable to the lessor at the excess profits tax rate, if the income method of computing the excess profits credit is used.

It should be emphasized that the real income of the lessor has not increased one iota; the so-called excess profits are the result solely of an increase in the income tax rates. It should also be borne in mind that the resulting excess profits tax, when paid by the lessee in the lessor's behalf, also becomes constructive income to the lessor, subject to a further excess profits tax, to be paid by the lessee.

It seems clear that income of the type here being considered was not the kind of income which Congress intended to reach by the excess profits tax. The income

of the lessor did not increase during the period because of any war activity on its part, for it engaged in no war activity, nor because of any inflation-inspired upturn in its business, for it engaged in no business. It continued precisely as it did before, collecting a fixed rental and distributing a fixed dividend to its stockholders. It had no additional funds which it could devote to its own corporate purposes or to the purposes of its stockholders.

The invested capital credit is not large enough in all cases to give relief from the inequitable result here complained of. Many of the leases of railroad properties were made many years ago, when interest and dividend rates were generally higher than they are now. In this connection see *Philadelphia, Germantown and Norristown Railroad Company* v. *Commissioner* (6. T. C. 789), involving an 1870 lease, where the taxpayer's excess profits credit under either the income method or the invested capital method was insufficient to provide relief. It should be noted that the taxpayer was there claiming relief under section 722 of the code and that the Tax Court held that this relief section did not apply.

It is submitted that under no acceptable philosophy of excess profits should the income constructively received by the lessor by reason of the payment of the lessor's Federal income and excess profits taxes by the lessee be subjected to the excess profits tax. Consequently, we urge that any excess profits tax law now to be enacted should provide for the exclusion of such income from the lessor's excess profits net income. Suggested amendments of the statute to accomplish this purpose are as follows:

Legislative proposals.—Amend section 711 (a) (1) by adding thereto the following new subparagraph:

"(K) INCOME UNDER CERTAIN LEASES.—In the case of a railroad corporation subject to part I of the Interstate Commerce Act, the railroad properties of which have been leased to another such corporation, where the lease requires the lessee to pay the Federal income and excess profits taxes imposed upon the lessor, there shall be excluded the income attributable to the payment by the lessee of such income and excess profits taxes."

Amend section 711 (a) (2) by adding thereto the following new subparagraph:

"(M) (Same as above.)"

Amend section 711 (b) (1) by adding thereto the following new subparagraph:

"(L) (Same as above.)"

IX. Excess profits credit of railroad lessor-lessee corporations

Seriously inequitable excess profits taxen often result from the operation of the properties of one railroad corporation by another under a long-term lease. A striking example is that of the New York, Chicago & St. Louis Railroad Co., ordinarily referred to as the Nickel Plate Road, which leased the railroad properties of the Wheeling & Lake Erie Railway Co. on December 1, 1949, and has since operated these properties as a part of the Nickel Plate system. The result is that for the year 1950 and subsequent taxable years, the net earnings from the operations of the Wheeling & Lake Erie properties will be reflected in the income and excess profits tax returns of the Nickel Plate, without, however, proper allowance of excess profits credit applicable thereto, either under the income method of computing the excess profits tax credit or the invested capital method.

Under this lease the lessee operates for its own account all of the properties of the Wheeling & Lake Erie. The lease is for an initial term of 99 years and may be renewed for additional 99-year periods in perpetuity at the option of the lessee. The lessee takes over completely under this lease. It collects for its its own account all the revenue from operation and pays all expenses of operation, including maintenance, taxes, and all other expenses of every kind and character. The lessee not only pays all expenses of operation but also pays all interest on the outstanding obligations of the lessor, guarantees the payment at maturity of all debts of the lessor, and pays as part of the rental amounts equal to $4 per share annually on the prior lien stock and $5.75 per share annually on the common stock of the lessor, other than such stock owned by the lessee. The lessor merely maintains its separate corporate existence, continues to hold the legal title to the railway properties, and acts as a conduit for the fixed return payable to its security holders.

The lease of these properties on December 1, 1949, results in an anomalous and seriously inequitable situation taxwise. Assuming that the income method of computing an excess profits credit will be available under any excess profits tax law which may be enacted, this inequity will result from the fact that in the taxable year 1950 and subsequent taxable years, the Nickel Plate's excess profits

tax return will include the earnings from the Wheeling & Lake Erie properties, whereas, in any prior base period, except for the 1 month of 1949, the Nickel Plate's earnings do not include the earnings from any of the Wheeling & Lake Erie properties.

The serious character of the inequity becomes apparent when the figures are examined. Taking the years 1946–49 for purposes of example, the excess profits net income of the Wheeling & Lake Erie and the Nickel Plate was as follows:

	Wheeling and Lake Erie	Nickel Plate Road	Combined
1946	$5, 570, 177	$4, 741, 464	$10, 311, 641
1947	10, 625, 834	12, 478, 152	23, 103, 986
1948	13, 810, 168	21, 395, 926	35, 206, 094
1949	8, 668, 052	15, 428, 213	24, 096, 265
Average	9, 668, 558	13, 510, 939	23, 179, 497

It is estimated that the Nickel Plate's excess profits net income for the year 1950, which includes, of course, the earnings from the operation of the properties of the Wheeling & Lake Erie, will be $31,215,000. If the Nickel Plate's base period net income is limited to its average earnings, without including the earnings of the Wheeling & Lake Erie, then $17,704,000 of this year's estimated earnings would be subject to the excess profits tax.[1] The fact is, however, that by any reasonable standard of normal profits, only $8,036,000, the excess of the current year's earnings from the two properties over the earnings from both properties during the base period, should be subjected to the excess profits tax.

The inequity in this case could be removed if the Nickel Plate owned sufficient stock of the Wheeling & Lake Erie to permit the filing of a consolidated return. It owns 99.44 percent of the prior-lien stock of the Wheeling & Lake Erie but only 72.90 percent of the common stock, or 79.66 percent of the entire capital stock. If Nickel Plate owned 95 percent of all of the stock, so that a consolidated return could be filed, it would be entitled under the consolidated excess profits tax regulations, section 33.31 (a) (25) regulations 110, to a base period net income of $23,179,497, this being the combined net income of the two companies during the base period. In other words, if it were possible to file a consolidated excess profits tax return, the inequity here complained of would be dissolved. Under the former law, however, the filing of a consolidated return is prohibited until the full 95 percent of the stock is acquired.

A gross inequity also exists if the excess profits credit is based on invested capital rather than the income method. In such case the investment of the Nickel Plate in $36,300,000 of the stock of the Wheeling & Lake Erie, which it owns, is excluded from invested capital because of the fact that it is technically an inadmissible asset. The theory underlying this exclusion is that any dividends received on the stock would not be subjected to the excess profits tax; consequently, the Nickel Plate's investment in the stock should not be allowed as a part of its invested capital. In this case, however, this theory is entirely inapplicable. All of the earnings from the Wheeling & Lake Erie properties are reported directly by the Nickel Plate and are subject in its hands to the excess profits tax law. Furthermore, no dividend income, which is the kind of income exempt from the excess profits tax, can be received in this case. That is specifically prohibited under the terms of the lease. As previously stated, the Nickel Plate pays as part of the rental amounts equal to a fixed return on the stock of the Wheeling & Lake Erie not owned by the Nickel Plate, but no such payments are made applicable to stock held by the Nickel Plate.

In other words, all of the income from the two properties, except an amount equivalent to a fixed return on the minority stock, is included in the excess profits net income of the Nickel Plate, with an invested capital allowance only for the investment in Nickel Plate property, and without any invested capital allowance, either borrowed capital or equity capital, with respect to the Wheeling & Lake Erie properties.

[1] Disregarding any provisions which might be made for the adjustment of average base period net income in arriving at the excess profits credit.

The inequity here complained of under the invested-capital method of computing the excess profits credit exists in all similar cases, regardless of the date of the lease. Under the income method of computing the excess profits credit the inequity exists only in those cases where the properties of the lessor were separately operated in the base period, or some part of it, or in other words, where the lease has been entered into after the beginning of the base period.

Two alternative methods of removing the inequities complained of are suggested, as follows:

(1) The lessor and the lessee corporations should be permitted to file a consolidated return; or

(2) The combined excess profits credit should be equitably apportioned between the lessor and lessee.

The theory of consolidated returns is especially applicable to the case where the properties of one railroad company are leased by another railroad company and are operated as an integral part of the lessee's system.

Consolidated returns have formed a part of the Federal income tax structure for many years. They first made their appearance in the regulations issued by the Commissioner under the Revenue Act of 1917. Thus prescribed, they were applicable only to excess profits tax. Consolidated returns were provided for by Congress in the Revenue Act of 1918 and were made mandatory with respect to both the income tax and the excess profits tax. In the 1921 act, Congress removed the mandatory provisions relating to such returns but retained them as a permissive method of computing the net incomes of affiliated groups. From 1921 to 1934, permission was continued in the various revenue acts for affiliated groups to file consolidated returns.

In the 1934 act, however, consolidated returns were abolished for all except railroad corporations, and from 1934 to 1940, only railroad corporations were permitted to file such returns. In 1940 and 1941 the privilege was extended to all affiliated corporations for the purposes of the excess profits tax. It was not until 1942, however, that affiliated corporations generally were again granted the privilege to file consolidated returns for both the income and excess profits taxes.

The principle underlying the making and filing of consolidated returns was expressed in article 631 of regulation 69 as follows:

"Consolidated returns are based upon the principle of levying the tax according to the true net income of a single enterprise, even though the business is operated through more than one corporation."

The Senate Finance Committee report accompanying the 1928 act restated the same idea in the following language:

"The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain * * *." (S. Rept. No. 960, 70th Cong., 1st sess., p. 14 [C. B. 1939—1 (pt. 2), 409, 418].)

Because of their unique position in the Nation's economy, this principle of levying the tax in accordance with the true net income of a single enterprise, even though the business is operated through more than one corporation, is particularly applicable to the railroads. This was recognized by Congress when in the 1934 act it permitted the continued filing of consolidated returns by railroad corporations, even though it abolished the privilege for other affiliated groups. Although the railroads must, for purposes of public convenience and necessity, operate across State lines, the provisions of law in some States, as well as financial requirements, necessitate the existence of subsidiary companies organized under the laws of the various States through which a railroad operates. As a result of these and other considerations, the major railroad system of the country have developed, not only by mergers and consolidations, but also by process of leasing operating properties from companies which thereafter have retained their corporate existence.

There is no situation to which the theory and philosophy of the consolidated return are more clearly applicable than the lessor-lessee situation in the railroad industry. The properties of the two corporations are operated as integral parts of one system. It is utterly impossible to determine, for any period of operation under such a lease, the amount of income attributable to the operations of the leased properties and the amount attributable to the operations of the owned properties. Revenues and expenses are all lumped together.

We submit, therefore, that it is entirely logical to permit the filing of a consolidated return by the lessor and lessee. This would remove the inequities otherwise inherent in the situation.

Legislative proposal.—Amend section 141 by adding thereto the following new subsection:

"(j) AFFILIATION OF LESSOR RAILROAD COMPANIES.—In the case of a railroad corporation subject to part I of the Interstate Commerce Act, the railroad properties of which have been leased to another such railroad corporation by an agreement entered into prior to January 1, 1950, where the lease requires the lessee to pay the Federal income and excess profits taxes imposed on the lessor, such lessor corporation may be included in consolidated income and excess profits tax returns with the lessee corporation, regardless of the percentage of the lessor's stock owned by the lessee or one or more other corporations in an affiliated group including the lessee, provided, however, that such lessor corporation includible in the affiliated group solely by reason of the provisions of this subsection shall not be liable for an amount of income and excess profits taxes in excess of the amount of such taxes for which it would have been liable if it had filed separate income and excess profits tax returns in its own behalf."

As an alternative remedy we suggest the equitable apportionment of the excess profits credit between the lessor and the lessee.

The Internal Revenue Code already provides for such apportionment of depletion deductions between the lessor and lessee of mining property. There is even more urgent need for apportionment of the excess profits credit in the case of a long-term lease of railroad property, if seriously inequitable results are to be avoided.

The excess profits tax is intended to apply to those corporations which having taken the risk incident to the conduct of business, realize a return above a normal standard measured either by base period earnings or by a fair return on the capital employed in the business. By entering into a lease relationship, the corporate lessor, and the owners of the stock of that corporation, remove themselves from the category of risk-takers and become mere passive recipients of the fixed return provided for in the lease. That fixed return must be paid, of course, by the lessee in good times and bad. It must be paid even though the revenues from operations do not yield enough to pay the operating expenses. In other words, it must be paid regardless of whether the lessee has a profit or a loss from the operation. Conversely, the payment need not be increased as the profits from operation increase.

In order to meet this fixed rate of return every year, including those years when it is not earned, as well as those when it is earned, the lessee must be enabled to keep a substantial part of the earnings, over and above this fixed rate of return, in years when there is an excess. This is obvious in any business such as the railroad business involving its inevitable ups and downs. If the lessee is allowed no part of the excess profits credit applicable to the lessor's properties and most of the earnings in profitable years must therefore be paid out in excess profits taxes, it will be absolutely impossible for the lessee to come out whole for any extended period of time.

Consequently, equitable apportionment of the excess profits credit is proposed as an alternative method of providing a remedy for the inequity complained of. This would give needed recognition to the fact that the lessor has, by virtue of the lease arrangement, placed itself irrevocably in the fixed income class. While the specific methods of apportionment might vary in individual cases, as a general rule sufficient excess profits credit would usually be allocated to the lessor so as to eliminate excess profits tax as to it. Conversely, the lessee corporation, which takes all the risk incident to the operation of the properties and obligates itself to pay the fixed return to the lessor in good times and bad, would be entitled to the remainder of the combined excess profits credit.

It is submitted, therefore, that equitable apportionment of the excess profits credit between the lessor and the lessee corporations is entirely sound. There follows a draft of amendment to the code to accomplish that objective.

Legislative proposal.—Amend section 712 by adding thereto the following new subsection:

"(e) APPORTIONMENT OF EXCESS PROFITS CREDIT OF CERTAIN LESSOR AND LESSEE CORPORATIONS.—In the case of a railroad corporation subject to part I of the Interstate Commerce Act, the railroad properties of which have been leased to another such railroad corporation by an agreement entered into prior to January 1, 1950, where the lease requires the lessee to pay the Federal income and excess profits taxes imposed upon the lessor, the combined excess profits credit

of such corporations, computed under section 713 or section 714, shall, under rules and regulations to be prescribed by the Commissioner, be equitably apportioned between the lessor and lessee."

X. Elimination of 2-percent penalty for filing consolidated returns

It is urged that the 2-percent penalty for filing a consolidated return, imposed by section 141 (c) of the code, be eliminated. The railroads agree with others that this penalty should be removed with respect to all corporations filing such returns, but they believe that in any event the special situation of the railroads warrants exemption of such companies from this additional and unreasonable burden.

The history and philosophy of consolidated returns and the special necessity for the consolidated return in the rairoad industry have been sufficiently set forth above (ante, pp. 37–38). To determine the true net income of two or more railroads operating as a system, a consolidated return must be filed, and there is no reason for imposing a 2-percent higher rate upon such return. In some cases the imposition of this penalty and the payment of the additional taxes, as a practical matter, necessitates the filing of separate returns. A consolidated return reflects the true net income of the affiliated group and avoids the complications which arise from intercorporate transactions; yet to make such a return and to report fairly its income, the consolidated group must pay the penalty of a rate of 2 percent higher than that applicable in the case of separate returns. In addition, in order to obtain a proper excess profits credit, affiliated corporations are frequently compelled to file consolidated returns at the price of the penalty.

Not only are consolidated returns designed to provide fair and reasonable treatment to affiliated taxpayers but they have been regarded by the Treasury Department as beneficial from an administrative standpoint. In his testimony before a subcommittee of the Ways and Means Committee on December 15, 1933, the Assistant Secretary of the Treasury advocated the continuance of consolidated returns. He stated:

"* * * the Department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue. On the other hand, there are considerable savings to the Treasury, as well as to the taxpayers, the present arrangement. The administration of the law is simpler since it conforms to established business practice. The Treasury need deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes—an undesirable result in itself. The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the Department, the law should not be changed in this particular."

Considered either from the viewpoint of equity or of administrative convenience, then, consolidated returns should be encouraged by elimination of the 2-percent penalty upon the exercise of that privilege. This is especially true of the railroads which, in many circumstances, are unable to merge or consolidate their subsidiaries and thus achieve the effect of a consolidated return without being subjected to the penalty.

Legislative proposal.—Amend section 141 (c) of the Internal Revenue Code by striking out the words "except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations."

XI. The average earnings base (item 2 of Mr. Stam's letter)

The railroad position with respect to item 2 of Mr. Stam's letter is succinctly stated in paragraph (9) of the summary of proposals already given (ante, p. 12).

It is the thought of the railroad industry that as a matter of course provision should be made for a credit based on earnings. For most industries, earnings during the period of 1946 to 1949 were uniformly good and it might be deemed fair to use the entire 4-year period as the base period for determination of the average earnings credit. But the use of such a base period in the case of the railroad industry would result in substantial injustice and hardship owning to the fact that 2 of the 4 years within that period were conspicuously bad years, even as compared with the generally depressed levels of railroad earnings which prevailed throughout the postwar period. In 1946 the class I railroads of the United States, excluding terminal and switching lines, earned only 2.75 percent on their recorded net investment. The corresponding figure in 1947 was 3.41 percent,

in 1948 it was 4.24 percent, and in 1949 it was only 2.85 percent. Clearly, then, the years 1946 and 1949 ought to be excluded in the determination of an average earnings credit for the railroad industry.

The recorded net investment used in making the calculations resulting in the rates of return shown above are the so-called book values minus accrued depreciation. These figures do not differ greatly from the valuation figures used by the Interstate Commerce Commission for rate-making purposes. The last valuation figure of the Commission was stated in ex parte 168 as of January 1, 1948. It was for class I line-haul railroads and amounted to $20,978,648,000. As of the same date the net recorded property investment of class I railroads was $22,-891,981,188. Thus the rate of return shown above of 3.41 percent for 1947, which was calculated on the recorded net investment, would be increased only to 3.72 percent if calculated upon the Commission's valuation figures.

For some railroads the year 1946 was the worst year in the postwar period, while for others the worst year was 1949. For the railroad industry, therefore, the average of the postwar years will not result in the attainment of the objective of a normal profit. It is deemed necessary that provision be made, as was done in the former excess profits tax law, for adjusting the earnings of the lowest year of the base period, as for example substituting for that year's earnings 75 percent of the average earnings of the other years, and also that provision be made in line with section 713 of the former law.

It is believed to be essential also that adjustments be made in arriving at excess profits net income, such as were included in section 711 of the former law. Reference is specifically made to the exclusion from excess profits net income of dividends, of gain from the retirement of bonds, and of capital gains and losses. The figures which have been given as to the rate of return upon net investment in the railroad industry emphasize that any earnings base applicable to the railroad industry must in justice be computed upon 100 percent of the average earnings after appropriate adjustment. In addition there should be added to the credit otherwise determined not less than 6 percent of all net capital additions, whether equity, borrowed, or retained earnings added during the last 2 years of the base period and all subsequent years prior to the first excess profits tax year.

Certain bills introduced in the present Congress have provided that the measure of normal profit should be at low as 75 percent upon average earnings during the base period. This proposal undoubtedly follows the thought that for many industries the period of the postwar years was one of great prosperity and resulted in earnings beyond those which should be considered as normal. But railroad earnings were low throughout the period and an arbitrary deduction from average earnings on a percentage basis would as to them plainly be unjust.

XII. Computation of invested capital base (item 3 of Mr. Stam's letter)

Here again the position of the railroads is succinctly stated in the summary, item (10), (ante, p. 12). Important points bearing upon the computation of the invested capital base (including the proposals for a proviso to protect from excess profits taxation a fair return, after normal and surtaxes; for inclusion in the base of 100 percent of borrowed capital; and for inclusion of indebtedness represented by conditional sales contracts) have been discussed already. It is hardly necessary to comment further at length with respect to them, but attention should be called to certain important additional considerations.

Ordinarily the starting point in the computation of invested capital would include money and property paid in for stock, as in the case of the former law. However, for most companies in the railroad industry this starting point is unsatisfactory, because original investment in such companies must be determined from transactions occurring from a half century to a century ago and from reorganizations occurring in depression years when the values of the securities or properties were abnormally low. An election for the determination of invested capital upon an asset basis along the lines provided in section 723 of the old law should be permitted. In such case, assets acquired before March 1, 1913, could properly be valued as of that date, which would correspond with the basis for determining gain in case of sale. In the railroad industry the Interstate Commerce Commission's basic valuation of assets of the railroads, made a short time after the March 1, 1913, date, would be helpful in determining the value as of that date.

There should be included accumulated earnings after July 1, 1950. No reason is perceived why earnings plowed back into a business in the future should be

excluded from invested capital. This form of investment is entitled to earn a return on the same basis as any other.

The railroads believe that any amount which they may be able to earn under the commonly accepted standard of public regulation cannot, in most cases at least, constitute excess profits. This point has been developed already.

The situation of Southern Pacific Co. may be cited as illustrative. Southern Pacific Co. is located in an area where the population has increased in a decade by approximately 50 percent. Industrial development has been proportionately high. The mileage of the railroad is substantially the same as it was at the turn of the century. Transportation needs can be met and the development of the country promoted only by a continued improvement in existing railroad plant, equipment and power. The required money can come only from plowing back earnings or from attracting investment by security holders. In the Southern Pacific capital structure equity capital is greatly needed, if not essential, for the building up of transportation to meet the needs of the growing population. If an excess profits credit is to be computed at a rate of approximately 5 percent, out of which normal taxes and surtaxes will have to be paid, this situatoin results: Southern Pacific Co., as an example, will have to pay 47 percent in normal taxes and surtaxes out of a return of 5 percent on its invested capital, leaving it in effect a return after taxes of 2.65 percent upon invested capital; and any appreciable balance would be taken away by the exceedingly high excess profits tax rates.

A striking example of the return which is required to attract new equity capital to the railroad industry is presented by the recent issue of Southern Pacific Co.'s convertible debentures which are convertible into Southern Pacific Co.'s stock at $55 per share. This is about the only instance of equity financing through issuance of stock in the railroad industry in recent years. In the few months they have been out, debentures of the face value of something less than $5,000,000 have been converted into stock. Since Southern Pacific Co. is currently paying dividends of $5 per share, the converting debenture holder would receive a return of approximately 9 percent upon his investment. Yet over 80 percent of the debenture holders have not yet converted. If a return of 6 percent upon the entire capital investment after normal taxes and surtaxes can be realized, issuance of stock under such terms is justified, the comparatively high return being paid on the stock being balanced by the comparatively low interest rate paid upon equipment trust certificates and senior bonds. However, if carriers should be restricted to a net return upon invested capital of less than 3 or even 4 percent, such equity financing would be impossible and carriers would be compelled to continue expanding their debt structures, a process which led to the wholesale reorganizations which occurred in the thirties.

At present transportation facilities are pressed to the utmost. Nothing could be more crippling to the transportation industry and to the free-enterprise system than to so drastically restrict railroad income that the public needs cannot be served by them.

XIII. Relief provisions, section 722

In the opinion of the railroads, relief provisions similar to section 722 should be incorporated in the law. Generally speaking, the railroads have not had great experience under this section and understand that the relief has not been very effective for other taxpayers. Nevertheless, its provisions may take care of extreme cases of hardship and the railroads think they should be retained. It would seem appropriate that section 722 be revised to cure the distortion of income which results from the long intervals required in order to adjust rates in line with increased costs for materials and labor.

In the railroad view, a new law should contain provision, as did the former law, making certain that the taxpayer's combined income and excess profits taxes shall not exceed a stated percent of its taxable income.

XIV. Capital gains should not be included in determining excess profits tax net income

It seems clear that capital gains should not be included in excess profits tax net income. A capital gain occurs upon the sale of assets which ofttimes, and indeed usually, have been held for a substantial number of years. The gain merely reflects the realization of appreciation which has occurred over the years. This is the basic reason why capital gains receive special treatment by the application of the maximum 25-percent capital-gain rate rather than the higher rates otherwise applicable. For similar reasons, such gains should be excluded in

computing an excess profits tax. Realization of capital gains has nothing to do with the real earnings of the particular year and their inclusion would distort income.

XV. The adjusted excess profits net income should be deducted in arriving at the normal and surtax base

It is the suggestion of the railroads that, subject to the qualification hereinafter mentioned, the scheme of the World War II excess profits tax be followed, that is, the adjusted excess profits net income should be deducted in arriving at the amount subject to the normal tax and surtax. However, as already pointed out, the railroads require a 6 percent return upon their invested capital after normal taxes and surtaxes before imposition of any excess profits tax if sound economic conditions are to be established and maintained in the railroad industry and the carriers are to be enabled to provide transportation facilities adequate to meet the public needs. In the case of the railroad industry, any amount less than a 6 percent return on invested capital after normal taxes and surtaxes cannot be deemed to constitute excess profits. Consequently, adequate provision to permit of such a return to the railroads should be made in any new excess profits tax law. This proposal has been fully developed already (ante, pp. 14–21).

XVI. The excess profits tax, normal and surtax, should be treated as one tax for limitation, credit, and refund purposes, the sending of 90-day letters, etc.

An important improvement over the World War II tax law would be brought about by treatment of excess profits taxes and income taxes as one tax for limitation, credit, and refund purposes and the sending of 90-day letters. If this were done, not only would procedural difficulties be overcome but a serious injustice in the computation of interest would be cured. Under existing law a deficiency in excess profits tax of 1 year usually creates an overpayment of income taxes for that same year. In this situation, even though the taxes of but 1 year are involved, the interest upon the refund of the income tax is computed from December 15 of the next succeeding year, while the interest upon the deficiency in excess profits tax is computed from March 15 of the same succeeding year. Such a result is obviously unfair.

XVII. The railroads do not favor requiring the taxpayer to elect a credit and have the election binding for all subsequent years

The railroads do not think that the taxpayer should be put to an election. In any particular tax year the excess profits tax credit should be computed upon the basis which is most favorable to the taxpayer whether or not the taxpayer was able to anticipate which result would be the more favorable when filing a return. Likewise, in subsequent years the taxpayer should be permitted to make use of the base which is more favorable to it. Conditions arise which change the controlling factors from year to year, as for example a new issue of securities enhancing the invested capital of a taxpayer previously upon an earnings basis. The taxpayer should not be required to speculate with respect to future developments. Neither should he be required to speculate at his peril with respect to the outcome of the final audit of the Commissioner of Internal Revenue.

XVIII. Surplus should not be reduced by elimination of so much of a subsidiary's surplus as was earned prior to acquisition of 95 percent stock ownership

This elimination, which the railroads deem arbitrary, is made pursuant to the consolidated excess profits regulations. In determining the consolidated average invested capital of an affiliated group for the purpose of computing the excess profits credit, the regulations require the elimination of all of the subsidiary's earnings and profits accumulated prior to the date as of which the parent company (or other members of the group) became owners of 95 percent of its stock. The purpose of this regulation is to prevent duplication in the computation of invested capital of a consolidated group. Upon an economic analysis it seems clear that if the duplication is to be eliminated by exclusion of the subsidiary's earnings and profits, the exclusion should be of the earnings and profits properly allocable to each share of stock as of the date of its acquisition by the parent company. The duplication is of that date. Obviously the earnings and profits of a subsidiary accumulated prior to the date of purchase of all of its stock in a single transaction by the parent corporation should not be included in consolidated invested capital, because this amount is already represented in the capital or the surplus of the parent which was used to buy the stock of the subsidiary.

However, where a large percentage of the stock was acquired before the surplus was accumulated and where, after the accumulation, a few more shares are acquired to make up the 95 percent ownership required for affiliation, the regulation purports to require an elimination of all the accumulated earnings and profits represented by all the shares held, regardless of when they were acquired. This results in an elimination where there is no duplication. Accumulated earnings and profits properly allocable to a share of stock arising after the date of its acquisition are not reflected in the purchase price paid by the parent for such share. The duplication is only as to the earnings and profits properly allocable to the share as of the date of its acquisition. Inclusion without regard to the 95 percent limitation of a subsidiary's accumulated earnings and profits allocable to each share of stock and arising subsequent to the date of its acquisition by the parent would not, it is believed present any great practical difficulty. The matter, we submit, ought to be corrected, administratively if possible—otherwise, by legislation.

XIX. Provision should be made for deduction for income and excess profits tax purposes of reserves for deferred railroad maintenance

The country is now confronted with the necessity of conversion to an emergency economy and no doubt greatly increased taxes. The railroads face the prospect of siphoning off by Government, through taxes, of funds which should, but owing to emergency scarcity of men and materials, will not be expended for current maintenance of their properties. Tax relief is imperative to permit the setting aside of such funds until they can be utilized for the purpose for which they would have been utilized but for factors arising out of the national emergency and beyond the control of railroad management. In other words, the reserves should be treated as constructive expenditures in the year in which set aside.

In accordance with the accounting classifications prescribed by the Interstate Commerce Commission, railroads charge the cost of current maintenance to operating expenses, which are deductible for tax purposes. Normally, what shall be expended in a given year is a matter of judgment. As a rule, such expenditures increased in years of heavy traffic, extraordinary wear and tear, and large earnings, and decrease in years of light traffic and meager earnings. Under normal conditions, then, wear and tear are made good out of earnings from the traffic that occasions them.

Emergency conditions dislocate this normal procedure. While emergency traffic brings extraordinary wear and tear, emergency restrictions upon the purchase and use of materials, emergency shortage of available labor, and emergency interruption of work owing to frequency of train movements, tend to reduce maintenance to the bare necessities of safe operation.

Unless provision be made to the contrary, the money which would have been expended to make good the extraordinary wear and tear attributable to the emergency will be subject to taxation, at very high rates. A tax on income which does not permit capital consumed to be made good is, in fact, a capital levy. Throughout World War II, the railroads were not permitted to make good the capital which they consumed, and as a result of the lack of recognition of this fact in the Internal Revenue Code the railroads were taxed at abnormally high rates upon fictitious income. Those railroads subject to excess profits taxes during World War II would have had to set aside $6.89 out of earnings in order to retain $1 after taxes for deferred maintenance.

Public interest requires that this injustice not be repeated. Money needed for maintenance of roadway must be earned. Post emergency earnings cannot be counted upon to produce sufficient funds to make good the extraordinary wear and tear occasioned by emergency usage.

The passing of the present crisis may leave the railroads with hundreds of miles of worn-out rail and ties, but without the financial resources with which to replace them.

It may be pointed out that Congress, by provision for rapid amortization of emergency facilities during World War II and the enactment of corresponding provision applicable in the present emergency, has in some degree recognized the principle that emergency plant utilization should be paid for out of emergency earnings. The proposal here advanced for deduction of reserves set aside for deferred maintenance is but an extension of that principle designed to give it more adequate effect.

We propose that for the duration of the existing crisis, threatening as it does a renewal of wartime shortages of men and materials, the railroads be permited to set aside from current income and to deduct for tax purposes,

amounts which but for such shortages would have been expended for current maintenance. The character and the location of the work to be done would be determined in the first instance by management, but that determination would be reviewed by the Interstate Commerce Commission, which would be called upon to certify the justifiability of that project. The reserves authorized and set aside would be invested in Government securities and so held until expended for the maintenance in respect of which they were established or until the expiration of 5 years following the end of the year in which the President proclaims the end of the period during which, owing to shortages of labor and materials, the carriers are unable to undertake or perform normal maintenance and repairs. Any portion of the reserves remaining unexpended at the conclusion of such 5-year post emergency period would be restored to net income taxable at the rate or rates applicable in the year or years in which the unexpended amount was set aside. Appropriate adjustments would be made in respect of taxable income for carry-back purposes. Thus, as to reserves not devoted to the purposes for which set aside, the status quo taxwise would be restored.

The Commission's Accounting Classifications, page 25, item 25,[2] presently permit the establishment for accounting purposes of deferred maintenance reserves, when so authorized by the Commission. The railroad applying for authority under this regulation is required to give full particulars concerning the nature of the maintenance work for which provision is being made and an estimate by primary accounts of the cost thereof. Some carriers have availed themselves of this regulation and established bookkeeping reserves, although the practice has not become general in view of the fact that no deduction under the Internal Revenue Code has been permissible. In administering the regulation the Commission requires detail as to specific maintenance projects for which the reserves are proposed—as, for instance, replacement of rail between designated mile posts—along with data to establish the actual necessity for the work and its present preclusion by inability to obtain material or labor. With these data, coupled with such special investigation as may be deemed advisable in particular cases, the Commission is in a position to reach an informed and expert judgment as to the justification for the reserve proposed.

We believe this proposal to be just to the Government, neecssary to the railroads, and beneficial to the general public.

LEGISLATIVE PROPOSAL

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That Chapter 1 of the Internal Revenue Code is amended by inserting after section 23, subsection (aa), the following new subsection:

"'(bb) MAINTENANCE AND REPAIRS—CARRIERS—The deduction for maintenance and repairs provided in section 127 (A).'"

"SEC. 2. Chapter 1 of the Internal Revenue Code is further amended by inserting after section 127 the following new section:

"'SEC. 127 (A) (a) DEDUCTION FOR MAINTENANCE AND REPAIRS—CARRIERS—In computing the net income of any carrier subject to Part I of the Interstate Commerce Act, there shall be allowed as a deduction, in addition to the deductions otherwise provided for in this chapter, the amount which such carrier shall, pursuant to authorization of the Interstate Commerce Commission, accrue in its accounts as a reserve to provide for the cost of maintenance and repairs which it is unable to undertake or complete in any taxable year beginning after Decem-

[2] 25. *Deferred maintenance and major repairs to equipment.*—When so authorized by the Commission there may be included each month in account 268, "Deferred maintenance—Way and structures"; account 339, "Deferred maintenance—Equipment"; and account 340, "Major repairs—Equipment," an equitable proportion of the amount estimated as necessary (*a*) to provide for the cost of repairs which the carrier finds it is unable to undertake or complete during any calendar year due to nonreceipt of material and supplies because of priorities regulations or due to adverse labor conditions; (*b*) also in anticipation of major repairs to equipment when such repairs are made at intervals of several years. The amounts included in these accounts shall be concurrently credited to account 774, "Maintenance reserves." The cost of such repairs when made shall be charged according to the repairs to the appropriate primary accounts under maintenance of way and structures and maintenance of equipment, and to the extent that provision has been made for such repairs, amounts including account 774, "Maintenance reserves," shall be cleared therefrom through the accounts originally charged. The carrier in its application to the Commission shall give full particulars concerning the nature of the repair work specifically provided for in this section and an estimate by primary accounts of the cost of such repairs.

ber 31, 1950, owing to unavailability of materials or adverse labor conditions: *Provided*, That United States Treasury securities shall be set aside and held by the taxpayer, under regulations prescribed by the Interstate Commerce Commission, in a face amount at all times not less than the balance in said reserve account for which deductions are allowable under this section: *Provided further*, That expenditures subsequently made for any maintenance or repairs, to the extent that accruals have been made in said reserve account and deductions have been allowed under this section, shall, under regulations prescribed by the Interstate Commerce Commission, be charged against said account and shall not be deductible in the determination of net income, except to the extent provided in subsection (b) hereof.

"'(b) The deductions provided in subsection (a) of this section shall be allowed only with respect to accruals which the Interstate Commerce Commission shall authorize on or before the date upon which the President shall proclaim that the necessities of national defense are no longer such as may occasion a shortage of materials and labor requisite for the initiation or completion of appropriate and proper railroad maintenance and repairs: *Provided*, That any amount remaining in the said reserve account on December 31 of the fifth year following the year in which the President shall issue his proclamation as aforesaid shall be disallowed as a deduction for the year in which it was allowed, and the taxpayer, by setting up said reserve hereunder, shall be taken to have consented to the assessment of any deficiencies resulting from such disallowance at any time within three years following the end of said fifth year, even though the statutory period for the assessment thereof shall have expired. Any other provision of law to the contrary notwithstanding, interest upon such deficiencies shall be calculated at the average rate borne by the Treasury securities set aside and held by the taxpayer pursuant to subsection (a) hereof. Upon the expiration of said fifth year, any expenditures subsequently made on account of such maintenance and repairs shall be deductible under section 23 (a), and the taxpayer shall be relieved of any further obligation to hold Treasury securities under the provisions of subsection (a) hereof.'"

APPENDIX I

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, October 3, 1950.

Mr. J. CARTER FORT,
Vice President and General Counsel, Association of American Railroads, Washington, D. C.

DEAR MR. FORT: At the committee's request, our staff and the Treasury staff are holding a series of informal joint-conferences on the problems of excess profits taxation with the idea of preparing for the committee suggestions for a new excess profits tax law.

We will appreciate meeting with the representatives of your organization on Thursday, October 12, 1950, at 2 o'clock in room 1011 New House Office Building, to secure any suggestions you may have as to the form such an excess profits tax should take.

It is suggested that among other factors special consideration be given to the following:

(1) The proper base for determining normal profits.

(2) If a base period is desired, (*a*) whether it should be based upon an average over a number of years; (*b*) whether the taxpayer should be permitted to elect certain years of the base period; (*c*) what adjustments should be made in arriving at excess profits tax net income.

(3) If an invested capital base is desired, (*a*) how should the invested capital be computed; (*b*) should borrowed capital be considered; (*c*) should accumulated earnings after July 1, 1950 be permitted to increase the invested capital base; (*d*) what rate of return should be allowed in determining the invested capital credit.

(4) What sort of a relief provision would you recommend? Should it be similar to the relief granted under section 722?

(5) Should capital gains be included in determining excess profits tax net income?

(6) Should the normal and surtax be deducted in arriving at excess profits net income or should the adjusted excess profits net income be deducted in arriving at the normal and surtax base?

(7) Should the excess profits tax, normal and surtax, be treated as one tax for limitation, credit and refund purposes, the sending of 90-day letters, etc.?

(8) Do you favor permitting the taxpayer to elect a credit and have the election binding for all subsequent years?

Please let us know at once of you can meet this appointment.

Sincerely yours,

COLIN F. STAM,
Chief of Staff.

APPENDIX II

(Subject IV, ante)

The suggested proviso contemplates an excess profits credit equal to a 6 percent return on all capital plus normal tax and surtax on income equivalent to such a return less interest paid on borrowed capital.

Hypothetical illustrations of the tax liabilities (with the excess profits credit based on invested capital) computed according to that proviso compared with similar liabilities computed under the formulae in the former law as shown hereunder.

Assumptions:	
Equity capital	$10,000
Borrowed capital	10,000
Total capital	20,000
Combined normal tax and surtax rate ... percent	45
Excess profits tax rate ... do	85
Rate of interest on borrowed capital ... do	4
Income, after interest on borrowed capital but before Federal income taxes:	
(1)	1,454
(2)	2,000
(3)	1,200
Excess profits credit:	
Computed in accordance with the suggested proviso:	
6 percent return on total capital of $20,000	1,200
Normal tax and surtax on income equivalent to a 6 percent return on capital less interest on borrowed capital [1]	654
Total	1,854
Computed in accordance with formula in former law:	
5 percent return on invested capital (equity capital of $10,000 plus 50 percent of borrowed capital or $5,000, total $15,000)	750

[1] This tax may be determined by a formula as follows:
Net return equals 6 percent minus interest on borrowed capital.

$$\text{Tax} = \frac{\text{Net return}}{.55} - \text{Net return.}$$

Assumption 1

	Computations under—	
	Suggested proviso	Former law
Excess profits tax:		
Income (1)	$1,454	$1,454
Plus interest on the amount of borrowed capital included in invested capital	400	200
Total	1,854	1,654
Excess profits credit	1,854	750
Income subject to excess profits tax	None	904
Tax at 85 percent	None	768
Normal tax and surtax:		
Income	1,454	1,454
Less income subject to excess profits tax		904
Income subject to normal and surtax	1,454	550
Tax at 45 percent	654	247
Recapitulation:		
Excess profits tax	None	768
Normal tax and surtax	654	247
Total	654	1,015
Income before taxes	1,454	1,454
Net income after taxes	800	439
Return on capital (net income plus interest)	1,200	839
Rate of return percent	6	4.20

Assumption 2

	Suggested proviso	Former law
Excess profits tax:		
Income (2)	$2,000	$2,000
Plus interest on the amount of borrowed capital included in invested capital	400	200
Total	2,400	2,200
Excess profits credit	1,854	750
Income subject to excess profits tax	546	1 450
Tax at 85 percent	464	1,232
Normal tax and surtax:		
Income	2,000	2,000
Less income subject to excess profits tax	546	1,450
Income subject to normal and surtax	1,454	550
Tax at 45 percent	654	247
Recapitulation:		
Excess profits tax	464	1,232
Normal tax and surtax	654	247
Total	1,118	1,479
Income before taxes	2,000	2,000
Net income after taxes	882	521
Return on capital (net income plus interest)	1,282	921
Rate of return percent	6.41	4.61

Assumption 3

	Computations under—	
	Suggested proviso	Former law
Excess profits tax:		
Income (3)	$1,200	$1,200
Plus interest on the amount of borrowed capital included in invested capital	400	200
Total	1,600	1,400
Excess profits credit	1,854	750
Income subject to excess profits tax	None	650
Tax at 85 percent	None	552
Normal tax and surtax:		
Income	1,200	1,200
Less income subject to excess profits tax	None	650
Income subject to normal and surtax	1,200	550
Tax at 45 percent	540	247
Recapitulation:		
Excess profits tax	None	552
Normal tax and surtax	540	247
Total	540	799
Income before taxes	1,200	1,200
Net income after taxes	660	401
Return on capital (net income plus interest)	1,060	801
Rate of return (percent)	5.30	4.01

The CHAIRMAN. We will have to recess on account of votes in the Senate. The committee will recess until 3 o'clock.

(Whereupon, at 1:10 p. m., a recess was taken, to reconvene at 3 p. m., this same day.)

AFTERNOON SESSION

(The committee reconvened at 3 p. m. upon the expiration of the recess.)

The CHAIRMAN. The committee will come to order.

At this point we wish to insert in the record the statement submitted by Mr. J. Rutledge Hill, of Dallas, Tex., on the excess profits tax bill.

(The statement referred to is as follows:)

STATEMENT OF J. RUTLEDGE HILL, OF DALLAS, TEX.

This statement is submitted in my capacity as chairman of the committee on taxation of the National Sand and Gravel Association, which organization represents a substantial majority of the commercial sand and gravel producers of the United States.

The sand and gravel industry questions the advisability and the wisdom, from the standpoint of sound taxation policies for the country, of enactment of an excess profits tax. However, since it is the desire of your committee to have the views of the various industries on H. R. 9827, the excess profits tax bill passed by the House of Representatives, I should like to submit a brief statement of the problems facing the members of our industry and to offer our suggestions for appropriate relief provisions which, in our judgment, will serve the public interest and which, at the same time, will avoid a disastrous and needless burden on our industry.

It may be helpful at the outset if I told your committee something about the industry represented by the National Sand and Gravel Association. Sand and gravel is the product of the natural weathering of rocks. Sand consists of the smaller particles, generally finer than about one-fourth inch. Gravel consists of sizes coarser than about one-fourth inch and is generally graded up to approximately 2 inches and sometimes to as large as 6 inches. A large proportion of the sand and gravel as found in nature is useless to this industry. Sand

and gravel have been deposited by running waters and glaciers in streams, lakes, pits, and banks over thousands of years past.

While our industry is one of the major economic forces in the United States and serves an indispensable need, it is nevertheless a small industry in terms of size of the individual company. In 1948, the last year for which detailed data are available, 2,371 commercial plants reported production to the United States Bureau of Mines. Of them 39 percent produced less than 25,000 tons each annually; less than 100,000 tons annually were produced by 73.4 percent of the plants, and 99.3 percent reported annual productions less than 1,000,000 tons. That is to say, only 0.7 percent of the plants reported annual productions in excess of 1,000,000 tons.

The production and dollar value of the products of the commercial sand and gravel industry for the years 1939 to 1949, inclusive, according to statistics of the United States Bureau of Mines, were as follows:

Year	Production (short tons)	Value	Average price	Year	Production (short tons)	Value	Average price
1939	118,393,120	$71,182,558	$0.60	1946	192,092,566	$148,096,762	$0.77
1940	131,256,267	78,270,134	.60	1947	212,562,417	182,371,638	.86
1941	181,556,467	114,706,913	.63	1948	233,503,522	211,319,732	.90
1942	232,947,787	159,427,273	.68	1949	231,205,478	211,336,119	.91
1943	176,469,256	127,902,121	.72				
1944	150,633,081	108,796,237	.72	Total	2,012,758,259	1,523,831,859	.76
1945	152,138,298	110,422,372	.73				

USES

Sand and gravel is used in many ways. The Bureau of Mines reports commercial tonnage and value for principal uses for 1949, as follows:

	Short tons	Value	
		Total	Average
Sand:			
Glass	4,339,033	$10,772,151	$2.48
Molding	6,113,520	10,140,458	1.66
Building	59,307,353	47,879,130	.81
Paving	31,520,407	25,849,473	.82
Grinding and polishing	1,080,886	2,063,866	1.91
Fire or furnace	318,373	429,512	1.35
Engine	1,883,580	1,830,549	.97
Filter	189,243	376,596	1.99
Railroad ballast	955,996	407,234	.43
Other	2,300,240	1,961,224	.85
Total commercial sand	108,008,631	101,710,193	.94
Gravel:			
Building	49,788,200	49,319,528	.99
Paving	60,571,091	52,972,235	.87
Railroad ballast	10,444,070	5,618,124	.54
Other	2,393,486	1,716,039	.72
Total commercial gravel	123,196,847	109,625,926	.89
Total commercial sand and gravel	231,205,478	211,336,119	.91

DEPLETION OF DEPOSITS

Sand and gravel are wasting assets. During World War II the rate of depletion of known deposits was accelerated greatly; in some areas the production was as much as 500 percent of normal. In substantially all areas the rate of depletion was greatly increased. With the closing of World War II the need for homes, factories, replacement of wornout and outmoded highways, bridges, water-treatment plants, sewage-disposal plants, and the many other needs of the Nation were so tremendous that the rate of depletion, instead of returning to prewar levels, continued to increase.

According to the United States Bureau of Mines, this sustained demand required the largest production in the history of our industry, and the demand in 1950 was so great that an all-time production record will undoubtedly be established. In many instances reserves are down to new low levels. In the case of my own companies, we have at none of our 12 plants more than 5 years of known reserve.

Your committee, recognizing that producers of exhausible mineral resources have a special problem, have agreed to the following taxation principles for most members of the mining industry: (*a*) discovery value depletion; (*b*) percentage depletion; (*c*) charge-offs of intangible development costs and wartime premium price payments. The sand and gravel industry has never received any of this sorely needed relief.

When World War II began, the acute need of relief from excess profits tax was recognized for our industry, and relief section 735 included sand and gravel. This section promised much but, as I shall point out, produced little or no relief for members of the sand and gravel industry. As a result, at the end of World War II our long-held reserves were critically low and we had little or nothing to show for the excessive exhaustion of our reserves during the war period except a severely and greatly reduced life of our business. Now, with the advent of another excess profits tax, a large portion of our industry faces certain extinction, if we are not granted more realistic relief from excess profits tax than was given in the act of 1942.

Our industry recently had the privilege of presenting to the House Ways and Means Committee the critical problems facing producers of sand and gravel in our appeal for percentage depletion allowance. The merits of our claim were recognized by that committee and percentage depletion allowances covering sand and gravel were written into the bill. While the relief proposed to be granted was inadequate, the taxation principle was sound and we hoped that Congress would later decide that we were entitled to the same consideration accorded under existing law to the other non metallic mineral industries. The advent of the Korean war caused the Congress to drop from the bill any provision which curtailed revenue, no matter how slight and regardless of the equity of the provision.

From the end of World War II until the present time, as a direct result of wartime excessive depletion and exhaustion of reserves, members of the industry have been forced to rebuild, move, and reconstitute their plants and properties; to replace worn-out equipment as equipment and means of replacement were available; to open up, develop, and market their limited remaining deposits; and to conduct costly exploration for the possible discovery of new sources of operations.

In the reduced reserves owned by our industry there are many deposits which were acquired before World War II, at a small fraction of their present market value. Without realistic relief such deposits will be liquidated at their prewar cost, or a small percentage of the present cost of exploration, acquisition, and development. Nearly all taxpayers are protected in some degree in such an instance either through special depletion allowances or capital gains provisions. No such protection is available to sand and gravel producers. This condition of affairs is a serious threat to the future of our business, and yet the committee will understand, I am sure, that our industry is expected to play a key role in the defense program.

The cost of exploration, acquisition, and development of a gravel deposit to a point where it may be marketed is now 300 percent of the cost which prevailed in 1940. The cost of plant equipment is some 225 percent of the 1940 figure. Landowners are reluctant to market or allow to be marketed sand and gravel from their properties at this time, their theory being that this property is rapidly increasing in price and is becoming scarcer each year. This situation tends to prevent acquisition of deposits when and if they are known to exist.

Without relief from excess profits taxes, our industry will not have the means required for further exploration, acquisition, and development of properties. In the last excess profits tax, Congress went to great pains to provide general relief for all taxpayers under section 722 of the Internal Revenue Code and special relief for operations such as ours under section 735. Both sections proved to be almost completely illusory.

Section 722 presumed to offer relief to those corporations whose operations were not normal during the base period. The preparation and presentation of claims under this section required extensive talent (legal, accounting, engineering, and economic) which, to a large extent, is not available to small corporations.

Many claims under section 722 are still pending, and few companies have received any real relief, the reason being that the amount of relief in each case is largely discretionary. The House of Representatives has recognized the illusory character of provisions such as section 722 and has omitted such provisions from H. R. 9827.

The House of Representatives has, however, included in H. R. 9827 a new section 451, almost identical with section 735 of the World War II excess profits tax, which provides special treatment for the increased production over normal output in the case of certain minerals. Section 735 was confusing, extremely complicated, inequitable, expensive, and produced little or no relief for the sand and gravel industry. Under section 735 the taxable year's production had to be segregated as to each mine, and each such separate production had to run an "obstacle course" of many strict requirements. Each obstructing requirement progressively diminished, or entirely eliminated, the excessive production being tested for relief and, at the end, little or no excessive production remained for relief. Since section 451 of H. R. 9827 is identical with section 735 of the old law except with respect to the base period and other minor respects, the sand and gravel industry will face the same problems as it did under the old law. Some of the actual situations which arose under section 735 of the old law will best serve to illustrate.

Section 735 required that a mine had to have been in operation for at least 6 months in the base period. One producer in 1940, after several years of production, exhausted all of his gravel reserves at his mine, and moved his operations to a rich deposit he had held for many years in a nearby area. In each of the years of 1942 and 1943 he produced from this different deposit several times his normal production, but none of his excessive production could qualify for relief because this particular mine was not in production during the base period. If by chance he had moved his operation a year earlier, all of his excess production would have qualified for relief.

Section 735 required that the amount of relief be computed, in addition to several other factors, on the base period unit profit. In 1937, a producer started operations on a difficult deposit and lost considerable money in 1937 and 1938 before he established profitable operations late in 1938. In 1942, his production from this mine was four times that of 1939. None of this excess production qualified for relief because he had no normal base period unit profit.

Section 735 required that the amount of relief be based on the percentage of total exhaustion sustained by each mine within the taxable year. A producer had operated two deposit at different locations for many years to best serve his normal customers. One deposit was considerably larger than the other, but they were approximately the same distance from the location of substantial wartime construction. It is now known that the smaller deposit could have met the uncertain demand, although it would have been almost completely exhausted, but the producer considered that he could serve the war effort better if he concentrated all of his movable equipment at the larger deposit and temporarily abandoned the small operation late in 1941. The 1942 production was excessive and, after meeting the many strict requirements of section 735, only 30 percent of the excess output qualified for relief. Had the producer not been overanxious to best serve the war effort, and concentrated production from the smaller deposit, 100 percent of the excess output would have qualified for relief.

Determination of the computation factors required in section 735 was complex, theoretical, and expensive, and covered not only the taxable year but each year of the base period. Overhead expenses had to be allocated to each separate mine, and depreciation on all movable equipment had to be segregated and applied to each mine. Engineers had to be employed to make test maps setting forth the reserves of sand and gravel at each mine, in a concise manner acceptable to the Bureau of Internal Revenue. All of this work had to be performed in many instances just to find out that a producer actually had no statutory income subject to section 735 relief. If a portion of the income did qualify for relief, all of these voluminous computations and test maps had to be verified by the Bureau. These problems, on the surface, did not appear complex but in actual practice they were feared by both the taxpayer and the Bureau.

The foregoing few examples of injustices and complexities can not fully describe the faults of section 735, and to an equal degree section 451, as it applied to production of sand and gravel. The failure of this section can best be proven by a contrast of the excess output of sand and gravel to the total section 735 relief allowed producers of sand and gravel, said data being furnished by the Bureau

of Mines and the Bureau of Internal Revenue, if possible. It is firmly believed that the answer would be concise and conclusive.

Many of the complexities and elements of sheer chance and adventure of section 735 can be removed by simple and just requirements in the new section 451 and the method of computing section 451 income. We respectfully suggest the following formula:

1. Output for taxable year ________ (tons)
2. Normal annual output (a base period) ________ (tons)
3. Excess output (1 minus 2) ________ (tons)
4. Total net profit for taxable year before tax ________ ($)
5. Unit net profit (4 divided by 1) ________ ($)
6. Profit from excess output (3 times 5) ________ ($)
7. Sec. 451 income exempt from excess profits tax ____ percent of 6______ ($)

All mines of a producer would be combined in the one computation shown above.

INDUSTRIAL SAND

I am authorized also to advise your committee that the views expressed in this statement are likewise the views of the industrial sand industry as represented by the National Industrial Sand Association. Perhaps a word of explanation of the difference between these two industries will be helpful.

Sand and gravel are essentially construction materials, used for a wide variety of purposes and basic to the great construction program of the country. Industrial sand is a commodity which is primarily a raw material used in many industries, including the glass industry, foundry industry ceramic industry, and a vast number of other industries who must have industrial sand in order to conduct their operations. Industrial sand also plays an indispensable role in the defense program. It is no exaggeration to say that without industrial sand there could be no defense program.

I must in all fairness to these two great industries say to your committee that Congress in the past has neglected to accord to them the elemental justice to which they are entitled in the formulation of taxation policies. Unless adequate recognition is given to the desperate problems which these two industries face, the combination of limited reserves and record-breaking demand will mean diminishing supplies of sand and gravel and industrial sand at a time when they are most critically needed.

In conclusion, I ask your committee to give careful consideration to these points of view, which are prompted by our desire to guarantee an ample supply of our commodities at a price which the country can afford to pay.

The CHAIRMAN. I wish to insert also in the record a brief by the Associated General Contractors of America, Inc., submitted by Mr. H. E. Foreman, managing director, on the excess profits tax.

(The statement referred to is as follows.)

STATEMENT OF H. E. FOREMAN, MANAGING DIRECTOR, OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, INC.

This statement is filed on behalf of members of the Associated General Contractors of America, Inc., for your consideration in connection with excess profits tax legislation.

The Associated General Contractors of America is the Nation-wide association representing more than 5,700 of the Nation's leading general contracting firms. They execute all types of construction, and annually perform the major portion of contract construction in the Nation. There are 112 affiliated local associations throughout the United States and Alaska.

The general contracting branch of the construction industry operates in an entirely different manner from other industries. It is not comparable to such industries as mining, manufacturing, etc. The general contractor has no line of merchandise in a manufactured form that can be sold and delivered immediately to a purchaser. The general contractor can only sell a completed structure, at a fixed price months and some times years before it comes into existence. It operates largely by fixed price contract. It is not possible for a general contractor to determine to an exact degree the cost of the completed structure until it is completed and delivered to the purchaser. Unlike other industries, a general contractor does not have an inventory already purchased to fall back upon. He

must go out in the open market and purchase his materials for each project. Likewise, when he signs a contract it is impossible for him to do more than make an approximate estimate of what his labor costs will be. During the construction of a structure he is forced to contend with weather conditions, work stoppages, shortages of materials, and many other conditions. The general contractor's equipment must be used in all kinds of weather and under varied conditions. It is not protected from the elements and, when in operation, cannot be completely maintained.

In many respects the general contractor's operation is more nearly comparable to a personal service group. The very nature of the contractor's operations requires relatively small invested capital, most of which is represented by equipment which, at best, has a short life. Unlike other industries, the general contractor's operation does not usually call for large plants or buildings, or similar fixed assets. Long-term borrowings are not of primary importance, as the general contractor is compensated, in part, as the work progresses. Thus, it may be said that the major factors in determining the general contractor's profit are the contractor's own experience, ingenuity, and skill of operation.

For these reasons it can be readily seen that any type of excess profits tax will create a definite hardship on the general contractor. Experience has shown that this type of tax encourages waste, inefficiency, and extravagance. It serves to destroy the incentive for efficient operation.

The contractor is penalized by this type of tax, due, in part, to the length of time it requires to complete a structure, thus creating an overlapping of the operation in different tax years. The excess profits tax cannot be made to apply equitably to all business corporations, and, for this reason, a tax based on earnings during a particular base period on an invested capital insures, proportionately, a greater rate of tax on general contractors.

RECOMMENDATIONS

Members of the general contracting branch of the construction industry are not opposed to the taxation of profits derived from wartime orders, directly or indirectly. Our purpose is to bring to the attention of the committee the difficulties that an excess profits tax creates and to make recommendations that will partially alleviate this hardship.

Excess profits taxes were enacted during World War I and World War II. This tax has now come to have a definite meaning. Theoretically, it is supposed to merely take away the profit that is in excess of what a corporation should normally earn if an emergency did not exist. To arrive at what are normal profits for each corporation, a formula is used that is based on a corporation's average earnings for a past period or on the invested capital of the corporation. Recognizing that many inequities and hardships would be used by the use of either of these methods, relief provisions were incorporated in both the World War I and the World War II tax acts.

In order to obtain some degree of equality in the application of an excess profits tax as applied to the general contractor, the following should be exempted:

1. Profits from all contracts awarded as a result of competitive bidding

As has already been stated, the normal practice of a general contractor is to sell a completed structure or improvement at a fixed price before it comes into existence. Generally, a purchaser requests several general contractors to bid in competition for the work. Ordinarily, the lowest responsible bidder receives the award. During the contractor's operation, any increase in the cost of materials or labor, as well as other factors, are the contractor's responsibility and generally serve to decrease the contractor's final profit. It is rare that a contractor's estimate at the time the contract is awarded is the same as when the work is completed.

2. Profits on all operations entered into at a fixed price prior to June 24, 1950, the date of the Korean invasion

The general contractor, because of the custom of doing the work by fixed-price contract, has no means of increasing the amount called for in the contract. It was not possible to foresee the Korean conflict, with its immediate increase in all types of costs going to complete the project called for by the contract. In no way can the work involved in these contracts be considered defense work or have any direct relation to the Korean conflict.

3. Profits on long-term contracts entered into prior to June 24, 1950, that are to be completed subsequent to that date

Many general contractors hold contracts predating the Korean conflict. Many of these contracts date back several years and many will require several years to complete. Certainly any profits realized from these long-term contracts cannot possibly be considered war profits. Many of these contractors have already been penalized by the increase in the normal rates of tax now in effect. This applies particularly to the contractors that report their income from long-term contracts on a completed contract basis; that is, at the time the work is completed. These contractors already face substantial reduction in anticipated profits from these long-term contracts because of increased costs that have already taken effect. Many general contractors operating under long-term contracts only begin to realize their profits when the project has been under way for quite a long period of time.

4. Profits on all negotiated fixed-price contracts that are subject to renegotiation

The purpose of renegotiation legislation is to recapture any abnormal or excessive profits which are attributable to the emergency. During the last war general contractors engaged in war work required to refund a very large part of their profits and were further subject to an excess profits tax. Inasmuch as renegotiation was not based on income after taxes, many contractors found themselves in financial difficulties by reason of additional taxes levied when their tax returns were examined by representatives of the Bureau of Internal Revenue.

An excess profits tax that follows the pattern of the last excess profits tax, to at least soften its impact on the general conractor, should be as follows:

Earnings method.—A base period embracing the years 1946 through 1949 should be used in determining normal earnings. A general contractor should be permitted to use the average of any 2 years out of this period, rather than of all the years embraced in the period. The normal earnings should be based on the full earnings, rather than a percentage of earnings. A general contractor has no assurance of a continuity of earnings. One year may produce net profits and another year no profit. He may have work 1 year and not any the next. A general contractor fully appreciates the truth of the expression, "It's chicken today and feathers tomorrow," that is so often heard in connection with the contractor's operations. In many instances a contractor may have a fixed-price contract for the building of a structure, and this work may continue for the greater part of one year and a half of the following year, and during the remainder of the latter year he is forced to remain idle because of lack of work. It is because of the uncertainties that confront the general contractor that the average of any 2 years in the base period is recommended.

Invested capital method.—A general contractor in figuring the tax base should be allowed the appraised value of his equipment and the total amount of his borrowed capital, as well as any accumulated earnings. Most general contractors that are forced to use the invested capital method because of negligible earnings during the base period are penalized because the contractor does not have or need to have a large investment in a plant, such as would be the case with most manufacturing concerns. For the most part, a contractor's invested capital consists largely of equipment used in his operations. The equipment, at most, has a short span of life and hence there is a constant shrinking of the invested capital attributable to this equipment.

Specific exemption.—A general contractor should be allowed a minimum of $50,000 as a specific exemption. The normal earnings, therefore, would be the average of the base period earnings plus the amount of the specific exemption. This pertains in like manner when the invested capital method is used. The last excess profits tax provided for the allowance of an annual specific exemption, thus permitting a portion of the contractor's profit to be exempt from this tax. This allowance for the last year the excess profits tax was in effect was $10,000. Based on the experience of the general contractor during the years the last excess profits tax was in effect, it was found that a specific exemption of $50,000 would be necessary to compensate, at least in part, for the hardship that the excess profits tax law caused the general contractor.

Relief provisions.—Any excess profits tax laws should contain clear and specific relief provisions that would, at least to some extent, alleviate hardships. These relief provisions should be set forth in the act and not left to administrative interpretations and rulings. In the last excess profits tax, relief provisions were incorporated that were expected to relieve hardship cases arising because of the

recognition that the excess profits tax rate would not fall equitably on all corporations. The building industry was specifically mentioned in the report of the Senate Finance Committee accompanying the World War II excess profits tax as possibly qualifying for relief due to a business cycle which might vary from the general business cycle. Actually, very little relief was forthcoming. A large number of these claims for relief are still pending. These relief provisions did not solve the problem of equitably applying the excess profits tax to all taxpayers. The cost of administration merely added to the burden of the taxpayer, without accomplishing the desired result. Many of these pending relief claims bear yearly interest at 6 percent, thus further burdening the taxpayer. The general contractors believe that the relief provisions of an excess profits tax law should be clearly spelled out by Congress and not left to administrative interpretations. No useful purpose would be accomplished by merely reenacting the same or similar provisions that were contained in the last excess profits tax law.

The purpose of incorporating relief provisions in an excess profits tax law is to insure that the tax rate will fall equitably on all taxpayers. To partially accomplish this, relief provisions should be incorporated insuring the right of a taxpayer to use the same base as other comparable competitors in the same industry.

Tax limitation.—Under section 710 (a) (1) (B) of the World War II excess profits tax the combined income and excess profits tax could not exceed 80 percent of the corporate surtax net income (computed without allowing credit for income subject to excess profits tax). With the benefit of the postwar refund credit of nearly 10 percent, the rate was limited to approximately 70 percent. A limitation as to the percentage of surtax net income that could be extracted from a taxpayer should also be incorporated in the proposed excess profits tax law now under consideration. The interests of small business should be safeguarded in an excess profits tax law to the same extent that they are now protected in the computation of the normal income tax. To this end, a taxpayer should be permitted to pay as a maximum tax a combined income and excess profits tax of 38 percent on all earnings up to $100,000, a combined income and excess profits tax of 45 percent on all earnings over $100,000 but not over $250,000, and a combined income and excess profits tax of 50 percent on all earnings over $250,000. In this way it is possible to afford small business the necessary protection, as well as to insure that the tax burden will fall equitably on the various types of taxpayers.

Reenactment.—There should also be reenacted in any excess profits tax law sections 721 and 736 (b) of the 1942 excess profits tax law, providing relief for companies reporting on a completed contract basis, so that the earnings associated with periods prior to the effect date of the new excess profits tax law will not be penalized simply because of the method of accounting. Section 721 protects companies with income in the form of dividends from foreign subsidiaries and is particularly important to construction companies operating on lump-sum contracts.

H. R. 9827 inadequate.—The excess profits tax plan as drafted by the House Ways and Means Committee and reported to the House of Representatives fails to relieve the hardships and inequities common to general contractors under this form of taxation.

The minimum credit or minimum normal profit of $25,000 in many instances will provide the only tax base that a general contractor will be able to use. Because of the contract system common to the general contractor and the overlapping of contracts in different taxable years, base period earnings may be abnormally low. This likewise applies to the computation of normal earnings on the basis of invested capital. This method is of very little help to the general contractor, as the greater part of the invested capital is in the equipment. This type of asset, at best, has a short life and is depreciated rapidly.

The relief sections, as drafted, still do not accord a general contractors a sufficient yardstick of measurement to permit a reconstruction of adequate earnings to offset the general contractor's uncertain profits attributable to operating under a contract that provides for sale, at a fixed price, months before the subject of the contract comes into existence.

A tax ceiling of 67 percent on corporate profits, embracing the regular tax and the excess profits tax, is extremely severe on a great number of general contractors. Experience has shown that during the period the last excess profits tax law was in force many of the general contractors were required to pay a flat rate of 80 percent of their profits, because of meager earnings and small invested

capital during the base period years 1936 through 1939. However, the general contractor was permitted a postwar credit which reduced his payments to approximately 70 percent. There is no reason to believe that this situation will not again prevail and that many general contractors will again be forced to pay the tax ceiling on corporate profits as finally approved by Congress. The rate of 67 percent now set forth in H. R. 9827 does not appear to be justified, especially in view of the fact that when the last excess profits tax law was in effect the country was engaged in a full scale war and yet during that period a maximum tax of approximately 70 percent was the full tax exacted from corporate taxpayers.

In order to effectuate, as far as possible, an even distribution of the increase in tax contemplated, consideration should be given to a limitation of tax that will encourage and protect small business. With this aim in view, we recommend that a tax limitation of 38 percent be placed on the first $100,000 of net profits, that this rate be increased to 45 percent on the next $150,000 of net profits, and that on all remaining net profits a tax of 50 percent be enacted. Under this method the inequities are largely removed and small business is afforded the necessary encouragement and protection.

Because of the general contractor's method of operation, special provisions should be incorporated in an excess profits tax bill that would exempt—

(1) Profits from all contracts awarded as a result of competitive bidding.

(2) Profits on all operations entered into at a fixed price prior to June 24, 1950, the date of the Korean invasion.

(3) Profits on long-term contracts entered into prior to June 24, 1950, that are to be completed subsequent to that date.

(4) Profits on all negotiated fixed-price contracts that are subject to renegotiation.

These special provisions are as necessary to the general contractor as the special provisions now incorporated in H. R. 9827 are to the public utilities, railroads, and regulated airlines.

The CHAIRMAN. Mr. Arthur Elder is next on the list.

Please identify yourself for the record.

STATEMENT OF ARTHUR A. ELDER, CONSULTANT, TAX COMMITTEE, AMERICAN FEDERATION OF LABOR

Mr. ELDER. My name is Arthur A. Elder, representing the American Federation of Labor.

On behalf of the 8,000,000 members of the American Federation of Labor, Mr. Chairman and members of the committee, I wish to express the very keen interest of our members as workers and as citizens in this legislation which is now being considered by your committee.

The American Federation of Labor appreciates that these hearings are being held as a very necessary preliminary to increasing over-all tax income in harmony with the intent of Congress in enacting the Revenue Act of 1950.

Since the enactment of that act it has become quite apparent that the total revenue needs of the Federal Government during the next few years will be considerably greater than anticipated. Defense expenditures certainly will run billions of dollars yearly in excess of original estimates.

These defense expenditures in addition to the ordinary irreducible expenditures of the Federal Government will undoubtedly demand still further increases in total revenue, requiring upward adjustments in tax rates over and above those now being considered. If inflationary deficits in the Federal budget are to be avoided to check further inflation with the probable consequent necessity of the imposition of drastic and rigid controls, the American Federation of Labor strongly favors financing the regular expenses of Government and the costs of the defense program as nearly as possible from current tax revenue.

We appreciate the serious nature of the problem facing Congress in determining the amount and nature of the tax increases that should be made. In the field of taxation, as in other fields of our economic life, however, we are of the opinion that if ever we were in a time that demanded equality of sacrifice, that time is the present.

We also believe that adherence to that principle is demanded by considerations of the over-all health and stability of our economy as well as by considerations of equity.

In terms of meeting our responsibilities at this time, therefore, we believe that due consideration for the principle of equality of sacrifice would demand that first priority should be given to equitable increases in tax rates in all types of taxation which do not depress or cut into the living standards which might be considered as basic and essential to maintain health and efficiency of any and all sections of the American people.

It is our considered opinion that this principle has been violated by Congress in the two tax revision bills enacted prior to 1950 which concentrated a disproportionate share of tax relief in the groups with net incomes in excess of $4,000. In some respects, those in the lower income groups were still further disadvantaged by the action taken by Congress earlier in 1950.

It should be pointed out that a single worker employed at the 75 cents hourly minimum wage established by Congress would under the 1950 tax revision have his yearly personal income tax increased from approximately $133 to $161, assuming full-time employment and a yearly income of $1,560.

The fact that the dollar is now worth only 57.2 cents in terms of its prewar value should also be taken into account in appraising this worker's purchasing power. Excise and sales taxes which at the Federal and State levels in combination have increased from 8.4 billion dollars in 1945 to 12.6 billion dollars in 1949—a 50 percent increase—add considerably to the tax load.

Senator KERR. That is on an annual basis that you are talking about now?

Mr. ELDER. On an annual basis; yes, sir.

This already tremendous increase in taxes on consumers would seem to argue most forcefully against proposals for raising any portion of increased governmental revenue needs through sales taxes or excise taxes on goods or services at the present time.

Excise taxes on transportation, goods, communications, and other services wherever pyramided in the price to the consumer without relation to ability to pay should, in our opinion, be eliminated as soon as possible. Certainly no consideration should be given to increasing them at this time.

While it is apparent that all the above-mentioned factors operate to some degree to limit the real purchasing power of all groups, it is obvious they are particularly burdensome and violate the equality-of-sacrifice principle to the extent that they cut into the basic and necessary living requirements of those in the lower-income groups.

It is our considered opinion, therefore, that increased emphasis at this time and for the foreseeable future should be placed on increases in personal and corporate income, but increases, we believe, should be apportioned with greater regard for the need of reducing or elimi-

nating the tax on that portion of income considered necessary to maintain necessary minimum living standards.

On an over-all basis the possibility of increasing our tax revenue from progressive taxes on income may be realized from the fact that in 1945, 64.47 percent of total tax revenue at all levels of government—that is, including Federal, State, and local—was derived from taxes on individual and corporate income.

The breakdown shows 18.7 billion dollars on individual, in addition to 15.5 billion dollars on corporate, income. That is a total of 34.2 billion dollars out of total tax collections of 53.05 billion dollars.

In 1949, by contrast, tax collections of 27.9 billion dollars on income were only 52.1 percent of total collections of 53.58 billion dollars. In other words, with an increase in total tax revenue of one-half billion dollars, the proportion of revenue derived from taxes based on the ability to pay had fallen from 64.47 percent to 52.1 percent of total tax collections.

We believe the facts we have cited argue most strongly that considerations of equity as well as economic considerations require the enactment of increased taxes on corporate profits at a time when they are running at a rate of $22,000,000,000 annually, after payment of existing taxes.

We consider Secretary Snyder's proposal that an excess profits tax be levied to produce additional revenue of $4,000,000,000 yearly decidedly modest. If your committee and Congress concur by enacting a measure substantially as recommended by the Secretary at this time, it would seem to involve no hardship to corporations at their present level of income.

If applied retroactively to July 1, 1950, the proposed excess profits rates when combined with the 45 percent rate established under the Revenue Act of 1950 would actually leave corporations with net income approximating the all-time high of $21,000,000,000 in 1948.

Senator KERR. May I ask a question there?

Mr. ELDER. Yes, sir.

Senator KERR. Do I understand that up above you said that they are now running at the rate of $22,000,000,000 annually after payment of existing taxes?

Mr. ELDER. That is the estimate, I believe, that Secretary Snyder gave.

Senator KERR. And you estimate that they could pay an additional $4,000,000,000 and then still have their net income after taxes at $21,000,000,000?

Mr. ELDER. Of course, we are talking about a half year, as far as the present year is concerned. I believe that they would have perhaps slightly under $21,000,000,000 if the excess profits tax as proposed by the Secretary were adopted.

Senator KERR. I thought you said "if applied retroactively to July 1, 1950."

Mr. ELDER. That would be for a half year, as far as the current year is concerned.

Senator KERR. You said:

> The proposed excess profits rates when combined with the current 45 percent rate established under the current Revenue Act of 1950 would actually leave corporations with a net income approximating the all-time high of $21,000,000,000 in 1948.

Mr. ELDER. That is true.

Senator KERR. And you just said that before the enactment of this tax they had $22,000,000,000.

Mr. ELDER. That is existing taxes, which do not take into account the excess profits tax.

Senator KERR. I wish you to explain to me how if they are now $22,000,000,000 annually——

Mr. ELDER. That is what I am trying to do, Senator.

Senator KERR (continuing). And you increased the take by $4,000,000,000, how they would have $21,000,000,000 left. I would appreciate something that would do that.

Mr. ELDER. Certainly. That is $4,000,000,000 on an annual basis. That is the way I understand the Secretary's proposal, which would mean $2,000,000,000 on the basis of a half year.

Senator KERR. Did I say that in this sentence?

Mr. ELDER. No. But I am explaining it now, Senator.

Senator KERR. Then you think that it should be amended to include that explanation?

Mr. ELDER. This statement?

Senator KERR. Yes.

Mr. ELDER. If it is not clear, I would be agreeable. I am assuming what I say goes into the record to clarify that point.

The CHAIRMAN. That is right.

Mr. ELDER. In view of these considerations, we are opposed to the amendments made by the House which would reduce the amount of revenue that is to be anticipated from the measure under consideration by approximately $1,000,000,000 yearly at current income levels. The present need for revenue, the current high level of corporate earnings, and the necessity for more balance in our tax structure combine to reinforce the necessity for an increase of not less than $4,000,000,000 at this time.

Secretary Snyder suggested setting base period earnings at 75 percent of the average of the best 3 years' earnings of the period 1946–49.

Senator MILLIKIN. Mr. Chairman, I would like to ask the witness why not five or why not three or why not some other figure. What is the sanctity about 4?

Mr. ELDER. Actually, Senator, I suppose the same question might be made with regard to any other figure. I would agree to that.

Senator MILLIKIN. Then there is no sanctity in the figure 4?

Mr. ELDER. I would say, in terms of the revenue needs, if you must choose a figure, 4 would be a better figure than 3, and if it would be possible at this time, or if it were considered practicable—in my opinion it is—you may not agree with that opinion—that 5 would be a practical figure, I would say 5 would be better than 4.

But as between 3, 4, or 5, I should say that at this time 4 would be the preferable figure.

Senator MILLIKIN. You are simply saying that we need more revenue?

Mr. ELDER. That is right.

Senator MILLIKEN. And that 25 is more than 3?

Mr. ELDER. That is right.

Senator MILLIKIN. And that 25 would be more than 4?

Mr. ELDER. That is right.

Senator MILLIKIN. And I cannot disagree with your mathematics.

Mr. ELDER. Thank you.

The House proposal to exempt 85 percent of the average base period earnings from the excess profits tax will lead to substantial loss of revenue. Profits since 1945 have been abnormally high, largely as a result of governmental, personal, and corporate expenditures growing directly out of World War II.

We believe, therefore, that the 75-percent figure was reasonable and adequate. The alternative either now or in the future would seem to be the adoption of a very high excess profits tax rate, possibly considerably higher than the 75-percent rate proposed which we believe should be avoided.

On the whole, we consider the provisions of the House-approved bill as sound, designed to facilitate administration, and to give the maximum consideration to the problems of new corporations and the necessary expansion of established corporations.

No other proposal submitted up to this time for the taxation of corporation income, in our opinion, is as equitable or would operate as effectively as the measure before your committee. It appears to embody the best of the suggestions growing out of previous experience with excess profits tax legislation.

We believe that if amended by your committee and approved by Congress to yield not less than $4,000,000,000 yearly in increased revenue retroactively to July 1, 1950, the bill now before your committee will, when enacted, be a necessary first step in facilitating full and adequate consideration of further revenue needs early in 1951.

The CHAIRMAN. Are there any further questions?

Senator KERR. I want to ask him one question.

The CHAIRMAN. Yes, sir.

Senator KERR. We have had a number of witnesses before us who have agreed with the figure of $4,000,000,000, but they have suggested another formula for raising it, their suggestion being that it would be raised from the same source—that is, corporation income—but the suggestion was for a straight across-the-board increase rather than an excess profits formula.

Are you familiar with those recommendations?

Mr. ELDER. I have heard of those suggestions; yes.

Senator KERR. What is your opinion about it?

Mr. ELDER. My opinion in that matter, of course, is that the view of the corporations on that particular matter—I mean, if a poll were possible—should weigh much more heavily than any opinion I might have. After all, if it were only a question of an equal amount of revenue and the corporations who paid that revenue expressed a preference for one type of tax as against another, it seems to me that their view should carry a great deal of weight.

My personal opinion, however, is that an across-the-board increase would not be fair, it would not be fair to the large corporation, which at the present time and perhaps during the last few years has enjoyed a very low rate of return on possibly a very high investment. Nor would it be fair to the smaller corporation, possibly, which is just getting established.

It obviously would be favored by those corporations which are making at the present time what might be considered an abnormally—I am not saying excessive; I am saying abnormally—high rate of profit.

The CHAIRMAN. Are there any other questions?

Senator KERR. That is all.

The CHAIRMAN. Thank you very much for your appearance, Mr. Elder.

Mr. ELDER. Thank you.

The CHAIRMAN. Admiral Ramsey. You are appearing for the Aircraft Industries Association of America, Inc.?

Mr. RAMSEY. I am appearing for the Aircraft Industries Association; yes, sir.

The CHAIRMAN. Very well, Admiral. We will be glad to hear from you.

STATEMENT OF ADMIRAL D. C. RAMSEY, UNITED STATES NAVY, RETIRED, PRESIDENT, AIRCRAFT INDUSTRIES ASSOCIATION OF AMERICA, INC.

Mr. RAMSEY. My name is De Witt Ramsey, president of the Aircraft Industries Association. This statement to you, Mr. Chairman, is made on behalf of virtually the entire aircraft, aircraft engine, and propeller manufacturing industry.

At the outset we wish to emphasize that the aircraft industry has no desire to derive excessive profits from its participation in present or future preparedness efforts. The aircraft industry, in fact, has been subject to profit limitation and control since 1934.

The record shows that aircraft industry earnings, as a percentage of sales, have been far less than the average for industry generally thoughout the last 8 years. The average for the aircraft industry is 1.3 as compared to 5.4 percent for industry generally, as the following chart shows:

(The chart referred to is on page 546.)

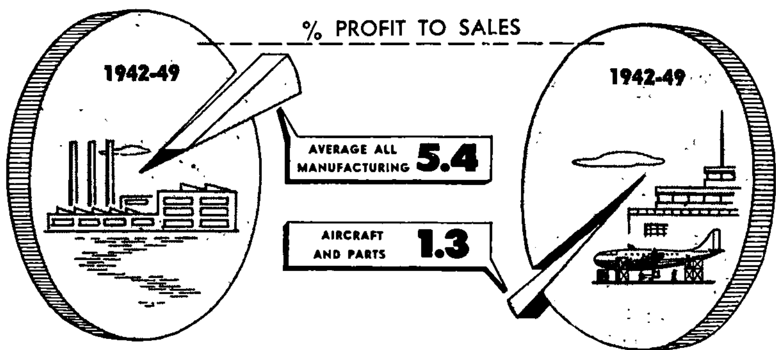
Mr. RAMSEY. We feel a very heavy sense of responsibility to the Nation, for it is our duty to provide the Armed Forces with the aircraft equipment which will enable them to keep the United States strong and free. In the light of our record in the last war, we feel that we do not need to present extensive evidence of the ability of our industry to provide to the Nation the weapons for air power which are needed, if we are allowed to maintain a sound financial structure. It is this last factor which concerns us with respect to the proposed excess profits tax.

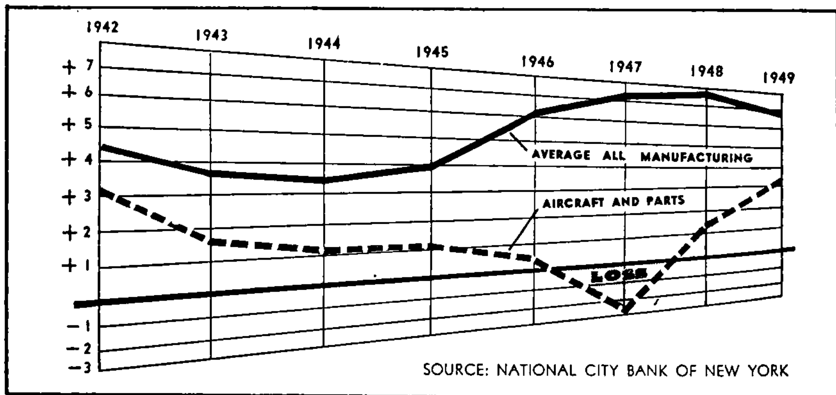
The heavy increase in production for the Government which is expected from our industry is graphically indicated in the following chart:

(The chart referred to is on page 547.)

Mr. RAMSEY. During the years 1946 to 1949 our industry suffered huge losses, though at the same time the industry output was far greater than during any pre-World War II period. These losses were the result of the cost of reconversion, coupled with the industry's desperate efforts to survive through turning to commercial work when military business radically declined at the end of the war.

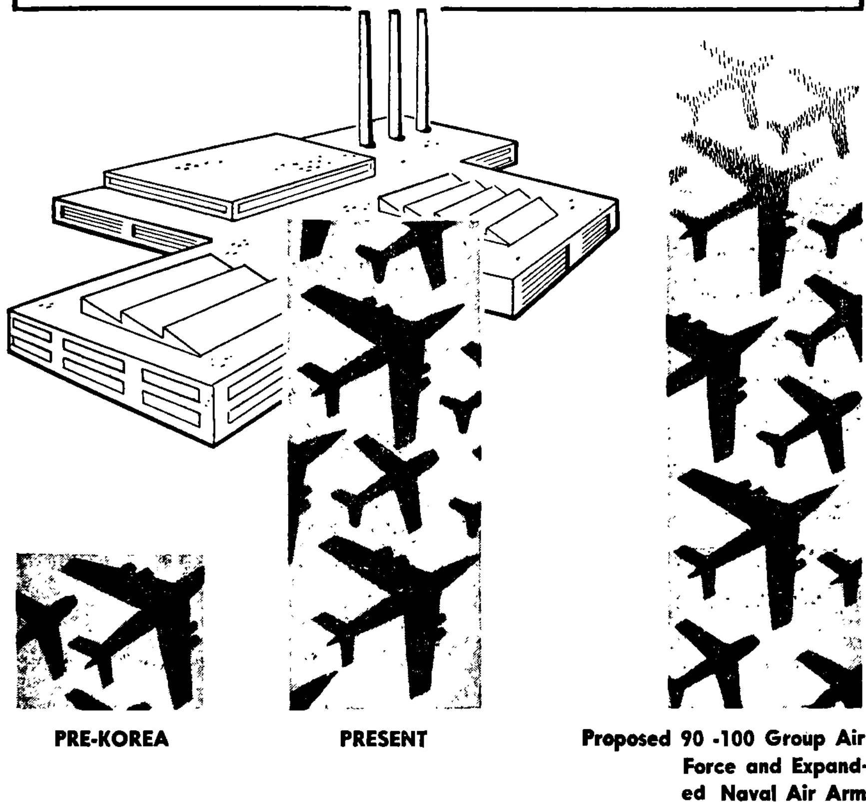
Aircraft Manufacturing Profits Far Below Most Other Industries





Aircraft manufacturing profits consistently are far below those of practically all other industries. Compiling the figures for 27 aircraft and parts companies, National City Bank of New York found that in 1949—best year since the end of the war—they had a net profit margin of 3.3% on sales. At the same time, for all the 1,710 manufacturing companies included in the survey the average profit margin was 6.8%. The chart also shows that the wide spread has prevailed since 1942 when the first large scale World War II orders were placed.

Military Aircraft Production Assignment Has Tripled Since Korea



Orders for military aircraft and related items have more than tripled since hostilities began in Korea. In fiscal year 1950, 2018 planes were ordered from the aircraft industry by the Air Force and the Naval Air Arm. In the current fiscal defense program 7785 planes have been ordered plus substantial undisclosed numbers for Military Defense Assistance Program and Army planes. If the expansion of the Air Force and the Naval Air Arm, now under consideration, is approved a further large increase in this production assignment can be expected.

Each of the five postwar transport models—with which many of you are familiar—resulted in a large loss to its maker. This is true of the Boeing Stratocruiser, Convair 240, Douglas DC–6, Lockheed Constellation, and Martin 202. Other companies incurred large losses in other projects or because of the lack of business, all as a result of their efforts to maintain going concerns which are urgently needed now.

Because of these conditions, one of the companies had a loss in a single year, before taxes, of over $25,000,000.

Senator KERR. You said a loss before taxes of over $25,000,000?

Mr. RAMSEY. Yes, sir.

Senator KERR. There would not be any taxes if they lost $25,000,000, would there?

Mr. RAMSEY. I beg your pardon?

Senator KERR. Do they still have to pay taxes if they lost $25,000,000?

Mr. RAMSEY. That was before the effects of any carry-back, sir.

Senator KERR. That was the operating loss for that year?

Mr. RAMSEY. Yes, sir, that is right, $25,000,000. Another large company had losses from operations in each of the 4 years 1946 to 1949 totaling over $50,000,000. If the companies had not been previously able to accumulate reserves and if Congress had not wisely provided for carry-back refunds, some of these companies might not have survived.

We have made a financial study of 15 of the 16 leading aircraft-manufacturing companies in our industry. For the years 1946–49, the 15 companies had an average annual loss of $1,200,000 before taxes, which may be compared to an actual World War II average excess profits tax credit of $4,000,000.

One of the companies had losses in each of the years 1946–49. Six companies had 1 or more profit years but an average loss for the 4 years. These seven manufacturers actually had an average loss for the period of $5,200,000 before taxes.

Senator MILLIKIN. What was their history prior to World War II?

Mr. RAMSEY. Prior to World War II our business was very light, sir, in the aircraft industry in general.

Senator MILLIKIN. So that the industry really got its growth and expansion out of World War II?

Mr. RAMSEY. That is where it started to expand at a great rate, sir.

Senator MILLIKIN. It is another way of saying out of Government money?

Mr. RAMSEY. The volume of business now, relatively, as compared to pre-World War II is eight times that amount. The other eight companies to which we refer here had an average annual profit, but the average was only $2,200,000 before taxes, and these same companies had an average World War II excess profits credit of $4,400,000.

Senator MILLIKIN. How do these companies finance themselves?

Mr. RAMSEY. In different ways, sirs. Lots of companies have had to fall back on the RFC. They have had common stock. And, of course, an important company turning out an important product might get the benefit of progress and advance payments from the contracting agent.

Senator MILLIKIN. How does the Government handle its financial relations with your companies during so-called peacetime? Do they advance you money against a certain model? Or how is that done?

Mr. RAMSEY. If a new plane is conceived by the military forces, the Air Force ordinarily would issue invitation bids to various people who were qualified in the particular field of that particular design of aircraft, and they would have a competition. The winner of the competition would, of course, get the contract. And if it is an experi-

mental model, let us say, it would probably be on a cost-plus-fixed-fee basis.

When you get into the field of production and you know what you are doing in large volume, then, of course, everybody shoots for a fixed-price basis.

Senator KERR. Both industry and the Government?

Mr. RAMSEY. Yes, sir. But their sales in the 1946–49 period were over seven times what they were during the World War II base period. And the sales of the entire 15 companies of 1946–49 were eight times what they were for 1936–39.

Senator MILLIKIN. What would be the ratio if you excluded Government orders. I am talking about the interval between World War II and III.

Mr. RAMSEY. Between World War II, sir——

Senator MILLIKIN. And III.

Mr. RAMSEY. And now?

Senator MILLIKIN. And now, if you wish.

Mr. RAMSEY. Senator, I do not have those figures. You are talking about the commercial production?

Senator MILLIKIN. Yes, I am trying to see how you have expanded commerciallly. I do not know that it is an important facet.

Senator KERR. This would answer it, if you knew: What part of this 1946–49 production is Government and what part is non-Government?

Mr. RAMSEY. We can certainly get the personal figures.

Senator MILLIKIN. I would not press you for it. I do not regard it as highly important.

Mr. RAMSEY. The foregoing summarized data clearly reveal that the aircraft industry of today is a far larger enterprise than it was in the pre-World War II base period. This has resulted in greatly increased financial problems which make it essential that an adequate amount of profits be retained by the aircraft companies.

The average earnings credit provided by the House bill is not adequate for the aircraft manufacturing industry because of the acute depression experienced by the industry which occurred in more than one of the base period years. The invested capital credit with the general "recent loss adjustment" provision in the House bill only incidentally provided limited relief for a few aircraft companies with an excessive net loss during the entire base period.

Aviation in the postwar period has made remarkable strides forward. The commercial transports we ride in cruise at over 300 miles per hour instead of 180 as they used to, and being pressurized fly at from 16,000 to 20,000 feet altitude. The development cost of a single one of these transports, the Lockheed Constellation, has been $35,000,000, with comparable costs for the Douglas DC–6, and the Boeing Stratocruiser.

The advent of the jet engine with its tremendous increase in power availability has revolutionized almost overnight the construction of modern military aircraft. For example, present-day fighter aircraft have top speeds in excess of 600 miles per hour with newer models in the 700 miles-per-hour class, compared to 450 miles-per hour for the faster World War II fighter types. Present military aircraft operate at altitudes up to 50,000 feet compared to 20,000 to 25,000 feet in World War II.

Production of airplanes for these speeds and altitudes involves enormously difficult problems. The designs of these new aircraft require new production techniques. The speeds generate very high temperatures, making imperative the development of cooling systems of great capacity and minimum weight.

I have here to show you a fantastic refrigeration unit weighing only 7 pounds revolving at over 100,000 revolutions per minute which, with its heat exchanger, produces refrigeration equal to that supplied by 60 ordinary household refrigerators. It cost over $1,000,000 of the funds of its manufacturer, AiResearch Manufacturing Co., to do the development work in cooling turbines, of which this is a representative specimen.

Senator MILLIKIN. Is this actual size or a model?

Mr. RAMSEY. That is actual size, sir.

Senator KERR. What is the power of this?

Mr. RAMSEY. I think about 13 horsepower, sir.

Senator KERR. No; I did not mean that. I did not make myself clear. What is it that powers it? You say it revolves 100,000 revolutions per minute. What makes it revolve?

Mr. RAMSEY. It is the air from the exhaust that turns the turbine pinwheel at that astounding number of revolutions per minute. And the reason for that, sir, is that our pilots, the boys flying at supersonic speeds, would burn up if they did not have refrigeration of that kind.

Senator KERR. I understood that it is needed. And when you told me the revolutions per minute that it made, I was curious to know what moved it that fast.

Senator MILLIKIN. I do not want to ask you for figures, and I do not want you to give me any figures. But at the present time, does your industry have a substantial backlog of Government orders?

Mr. RAMSEY. Oh, yes, sir. We have a very substantial backlog of Government orders. The current appropriation, Senator, including the latest supplemental, is over $10,000,000,000 for the whole industry.

Senator KERR. I would like to ask you this: What part of your 1950 income, if profit, will result from work done and paid for during this calendar year? That is, of the accelerated governmental spending program. Would it be considerable or partial?

Mr. RAMSEY. You mean for the present fiscal year?

Senator KERR. For the present calendar year.

The CHAIRMAN. Calendar year, through December 31.

Mr. RAMSEY. Of course, in the last part of the last year, particularly since the Korean episode, our orders have increased.

Senator KERR. Yes. Your orders have. I am wondering whether or not they will have resulted in finished work and the collection of the pay for it, so that the earnings for the current calendar year will reflect a considerable acceleration by reason of the accelerated military expansion.

Mr. RAMSEY. No; I do not think there will be very much of that, sir, for the reason that while the orders may be placed and the fabrication of materials is under way, it will take a long time for the industry to absorb the large number of orders that are placed, and a lot of the money which is provided by appropriations will not be spent for several years.

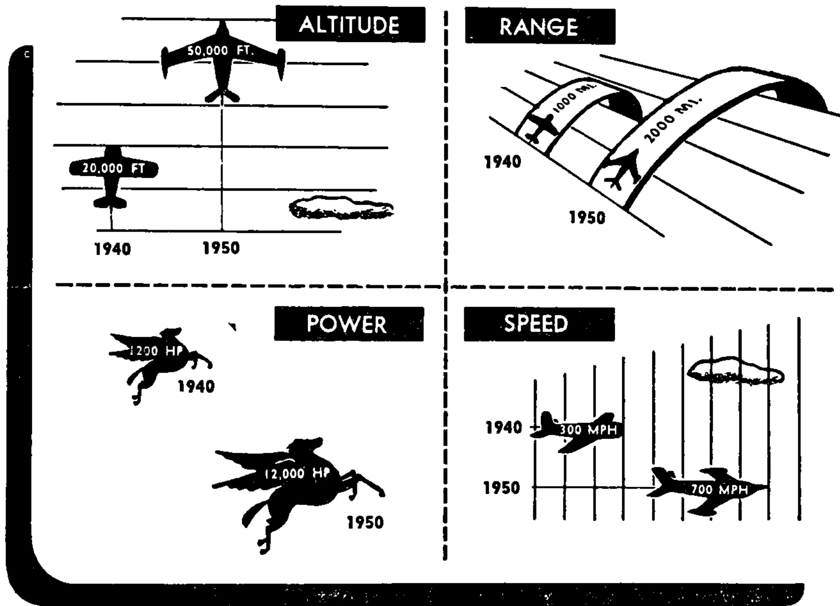
Senator KERR. And the money will not be received at an equal amount per month during the period of time from the date of the placing of the order until its completion?

Mr. RAMSEY. No, sir; it will not. The greater plane performance, increasing the production problems of the aircraft industry, is summarized in the following chart.

(The chart referred to is as follows:)

GREATER PLANE PERFORMANCE

(Makes Airplane Costs Higher)



Mr. RAMSEY. Our industry believes it is vital that we have adequate funds from profits to enable us successfully to carry on our operations. The important requirements for such profits include the need for funds for research and for plant improvement.

In this connection, we wish to point out that if, due to lack of adequate profits, these costs are temporarily not provided for, the Nation will have to provide them later at a time when they may be doubled or tripled because of the urgency then involved. If, for example, our plants are not currently modernized out of profits, this may have to be done ultimately at much higher costs due to mergency conditions. Sometimes it is impossible to bring equipment up to date in a hurry, since the procurement time on some heavy equipment stretches into 2 years.

While the Government has necessarily carried on a large amount of research work, we are certain that our industry can only hope to furnish the Nation with superior aviation leadership if each of our com-

panies is able to continue to carry on competitively a large amount of research for its own use within its own organization.

Major advances in aviation result to a large extent from intensive engineering effort. Engineering productivity does not flourish in an atmosphere of financial stringency. Aviation, to a peculiar degree, depends upon costly research for its progress. Aircraft manufacturers must be able generously to finance applied research programs to maintain our leadership in the air.

Like other industries, aircraft manufacturers are confronted with the fact that all replacements are far more expensive than the items replaced.

For example, one manufacturer has reported that a worn-out lathe originally costing $3,600 in 1941 was replaced in 1948 at a cost of four times that amount. Since the depreciation reserve covered only the original cost, the extra $11,000 had to come from profits after taxes.

Far more important is the fact that the aircraft industry is at the threshold of a new cycle of progress in manufacturing methods and must now use much more expensive and intricate processing machinery.

These requirements for new plants, facilities, and machinery involve investments of very large sums, compared to aircraft industry earnings and working capital. North American Aviation is spending more than $6,000,000 for new plant and machinery. Boeing has authorized the expenditure of over $7,500,000 from earnings for additional research, manufacturing and operating equipment and is deferring the acquisition of other needed facilities because of the drain on working capital.

These sums exceed the net earnings of these two companies for the 1946–48 period. Lockheed Aircraft in the last 18 months has spent $4,000,000 for new equipment and has determined that it needs to spend $9,000,000 more in the next 18 months to meet its manufacturing requirements, and yet this company had an average loss for the period 1946–49.

The following pictures show some of the elaborate new manufacturing equipment recently installed and paid for by various aircraft manufacturers:

(The pictures referred to have been placed in the committee files.)

Mr. RAMSEY. We wish to point out that renegotiation of contracts, price redetermination and the profit limitation of the Vinson-Trammell Act, all impose substantial limitations on the amount of profits which the industry realizes from its principal customer, the Government. These controls should be taken into account in considering the imposition of an additional profits control in the form of an excess profits tax.

To meet the problem of the aircraft industry and provide an adequate excess profit credit for all of the companies in the industry, a credit is recommended based on applying to gross receipts in the taxable years 85 percent of the percentage of average net income to gross receipts in the 14-year period 1936–49.

This special credit should be made available only to taxpayers 50 percent or more of whose business is the manufacture, modification, and/or maintenance of aircraft, missiles, or parts thereof. The amount of gross receipts in the current year to which the percentage

is applied shall not exceed one-half of the highest annual gross receipts of the taxpayer during the 14-year period.

If Congress believes that the foregoing proposal, which would provide adequate relief to the entire aircraft industry, cannot be enacted, then the following two credit bases are both absolutely essential to provide a minimum amount of relief for the aircraft industry:

1. Broadening of the growth formula provided in section 435 (e) of the House bill to be made specifically available to taxpayers 50 percent or more of whose business is the manufacture, modification, and/or maintenance of aircraft, missiles, and parts thereof. This would permit use of the earnings in the year 1949, or the average of 1948–49, as a credit.
2. A credit for the aircraft industry group described above, equal to the credit actually used for the taxable year ending in 1945 under the World War II excess profits tax plus 50 percent thereof.

Our proposal with respect to a credit based on use of the 14-year average percentage of net income to gross receipts corrects the inequities resulting from the application of a 4-year base to our industry which, because of its inherent nature, is plagued by its "feast or famine" characteristics.

The 14-year period averages the effect of peacetime periods and the previous wartime period, when the profit rate was controlled by renegotiation. The percentage rate derived is reduced to 85 percent thereof to match a similar reduction in the House bill. The gross receipts figure is limited to one-half of the taxpayer's highest previous gross receipts thus providing an effective ceiling upon the possible amount of the credit.

The alternative proposals relating to the growth formula and the World War II credit are absolutely essential as a minimum. The growth formula in the House bill is not available to most of the aircraft manufacturers; yet a number of them have had, during the base period, an earnings pattern making the use of 1948–49 average earnings or 1949 earnings most appropriate.

The postwar depression which they experienced gives them the characteristics of growth companies. The use of the 1945 excess profits tax credit plus 50 percent is justified by the decline of the value of the dollar and the similar treatment with respect to the invested capital credit in the House bill which increased the invested capital percentages by over 50 percent.

Attached to our statement are drafts of legislative language which would provide for each of the recommendations proposed above. We respectfully urge the committee to incorporate in the bill reported by the committee provision for adequate relief to the aircraft industry.

We propose the following:

Amendment to provide aircraft industry credit based on 14-year percentage of net income to sales:

(*a*) Amend section 434 (a) by inserting, after the words "or section 436," the following: "or section 456,".

(*b*) Add a new section following section 455, as follows:

SEC. 456. AIRCRAFT INDUSTRY CREDIT.

(a) The excess profits credit provided in subsection (b) may be employed by any taxpayer if more than 50 percent of its gross receipts (as defined in sec. 435 (e) (5)) during the taxable year are, and during the taxable years ending after December 31, 1935, and before January 1, 1950 (or so many of

said years as it was in existence), were, derived from the manufacture, modification, and/or maintenance of aircraft, missiles, or parts thereof.

(b) There shall be determined the excess of the aggregate of the net income (without deduction of net operating losses) for each taxable year of the taxpayer ending during the period after December 31, 1935, and before January 1, 1950, over the aggregate of the net operating loss of the taxpayer for each taxable year ending during such period. The percentage of said excess to the aggregate of gross receipts (as defined in sec. 435 (e) (5)) of the taxpayer for each taxable year ending during such period shall be computed. The excess profits credit under this section shall be an amount equal to 85 percent of said percentage applied to the gross receipts (as defined in sec. 435 (e) (5)) of the taxpayer during the taxable year: *Provided*, That the amount of such gross receipts during the taxable year to which said percentage is applied shall not exceed one-half of the taxpayer's highest gross receipts for any taxable year ending during said period after December 31, 1935, and before January 1, 1950.

(c) If the taxpayer is an acquiring corporation as defined in section 461 (a), and if it has had any component corporation which, prior to the transaction which caused it to be a component corporation, met the requirements of subsection (a) of this section, then the net income, net operating losses, and gross receipts of said component corporation shall be included in the amounts thereof determined for the acquiring corporation under subsection (b) of this section.

Amendments to provide aircraft industry credit based on growth formula and World War II credit plus 50 percent.

1. Growth formula:

Amend section 435 (e) (1) by changing the period at the end thereof to a semicolon, and adding the following:

(D) or, if more than 50 percent of the gross receipts (as defined in par. (5) of this subsection) of the taxpayer during the taxable year are, and during its base period were, derived from the manufacture, modification, and/or maintenance of aircraft, missiles, or parts thereof.

2. World War II credit plus 50 percent:

(*a*) Amend section 434 (a) by inserting after the words "or section 436", the following: "or section 456,".

(*b*) Add a new section following section 455, as follows:

SEC. 456. AIRCRAFT INDUSTRY CREDIT.

(a) The excess profits credit provided in subsection (b) may be employed by any taxpayer if more than 50 percent of its gross receipts (as defined in sec. 435 (e) (5)) during the taxable year are, and during its base period were, derived from the manufacture, modification, and/or maintenance of aircraft, missiles, or parts thereof.

(b) The excess profits credit provided by this section shall be an amount equal to the amount of the excess profits credit of the taxpayer determined under section 712 for its taxable year ended during the calendar year 1945, plus 50 percent of the amount of such credit.

That concludes my statement, Mr. Chairman.

The CHAIRMAN. Thank you very much, Admiral, for your statement and for your appearance here. Are there any questions?

Senator KERR. No questions.

Senator MILLIKIN. No questions.

The CHAIRMAN. We thank you very much, sir.

Mr. Woolfolk, you may identify yourself for the record and proceed with your statement, sir.

STATEMENT OF WILLIAM G. WOOLFOLK, CHAIRMAN, AMERICAN NATURAL GAS CO.

Mr. WOOLFOLK. My name is William G. Woolfolk. My home is in Detroit, Mich. I appear here on behalf of American Natural Gas Co., of which I am chairman.

Ours is an integrated natural-gas system under the Public Utility Holding Company Act. Each of its units is strictly regulated as to methods of financing, accounting, rates, and earnings permitted. This regulation stems from the State Public Utility Commissions of Wisconsin and Michigan and from the Federal Power Commission and the Securities and Exchange Commission in Washington.

American Natural Gas furnishes natural-gas service to some of the Nation's most important middle western industrial areas which are vital to our defense program. These areas have a population exceeding 4,000,000 people and include Detroit, Milwaukee, and other important communities in Michigan and Wisconsin. We transport the major portion of our gas suppy through our own pipeline from Texas and Oklahoma, which was constructed during the past 3 years at a cost exceeding $100,000,000.

I did not request the privilege of appearing before your committee to urge any special treatment that would result in increased earnings for regulated public utilities during this period of national crisis. My main purpose is to point out that an excess profits tax on our normal earnings will only result in higher rates to our consumers of natural gas or a curtailment of our services.

Apart from any war effort, the effects of which we have not yet felt, in our company the demands for our service are more than we can supply with our present facilities. To increase them we must have money.

In competing with other industries for new money, all we can offer investors is the expectation of a steady, although limited, return. We have a constant ceiling on earnings, both in peacetime and in wartime. Thus, continuity of reasonable earnings is vital.

Our earnings are limited to the bare amount which the regulatory bodies consider necessary to attract capital into the business. If we can retain these earnings, we can pay the interest on the new bonds and the dividends on the new stock which we will have to pay to induce investors to buy the securities we must sell. If our earnings, regulated by law, are reduced, we cannot raise new money, construction must stop, and we will have to curtail our service and ration gas.

We were gratified to note that the House Committee on Ways and Means recognized the basic difference between the earnings of regulated and unregulated industry when it approved the principle that public utilities should be permitted to earn a 6-percent rate of return, after taxes. This principle was expressed by the House committee when it stated in its report:

> The effect of this minimum credit for certain public utilities is to give assurance that an excess profits tax will not be imposed until after the regulated industries earn a rate of return of * * * 6 percent after paying corporate normal taxes and surtaxes.

The Secretary of the Treasury appeared before your committee on Monday and objected to this basic principle. He said:

> The adoption of this provision would bring into question the underlying principle of the income tax.

But this principle of special treatment for special groups is not new. The adoption of it by Congress would in no way jeopardize the underlying principles of the income tax.

On the contrary, Congress has given recognition to companies in unique circumstances since 1913. Income tax laws now recognize the special circumstances of insurance companies, mutual savings banks, shipping companies, mining and oil enterprises, and regulated investment trusts, and provide benefits for such organizations.

When Secretary Snyder testified before your committee he suggested that regulated public-utility companies—earning no excess profits—should pay the same excess profits taxes as industries not subject to any form of governmental profit regulation.

The Secretary's recommendation causes us considerable concern, for it could only result in higher rates for utility customers. We have made an effort to determine the effect of the House bill upon our system if the measure did not include the alternative excess profits tax credit for regulated public utilities.

Should such a law, without the alternative tax credit, be enacted, the effect upon the American Natural Gas System would be as though the normal tax and surtax rates were increased from the present level of 45 percent to 62 percent. In this event, our system would have to apply for increases of about $14,600,000 in its charges to the public for utility service to bring its earnings up to a normal return. This would mean an increase of 18 percent in the rates which we must charge our customers.

Senator MILLIKIN. How much would that increase the price of gas per 1,000?

Mr. WOOLFOLK. About 18 percent, sir. I cannot give you that figure, Senator, for the reason that it will affect different classes. The heavier load would come upon our small consumers. We could not spread that 18 percent directly over all, because the gas that we sell to industry, particularly the automobile industry, is competitive, and we can get a certain ceiling, and the balance would have to come up on our water heaters, cooking, and house-heating customers.

It might be 10 to 15 cents a thousand.

Senator MILLIKIN. Are you a completely integrated company?

Mr. WOOLFOLK. Yes, sir.

Senator MILLIKIN. Do you produce gas?

Mr. WOOLFOLK. No, sir. We buy our gas in the field in Oklahoma and transport it.

Senator MILLIKIN. And you distribute house to house as well as to large consumers?

Mr. WOOLFOLK. Yes, sir; with about 800,000 customers.

Senator MILLIKIN. What kind of charge do you make for a thousand feet of gas?

Mr. WOOLFOLK. Our house heating is about 67 cents a thousand. This is in Michigan. I think it is about 90 cents in Wisconsin.

And for cooking and water heating, it is about 80 cents.

Senator MILLIKIN. If that were your entire type of business, that would be even raised higher, in view of the fact that you sell in bulk to larger consumers—it would be 10 to 20 cents a thousand higher; would it not?

Mr. WOOLFOLK. That is it. It would go well beyond a dollar.

Senator MILLIKIN. So the householder would be paying the tax? The consumer would be paying the tax?

Mr. WOOLFOLK. That is what we fear.

Senator MILLIKIN. I think your fear is well warranted.

Senator MARTIN. What percentage of your gas is sold to industries?

Mr. WOOLFOLK. About 20 percent.

Will you take these figures as being round figures, Senator Martin?

Senator MARTIN. Yes.

Mr. WOOLFOLK. Thank you.

Senator MILLIKIN. May I ask roughly what you get for that wholesale? About 30 cents?

Mr. WOOLFOLK. A little higher than that.

Senator KERR. Now, are you talking about industry or to other distributors?

Mr. WOOLFOLK. I understood industry.

Senator MILLIKIN. Yes.

Mr. WOOLFOLK. We get a substantial price in the automobile districts in Detroit. Some of our prices go up to 55 cents a thousand. I think we get about the highest price for industry of any companies in my recollection. They figure out not only a break-even price with coal and oil, but its applicability.

And there is a profit in there, which profit is dropped in the general kitty, and it kept the prices of our other operations down.

Senator MILLIKIN. How do you finance your operations? What is your debt structure?

Mr. WOOLFOLK. We have three units. Two are the Michigan Consolidated, a straight utility, and the other is the Milwaukee Gas Light, a straight utility. And there is pipeline.

Senator MILLIKIN. What percentage is that?

Mr. WOOLFOLK. On our Milwaukee Consolidated, it is about 60–40, 60 percent bonds; and on our pipelines, about 75–25. And our overall is about 31 percent equity.

That is a fairly representative utility.

Senator MILLIKIN. The figures we have been getting here, I believe, are a little less on the debt side. We have been told the average is about 50 percent, and that that represents a raise in recent years from, say, a somewhat lower figure.

Senator KERR. Wasn't that in reference to the electric companies?

Senator MILLIKIN. Yes, sir; and I think one or two others, Senator.

Senator KERR. One gas company.

Senator MARTIN. Yes, one gas company, to my recollection.

Mr. WOOLFOLK. There are a few gas companies that have very low debt, practically none, such as Consolidated Gas.

Senator MILLIKIN. What is your average rate of interest?

Mr. WOOLFOLK. The high is 3⅛ and the low is 2⅞. And the low is on our utility properties.

Senator MILLIKIN. What do your stockholders receive?

Mr. WOOLFOLK. On the present price of our stock, it is about 4½. The stock is high because of expectations, when the line is completed, that our earnings will increase, which they will. And it is selling on the basis of about 5 percent.

Senator MILLIKIN. Thank you very much.

Mr. WOOLFOLK. And that is not high enough ratio to get it up to the point where we want to sell.

Senator MILLIKIN. That is somewhat surprising. I would expect a higher return considering the amount of your indebtedness.

Mr. WOOLFOLK. Really, our return is low, Senator, because our system is not complete, our pipeline is not running full capacity. And I

feel confident that the market has appraised our stock at a high figure, anticipating the earnings, rather than on a yield basis.

On a yield basis, our stock is selling too high, or our yield is too low, whichever way you want to express it.

But in that connection, if I may say, sir, a good ratio that the utility man likes to keep is 45 percent of debt to 55 percent equity. When times are good, you can sell more equity to get your debt down, because the time comes when you cannot sell stock or give it away, and then you increase your debt.

We like to shift it back and forth at the present time. Because of the high debt on our pipeline, our system debt is a little higher.

Should I proceed?

Senator MILLIKIN. Yes.

Mr. WOOLFOLK. I just said that we would have to increase our rates by a startling amount of money to get back on an equilibrium.

Legally, we would be entitled to these higher rates. From a practical standpoint, the State and Federal regulatory bodies must grant them if we are to obtain capital to expand and meet the demands of our markets.

Although it is the expressed intent of the House committee to give regulated public utilities a 6-percent rate of return after taxes, the bill itself actually does not do this. The report of the committee, which I read with great care, and the bill itself, do not describe the same capital.

The House committee apparently intended to allow a 6-percent return upon the total of all classes of capital employed in the business. An examination of the language of the bill, however, discloses that this intent was not carried out, because a part of the total capital is to be adjusted, and adjusted downward. That is, in the difference between the two definitions, it is an amount of $17,000,000 in our earnings base. And that means that we would be required to raise our taxes something less than $1,000,000 to earn sufficient money to pay the tax on nonexistent excess profits taxes and secure a 6-percent return.

I have been talking about raising rates. But we utility operators dislike exceedingly to ask for increases in rates. We like to go in the other direction. And for a long period of years, we have. But there is a basic economic reason why gas utility companies must earn the return permitted by State and Federal regulation.

The rates for utility services as fixed by the regultory bodies are designed to cover all operating expenses, including wages, salaries, and taxes and still provide a return that is only high enough to attract capital into the business.

If the capital used in the business is to be adjusted downward as a basis for computing an excess profits tax credit, it would be necessary for our company to receive a credit of at least 6½ percent after normal income and surtaxes to obtain the minimum earnings allowed by Government regulation.

We urge, therefore, that regulated public utilities be permitted an excess profits tax credit consisting of the normal tax and surtax, plus 6½ percent of the sum of the adjusted equity capital, retaining earnings, and borrowed capital, less the interest payable on borrowed capital.

In conclusion, let me say with all the earnestness at my command, American Natural Gas wants no war profits. What we want and what

we need and what we must have to finance is a reasonable return upon the money invested in the business, all of it which it needs, to render full, complete, and satisfactory service to the public.

Thank you very much, sir. I hope I have not take more than my time allotted.

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

Mr. Weston Thomas.

Mr. Thomas, you may be seated. Identify yourself for the record, please, sir.

STATEMENT OF WESTON G. THOMAS, TREASURER, CLIMAX MOYBDENUM CO., NEW YORK CITY

Mr. THOMAS. My name is Weston G. Thomas, and I am treasurer of Climax Molybdenum Co., a mining and refining company whose headquarters are at 500 Fifth Avenue, in New York, and whose property, at Climax, Colo., conducts the largest mining operation in that State.

Senator MILLIKIN. Mr. Chairman, this man is well known to me, and the management of his company is well known to me. It is our largest mining enterprise. It is an outfit of high repute, and this witness is a man of high repute.

I commend the close attention of the committee to what he has to say.

Mr. THOMAS. Thank you, sir.

The CHAIRMAN. We will certainly be glad to hear you, Mr. Thomas.

Mr. THOMAS. Molybdenum is a strategic metal, generally unfamiliar to the public but otherwise in the family of all essential alloying elements such as chromium, tungsten, or nickel. Its peculiar and characteristic properties make it almost indispensable in modern metallurgy and vital to certain armament, such as guns and tanks. Added in small amounts to steel and iron, molybdenum imparts great hardness and toughness at both normal and highly elevated temperatures.

The Climax Mine is the only known large deposit of molybdenum ore in the world and has been responsible for about 80 percent of world production to date, although very substantial amounts of the metal are now produced as a byproduct of various copper operations in this country and in Chile.

We have asked for the privilege of testifying today, because we feel strongly that the bill before you would affect our company unfairly. This is true because no part of the earnings base period, mandatory in this bill, was in any sense normal for our company; nor do any of the relief provisions mitigate this condition.

Prior to World War II our company conducted its business in reasonably normal fashion for many years and made substantial earnings which resulted in an average base period net income credit under the old excess profits tax of almost $9,000,000.

In contrast, our average base period net income credit under the relief provisions of the proposed bill is less than $3,000,000.

Senator KERR. Do you produce an irreplaceable resource?

Mr. THOMAS. That is right, Senator.

Senator KERR. The war demand would greatly accelerate the rate of production?

Mr. THOMAS. Yes, sir.

Senator KERR. The workings, then, of the tax would amount to your being compelled, as a matter of private urge and public duty, if

not of law, to produce the resource to meet the country's needs, yet the operation of the tax would be such that all of the value that you had in it or what you produced out of it would go back to the Government in the form of excess profits tax, and your accelerated program would soon leave you with an exhausted property and nothing to replace it with, is that about what you are saying?

Mr. THOMAS. That is exactly correct, Senator.

The difference between the comparatively high credit under the first bill and the lower one under the proposed bill arises from the following causes, some of which the Senator has already mentioned:

First, World War II imposed enormous demands upon our company which could not have been imagined in peacetime planning before the event. To meet these demands the company exhausted all of its developed supply of high-grade ore, leaving it, in 1946, with only low-grade ore available containing less than 40 percent of the metal available at the commencement of hostilities.

Second, all available manpower was used in production to meet the war effort so that no forward development was accomplished to provide a replacement ore backlog for the peace to follow. In fact, the mine had to be "high graded" to serve the military demands.

Third, great quantities of molybdenum containing scrap from armament returned to the market from World War II and thus reduced the demand for newly produced metal in peaceful uses. Furthermore, foreign demand almost disappeared due to war destruction of steel plants and to dollar shortages.

The combination of these circumstances of abnormally lowered demand coupled with higher unit costs arising from the use of low-grade ore—in effect, the consequence of all-out war effort—reversed, for this company, the postwar earnings pattern of American industry in general.

From this postwar trough, we are again suddenly confronted with a demand from industry and Government for all-out production for the next 5 years. Indeed, we have just committed ourselves to this program by contract with the Government. Under the proposed bill, irreplaceable assets will be sold possibly for years, against an abnormally low tax base.

We seek no exemption from excess profits tax. We do, however, seek recognition of the fact that the consequences of World War II upon our operations have resulted in a wholly abnormal and suppressed earnings history over the past few years.

Accordingly, we urge some alternative choice in our base which more nearly reflects normality. We have attempted to indicate why the proposed 1946–49 base is wholly abnormal for us. As a positive test of abnormality of that whole base period, we would suggest, for example, that when taxable earnings are 50 percent less in the postwar than in the prewar years, there should be provided a choice of some suitable prewar or reconstructed base.

Senator MILLIKIN. Mr. Chairman, could I ask Mr. Stan what the thinking of the House Ways and Means Committee was in that? That has certain phases that reach over into the whole mining business.

Mr. THOMAS. That is right, sir.

Senator MILLIKIN. And I am trying to find out what the thinking of the House Ways and Means Committee was on that.

The CHAIRMAN. Did you present your problem to the House Ways and Means Committee?

Mr. THOMAS. No, Senator; we did not.

The CHAIRMAN. You did not.

Very well, Mr. Stan, can you answer Senator Millikin, what the reaction of the House to this problem was?

Mr. STAN. The bill contains a provision exempting strategic minerals and also critical minerals that are certified to by whoever has the authority to certify in the executive department. That was the approach that the House people gave to this problem. They felt that a strategic material, generally speaking, is one that there is very little production of in the United States. Most of it had to come from abroad. And you wanted to encourage people in this country to see if they could not mine that same sort of mineral.

Senator MILLIKIN. You see, Mr. Stan, that whole thing is reversed here. We have the largest molybdenum production in the world. We have the largest mine in the world in this country. So it seems to me that you have reverse English to that.

Mr. STAN. Except that I think that that, Senator Millikin, would come under the second part of the provision in the bill, which deals with critical minerals, and they can certify those as being essential to the defense effort. And then they would come in under the exemption.

In other words, there are two parts to the bill.

Senator MILLIKIN. Is it a complete exemption?

Mr. STAN. It would be a complete exemption from the excess profits tax if it was certified.

Senator MILLIKIN. Do you have any fear of not being able to get a certification?

Mr. THOMAS. Senator, in reading the list of the so-called strategic minerals—I only heard yesterday afternoon about this critical list—in all conscience, it did not occur to us that we were strategic in the sense of the tax law.

I believe in terms of the war effort, we are most critical, because, for example, if metals like tungsten, most of which does come from abroad, cannot be obtained, we can substitute for them. In fact, the WPB ordered industry to use us as a substitute the last time.

Senator MILLIKIN. You can substitute for nickel, too?

Mr. THOMAS. That is right.

Senator MILLIKIN. May I suggest to you that you check on the classification of these minerals, so that you can find out whether you are in or out.

Mr. THOMAS. Yes, sir. Should we come within the critical——

Senator KERR. You have a feeling that if Congress spelled you out, that you would come in whether Congress certified you or not?

Mr. THOMAS. That is right, sir.

Again, we did not seek complete exemption under that. We would obviously be glad to have it.

Senator MILLIKIN. That is what you are after?

Senator KERR. That is not what he is after.

Mr. THOMAS. We are not after complete exemption, just a fairer base.

Senator MILLIKIN. As a defender of the State of Colorado, I would go along with complete exemption. Take what you can get.

Senator KERR. As I understand what you said, it would apply to any resource—bauxite, coal, oil, gas, copper.

Mr. THOMAS. Not necessarily.

Senator KERR. If production were stepped up due to the war effort, where the result would be that the operator would just be a vehicle through which it would be siphoned into the expansion program, and then by reason of the accelerated income the proceeds would chiefly be extracted by the excess profits tax, wouldn't that be the same result?

Mr. THOMAS. Senator, I cannot speak for the rest of the mining industry. But there are a number of other mining companies who are in precisely the same boat as ours is.

On the other hand, there are many which are not, because the peacetime demand, for example, for such materials as copper has led to greatly accelerated production since the war. We were not able to do that, because we pulled our mine down to a point during the war which made it impossible to do so.

Senator KERR. The only reason why it would not apply to them was that they had been producing at a rate which would provide them with a base that would leave them some fair percentage of the proceeds of their production that they might keep.

Mr. THOMAS. It appears so to us, sir.

Senator KERR. In other words, that does not change the principle, as I understand it, that you are talking about.

Mr. THOMAS. It does not change the principle of the wasting asset, certainly.

The CHAIRMAN. Do you get any other metal or mineral in connection with that?

Mr. THOMAS. We have a small by-product production of tungsten from our mine at Climax. And I believe we are the only tin producers in the United States. We produced two carloads last year of concentrates.

Senator MILLIKIN. And you have recently been moving into the uranium business?

Mr. THOMAS. That is correct, sir.

Senator MILLIKIN. But that is not large yet?

Mr. THOMAS. No, sir.

Senator MILLIKIN. I hope it gets larger.

Mr. THOMAS. So do we.

Mr. STAN. I might say, Senator Millikin, that this definition of "critical mineral" is defined in the statute, and it means "a mineral other than a strategic material which the certifying agency has certified to the Secretary"—that is, the Secretary of Defense—"that additional production thereof within the United States is essential for the defense effort."

And then these other qualifications apply. And—

(b) which is mined from a mineral property which was developed and brought into production subsequent to June 25, 1950.

Mr. THOMAS. No.

The CHAIRMAN. That would let you out.

Mr. STAN. No; there are some other qualifications:

Or a mineral property which had been in production prior to June 25, 1950, but was not in production on such date, or a mineral property from which during the period it was in production during 1946, 1947, 1948, and 1949, the aggregate gross income derived was less than the aggregate of the deductions

allowable under section 23 without regard to any net operating loss deduction, but attributable to such property during such period of production.

So if you had a net loss in that period, you would come in.

Mr. THOMAS. I believe none of those qualifications would apply to us, Mr. Stan. We have not had a net loss.

The CHAIRMAN. At this time you had better take a careful look at the definition and see if we cannot improve it.

Mr. STAN. Very well, sir.

Senator MILLIKIN. Would you mind checking just where you stand as to the type of mineral that is produced, and get your head together with Mr. Stan?

Mr. THOMAS. We shall do that, sir. Thank you, sir.

The CHAIRMAN. Are there any other questions?

(No response.)

The CHAIRMAN. Thank you very much, Mr. Thomas, for your appearance.

Mr. THOMAS. Thank you, sir.

The CHAIRMAN. Mr. John J. Barr. Will you identify yourself for the record and proceed with your statement?

STATEMENT OF JOHN J. BARR, APPEARING ON BEHALF OF PRIVATELY OWNED WATER UTILITIES

Mr. BARR. My name is John J. Barr. I am vice president of the American Water Works Co., having its principal offices in Wilmington, Del., and I am appearing on behalf of a group of water utilities representing, in the aggregate, over one-half of the privately owned water companies in the United States.

The water companies represented include the Northeastern and American Water Co. systems, embracing 121 water companies in 22 different States; the General Waterworks Corp., controlling some 25 water companies in 9 different States; and also a number of individual operating companies including three substantial companies in California, and others whose principal operations are in Connecticut, Delaware, Indiana, Ohio, and Pennsylvania. A complete list of the companies represented is attached to my statement.

The tax problems of the privately owned water companies are basically similar to those of the other regulated public utilities.

There are two principal distinguishing features which apply to water utilties. In the first place a substantially larger percentage of their entire capital is represented by borrowed capital, frequently amounting to 70 percent or more of their total capitalization. In the second place, the earnings of the water utilties during the period from 1946 through 1949 were, in general, subnormal. During most of this time, the rates were stable, and any increase in gross receipts which occurred was more than offset by increased costs of operation.

The water utilities support generally the position taken by the NARUC and by representatives of other regulated industries. In particular, however, the attention of your committee is called to two features of the excess profits tax bill passed by the House of Representatives, last Tuesday.

It would seem that the problems with reference to the ascertainment of the amount of equity capital and the allowance of a 6 percent return has been fully discussed by the gentlemen who have preceded me today.

I would like to invite your attention to the possible problem relating to the filing of consolidated returns. The general provisions of the House bill permit the filing of consolidated returns for affiliated corporations. We believe affiliated utilities should have the same privilege without sacrificing the optional credit provided for utilities in the House bill. Since the common parent of an affiliated group of water utilities is not normally engaged in the sale of water, it therefore would not fall within the definition of regulated utilities contained within the House bill.

As to the average earnings credit, the House bill provides for an average earnings credit limited to 85 percent of the average earnings for any 3 of the 4 years 1946 to 1949 inclusive. Since the earnings of the water utility industry during those years were less than normal, it is self-evident that to make any portion of those earnings subject to excess profits tax is not only unfair and inequitable but would in substance constitute an increased "normal" tax rather than an excess profits tax.

There are many utilities which by reason of the abnormalities frequently encountered in determining "adjusted basis" for tax purposes, would elect to compute their excess profits on the average earnings if a fair and reasonable basis were available.

It is respectfully submitted that in the case of a public utility, the excess profits tax credit under the average earnings method should not be less than 100 percent of the average income of any 3 of the 4 years 1946 to 1949, inclusive, and that there should be added to the credit thus determined an amount equal to any increase of income to any public utility resulting from an increase in rates allowed by a regulatory body having jurisdiction thereof to the extent that such increase in rates would have increased the credit had said rate increase been effective throughout the years 1946 to 1949, inclusive.

It is also essential that such an average earnings credit should be adjusted to reflect a proper return on increased investments, whether from retained earnings or new borrowed or equity capital, occurring during the base period and subsequent thereto.

The water companies during the base period were faced with rapidly rising costs which in many instances exceeded the increase in their gross revenues. It is only comparatively recently that rate increases have been allowed in order to meet the increased cost of operations. In many cases applications for these rate raises are still pending. And yet, for the purpose of computing an excess profits tax under the average earnings method it is proposed to allow as a credit only 85 percent of 3 subnormal years. This would mean that a major portion of the rate increases allowed or presently sought would be taken away by excess profits taxes.

Thus, in effect, the decisions of the regulatory bodies would be reversed and the utilities deprived of income which after full and careful consideration was determined to be necessary for their financial well-being.

Senator KERR. Is it not possible that one alternative result would be that you would be persuaded or induced to go back and ask for an additional raise in rates in order to put you in the position in which they thought they were putting you, and that you would be successful in an application, and that would result in an additional cost to your consumers?

Mr. BARR. I think that is about the only alternative, sir. I think that would definitely result.

Senator MILLIKIN. Do you have franchises or what gives you your right to deliver water?

Mr. BARR. In many instances franchises, whether they be granted by local municipal bodies or in some instances by the certificate of incorporation issued by the State in which the company operates.

Senator KERR. Do you deliver in containers primarily?

Mr. BARR. No, sir. We deliver through pipe lines and spigots, sir.

Senator KERR. Only?

Mr. BARR. Only, sir.

Senator MARTIN. Can you go into an incorporated municipality without a permit or a franchise?

Mr. BARR. Normally I would say not, sir. You would normally be required either to obtain the franchises from the existing service company, or in some instances you even are required to create a new corporation which is given the corporate powers through its charter, just to service a new community.

Senator MARTIN. If you did go in without the necessity of the certificate of convenience and necessity or franchises, then you would not be a regulated utility?

Mr. BARR. Very probably not, sir.

Senator MILLIKIN. And many of the franchises in themselves prescribe the rates, and many of them are long term, and many of them do not provide for a revision of the terms, so you might get yourself into a very bad box on some of those franchises if your costs were increased in this way?

Mr. BARR. There are some places where that could readily have happened; yes, sir.

Senator MARTIN. Mr. Chairman, I do not know whether I made myself entirely clear. I was under the impression that a utility—we are now discussing water companies—before it could go into an incorporated town, village, or city, had to have a franchise from the town council or the city council.

Then, in addition to that, you would have to have regulation from your State regulatory body as to the rates you would charge?

Mr. BARR. That is approximately so; yes, sir.

Senator MARTIN. I thought there were two steps.

Mr. BARR. There are, essentially; that is true.

Senator MILLIKIN. One thing is a cinch: You cannot go into a town just because you have a franchise from the water company and start digging up the streets of the town, without some kind of arrangement with the town.

Mr. BARR. That is right, sir. You have to have some form of permanency in the form of franchise.

Senator MARTIN. You have to have an ordinance or something along that line.

Mr. BARR. That is right, sir.

A water utility cannot stand still; it must meet all of the demands of its customers for service. This means a constant need for new capital to finance expansion.

Effect on future expansion:

Many of the required plant additions do not result in any immediate increase in income. Thus amounts spent to increase supply and stor-

age facilities do not immediately afford any increase in revenue. Amounts spent in reenforcement of pipelines do not increase revenues.

The water companies' capital structures with their large proportion of borrowed capital have been built up on the expectation that their normal earnings would continue and that they would possess income after taxes but before interest which would be sufficient not only to service outstanding loans but also to leave a fair return for equity capital.

In numerous cases the utility would be faced with insuperable difficulties in attempting to obtain further loans for needed additions which needs would often be directly attributable to the defense effort.

If a utility's financial position is such that it is prevented from acquiring new capital, its only resort is to seek and obtain a rate increase.

This means that for each $1 available to service new capital the cost of water to the consumer must be increased approximately $2.50 because of the impact of profits taxes.

Senator MILLIKIN. What do you want? What formula do you want?

The CHAIRMAN. What is your suggestion?

Senator KERR. He had a suggestion there, Mr. Chairman.

Mr. BARR. We have suggested that we should be allowed 100 percent of the average earnings, in recognition of the fact that the years 1946–49 were subnormal to the water utilities, and we feel that this suggestion comes closer to the methods and procedure followed by regulating authorities.

Senator MARTIN. Mr. Chairman, I might ask a question, because I would like a little further development. As I understand, you feel that a utility ought to have 100 percent against 85 percent for other corporations. I would like a little further development on that, Mr. Chairman.

The CHAIRMAN. What was that, Senator?

Senator MARTIN. He makes the statement that he feels that utilities ought to have 100 percent against 85 percent to other taxpayers. Now, I feel he ought to make a little further development of that.

Mr. BARR. Senator Martin, I do not mean to imply that 100 percent credit should not be given to all, but I have attempted to emphasize the problem of the water utilities whose earnings were definitely less than normal during the base period from 1946 to 1949.

Furthermore, if the average-earnings base is available to a utility, a water utility, it will avoid a terrific amount of trouble, problems, and expense, in preparing a return on an uncertain and complicated adjustment basis for excess profits, equity capital, and credit under section 446.

Senator MARTIN. Now, as I understand it, in the water companies and other utilities there is not any way that you can have an increase except by the State regulatory commissions?

Mr. BARR. That is true, sir. Our income is constantly subject to review and adjustment, if necessary, by the regulatory commissions.

Senator MARTIN. Then the only way you would have to take care of dividends on your equity capital and paying the interest on your borrowed money, if you don't have enough to do that, is to get an increase in rates which, of course, takes it from the consumer?

Mr. BARR. That is absolutely true, sir.

Senator MARTIN. But there is not any way that you can get this increase except as approved by the State regulatory commission?

Mr. BARR. Approved after lengthy investigation and inspection; yes, sir.

Senator MILLIKIN. And you might not get it?

Mr. BARR. Not always.

The CHAIRMAN. Thank you very much, Mr. Barr, for your statement.

Mr. BARR. Thank you, sir.

The CHAIRMAN. Mr. Dudley.

You may be seated, and identify yourself for the record.

STATEMENT OF CLAUDE W. DUDLEY, ATTORNEY, WASHINGTON, D. C., REPRESENTING NEW YORK, CHICAGO & ST. LOUIS RAILROAD CO., OF CLEVELAND, OHIO

Mr. DUDLEY. My name is Claude W. Dudley. I am a lawyer, and my office is in the Dupont Circle Building here in Washington. I appear here as a representative of the New York, Chicago & St. Louis Railroad Co., of Cleveland, Ohio, commonly called the Nickel Plate Road.

This company, the Nickel Plate Road, leased all of the properties of the Wheeling & Lake Erie Railway Co. on December 1, 1949, for a period of 99 years and renewable in perpetuity at the option of the Nickel Plate. The net earnings from the operation of the properties of both companies will be reflected in the income and excess profits tax returns filed by the Nickel Plate for 1950 and subsequent years, whereas the earnings prior thereto were reflected in separate returns filed by the two companies. Consequently, a seriously inequitable situation results, because the Nickel Plate's credit based on the operations during the period of 1946–49 would be limited to the earnings from its properties alone, whereas the income reported in 1950 and subsequent years would include the earnings from the operation of the Wheeling & Lake Erie properties as well.

The inequity was explained to the Ways and Means Committee and to the staffs of the joint committee and the Treasury. The House bill contains a provision in section 434 (d) to correct this situation. It is there provided that where substantially all of the properties of a railroad corporation have been leased to another railroad corporation under a long-term lease entered into prior to July 1, 1950, and where the lease requires the lessee to pay the income and excess profits taxes of the lessor, the combined excess profits credit of the two companies may be a apportioned between them by agreement, subject to approval by the Secretary of the Treasury.

The need for such a provision and the serious inequity which this company would suffer without such a provision are readily apparent upon examination of the figures. The Nickel Plate's average net income for its best 3 years of the base period is $16,434,000. Eighty-five percent of this is $13,969,000, and this is the excess profits credit allowable to the Nickel Plate, based on its base-period experience alone. The excess profits credit of the Wheeling & Lake Erie, computed in a similar manner, is $9,379,000. The combined excess profits credit of the two companies is $23,348,000.

I might say that it is not our request that that combined credit be increased, but it is only our request that the combined credit be equitably apportioned between the two companies.

It is estimated that the Nickel Plate's excess profits net income for the year 1950, which includes, of course, the earnings from the operation of the properties of the Wheeling & Lake Erie, will be $31,215,000. If the Nickel Plate's base period net income is limited to its average earnings, without including the earnings of the Wheeling & Lake Erie, then $17,247,000 of this year's estimated earnings will be subject to the excess profits tax. The fact is, however, that by any reasonable standard of normal profits, only $7,867,000, the excess of the current year's earnings from the operation of the two properties over the earnings from the operation of both properties during the base period, should be subjected to the excess profits tax.

In other words, by reason of entering into this lease as late as December 1949, this law, without the special provision which I mentioned a while ago, would reach $10,000,000 on normal profits and taxed profits as excess profits.

A similar basic inequity exists if the excess profits credit is computed under the invested capital method or under the regulated public utilities provisions of section 446 of the House bill. In both such computations, the earnings from the operations of both properties are related to a credit based on the capital invested in only one property. This anomalous situation has likewise been corrected in section 434 (d) of the House bill, permitting the equitable apportionment of the combined excess profits credit between the lessor and lessee corporations, regardless of whether that credit be computed by reference to base period net income or in any other manner.

In this case the excess profits credit based on income, the figures for which have already been included in this statement, is substantially greater than the excess profits credit based on invested capital. It is approximately equivalent to the excess profits credit computed under the regulated public utilities provisions contained in section 446 of the House bill.

In referring to his statement to "preferential treatment amounting to virtual exemption of certain types of businesses which are generally subject to public regulation," Secretary Snyder was presumably considering only industry-wide return, which is under 5 percent in the railroad industry. The fact is, however, that some railroads, including the Nickel Plate, earn more than 5 percent on their capital, after the payment of the normal tax and the surtax, and the regulated public utilities provisions do not give and are not intended to give to such companies an exemption from the excess profits tax.

The inequity in the Nickel Plate case could be removed under the general provisions of law if the Nickel Plate owned sufficient stock of the Wheeling & Lake Erie to permit the filing of a consolidated return. It owns 99 percent of the prior lien stock of the Wheeling & Lake Erie, but only 73 percent of the common stock. It owns 80 percent of the entire capital stock. If the Nickel Plate owned 95 percent of all of the stock so that a consolidated return could be filed, it would be entitled to the combined excess profits credit of both companies in the consolidated return. It will be many years, however, before the Nickel Plate is able to acquire 95 percent ownership of the Wheeling & Lake Erie stock. In the meantime, such a provision as that contained

in section 434 (d) of the House bill is necessary to prevent taxing as profit a substantial part of the normal earnings from the operation of the two railroad properties now operated by the Nickel Plate.

The equitable apportionment of the aggregate of the excess profits credit of the lessor and lessee corporations between them, as permitted in section 434 (d) of the House bill, is similar to the apportionment of depletion deductions between the lessor and lessee of mining property, which is now permitted under section 23 (m) of the Internal Revenue Code. There is even greater need for the apportionment of the excess profits credit between the lessor and lessee if seriously inequitable results are to be avoided in the impact of the excess profits tax. The excess profits tax is intended to apply to those corporations which have taken the risk incident to the conduct of the business and realize a return above a normal standard, measured either by base period earnings or by a fair return on the capital employed in the business. By entering into a long-term lease of its properties, providing for a guaranteed return to the minority stockholders of the lessor, that corporation removes itself and its stockholders from the category of risk takers, and they become mere passive recipients of the fixed return provided for in the lease. That fixed return must be paid, of course, by the lessee in good times and bad. It must be paid even though the revenues from operation do not yield enough to pay the operating expenses.

In order to meet this fixed rate of return every year, including those years when it is not earned, as well as those years when it is earned, the lessee must be enabled to keep a substantial part of its earnings over and above this fixed rate of return when there is an excess. This is obvious in any business such as the railroad business, involving its inevitable ups and downs. If the lessee is allowed no part of the excess profits credit applicable to the lessor's properties so that most of its earnings in profitable years are required to be paid out in excess profits taxes, it will be absolutely impossible for the lessee to come out whole for any extended period of time.

Senator KERR. Is the gist of your statement a request to the committee to retain the provisions in the bill as passed by the House?

Mr. DUDLEY. That is correct, Senator.

Senator KERR. You are entirely satisfied with that?

Mr. DUDLEY. That is correct; yes, sir.

The CHAIRMAN. We have been very glad to hear you. We are glad to have satisfied customers.

Mr. DUDLEY. Thank you.

The CHAIRMAN. Mr. Claude A. Williams.

Mr. Williams, you may identify yourself and proceed?

STATEMENT OF CLAUDE A. WILLIAMS, PRESIDENT, TRANSCONTINENTAL GAS PIPE LINE CORP., HOUSTON, TEX.

Mr. WILLIAMS. Mr. Chairman, the hour is growing late, and if I may, I have a prepared statement which I would like to just have filed for the record, and make one observation.

The CHAIRMAN. That will be all right.

Mr. WILLIAMS. A great deal of what I might say has already been said today, but I would like for you to keep in mind the principles

as set forth by the House Ways and Means Committee, that public utilities should have a fair return after income and surtaxes, since all of our regulations and the prices which we charge for our products are based upon taxes as being a cost of business.

If there are any questions that any of you would like to ask me, I would be very happy to answer them, but in the interest of time, and the lateness of the hour, I will file my statement.

The CHAIRMAN. We will be glad to have you do so. It will go into the record just as you have it prepared.

Are there any questions?

Senator KERR. Your position is similar to that of Mr. Hulcy and Mr. Woolfolk, primarily?

Mr. WILLIAMS. That is correct.

Senator KERR. Tell us the name of your company.

Mr. WILLIAMS. My company is Transcontinental Gas Pipe Line Corp. Our headquarters are at 2100 Niels Esperson Building, Houston, Tex.

We are just completing the construction of a pipeline from Mercedes, Tex., One hundred thirty-fourth Street, the east bank of the Hudson River, about 1,830 miles of main 13-inch pipeline. We will deliver gas along the route of the line to some 43 municipalities and communities.

Senator KERR. Will you tell us the percentage of your entire capital structure, debt, and equity?

Mr. WILLIAMS. We have $175,000,000 of first mortgage bonds, of which $143,000,000 bear interest at the rate of 3⅝ percent, $32,000,000 bear interest at the rate of 3¼ percent. That represents 75.4 percent of the total capital in the company.

We have 28½ million dollars of interim notes, which are in effect preferred stock, which bear 6 percent rate of interest. That represents approximately 10½ percent of the total capitalization. We have some $30,000,000 of common stock, which represents just a fraction over 10 percent of the total capitalization.

Senator KERR. Do the provisions of the House bill meet the requirements that you feel the industry of which you are a part have with reference to maintaining their position and being able to secure the capital for further expansion?

Mr. WILLIAMS. It is a bare minimum. That is the least that we can operate under, would be the 6 percent rate of return on our total capital structure.

The reason for that is that natural gas pipelines are peculiar in that we are dependent upon a supply or a product which may play out some day, with the result that when you finance one of these, you must set them up on a 20-year supply of gas, and a 20-year sale of gas. The people who loan you the money will expect you to retire your indebtedness over that 20-year period. So it is necessary for these natural gas pipelines to dip into earnings that would normally be used to pay dividends to common-stock holders in order to retire their entire debt over the 20-year period. So a 6 percent rate of return on your total capital structure is the least we can have and meet our obligations of paying the interest on our debt, retiring debt, pay the dividends on the preferred stock, and retire the preferred stock, and have a small amount of money left over for dividends on the common

stock, and some to retain as earnings for future expansion of our company.

Senator MARTIN. Do you produce any gas, or do you buy it?

Mr. WILLIAMS. We buy it all.

Senator KERR. That is all the questions I have.

The CHAIRMAN. Thank you very much, and your full statement will go into the record.

Mr. WILLIAMS. Thank you, sir.

(The statement submitted by Mr. Williams reads in full as follows:)

STATEMENT OF CLAUDE A. WILLIAMS, PRESIDENT, TRANSCONTINENTAL GAS PIPE LINE CORP., HOUSTON, TEX.

My name is Claude A. Williams. My address is 2100 Niels Esperson Building, Houston, Tex. I am president of Transcontinental Gas Pipe Line Corp. in whose interest I appear before this committee.

I urge that the Committee on Finance retain in any excess profits tax bill which may be enacted into law the provisions adopted by the House which would permit regulated utility companies to earn their minimum allowable return after normal tax and surtax before the imposition of any excess profits tax.

Transcontinental Gas Pipe Line Corp. was organized in February of 1946 for the purpose of bidding on the Big and Little Inch Pipe Lines. While it failed to acquire these lines, the survey which it had made in that connection convinced it of the feasibility of constructing and operating a line from the Texas coast to the northeastern part of the United States and it thereupon applied to the Federal Power Commission for authority to construct and operate such a line.

This authority was granted early in 1948 and construction started. Transcontinental now holds a certificate of public convenience and necessity covering a natural gas transmission system consisting of 1,830 miles of main transmission line traversing 12 States from Texas to New York, 500 miles of gathering and sales lateral lines, 19 compressor stations with an aggregate compressor capacity of 207,000 horsepower, and the necessary appurtenant facilities, to deliver 505,000,000 cubic feet of natural gas a day from 56 gas fields along the Texas-Louisiana Gulf coast to 43 municipalities and gas distributing companies in the States of Louisiana, Alabama, Georgia, South Carolina, North Carolina, Virginia, Pennsylvania, New Jersey, and New York.

The first gas was delivered from the line only within the last day or so—to Danville, Va. When testing of the remainder of the line—now in progress—is completed, deliveries will start in North and South Carolina, Pennsylvania, New Jersey, and New York. It is anticipated that the line will reach its full capacity of 505,000,000 cubic feet of gas a day by April 1, 1951.

The company is a "natural gas company" under the Natural Gas Act of 1938, as amended, and is subject to the jurisdiction of the Federal Power Commission. Thus, the Federal Government regulates and controls the quantities of gas to be sold to the company's various customers, the adequacy or inadequacy of committed gas reserves, the expansion or abandonment of facilities or service, the determination of allowable operating costs and the cost of the company's facilities for rate-making purposes, the rates at which depreciation and amortization of the cost of facilities may be taken and the manner in which the books and records of the company are to be kept.

Moreover, the Federal Power Commission has complete control of the rates which the company may charge on its sales to distributing utility customers and municipalities and is charged by the specific provisions of the Natural Gas Act with the duty of fixing rates or charges that "shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful."

The Federal Power Commission issued a certificate of convenience and necessity to Transcontinental in order to meet the needs of the millions of potential gas customers along the Atlantic seaboard and throughout the Northeastern States. At its present capacity, Transcontinental's line will serve 5,000,000 meters involving, we estimate, 15,000,000 individual consumers. Under the expansion program presently contemplated, these 15,000,000 persons will increase substantially their use of cheap natural gas and many millions more will commence to enjoy its benefits.

Today it costs from $1.20 to $2 to manufacture gas containing 1,000,000 B. t. u.'s in the Northeastern States. Transcontinental will deliver natural gas containing the same number of B. t. u.'s in New York for from 29.8 cents to 31.5 cents, or less than one-fourth the present cost of manufactured gas in that area. This differential between the cost of manufactured gas and natural gas gives some idea of the very substantial fuel cost savings which will be enjoyed by people in the northeastern part of the United States and along the Atlantic seaboard.

With our line only just starting to deliver gas, we are already faced with demands for gas exceeding our present capacity of 505,000,000 cubic feet a day by 150,000,000 cubic feet a day. From the experience of other gas pipeline companies, it is reasonable to expect that the demands for gas in the foreseeable future in the are which our line serves will exceed 5,000,000,000 cubic feet per day, or 10 times our present capacity. These figures demonstrate the natural and normal growth of this relatively new but dynamic industry without regard to the impetus of any war emergency.

These are the considerations which moved the Federal Power Commission to authorize Transcontinental to construct and operate its gas transmission system. Before the Commission would issue a certificate to our company we were obliged to demonstrate that:

1. The system was in the public interest;
2. It would provide gas at a price highly advantageous to its consumers;
3. It was financially able to construct and maintain the proposed system;
4. It had commitments for an adequate supply of natural gas for a period of at least 20 years;
5. It had commitments to dispose of this gas to its customers for a period of at least 20 years; and
6. In all other respects, the project was economically feasible.

To meet these requirements the company was obliged to enter into understandings both with its vendors and customers with respect to minimum and maximum daily quantities of gas for a period of 20 years and to prove these understandings to the satisfaction of the Federal Power Commission. All of these steps were taken irrevocably by the company beginning in 1948 and before May of 1950. Thus, before the Korean War commenced, the die was cast, the capacity of the line was fixed, the maximum volume of unit sales was established, the price per unit was determined, and the amount of money which the company would be permitted to earn as its fair return after taxes was prescribed. No increased volume of business, whether due to the impetus of wartime demands or otherwise, could have or will have any bearing on the number of dollars which the Commission has prescribed as the fair return. For this reason, it is simply impossible for Transcontinental, or any other utility company regulated on a company-by-company basis, to earn excessive profits by any reasonable standard.

In determining the economic feasibility of this project, it was necessary for Transcontinental to present to the Federal Power Commission its estimated cost of operations and its estimated revenues. From the experience the Federal Power Commission has had with other gas transmission lines subject to its control, it was possible for the Commission to establish yardsticks for measuring the adequacy and accuracy of our figures. The natural-gas transmission business is peculiar in this respect. The income and outgo, even for a period as long as 20 years, can be determined with a great degree of accuracy. The biggest items of cost are fixed. These items are depreciation, the cost of gas, bond interest, and the cost of fuel to pump the gas from the point of production to the point of delivery. The only two items of expense which cannot be calculated precisely are the cost of labor and taxes.

In fixing the rate at which gas is to be sold, the Federal Power Commission has two major objectives—

1. It makes certain that the price is fair to customers; and
2. It makes certain that the price will not result in the company's making, after taxes, a return greater than a fair return—this fair return being considered to be 6 percent of the capital structure, both equity capital and borrowed capital.

This fair return is established at this level in order to assure sufficient funds to—

(*a*) cover the company's cost of doing business, including in such cost all State and local taxes and the Federal normal tax and surtax;

(*b*) permit the company to pay its interest and preferred stock dividends and to retire its debt and preferred stock over a reasonable period of time, and

(c) to leave the company with a reasonable amount for dividends to its common stockholders and to meet normal expansion demands.

In order to secure the funds to finance a project of this sort, you must be able to show your bondholders that you will have sufficient funds after the payment of all expenses and fixed charges, including Federal taxes, to pay the interest and to retire the debt in a reasonable period. You must demonstrate to the preferred-stock holder that you will be able to pay dividends on the preferred stock and to retire the stock through a sinking-fund operation in a reasonable time. In addition, the common-stock holder must be convinced that after all of these charges, there will be sufficient funds left to warrant his investment risk.

The costs of constructing this project have been completely financed by funds received from sales of the following debt and equity securities and from temporary bank loans as needed:

	Amount	Percent
First-mortgage bonds	$175,000,000	75.3
6-percent interim notes convertible into preferred stock	26,500,000	11.4
3,530,000 shares of common stock	30,773,000	13.3
Total	232,273,000	100.0

All of the first-mortgage bonds are held by 18 institutional investors. Interest rates are 3⅝ percent on $143,000,000 principal amount and 3¼ percent on $32,000,000 principal amount. At December 31, 1949, the 6 percent interim notes were held by 3,973 noteholders and the common stock was held by 4,937 stockholders in all of the 48 States, Mexico, Canada, Hawaii, and Bermuda.

Approximately $200,000,000 of the company's financing, including 93 percent of its entire equity capital, was raised in December 1948, at least 2 years before the project could be completed and placed in operation and an even longer period before dividends on the equity capital could be initiated and the equity holders could expect to realize any return on their investment.

During the period a natural gas pipeline is under construction, the equity shareholders have an extremely high degree of risk. As an illustration, Transcontinental's is one of the few pipelines that will be completed at the originally estimated cost. But in addition to this risk during construction, the persons who subscribe the equity capital cannot under any circumstances expect dividends until after the construction is completed and the company begins to realize earnings—a period of at least 3 years.

This high degree of risk, together with the time which must of necessity elapse between the raising of capital and the realization of earning power and dividend return, requires that natural gas pipelines be financed with a high debt-equity ratio, for prospective subscribers of equity capital insist on a higher rate of return on their equity than the 6 percent over-all return allowed by the Federal Power Commission. The only way this higher return result can be accomplished is to have a capital structure wherein the earnings on borrowed funds in excess of the interest thereon will produce for the equity owners the kind of return they insist on as a condition of investing their money in equity securities. In the case of natural-gas pipelines, this capital structure, for the reasons we have outlined, is typically 75 percent debt to 25 percent equity when construction begins, the debt thereafter being progressively retired out of earnings.

In short, the method by which a transcontinental gas line or other federally regulated utility is financed is dictated almost entirely by the Power Commission's modest profit allowance. With the fixed ceiling on their return, investors in the current market simply will not place a higher percentage of their investment in equity capital in companies of this character under the circumstances. The resulting high ratio of borrowed to equity capital is by economic necessity, not by choice.

Since the prospective life of natural gas pipeline companies is inherently limited by the nature of the natural resource which is their only salable commodity, the element of risk for all of its security holders is greater than in the case of companies engaged in many other types of business.

Also, because of the investors', and even the geologist's, natural reluctance to predict the productive life of any known natural gas reserves beyond a reasonable period of years, the debt securities and the preferred stocks of natural gas pipe-

line companies generally are not salable except on a basis providing for annual or semiannual maturities over a period not exceeding 20 years in the case of debt securities and slightly longer in the case of preferred stocks. Natural gas pipeline companies, therefore, must retain and use for debt and preferred-stock retirements substantial portions of their annual earnings which otherwise would be usable for the payment of dividends on common stock. In addition to the large amounts of cash earnings retained for sinking-fund purposes, pipeline companies, like other companies, must have cash available for dividend payments to sustain their equity capital structures and provide a market for the sale of additional securities to finance needed expansions and improvements in their service.

The financial structures which have been set up by such companies for the purpose of bringing needed natural gas to large areas of the country can only be soundly preserved if the earning power projected in the planning of the projects is realized to the degeree anticipated under the regulatory policies of the Federal Power Commission. If the regulated modest rate of return is diminished through heavily increased taxes without a corresponding increase in the selling price of gas, the companies' security position will be seriously weakened and expansion of facilities to increase service will be retarded or entirely eliminated. On the other hand, if the companies were authorized by the Federal Power Commission to increase the selling price of gas to offset tax increases, the benefits of the new lines to the public would be correspondingly diminished.

Should we not be permitted to increase the price of our gas, the equity owners in our company could never get a dividend if the Treasury-recommended proposal were adopted without including therein the utility provision adopted by the House. Except for the circumstance of our going into our first year of operation with an operating loss carry-over for tax purposes (which the House bill allows us to deduct in computing our excess profits net income), we would, under the excess profits tax, without the House utility provision, be broke, out of cash, and unable to meet our obligations at the end of 1951. Even the benefits of this operating loss carry-over have been taken away from us in large measure, for the Federal Power Commission recently—before we sold a foot of gas or derived a cent of revenue—reduced our rates in order to cancel out the benefits of that carry-over to the company and to pass such benefits on to our customers.

To deny the common-stock holders any possibility of obtaining any return on their investment for all practical purposes wipes out their equity in the company. And while the company presumably could continue to exist and operate, it is plain that its ability to meet the expanding demands for natural gas in the area it serves will be completely destroyed.

Under the terms of our first mortgage indenture, any new facilities which we add to our system may only be mortgaged to the extent of 60 percent of their cost. This makes it necessary to raise 40 cents of equity out of each dollar spent to expand the company's facilities. With no prospect of dividends on the equity capital, it goes without saying that no one would invest in its common stock. Even should there be a prospect of dividends, in order to raise equity capital on a fair basis through the sale of common stock, dividends alone are not enough. It is essential that some of the earnings of the company be retained and plowed back into the enterprise.

The stockholders, both common and preferred, that subscribed to our stock, the institutions that bought our bonds and the banks that have lent us money, all in the aggregate amount of some $240,000,000, did so on the basis that this project would be allowed to earn, after all taxes, a return of at least 6 percent of its entire capital structure, both equity capital and borrowed capital. This rate of return has been found to be fair, just and reasonable by the Federal Power Commission and is adequate, but no more than adequate, to assure the economic feasiblity of this project. It allows sufficient cash to pay interest to the bondholders, pay dividends on the preferred stock, retire our debt and refund the preferred stock and at the same time pay a reasonable dividend on the common stock and leave a small amount of retained earnings to expand our facilities as they are needed.

If the utility proviison of the House bill is not retained, all of these investments will be in serious jeopardy.

Along the route of the Transcontinental line there are a number of small companies which have been organized for the purpose of buying gas from our line to supply to their various communities. They are now in the process of trying to finance their projects. It is my opinion that they will not be able to finance them if the utility provision which the House adopted is not adopted by Con-

gress, in which event many communities along the route of our line will be deprived of this cheap and efficient fuel.

The utility provision of the House bill adopts two principles that are vital to every public utility:

1. A public utility cannot have "excess profits" if, after the payment of normal tax and surtax it has left no more than the fair return allowed it by the regulatory body.

2. A public utility must be allowed to include all of its capital, both equity and borrowed in its capital base for excess profits tax purposes.

Both of these principles are of equal importance. Neither one would without the other, solve the utility problem under the excess profits tax. The retention of both is essential, for otherwise the ability of the utilities to serve their customers and to secure capital required for necessary expansion would be very seriously impaired. We hope your committee will keep the utility provision of the House bill.

The CHAIRMAN. Mr. William Gess. Will you have a seat, please, and identify yourself for the record.

STATEMENT OF WILLIAM B. GESS, LEXINGTON, KY.

Mr. GESS. My name is William B. Gess; my office is in the Citizens Bank Building, Lexington, Ky. I represent the Kentucky Real Estate Commission, J. Bruce Davis, chairman; the Lexington Real Estate Board; and the operators of certain commercial office buildings in midtown Manhattan, New York City, including Bryant Park Building, Inc., 11 West Forty-second Street, Inc., and 500 Fifth Avenue, Inc.

We all recognize that an excess profits tax should be imposed on excessive earnings—that is, on income which exceeds an established base.

The problem: The chief problem is to formulate the base for determining whether profits are excessive, so as to insure that only such earnings will be subject to this high wartime levy as are obviously attributable to war conditions. An excess profits tax, in other words, should not reach earnings which would have been made anyway. We are to tax, not boom profits, but war profits.

The World War II excess profits tax statute said that the excess profits base should be either a percentage of depreciated original cost plus accumulated earnings and profits—the invested capital method—or 95 percent of the average earnings of the taxpayer for a 4-year base period—the earnings method. This resulted in a discriminatory tax on the real estate enterprise which, let us say, had bought its fee or leasehold in 1932 or 1938 at a lot cost and had thereafter operated at a loss, year after year, until the outbreak of war. This resulted in a low invested capital base; moreover, the earnings credit was of no help, because the base period was poor.

No adequate relief provisions were made in World War II statutes for real estate. Sections 721, 722, and 723 have proven an illusion to the great majority of taxpayers who felt, with considerable justification, that they were being unfairly treated. The tax court has never granted any substantial relief to a real estate company.

The faith of such a management in its enterprise was rewarded by a low credit and a high tax; whereas an organization, whose management happened to be extravagant, in its original investment or which somehow had gotten into profitable operations during the base period, was favored with a high credit and a low war tax. Thriftiness or bad operating history was punished and extravagance or a base period

bonanza were rewarded. This was bad enough, but what was far worse was that the war tax payable depended too much on the accidental factors of when the business had started and how it happened to function during the base period. The chances for discriminatory treatment of closely similar properties were abundant, and this discrimination far too often took place.

So far, the Eighty-first Congress had done nothing to alleviate or solve the tax problems of real estate enterprises. As far as I have been able to determine in the short time available to me, the House bill, now before this honorable body, contains nothing which will remove the discriminatory and unfair treatment here complained of.

The determination of whether earnings from investments in, and operation of, real estate are reasonable or excessive is one of our basic tasks, for our lands and buildings are a basic national resource. We fail completely to do equity if we apply vastly different standards, having no relation to whether profits are reasonable or excessive, to similar properties.

The remedy: A most desirable and sensible result can be simply achieved by allowing real estate corporations to compute their invested capital on current values, rather than on historical costs. A standard based on present-day worth will reflect the effort the operator has put into the property and correct for the accidental factors of time of original investment and subsequent adversity.

It is at once objected, that it would be an impossible administrative job for the Treasury to endeavor to make current valuations of all property in the country, so that such current valuations could be made a basis for excess profits tax calculations.

For real estate, however, several types of current valuations are available. First, there are the assessed values that must be carefully and regularly established for local tax purposes. Second, there is the local real estate market; your real estate man typically is well versed in current sales values and in appraisals made for the purposes of buying or selling leaseholds or fee estates. The prices thus arrived at are reached at arm's-length and constitute the best available evidence of current value. Finally, values are frequently determined by arbitration or by court proceedings which have been brought for various purposes.

Thus, to obviate the administrative burden on the Valuation Section of the Bureau of Internal Revenue of prescribing fair values for all of the commercial properties in the particular Federal collection districts, the statute could grant real estate corporations the privilege of using as an excess profits credit base "the fair market value of their premises as of January 1 of the taxable year established by any lawful evidence." The burden of proof would be gladly assumed by the taxpaying operator: Taxpayers are used to that sort of burden—they have borne it all of their taxable lives.

Nothing herein contained should be taken as an expression of opinion that an excess profits tax is the best way of meeting the present emergency. But if we must have a tax, heavy though it may be, let us set up provisions which will insure that such a levy will reach only the excessive profits, and let us write the law on a scientific rather than a hit-or-miss historical basis. The results to all concerned—to the Treasury, the war economy, and to the people who must

produce the revenues would be stimulating, fairer and easier to administer than anything we have ever heretofore experienced.

Incidentally, we are not requesting automatic relief in every instance, but rather special relief when it is proved that discrimination in fact exists in a special case. In other words, this is the similar procedure as was permitted and which existed under section 72.

That, gentlemen, is my statement.

The CHAIRMAN. Are there any questions?

There are no questions. We thank you very much.

Mr. GESS. Thank you very much.

The CHAIRMAN. Mr. Marbury.

STATEMENT OF WILLIAM G. MARBURY, APPEARING FOR THE INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

Mr. MARBURY. Mr. Chairman, in view of the hour, I do not need to read all of this. I just have a couple of points I would like to call to your attention, but I would like the permission of the Chair to leave these copies and insert it in the record.

The CHAIRMAN. Yes, you may do so.

Mr. MARBURY. There are a couple of matters, though, that I think warrant——

The CHAIRMAN. You are appearing here for the Independent Natural Gas Association?

Mr. MARBURY. Yes, sir. I am William G. Marbury, of St. Louis, Mo. I am president of the Mississippi River Fuel Corp. and I am appearing here in behalf of the Independent Natural Gas Association of America.

I appeared before the Ways and Means Committee of the House last month in a similar capacity. I am here to urge the reenactment of section 735 of the Internal Revenue Code, section 208 of the Revenue Act of 1943, and section 451 of the House bill.

The Independent Natural Gas Association is a group composed of 1,800 members in 43 States, of natural gas producing, consuming, and transportation companies.

This committee has heard Mr. Hulcey, of the American Gas Association, and the electric industry's representative, and I am sure you have heard enough about the necessity of exemption as it relates to 6 percent earnings on the rate base of gas and electric utilities.

There is one phase, however, that has not been dealt with today, and that is the phase of selling a natural resource, natural gas.

Now, there are a number of companies in the industry that have their own production, and practically all natural-gas pipeline companies either have part of their own production and buy the rest of their gas from others or they buy all of it from others.

Congress in the last war's excess profits tax saw fit to make a provision to exempt half of the unit profit from the impact of the excess profits tax law, and the House has inserted such a section into its bill. Our association is very interested to protect that provision.

In explanation of it a lot of the mortgages of our companies are tied to the natural-gas reserves; and if we draw on those reserves at an accelerated rate due to an expanding economy because of the war effort, we also have to accelerate our debt payments.

In addition to that, these natural reserves of gas, anywhere from 5,000 to 10,000 feet in the ground, to be replaced are going to cost a great deal more money. Our industry does not feel that this Congress or this committee wants us to expand into the war economy or the defense economy that we are going to have, deplete our reserves, and end up with not enough money to replace them by the development and exploration of other properties.

Now, that position is true whether a man owns the reserves or whether a company has them under contract from other ownership, because the pipeline transmission business, as such, is tied to a specific reserve, whether he owns it or whether he has it committed for 20 or 25 years or the life of the field.

So we urge this committee, in behalf of our industry, to give us the same relief that Congress gave us in the last excess profits tax law, and which the House has incorporated in its bill in section 451.

The CHAIRMAN. Thank you very much. You may file the brief with the reporter.

Mr. MARBURY. Thank you, sir.

(The statement submitted by Mr. Marbury reads in full as follows:)

STATEMENT OF WILLIAM G. MARBURY ON BEHALF OF THE INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

My name is William G. Marbury, of St. Louis, Mo. I am president of the Mississippi River Fuel Corp. and I am appearing here in behalf of the Independent Natural Gas Association of America.[1]

I appeared before the Ways and Means Committee of the House last month in a similar capacity. I am here to urge the reenactment of section 735 of the Internal Revenue Code (sec. 208 of the Revenue Act of 1943) relating to the natural gas industry in any excess profits tax law which may be passed. This section has been incorporated in H. R. 9827 in the same language as it was enacted by Congress in the excess profits tax law of the last war.

I. The problem of the natural gas industry, which is comprehensively regulated, is how to remain a solvent and expanding industry under the impact of an excess profits tax, selling an irreplaceable natural resource—natural gas.

(*a*) To remain solvent the industry must receive sufficient relief to assure the servicing of present debt.

(*b*) To be an expanding industry relief must be granted to assure our ability to raise money for building additional properties.

(*c*) Earnings resulting from increased sales of an irreplaceable natural resource—natural gas—must not be excessively taxed or the replacement of this capital asset will be impossible.

II. The relief requested is: (*a*) Reenactment of section 735 of the Internal Revenue Code (sec. 208 of the Revenu Act of 1943) relating to the natural-gas industry in any excess profits tax law which may be passed.[2]

The House Ways and Means Committee wisely included section 735 in the Excess Profits Tax Law of 1943. In so doing, your committee made it possible for our industry to remain solvent and supply the needs of this Nation in time of war. Your judgment was further established as being sound in that through your committee's action in recommending section 735 our industry at the conclusion of World War II was in a healthy condition and financially able to meet the expanding requirements of the postwar era. Now, as we approach an era of preparation for defense, coupled with the maintenance of a reasonably normal economy for this country, we again appear to prevail upon the sound judgment

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[1] The Independent Natural Gas Association of America is a nonprofit corporation with approximately 1,800 members located in 43 different States, including all natural gas producing and consuming States. This membership includes producers, royalty owners, transporters, and distributors of natural gas.

[2] Under the provisions of sec. 735 certain natural gas companies were granted a partial exemption from excess profits taxes on the net income attributable to the excess output during the current taxable year as compared to the normal output. Normal output was defined as the average output during the base period. The partial exemption was limited to the excess output multiplied by one-half of the unit net income during the taxable year.

of your committee to favorably consider reinstating the relief provided by section 735 in any excess profits tax law that may be passed.

In meeting the defense expenditures that our country faces, there is a need for increased Government revenues. Our industry recognizes that it must pay its portion within its ability. We are not here to seek full exemption, but to urge that the minimum relief granted to our industry by section 735 be reenacted so that we may remain solvent and continue to expand. This request is made in the firm belief that the defense effort would be aided and the public welfare protected by the granting of our request.

(a) *To remain solvent the industry must receive sufficient relief to assure the servicing of present debt*

A substantial number of companies in the natural-gas industry built facilities with funds derived from the sale of bonds and the borrowing of money from banks as indicated by table I. Outstanding long-term debt totaled $1,659,000,000 at the end of 1949. A major portion of the industry's bonds is owned by insurance companies and some are owned by the public.

In many cases borrowing by the individual companies was geared to a depreciation allowance and earnings established by regulatory bodies—to a great extent by the Federal Power Commission. The lender relied upon the established policies of the regulatory body, both as to allowable earnings and depreciation accruals as a source of cash for the retirement of debt. The imposition of an excess profits tax law without relief upon these funds would so deplete the cash flow of many companies that they would be unable to service their debt in accordance with the maturities.

Under regulations by the Federal Power Commission or State regulatory bodies, to which the major portion of the industry is subject, any excess profits tax must be absorbed by the industry from funds now used to service debt, expand facilities, and maintain existing properties.

The bond sinking-fund requirements of many companies makes it mandatory to accelerate the rate of debt retirement when withdrawals from available gas reserves, whether owned or purchased, are accelerated. When a particular company, therefore, expands its operation and delivers a greater volume of gas it must retain sufficient earnings from those increased sales to make possible the servicing of accelerated sinking-fund requirements. In other words, the lenders have been cautious to require that if the available gas supply is drawn on excessively, the sinking-fund payments should be increased accordingly for their protection.

Obviously, if the normal profit on these increased sales is taxed away as an excess profit, cash will not be available to meet accelerated sinking-fund payments.

(b) *To be an expanding industry relief must be granted to assure our ability to raise money for building additional properties*

Our industry faces the necessity of continuing service to many industries essential to the new defense program. In addition, it faces the responsibility of serving the needs for natural gas in the homes of literally millions of people of this country. To maintain this service places a tremendous financial burden on the industry. In addition to the maintenance of proper service to those industries and persons who are now relying on the natural-gas industry, additional requirements for new defense industries and new housing will have to be met in the expanded economy that we face in the defense program. To do this effectively the industry must continue all of the phases of its business, from the actual discovery and development of reserves to the building of additional facilities and the maintenance of present facilities. When viewed as an industry problem, this undertaking necessarily presents a great need for raising a substantial amount of money. Additional facilities by the industry must be bought and paid for.

Whether it is debt money or equity money, the industry must be able to convince the purchaser of a security that he is acting prudently in making available his money to our industry. To convince a man with money that he is acting prudently when purchasing our bonds or notes, we must be able to convince him that we can pay the interest and repay the principal when due. To convince the purchaser of an equity security that he is acting wisely, we must demonstrate that he will earn a fair return. These problems seem elementary. Unless relief is granted to our industry by the reenactment of section 735, however, it is our considered judgment that with a few exceptions our industry will not be able to

attract the necessary capital to expand and bear its proper responsibility in the expanding economy of this country.

Our industry is not one that you can stop and permit to remain as is. We must be continually exploring for new gas reserves. After exploration we must develop fields to make large quantities of gas available. We must build facilities to those fields and undertake to build facilities all the way to distant markets. This undertaking requires tremendous capital. To assure its success, we must be able to go to the money market of this country and demonstrate that an excess profits tax will not preclude our ability to repay money borrowed and to pay a reasonable return to investors.

Section 735 does not grant full relief to our industry, nor will its application create a condition whereby the industry will be unusually attractive to the money markets of this country. It has been demonstrated during the last World War and by recent studies that it is essential. If section 735 is not reenacted the industry may face the possibility of being foreclosed from entering the money market.

The association, for which I am spokesman, after comprehensive studies has concluded that, if the relief provided for in section 735 is not granted to our industry, a large group may be foreclosed from paying any return on its equity capital. When this condition is coupled with the inability to service debt requirements, as heretofore presented, it is obvious that the industry will lack the ability to expand. As illustrative of the money requirements of our industry, we have prepared table II, which for 2 years shows the need for approximately $2,000,000,000.

With conditions as outlined above, your committee must recognize that, without relief, the entire industry faces the problem of the public withdrawing its financial support.

(c) Earnings resulting from increased sales of an irreplaceable natural resource—natural gas—must not be excessively taxed or the replacement of this capital asset will be impossible

The natural-gas industry is engaged in the business of producing, transporting, and selling an exhaustible natural resource. An adequate supply of gas is vital to the continued existence of every natural-gas company, and conditions must be such as to make it economically feasible to drill the necessary wells and construct pipeline facilities from field to market. The market cannot be moved; the product cannot be transported by rail or truck, but each company must build or depend upon transportation facilities constucted at great cost as gas can only be transported by pipeline.

The natural-gas industry is probably the only industry which must constantly increase its facilities and investment to furnish the same amount of the same commodity to the same market. The drilling of deeper wells to discover gas for replacing dwindling reserves, the installation of compressor stations because of decreasing gas field pressures, and the necessity of longer field gathering and transmission lines are all factors tending to increase the financial expenditures of the gas industry and also increase the cost of gas. Thus, even in normal times gas companies are required to make substantial expenditures in serving their market.

When natural-gas companies increase their output they must do so by using up a capital asset, their only stock in trade, an irreplaceable and exhaustible natural resource. A new gas supply may be close to existing markets or existing transportation systems, but many are far enough distant from both to require large expenditures in the construction of new pipeline facilities. The size of the total proven reserves of the Nation offers little consolation to the company which is connected to a failing gas supply and is unable to finance an expensive drilling campaign or the construction of pipelines to a field having adequate reserves.

Every time a well is drilled, every time a new well is connected to a pipeline system, and every time a well is abandoned, the expenditure of substantial sums of money is required. When new fields are connected, the required expenditures are substantially greater, especially since the pipe in the old lines usually cannot be removed until the new lines are constructed, and old lines are never removed until the wells to which they are connected have declined in pressure to the point of abandonment. Thus even in normal times the average gas company must constantly and continually make substantial expenditures in searching for new supplies of gas, rearranging its existing pipeline systems, building additional compressing station capacity, and constructing additional pipelines to new sources of supply.

The essential requisites of our industry to serve the Nation's need for our product—natural gas—are—

(1) There must be dedicated natural gas reserves in the ground sufficient to assure a long-term supply, approximately 20 years, to our markets. Upon this dedication of reserves the companies of our industry are granted certificates of public convenience and necessity by governmental regulatory bodies to build transportation facilities.

(2) Our ability to get the support of the investing public follows a dedication of reserves and granting of authority to build the property. Whether those reserves are owned by the transporting company or are purchased under long-term contracts by a transporting company, they become an inherent, inseparable component part of the over-all business. When they are depleted, a capital asset has been converted into cash. They must be replaced. Whether that replacement is by discovery and production or by contract for purchase, capital will be required to make new reserves available. You do not find gas fields next to each other. It has been the history of our business that the replacement of reserves, whether produced or purchased, will be at a substantially higher cost. This is particularly true as we face the future.

Therefore, unless we have the relief provided by section 735 we, as an industry, are exhausting the very basic element of our business, namely, our product, without adequate remuneration and are facing the necessity of replacing that product at increased cost—at greater risk—with less money.

CONCLUSION

In conclusion, we urge your committee to give our industry the relief provided for by the reenactment of the provisions of section 735 under which we paid huge amounts of excess profits tax during World War II.

It is our sincere opinion and judgment that the industry is entitled to this relief and that it is necessary in the public interest. During the last war the reasonableness and workability of section 735 was established. We are not venturing into a new field.

We feel that this is the irreducible minimum amount of relief necessary to maintain our industry and enable us to service an expanding economy.

My attendance is not for the purpose of discussing generally the impact of an excess profits tax law on the natural gas business. This is being done by others. The proposal of the American Gas Association will ably present the over-all views and we subscribe to them.

We do not purport to cover the obvious necessity of special treatment of an excess profits tax law for a new company which has not operated during the base period, or certain substantially expanded companies. Their problems will be ably and fully presented by others and they are certainly entitled to full consideration.

The natural gas industry is one of the newest industries of this country. Its development and expansion since the end of World War II has been phenomenal. Its growth serves again as an apt illustration of the vitality and capacity of business in this free country.

TABLE I.—*Capitalization of 22 natural gas companies, Dec. 31, 1949*

Company	Capital stock and surplus	Long-term debt	Total capitalization	Percent long-term debt
Alabama-Tennessee Natural Gas Co	$896, 700	$1, 700, 000	$2, 596, 700	65.5
Atlantic Seaboard Co	16, 882, 138	21, 665, 000	38, 547, 138	56.2
Austin Field Pipe Line Co	3, 118, 387	7, 395, 039	10, 513, 426	70.3
Central Kentucky Natural Gas Co	6, 456, 614	5, 974, 000	12, 430, 614	48.1
Cities Service Gas Co	34, 196, 605	64, 500, 000	98, 696, 605	65.4
Colorado Interstate Gas Co	13, 455, 299	20, 000, 000	33, 455, 299	59.8
East Tennessee Natural Gas Co	564, 747	9, 950, 000	10, 514, 747	94.6
El Paso Natural Gas Co	39, 024, 101	148, 736, 881	187, 760, 982	79.2
Iowa-Illinois Gas & Electric Co	23, 591, 143	32, 000, 000	55, 591, 143	57.6
Iowa Public Service Co	25, 631, 307	29, 470, 000	55, 101, 307	53.5
Lone Star Gas Co	64, 047, 266	47, 500, 000	111, 547, 266	43.5
Michigan Consolidated Gas Co	50, 483, 280	74, 575, 000	125, 058, 280	59.6
Michigan, Wisconsin Pipe Line Co	22, 370, 986	66, 000, 000	88, 370, 986	74.5
Mississippi River Fuel Corp	19, 515, 243	27, 500, 000	47, 015, 243	58.5
Natural Gas Pipe Line Co. of America	26, 630, 981	51, 564, 759	78, 195, 740	65.9
Panhandle Eastern Pipe Line Co	58, 871, 055	74, 000, 000	132, 871, 055	55.7
Tennessee Gas Transmission Co	84, 549, 609	156, 735, 000	241, 284, 609	65.0
Texas Eastern Transmission Corp	44, 678, 584	150, 781, 500	195, 460, 084	77.4
Texas Gas Transmission Corp	19, 412, 073	60, 000, 000	79, 412, 073	75.1
Texas Natural Gas Co	6, 854, 268	14, 147, 000	21, 001, 268	67.6
Transcontinental Gas Pipe Line Corp	31, 403, 701	169, 500, 000	200, 903, 701	84.4
Wisconsin Southern Gas Co	691, 906	814, 000	1, 505, 906	54.1

TABLE II.—*Construction expenditure of the natural gas industry, 1946–49, actual; estimated 1950–54, inclusive*

Year	*Millions of dollars*
1946	236.8
1947	623.6
1948	629.2
1949	848.1
	2, 317.7
1950	954.3
1951	890.8
1952	365.1
1953	276.9
1954	259.7
	2, 746.8

Source. Gas Facts, 1949—American Gas Association Bureau of Statistics.

The CHAIRMAN. Mr. Ray Murphy. Mr. Murphy, you may have a seat. Please identify yourself, and proceed.

STATEMENT OF RAY MURPHY, GENERAL COUNSEL, ASSOCIATION OF CASUALTY AND SURETY COMPANIES; ACCOMPANIED BY CHARLES W. TYE, TAX COUNSEL, ROYAL INDEMITY CO.

Mr. MURPHY. Mr. Chairman and gentlemen of the committee, my name is Ray Murphy, general counsel for the Association of Casualty and Surety Cos., and with me is Mr. Charles Tye, tax counsel of the Globe & Royal Insurance Co.

The association is a trade association consisting of 80 capital stock casualty and surety companies doing business Nation-wide and in a few foreign countries. Some of the companies are very old and some of them are large, and a few are new and quite small.

We are not life insurance companies. We write all lines of casualty insurance and corporate suretyship.

We, of course, have always been subject to normal income tax and surtax on our investment income and underwriting profit. We were subject to the excess profits tax law of World War II.

We fully recognize that the Federal Government must have additional revenue now. The capital stock insurance business should and will pay its fair share of the eventual tax burden. This statement is directed toward the hardships which will result to that business if H. R. 9827 becomes law in present form. It will attempt in briefest detail to cover the principal points involved.

1. Neither the invested capital method nor the average earnings credit method provided in the bill is a reasonable formula for determining the excess profits tax of insurance companies affected: this for the reasons (*a*) the base period was a period of very unfavorable earning experience in the insurance business; (*b*) invested capital is not a predominant factor in the business.

2. Under H. R. 9827 the interest paid factor is the sole basis for determining that part of the invested capital attributable to borrowed capital. The interest-paid factor is not helpful to insurance companies, because with rarest exceptions they do not borrow money. However, the unearned premium reserve of insurance companies somewhat resembles borrowed capital, and for that reason under the World War II excess profits tax law 50 percent of that reserve was added to equity capital in such manner as to produce a credit under the invested capital method. We have not received that credit under H. R. 9827, nor any comparable credit to compensate for the interest paid factor available to other corporate taxpayers under H. R. 9827.

Senator MILLIKIN. May I ask why your earnings were so poor during the base-period years?

Mr. MURPHY. Senator, of course, they are always poor because of poor loss experience or great loss experience, and the rates that have been permitted by the supervising authorities turn out not to have been sufficient to cover the acquisition costs, the administration costs, and the payment of losses.

The business is quite cyclical and rather irregular in its cycles. Sometimes we have a period of 3 or 4 bad years, or a bad year and then a good year, and sometimes it works the other way.

Senator MILLIKIN. Was there anything special in those years that you recall that increased your losses or decreased your revenue?

Mr. MURPHY. I do not recall that in our business, the casualty and surety business, there were any special large or catastrophic losses that caused it. It was just a gradual attrition. One thing that has, of course, affected our business is the constantly increasing cost on everything. For example, in an automobile damage case not only the physical damage, but to repair, to pay for the repairs costs a great deal more, and that has been constantly going up. And the cost of damage suits have increased terrificly.

Senator MILLIKIN. You have not been able to keep up with those increases?

Mr. MURPHY. We have not been able to keep up with those developments. We always lag behind when we have loss years in catching up with them.

Senator MARTIN. And do all States have a regulatory body to fix the premiums?

Mr. MURPHY. Yes, sir; generally regulated by the supervision of the commissioner of insurance.

Senator MARTIN. Is that done each year?

Mr. MURPHY. That is done normally each year. It may be done oftener or less often. It is constantly going on at all times, and your rates are always subject to revision if they appear to be out of line, particularly if they are high.

Senator MARTIN. If they are too low, then that would make a bad year for you?

Mr. MURPHY. That is right, sir.

The CHAIRMAN. Mr. Murphy, under the World War II Act, you had a credit of 50 percent of your unearned premium reserve, did you not?

Mr. MURPHY. As a capital credit?

The CHAIRMAN. Yes; as a capital credit.

Mr. MURPHY. That is right.

The CHAIRMAN. You are not given that under this bill?

Mr. MURPHY. No, sir.

The CHAIRMAN. I see.

Senator MILLIKIN. Why is that, Mr. Stam?

Mr. MURPHY. Mr. Tye has brought it out. I think the ratio is about 4 to 1 against us in this bill as compared to the last bill.

The CHAIRMAN. What was the reason, Mr. Stam, they were not given unearned reserve premium credit?

Mr. STAM. I think the same problem comes up in connection with these reserves required by law for the mutual insurance companies, and under the old law they got 50 percent of the mean of the reserve between the beginning and the end of the year.

I think the problem is somewhat tied up with this new definition of borrowed capital that is in the new bill. It is tied up with the question of whether interest is paid, or something of that sort.

Mr. MURPHY. If Mr. Tye may make a brief statement on that point.

The CHAIRMAN. Yes, sir.

Mr. TYE. The interest-paid factor of insurance companies is purely illusory for the simple reason that we cannot get finance in order to increase our capacity. If we should need additional capital, we must get it in the equity market and not through bonded indebtedness because obviously issuing bonds would merely create a liability to offset the asset, and our capital position to increase our capacity would be just the same as it was before.

So, for that reason, there has been no debt financing of any consequence in the insurance business. For that reason, to tie our borrowed capital to the interest-paid factor of other industry is meaningless, for the simple reason that there is no interest-paid factor in our business. For that reason we feel that we should have at least 6 percent on our unearned premium account as borrowed capital, which would compensate for the enhanced percentage allowed on equity capital which, I understand, is now 12 percent. We are recommending that in a form of amendment we hope to submit to you.

The CHAIRMAN. Are you submitting an amendment?

Mr. TYE. That is right.

Senator MARTIN. What consideration do you give to the earnings on your various reserves?

Mr. TYE. The investment income which, to the extent it is traceable back to reserves, is taxable. We pay taxes on all of our underwriting and invested income.

Senator MARTIN. I see.

Mr. TYE. At regular rates.

The CHAIRMAN. That looks like it is your problem.

Mr. MURPHY. Yes, sir. I would like to touch on one or two other points.

H. R. 9827 is drafted on the assumption that the base period 1946–49 was a highly profitable era for business generally. This assumption is unwarranted as to fire and casualty insurance companies. They quite generally operated at a loss in 2 years of the base period, 1946–47, and all casualty reinsurance companies operated at either an underwriting loss, or at best a nominal profit during all years of the base period.

In fact, I would have to change that and say that all casualty reinsurance companies operated at a loss during all four of those years.

Senator MARTIN. Was not the ratio of loss in the fire insurance companies much heavier than it was in the casualty during that period?

Mr. TYE. That is right.

Senator MARTIN. That is my recollection of it; yes.

Mr. MURPHY. The aggregate loss was larger; yes.

Senator MARTIN. The loss ratio.

Mr. TYE. For the record, I might say we checked the averages yesterday for the years 1946 and 1947 in the fire business. There was an over-all loss of approximately $170,000,000 for the industry. On the casualty side, as I recall, it was $67,000,000 for 1946, and such a small margin of profit over-all for 1947 as to indicate that most of the companies, or many of the companies, had net operating losses.

I might change that $170,000,000. As I recall, that is the aggregate of both casualty and fire, but it is more predominantly higher than it is casualty.

Mr. MURPHY. That is right.

Senator MARTIN. What I meant by loss ratio is as it relates to the premiums earned. That is what I mean, because that makes a percentage.

Mr. TYE. I think the percentage is lower in the fire than in the casualty, that is, there would be more loss on fire in those years.

Senator MARTIN. Yes.

Senator MILLIKIN. Are you moving now into better profit?

Mr. TYE. Yes.

Mr. MURPHY. Nineteen hundred and forty-eight was a better year and 1949 was better than 1946 and 1947, of course, because there was some profit generally. Nineteen hundred and forty-nine was not as good as 1948. In 1950 there seems to be considerable doubt as to whether there will be profit this year, although it is a little too early to have the figures.

Mr. TYE. Nineteen hundred and fifty may also be affected by the nearly a quarter of a million claims that have been filed on the hurricane loss recently in the New York area.

Mr. MURPHY. If there is to be any reasonable average earnings credit for insurance companies generally, the loss years of the base period should be eliminated from the base. Even this could not help

the casualty reinsurance companies, which would be forced to rely on an inadequate invested capital credit.

Senator MILLIKIN. Do you suggest you carry forward your losses in 1948 and 1949 against the profits you may make?

Mr. TYE. May I make a statement on that? The insurance industry, having investment income as much, sometimes, as operating income, gets very little, if any, benefit out of carry-overs for the reason that under the 122, I believe it is, there are adjustments required to get at the so-called economic loss. By the time we get through with adjusting for all of the investment items that we have under these various sections, we end up with very little, if any, net operating loss carry-over. So those particular sections have hit the insurance industry here heavier than any other industry because of the fact we do have investment income, with the result that most companies, if they can, attempt to, if necessary, sell at a gain during the current year their portfolio to offset the operating losses rather than to lose most of it through carry-overs and carry-backs.

Mr. MURPHY. I think a minimum credit should be granted insurance companies, as such credit is established under H. R. 9827 for public utilities. I say this is a novel approach for our business, but nevertheless, like utilities, the business of insurance is clothed with a public interest. The business is highly regulated. Every State regulates insurance rates, which by law must be reasonable, not excessive, and not unfairly discriminatory. We quote from pages 25–26 of the report of the Committee on Ways and Means which accompanies H. R. 9827:

1. Minimum credit for certain regulated industries

Your committee's bill provides a minimum excess profits tax credit which is available for certain specified types of regulated industries. This credit is an alterative to the average earnings credit and the invested capital credit for such taxpayers.

* * * * * * *

The effect of this minimum credit for certain public utilities is to give assurance that an excess profits tax will not be imposed until after the regulated industries earn a rate of return of 5 percent or 6 percent after paying corporate normal taxes and surtaxes. Your committee believes that this is appropriate in view of the fact that the profits of these industries in the base period years were held down well below the profits earned by unregulated industries. Moreover, there is considerable evidence that rate adjustments for these industries lagged considerably behind increases in their costs of doing business. Your committee also believes that where industries are regulated by other governmental bodies providing only a fair rate of return, it is undesirable to consider profits allowed by such regulated bodies as excessive for purposes of an excess profits tax. The 5 and 6 percent rates of return provided for in this minimum credit will be approximately the average rates of return customarily allowed for the regulated industries in question.

The reasoning of the Committee on Ways and Means applies equally to the business of insurance. It is regulated as are the utilities, to the end that the business shall receive no more than a reasonable rate of return, though profit, if any, is not guaranteed. True, the criterion for rate regulation of the utilities is a percentage of capital, whereas the criterion for regulation of insurance rates is a percentage of earned premiums. Each is a proper criterion for regulation of rates of the respective business to which it applies, and each is a criterion established by the arm of government dealing respectively with each business.

In conclusion, it should be said that the insurance business is not at any time or under any circumstances the beneficiary of windfall profits. During World War II, and the prior armament program, the business operated on a nonprofit basis in relation to Government contracts, under a retrospective rating plan evolved by the Defense Department itself, which plan provides for a service fee, but no profit. Such a plan will certainly be developed for the current program, and for any ensuing national emergency. The insurance companies will not profit therefrom.

We have prepared amendments to H. R. 9827, which, with your permission, we will leave with the committee. We urge your favorable consideration as a matter of fairness to an important and essential element of the national economy, the special nature of which has not thus far been adequately considered.

The CHAIRMAN. You file the amendments with the reporter and they will be placed in the record.

Mr. MURPHY. Yes.

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

(The amendments submitted by Mr. Murphy are as follows:)

PROPOSED AMENDMENTS TO H. R. 9827

Amend section 439 (b) on page 52 by deleting the following words appearing on line 14: "the sum of the following" and deleting the matter on lines 15 through 19 and substituting therefor the following:

"(1) In the case of an insurance company taxable under section 204, an amount equal to 6 per centum of the mean pro rata unearned premiums, determined at the beginning and end of the taxable year."

Amend H. R. 9827 by inserting a new section 446A entitled "Excess Profits Credit—Rate Regulated Insurance Companies Taxable Under Section 204" immediately following section 446, to read as follows:

"(*a*) The excess profits credit for any taxable year computed under this section shall be the regulated insurance companies credit, as defined in subsection (b).

"(*b*) The regulated insurance companies credit for any taxable year shall be the sum of the following:

"(1) the tax imposed by sections 13, 14, and 15, for such taxable year, and
"(2) 6 per centum of the earned premiums for such taxable year."

Amend section 435 (d) by adding thereto a new paragraph 5 to read as follows:

"(5) In the case of insurance companies taxable under section 204, by eliminating from the base period any loss years and averaging the profitable years remaining."

The CHAIRMAN. Mr. J. R. Berry. Identify yourself for the record, Mr. Berry.

STATEMENT OF J. RAYMOND BERRY, GENERAL COUNSEL, NATIONAL BOARD OF FIRE UNDERWRITERS

Mr. BERRY. Mr. Chairman, I will high light my statement and submit it for the record.

The CHAIRMAN. That will be all right.

Mr. BERRY. This statement is made on behalf of approximately 200 stock fire insurance companies, members of the National Board of Fire Underwriters. These companies are now paying substantial Federal income taxes, and in view of the present emergency expect to assume their appropriate share of the increased tax burden. Our

appearance here today is, therefore, not in opposition to increased taxes, but is in opposition to those provisions of H. R. 9827 which in their application to the stock fire insurance business impose unwarranted hardship on this business.

I am not going to burden you again with the history of our sad experience during the base period. I merely want to say that your information is correct, Senator Martin. Our experience was very sad during the first 2 years. Some of our companies made money during the third year, and the fourth year generally our companies made money. But it was worse for the fire companies than for the casualty companies. You may remember we got one real wallop when Texas City went up. I have forgotten how many millions of dollars that cost us. That was during the base period.

The result is, if you are going to use that as our test, we just cannot get the advantage of a fair base.

The invested-capital method of computing the credit affords little or no relief for the stock fire insurance because this business is one of service, and capital is not a dominant factor therein.

Further, the required statutory adjustments of the invested capital credit for so-called inadmissibles work an undue hardship on the stock fire insurance business by drastically reducing the allowable credit—this because a large portion of their investments is in corporate stock and bonds classified as inadmissible assets.

We submit these investments are capital employed in the business and should be treated as such. In this connection the stock fire insurance business rarely borrows money. As a result the interest-paid factor which provides the sole basis for a credit on borrowed capital is not available to our business.

I want to repeat what Mr. Murphy has said as to the casualty business. The stock fire insurance rates are regulated in every State, Senator. Under the rating laws, these rates must be reasonable, not excessive, inadequate or unfairly discriminatory. The reasonableness of such rates is measured by a fair rate of return on earned premiums.

The procedure generally is the filing of your rating plan, a waiting period while the State authority has an opportunity to study it, and if it is not approved by the rating authority, we cannot use it.

At any time the State officials can call a hearing if they think our rates are out of line and order those rates to be reduced.

The result is, I think, without repeating the quotation from the House report, gentlemen, every consideration that moved the House committee applies with equal force to the stock fire insurance business, changing, of course, the basis upon which you are considering the 6-percent return to a percentage of earned premium, because that is the base upon which our rates are made.

We, too, have prepared amendments, as have the casualty people. We have tried to mesh those amendments with them, and we are in agreement with them as to the language of the three amendments they have suggested. We have suggested a fourth merely on the $20,000,000 limit, which we think should be removed.

I want to thank you, Senator.

The CHAIRMAN. The committee thanks you for your appearance. Your statement and proposed amendments will appear in the record.

(The statement and amendments submitted by Mr. Berry read in full as follows:)

STATEMENT OF J. RAYMOND BERRY, REPRESENTING THE NATIONAL BOARD OF FIRE UNDERWRITERS

This statement is made on behalf of approximately 200 stock fire insurance companies, members of the National Board of Fire Underwriters. These companies are now paying substantial Federal income taxes and, in view of the present emergency, expect to assume their appropriate share of the increased tax burden. Our appearance here today is, therefore, not in opposition to increased taxes, but is in opposition to those provisions of H. R. 9827 which, in their application to the stock fire insurance business, impose unwarranted hardship on this business.

The very unfavorable earnings experience of these companies during a large part of the base period 1946–49 is productive of inadequate and unreasonably low credits under the income method of calculating the credit. Two years of the base period were years in which aggregate results for the business as a whole showed an underwriting loss. A number of companies showed an underwriting loss in 3 years of the base period.

It is generally agreed this legislation is not intended to afford a competitive advantage to any segment of a business. However, the application of the income credit provisions of this bill not only creates gross competitive disadvantages for certain segments of the business, but in effect penalizes most heavily those companies which in their efforts to meet the great public need for insurance during years of very unfavorable loss experience extended their writings with the knowledge they were increasing the impact of these loss years by so doing. Companies which restricted and more carefully selected their risks during these loss years now enjoy a decided advantage taxwise under the present provisions of H. R. 9827.

The report of the House Committee on Ways and Means on this bill states in part on page 5:

"The period 1946–49 is the only recent 4-year, nonwar period available. However, it is a period of unusual business prosperity which to a substantial degree was built on the deferred demands, accumulated savings of World War II, and large postwar defense expenditures."

The experience of the stock fire insurance business does not follow that pattern but as stated above, shows aggregate underwriting losses for 1946–47, and a number of companies show underwriting losses for 1948.

The income credit provisions of the bill are further restricted by limiting the growth formula to companies having less than $20,000,000 of assets as of January 1, 1946. This restriction also provides a competitive advantage to some companies.

The invested-capital method of computing the credit affords little or no relief for the stock fire insurance because this business is one of service, and capital is not a dominant factor therein. Further, the required statutory adjustments of the invested-capital credit for so-called inadmissibles, work an undue hardship on the stock fire insurance business by drastically reducing the allowable credit—this because a large portion of their investments is in corporate stock and bonds classified as inadmissable assets. We submit these investments are capital employed in the business and should be treated as such. In this connection the stock fire insurance business rarely borrows money. As a result the interest-paid factor which provides the sole basis for a credit on borrowed capital is not available to our business. Under the World War II law, the unearned premium reserve, while not considered borrowed capital, was allowed to the extent of 50 percent thereof, as an addition to equity capital in determining the amount of credit available. It would be helpful if H. R. 9827 were amended to provide similar treatment.

Stock fire-insurance rates are regulated in every State. Under the rating laws, these rates must be reasonable—not excessive, inadequate, or unfairly discriminatory. The reasonableness of such rates is measured by a fair rate of return on earned premiums. In its report on H. R. 9827, the House Committee on Ways and Means recognized the need for a minimum alternative credit for certain regulated industries, in the statements made on pages 25 and 26 of such report, which, in part, read as follows:

"*1. Minimum credit for certain regulated industries*

"Your committee's bill provides a minimum excess profits tax credit which is available for certain specified types of regulated industries. This credit is an

alternative to the average earnings credit and the invested capital credit for such taxpayers.

* * * * * * *

"The effect of this minimum credit for certain public utilities is to give assurance that an excess-profits tax will not be imposed until after the regulated industries earn a rate of return of 5 or 6 percent after paying corporate normal taxes and surtaxes. Your committee believes that this is appropriate in view of the fact that the profits of these industries in the base-period years were held down well below the profits earned by unregulated industries. Moreover, there is considerable evidence that rate adjustments for these industries lagged considerably behind increases in their costs of doing business. Your committee also believes that where industries are regulated by other governmental bodies providing only a fair rate of return, it is undesirable to consider profits allowed by such regulated bodies as excessive for purposes of an excess profits tax. The 5- and 6-percent rates of return provided for in this minimum credit will be approximately the average rates of return customarily allowed for the regulated industries in question."

We believe these principles apply with equal force to the stock fire-insurance business, and that the benefits of this provision should likewise apply to our business, geared, of course, to a percentage return on earned premiums, in line with the recognized method followed by State regulatory bodies in measuring the reasonableness of our rates.

Proposed amendments designed to afford some measure of the relief sought in this statement are attached hereto.

PROPOSED AMENDMENTS TO H. R. 9827

Amend section 435 (d) by adding thereto a new paragraph 5 to read as follows:

"(5) In the case of insurance companies taxable under section 204, by eliminating from the base period any loss years and averaging the profitable years remaining."

Amend section 439 (b) on page 52 by deleting the following words appearing on line 14: "the sum of the following" and deleting the matter on lines 15 through 19 and substituting therefor the following:

"(1) In the case of an insurance company taxable under section 204, an amount equal to 6 percent of the mean pro rata unearned premiums, determined at the beginning and end of the taxable year."

Amend H. R. 9827 by inserting a new section 446A entitled "Excess Profits Credit—Rate Regulated Insurance Companies Taxable Under Section 204" immediately following section 446, to read as follows:

"(a) The excess profits credit for any taxable year computed under this section shall be the regulated insurance companies credit, as defined in subsection (b).

"(b) The regulated insurance companies credit for any taxable year shall be the sum of the following:

"(1) The tax imposed by sections 13, 14, and 15 for such taxable year, and

"(2) Six per centum of the earned premiums for such taxable year.

Amend section 435 (e) (1) by deleting therefrom subparagraph (B).

The CHAIRMAN. There is one additional witness, Mr. James J. Minot.

Mr. Minot not being here, that completes the call of the calendar for today.

We meet tomorrow at 10 o'clock.

The committee will recess until 10 o'clock tomorrow.

(The following statements were submitted for the record:)

STATEMENT OF A. J. STEWART ON BEHALF OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

Mr. Chairman and members of the committee, I am A. J. Stewart, chairman of the Realtors' Washington Committee of the National Association of Real Estate Boards. 1737 K Street NW., Washington, D. C., and 22 West Monroe Street, Chicago, Ill. Our membership, consisting of 1,107 local real estate

boards and 43,355 individual realtors, represents every phase of the real-estate industry.

I am vice president and in charge of real estate activities for the Citizens Fidelity Bank & Trust Co. of Louisville, Ky. I have been associated with the bank for 31 years. I am a member of the Louisville Real Estate Board and was chairman of the central business district committee of the Urban Land Institute from 1946 through 1949.

We appreciate very much this opportunity of appearing before your committee on behalf of the National Association of Real Estate Boards and its members located in every State of the Union. During the course of our forty-third annual national convention recently held in Miami Beach, Fla., there was considerable discussion centered on the proposed excess profits tax.

This Congress has just completed debate and passed an extension of the Federal rent control law for several more months. This extension was predicated upon the fact that Government witnesses felt rent control was needed to protect the tenants in and about military and defense areas.

Only Government witnesses were heard by both Senate and House Banking and Currency Committees. No representatives of the rental housing industry or of the real estate or financing industries were permitted to testify because, it was pointed out, this is an emergency measure and not necessarily permanent legislation.

In perusing the testimony of these Government officials, we find that they are constantly referring to the need for more rental housing. We are not in any way attempting to argue the merits or lack of merits of Federal rent control. We are mentioning it as a means of bringing to your attention a matter which this Congress felt so important that it excluded testimony of representatives of private industry and business organizations in the interest of expediting passage of a law which will protect occupancy in rental housing for a certain group of tenants.

This points up then, of necessity, the importance of rental housing to the national economy, and it is from the standpoint of rental housing owners that we have requested this appearance before your committee, Mr. Chairman.

This Congress called upon our industry to construct greater and greater amounts of housing each consecutive year since 1946, or shortly after VJ-day. All we heard was housing shortage, the need for more housing. As a result, private enterprise has invested millions upon millions of dollars in an endeavor to provide additional rental housing throughout the United States. The result has been an expansion in the construction of rental housing following the war. Because of this expansion, coupled with the inevitable lag between the time the funds for construction are obligated and the time when the end product begins to produce income, the use of the 1946–49 period as a measuring rod for what might be termed "normal earnings" would place rental-housing corporations in a precarious position even in the absence of all other factors.

Might I call your attention to the fact that during a large part of the proposed base period, housing did not operate in a free market because of rent control, that some housing has been continuously subject to such controls, and that at least the immediate future promises to hold more controls.

Thus, in a realistic sense, housing has been classed as a public utility insofar as operating in a free market is concerned, and has a similar claim to special consideration in excess profits tax legislation.

The legislation, in general, is predicated upon a free market during at least 3 years of the base period, and this free market does not apply to the great bulk of rental property.

Furthermore, it is in the public interest that housing facilities be expanded in certain areas and that they be efficiently operated and maintained in all areas.

Regardless of intent, H. R. 9827 will have the effect of implementing a drive for future Government rental housing instead of private rental housing, unless the measure is so amended as to leave an incentive for private enterprise to do the job. For this reason we do not hesitate to ask that the legislation be so modified as to leave in the field of rental housing an incentive comparable to that afforded other segments of free enterprise.

Our segment of the economy will not profit from the industry yardsticks available to firms in other lines of endeavor, for the widespread effects of rent control make the yardstick itself an unrealistic measure.

If some realistic yardstick of its past earnings is to be afforded the individual business, it should be based on the rental income for comparable uncontrolled

accommodations. Due to the special nature of rental contracts, these afford a yardstick which can be readily projected as representing normal earnings.

We also feel strongly that rental property owners who may have to rely on an invested capital base should be afforded the same treatment whether or not part of their capital has been borrowed.

Let us consider for a moment facilities which cost the X company, the operator, a million dollars. The question is what is a fair return to the X company on this property. The yardstick in the bill is a 12-percent return before taxes—that is, if there is no borrowed money. We cannot see why the yardstick should be less if the company has borrowed part of the money and mortgaged the building. Obviously the borrowing does not substantially affect the company's risk as owner of the building. What has happened is merely that the owners have obtained some of the capital—the relatively riskless part—by way of a loan secured by the property. The corporation has substantially the same risk that it would have had if the money had not been borrowed. It owns the million-dollar building in the same risk sense as if it had not borrowed part of its capital invested in the building. And it should receive the same return on its investment whether or not a relatively riskless part of the necessary investment was obtained by it from borrowed funds which it is obligated to pay.

The mortgage indentures covering rental housing usually required monthly, quarterly, or yearly level payments consisting of both interest and amortization of principal under the World War II excess profits tax. The result was that the portion of the payments consisting of interest gradually decreased over the period of the mortgage, and the portion consisting of principal amortization correspondingly increased. These level-payment provisions produce larger interest deductions and hence less net income in the earlier years and smaller interest deductions and thus greater net income in the later years, thereby causing a material distortion of income as between that in the base period and that in the taxable period.

Because of these factors, the reimposition of the World War II excess profits tax would have a disastrous effect upon corporations owning and operating rental housing. That law, it will be recalled, measured excess profits by one of two methods: (*a*) With reference to the earnings in a normal or base period or (*b*) with reference to an allowable percentage returned on invested capital. Earnings during the excess profits tax period that exceeded normal earnings, or in the case of a taxpayer using the invested capital method that exceeded the allowable percentage of invested capital, were taxed at an effective rate of 85½ percent. As previously stated, only half of the borrowed capital was included in invested capital.

While the World War II law did contain a number of provisions directed to the problem of growth and expansion, and to the problem of distortion of income, such provisions were inadequate even with the use of the relatively stable period 1936 through 1939 as the base period. The result was that taxpayers who had experienced any substantial growth during the base period or the income of whom during the base period was abnormally low because of peculiar circumstances, were relegated to the general relief provisions of the old law. This provision compelled an attempt to show the Commissioner of Internal Revenue what ought to be used as fair and reasonable standards of normal earnings for the properties. In the meantime, however, the owners of the property had to pay the tax, or most of it, computed without the relief, and hope to get it back at some indefinite time in the future, if at all.

Mr. Chairman and gentlemen of the committee, it must be remembered that the owners of rental homes were the only citizens who remained under Federal control after all other controls were removed. In some sections of the country rental homes still remain under control. We feel that it would be only fair and reasonable that consideration be given to the abnormally low income which resulted from the rental of housing as compared with other commodities because rental housing was the only industry—the only commodity, if you please—which remained under control. Therefore, through no fault of its own, this industry in complying with another law adopted by the Congress would be subjected to an unfair tax.

We believe also it would be unthinkable to enact a new excess profits tax whose provisions were such as to place any large group of citizens, such as those in the rental-housing industry, at the mercy of administrative discretion under a general relief section. Ways must be found to meet the problems of the rental housing taxpayers in some other fashion, in our opinion.

Mr. Chairman, permit us to give you two specific examples of how an excess profits tax would affect the rental-housing industry. The Lowich Properties, Inc., a Texas corporation located in Waco, Tex., was organized with a capital stock of $1,000 in 1946 as a real-estate corporation. During the first 2 or 3 years its income was only $2,000 or $3,000 a year. In 1948 this corporation entered into contracts to build two buildings at a cost of several hundred thousand dollars under a long-term lease agreement on each building. The cost of these buildings was paid to a large extent by a loan secured by mortgages on the buildings and assignments of leases, which loans are payable on an amortization plan extending over a number of years. The income representing lease payments is sufficient to meet the payments on the loan including the principal, interest, taxes, insurance, and maintenance with only a little left over. One of these buildings was completed in 1949; the other in 1950.

Under the old excess profits tax law, which was in effect from 1940 until 1945, this corporation would not have a base period which would include the income from these leases. Under section 722 of the Internal Revenue Code the old excess profits tax law provided that a corporation in such situation would be required to pay the tax and then seek relief by refund on the grounds that the tax was excessive and discriminatory. During the process of getting such refund the corporation, such as we have just mentioned, stands to lose its properties through foreclosures for failure to meet the loan payments as a result of having to make the excess profits tax payments. We believe that a proper objective for such corporations would be to provide in any new proposed legislation for excess profits tax a base period which will permit the inclusion of the lease income as normal earnings and not subject to excess profits tax. It should be pointed out in all fairness that these leases were contracted before the Korean War and the income from the leases is not the result, directly or indirectly, of the new national-defense program.

Mr. Chairman, while I realize the committee has already received some information from the Noble-Washtenaw Corp., of Detroit, for the record I should like to review two points of this corporation's problem. This organization, to which I shall refer as the Noble Corp. for the purposes of brevity, is the owner of a project which includes 422 one- and two-bedroom apartments. These apartment units are in some 106 separate buildings consisting of two, four, and six apartments each. All apartments are on the ground floor level with basements. Each has access to a medium-size lawn area on the street side and a large lawn and playground area on the opposite side. The apartments are known as Pittsfield Village located near Ann Arbor, Mich. It covers some 80 acres. It was completed in 1945. Some units were occupied early in 1944.

The village contains and operates its own water system, its own sewerage equipment, fire equipment, and playgrounds. It maintains and cuts all lawn areas, removes snow, garbage, and provides the other services ordinarily provided by a municipal government. In 1946 it added a $60,000 water softening plant. In 1947 some 2 miles of roads in the village were paved, and in late 1949 and early 1950 an additional $78,000 worth of gas-burning furnace units were installed in the village to replace rather unsatisfactory wartime coal-burning units.

As some of the construction was done with wartime materials, it had to be replaced. This activity included painting, digging, or improving drains, and making sewerage changes on the basis of demands by the State health department. This involved some $60,000 of additional improvements. The village was constructed on a 608 mortgage loan from the Equitable Life Assurance Society, insured by FHA in the amount of $2,244,000.

The mortgage originally called for level monthly payments commencing in March, 1945, of $11,200 of which amount approximately $7,480 would be interest at 4 percent and $3,740 would be principal, with an additional replacement reserve payment required by FHA of $1,599.17 monthly. An additional loan of $50,000 was made by the same insurance company and insured by FHA to finance the water softening plant which has been mentioned before. To cover this investment the mortgage was amended to call for a level monthly payment of $11,660.37 commencing in May, 1946. At the same time the monthly replacement reserve was increased to $1,722 monthly. An additional amendment to the mortgage provided for $60,000 in additional loans to cover the gas-burning furnaces. That was a 5-year loan and increased the level payments to $12,765.37 monthly to and including September 1954, when it returns to the former amount of $11,660.37.

Rents in this project originally were set by the Federal Government agencies at a rate to yield approximately 10 percent. From the time the first units were rented in 1944, however, through 1949, this project was subject to Federal rent

control. While some small measure of relief on the project's rents was secured during this period, it never was allowed quickly enough or in amounts sufficient to keep pace with the rapidly rising costs and taxes. In addition, during the years 1944 through 1949 the company had numerous expenses of nonrecurring nature of the sort mentioned above growing out of wartime construction and operation, together with the usual problems in the commencement of such a rental property operation as this.

Consequently, and as a direct result of the imposition and continuance of rent control in this project during the proposed base period years of either 1946 or 1947 through 1949 and of nonrecurring expenses which we have previously recited, the Noble-Washtenaw Corp. did not earn anything at all as it should have, or normally could have, during these years, nor enough to carry it through the years lying immediately ahead. In January 1950 this project was decontrolled and with a 10 percent increase in rental ratios at that time, plus adjustments made during the period that general rent controls had been invoked, a profit was beginning to show up against a decrease in the nonrecurring expenses mentioned before.

With this information at hand it shows how utterly unfair it would be to say that this company and similar companies of this type all over the Nation, whose net incomes for the years 1947 through 1949 were controlled by the Federal Government, would be required to make an additional sacrifice if excess profits taxes are levied.

Mr. Chairman and members of the committee, we do not feel that these owners and other owners like them should be penalized again for their compliance with a Federal rent-control law. The general relief provisions of the World War II law did not and would not give adequate relief to businesses in the same situation as mentioned heretofore. It is a matter of record that approximately $10,000 of the Noble Co.'s principal and replacement reserve payments on its mortgage must come from the earnings after payment, of course, of all Federal income taxes. It should also be called to the committee's attention that the Noble Co. in its 7 years of existence has never paid any dividends to its common-stock holders nor any salaries or directors' fees to any of its officers or directors. Everything has been put right back into the company.

Mr. Chairman, we have several general snggestions to make for consideration of the committee and one or two specific suggestions which might be applied to this industry. Hundreds of corporations throughout the nation have responded to the request of the President and the Congress to provide rental housing. Now there is a lot of misunderstanding about the part FHA plays in providing the insurance for this housing. Under a 608 mortgage, FHA insures the money which is actually borrowed from private concerns. For example, the Noble Corp. borrowed its money from the Equitable Life Assurance Society. This loan was insured by FHA, and the borrower paid a premium. Thus, not 1 cent of Federal money actually is invested in these properties. The credit of the Federal Government is extended to the lending institutions and, if anything goes wrong with the loan, the insurance reserve and Federal credit will be there to protect the institution.

Stressing the fact that the money is actually borrowed from private concerns and that a premium is paid for the insurance by the borrower, may we respectfully suggest to the committee that 100 percent of the borrowed capital be included in the computation of invested capital. Perhaps a formula could be adopted which would provide an amount equal to the normal tax and surtax, plus 6 percent of the entire capital, both equity and borrowed. This provides for a 6 percent return on the investment after payment of taxes. Over and above that figure an excess profits tax, if any is imposed, could be computed.

We strongly urge that the law be designed to provide for what the Congress intends and not leave the decision to administrative discretion. We are apprehensive about any possible fairness if the discretion is left entirely to administration.

For that reason we support what is commonly known as the push-back method which would provide a hypothetical income on the basis of the capacity at the beginning of the excess profits tax period and on the basis of the rents and the prices then prevailing being computed for the purpose of the tax. If a fair hypothetical base period for net income can be constructed on the basis of the taxpayer's capacity as of the beginning of the excess profits tax period, we believe it would take care of a large part of the expansion and growth problem, as well as the rent control problem, which is peculiarly applicable to the rental housing industry.

As another alternative, Mr. Chairman, we respectfully suggest that the committee also might give consideration to deducting from net income, to arrive at excess profits net income, the income, less all expenses properly applicable to the property which was under Federal rent control during all or substantially all of the base period years.

Another suggestion, Mr. Chairman, may be to consider the possibility of giving a lump-sum exemption for properties, based upon the number of units under control, the number of years which they were under control, and the average rent presently being received from those years computed so as to give those companies the benefit of the difference between their present income and the previous income from rents, permitting that as a deduction in the form of a lump sum. This would give some consideration to the fact that income was not normal during the period of time that the properties were under rent control.

We realize, Mr. Chairman, that the committee's task is great. We are cognizant of the effort which the committee is making to obtain additional income to offset the increased costs for the defense program. The National Association through its membership is most anxious to cooperate and do everything possible to help the committee attain this objective. We do feel, however, that the matter of the unfairness presently existing, because of a frozen income during a period of years due to rent control imposed by the Federal Government, should be brought to the committee's attention.

STATEMENT OF PHIL B. SWING, PRESIDENT OF THE NATIONAL ASSOCIATION OF WHOLESALERS

The membership of the National Association of Wholesalers consists of the following trade associations in the wholesale field: The American Coal Sales Association; National-American Wholesale Lumber Association; National Association of Tobacco Distributors; National Wholesale Druggists Association; Wall Paper Wholesalers Association; Wholesale Dry Goods Institute. Each of these individual associations includes in its membership a great number of member wholesale firms of all sizes.

The National Association of Wholesalers object to the so-called excess profits tax included in H. R. 9827 for the following reasons:

1. Wholesalers generally have relatively small invested capital in proportion to their volume of business and normal earned income. As a result the so-called excess profits tax in many instances would be applied to the number of dollars they earned in excess of those earned in their base period years. However, during inflation the total dollars earned annually including the so-called excess dollars may not exceed the actual value of the lesser number of dollars earned annually in the base period years. By the same token the number of unit transactions of the wholesaler may not exceed those of the base years. Therefore, the so-called excess profits tax would be applied to earnings which in fact do not exceed the actual value of the base period earnings.

2. An excess profits tax is inflationary in that it inevitably results in some degree of taxpayers' extravagance as to expense items which are deductible in computing taxes.

3. The so-called excess profits tax would not produce a definitely predictable volume of future Government revenue as would an increase in ordinary income tax rates. Furthermore, the so-called excess profits tax would not produce as much additional Government revenue as would an increase in the regular income tax rates.

4. The so-called excess profits tax would be more difficult and expensive for the Government to administer in view of the complicated character of the tax.

5. The so-called excess profits tax would discourage business expansion. This means that it not only would discourage the establishment of new enterprises but it also very definitely would discourage the further development and expansion of established businesses.

In view of the foregoing, the National Association of Wholesalers in a recent meeting authorized and requested the submission of this statement in opposition to the proposed excess profits tax.

STATEMENT OF GEORGE S. EATON, EXECUTIVE SECRETARY, NATIONAL TOOL AND DIE MANUFACTURERS ASSOCIATION, CLEVELAND, OHIO

My name is George S. Eaton, and I am executive secretary of the National Tool and Die Manufacturers Association, Cleveland, Ohio.

Our association has as members leading contract tool, die, and machine manufacturers. All are small-business men, with employment ranging from 200 down to 5. They have repeatedly been referred to as typical small-business men, and my testimony will be from the viewpoint of these small-business men, most of whom fared very poorly indeed under the World War II excess profits tax.

Our members have indicated strong opposition to any kind of an excess profits tax—not because of any desire to avoid payment of their share of the taxes made necessary by the enlarged defense program, but because they firmly believe an emergency defense tax added to the regular corporate income tax will be much fairer and administratively much more workable.

Because of the fundamental difficulties in devising an equitable basis for an excess profits tax, and its encouragement of wasteful expenditures and methods of operation, the tool, die and machine manufacturers oppose the establishment of such a tax at this time.

They agree, however, that the heavy and unusual cost of the enlarged defense program should be paid for by current taxes. And, of course, corporations must expect to bear their share of this increased tax burden. At the same time, they must not be loaded down with more than their share—partnerships, individuals, and other sources of tax revenue must likewise contribute their shares.

Since the money is needed to meet an emergency, tool and die shop owners believe that the necessary tax should be definitely labeled as an emergency tax, and therefore do not favor merely increasing the corporate income-tax rates, to raise the corporations' share. In place of an excess profits tax, they would favor imposing a special tax consisting of a flat percentage increase to be applied to the regular corporation taxes.

This tax might be termed a "corporation defense tax." The basic corporate income-tax rate should be set back to the 38-percent rate in effect before the Revenue Act of 1950 was passed, by changing the normal tax rate from 25 percent to 18 percent, leaving the surtax rate at 20 percent as now provided. This change would be logical inasmuch as the recent increase to 45 percent was necessitated by the need for raising money for the defense program.

The next step would be to determine what percentage increase of the corporate income tax would be needed to raise the corporations' fair share of the total increase required in taxes. This percentage would then be applied to the corporation taxes figured in the usual way.

A brief explanation of the character of our industry will help in understanding our opposition to an excess profits tax.

These contract, or job, shops make to order specially designed tools, dies, jigs, fixtures, gages, molds, and special-purpose machines. Usually there is only one of a kind ordered. Many of them also do precision machining on a jobbing basis. Their men often must work to a thousandth or even a ten-thousandth of an inch.

Without this special tooling, the machinery of a mass-production plant must stand idle.

Those who own and manage the tool and die shops ordinarily supply the capital for their operations. Control of the firm is usually in the hands of one, two, or three individuals who have come up through the ranks as tool and die makers, die sinkers, or men of similar skill. Of the better established shops, about half are incorporated.

Some primarily serve one industry or one group of industries—others another. Their profits vary much more than for manufacturing generally, and in any one year some will be prosperous while others are losing money. There is no stability of operations, as the business of these tool, die, and machine shops is entirely dependent on orders from mass-production manufacturers who are bringing out new or revised models of metal or plastic articles.

A shop for a couple of years may have been working out some speciality, or concentrating on getting new customers, or rebuilding its manpower (it takes at least 4 years to train a tool and die maker), and will have a very small profit average in the postwar period. Yet it may now be in position to cash in on its previous efforts, and should not be prevented from doing so by a confiscatory excess profits tax. In particular, a new shop—and many have started since the war—may have had no chance to build up a profits record.

What happened profitwise last year or 3 years ago is no real guide as to what may happen this year or next year. And swings in profits in the tool, die, and machine industry are greater than for most other industries.

For that reason, the way to take the profit out of the defense effort is to tax the shops in the years when they make a profit without too much regard to what they may have done in previous years. Of course, those operating as sole proprietorships or partnerships as well as corporations should bear their share of increased taxes.

Even though we do not favor any excess profits tax, it would seem in order to offer comments on some of the suggestions that have been advanced for such a tax.

First, the plan to cut back the profits realized in the base period, to only 75 percent in order to obtain the exempted base. And then to tax all profits over that 75 percent base at a 75 percent rate.

How anyone can seriously refer to this plan as one that is easier than the World War II excess profit tax is incomprehensible. Take a small corporation earning a yearly average of $100,000 in the base period. Only $75,000 of this would be allowed as exempt earnings. Now suppose the earnings are doubled. A tax at 75 percent must then be paid on $125,000, which amounts to $93,750, or 93+3/4 percent of the actual increase in profits. At the World War II rate of 85½ percent, on $100,000 the tax would be but $85,500. Or suppose the same corporation earns only $125,000 next year. The 75 percent tax on $50,000 would be $37,500, or 1½ times the total increase in profits, whereas in World War II it would have been 85+½ percent of $25,000, or only $21,375.

If someone points out that profits in the proposed base period of 1946–49 are higher than in the old base period of 1936–39, the answer is that so is everything else measured in dollars. And in World War II, practically all business was war production, whereas now very little is.

In any case, to reduce actual profits to get a lower profits exemption is to admit that the plan is to tax what are held by some to be high profits in past years, and not to take the excess profits out of defense business.

Certainly no surer way could be found to remove all incentive for expanding production or keeping down costs than to tax increased profits at 93¾ percent, up to 150 percent, or even higher.

Two alternatives have been widely discussed for determining the base exemption of profits, namely, the average profits during the best 3 years in the 1946–49 period, or a percentage on capital investment. Neither of these will be equitable for a great many tool and die shops. Therefore, we recommend that a third be added, a percentage on gross sales, at least for small manufacturers. And we suggest 15 percent as the figure.

In a cyclical and erratic industry such as ours, any shop making less than 15 percent before taxes, on gross sales, in normal years can hardly expect to stay in business, to say nothing of expanding. This proposal should receive careful attention. It would be especially important for new businesses, and expanded businesses.

As regards the base period alternative, the suggested years 1946–49 are the most equitable, so long as the option is given of choosing the best three out of those four, as the base period. This option is very important, in view of the greatly varying profit experience of the different shops since the war.

You are, of course, familiar with the widespread dissatisfaction with the excess profits tax of World War II, and the thousands of claims that are still unsettled, amounting to $7,000,000,000, more than 5 years after the end of hostilities. While the great majority of the tool and die manufacturers felt that the tax was unfair to them, because of the inflexible base period and the uncooperative attitude of the Bureau of Internal Revenue, not many have persisted in efforts to obtain relief because of the expense, time, and trouble required. It was almost impossible to get any relief from the Bureau of Internal Revenue, under the rigid and inequitable rules it set up, which simply ignored the evident intent of Congress to provide equitable relief. Therefore, any flexibility that Congress wishes to include should be clearly spelled out in any new excess profits tax law, if the relief is to be effective.

To prevent the excess profits tax from throttling very small businesses which must plow back their earnings into the business if they are to grow and to allow other small businesses to replace their worn-out equipment—which present depreciation allowances will not do—or to add to their facilities, it is recommended

that the first $25,000 to $100,000 of profits before taxes should be exempted, depending upon the size of the company, in accordance with the following table:

Total employment:	*Profits exemption*
1 to 25	$25,000
26 to 50	50,000
51 to 75	75,000
76 to 100	100,000

In our industry there is no justification for making an excess profits tax retroactive to cover part of 1950. Very little of the business of the tool, die, and machine shops has been for rearmament tooling. Even as late as October 25 reports received by our association from various tool centers over the country showed that only a small part of the special tooling then being made in the shops was for rearmament—not more than 10 to 20 percent. Earlier it had been almost negligible in most areas. After very generally poor business in 1949 and early 1950, orders for special tooling took a definite turn for the better in March of this year, and there was a very strong upturn in shipments in June. There is good reason to believe that this improvement would have continued throughout 1950 if there had been no Korean war. And retroactive legislation has no place in a democracy.

Special incentives could properly be provided for plant expansion and modernization through lower taxes on profits so spent. This would help the shop owners prepare their equipment for more efficient production, which would be especially valuable in case an all-out effort becomes necessary. Likewise, it would be fine for the civilian economy.

The political pressure for a tax labeled as an excess profits tax is recognized. But the typical independent small businessmen in our industry believe that the public has proved it is aware of the need for sound thinking and courageous action on the part of the lawmakers and will approve your doing what is really best for the country rather than taking action to meet a demand from certain elements of the population not based on an understanding of the problem—or any real desire to solve it—or clear thinking about the effects of an excess profits tax as compared with more equitable, effective, and workable alternatives.

STATEMENT OF ROBERT P. SCHERMERHORN, CHAIRMAN, TAXATION COMMITTEE, BUFFALO CHAMBER OF COMMERCE

After thorough study of all aspects of the excess profits tax proposal by appropriate subcommittees and the taxation committee as a whole, the following statement was resolved by the committee and unanimously approved by the board of directors of the Buffalo Chamber of Commerce on November 20, 1950:

"The Buffalo Chamber of Commerce has long advocated a pay-as-you-go policy for the Federal Government. It now advocates a pay-as-you-fight policy. We believe in a balanced budget arrived at by foregoing less essential peacetime activities and drastically cutting down on expenditures on deferable programs. As additional revenue may be required, we urge that sufficient funds be raised to balance the budget by imposing a nonretroactive emergency tax at a rate to be determined by Congress. We are of the opinion that such an emergency tax should be in the form of either an emergency surtax in addition to existing corporate tax rates or in the form of a flat rate, across-the-board manufacturers' tax imposed once only at the final stage of manufacture. Any emergency tax imposed should be limited to the duration of the emergency. We respectfully request that the Congress carefully give consideration to these alternatives to an excess profits tax.

"While the so-called excess profits tax has a popular appeal, it is economically unsound and has many bad features. Chief among the defects are:

"1. The difficulty of selecting a fair base for imposition of the tax.

"2. The undue burden of filing complicated tax returns placed on small business enterprises and the possibility of being subject to penalties for failure to meet technical requirements of the law.

"3. The high cost of collection of revenue derived from an excess profits tax as compared with the costs of collecting other taxes. (In this connection it should be kept in mind that a substantial portion of the collections classed as excess profits taxes would be recovered as normal and surtax if it were not for exemptions granted on amounts subject to the excess profits tax.)

"4. The unnecessary, costly, and prolonged litigation in the ultimate settlement of the liability of the tax. (There are still cases in the courts from 1917.)

"5. The extravagance, waste, and high overhead expenses which result from imposition of such a tax.

"The Federal Government itself can materially aid the defense effort by curtailing normal activities as previously mentioned, thus making more tax dollars available for the emergency, and by strictly controlling defense procurement. Much of the overbuying in wartime could be prevented by more prudent procurement and more effective controls. The establishment of a Civilian Control Authority to police the spending of the Armed Forces procurement agencies would result in a more orderly plan to reduce the possibility of wasteful spending for unneeded supplies and equipment.

"Summarizing briefly, to raise additional funds, the Buffalo Chamber of Commerce advocates the imposition of a nonretroactive emergency defense tax to put the United States on a pay-as-you-go basis; that consideration be given to an increased surtax or a manufacturers' tax in place of an excess profits tax; that the Federal Government severely cut its peacetime activities and expenditures and that a civilian control be established to plan defense procurement and assist the Armed Forces procurement officers in curbing unnecessary spending."

The representative make-up and the expert qualifications of the members of the taxation committee of the Buffalo Chamber of Commerce are evidenced by the following list of its members and their business connections:

Ralph M. Andrews, partner, Hodgson, Russ, Andrews, Woods & Goodyear, attorneys.
L. Robert Arthur, assistant vice president, Liberty Bank of Buffalo.
W. R. Bonthron, tax manager, Price, Waterhouse & Co.
Homer Browning, vice president, Marine Trust Co., of Buffalo.
Robert S. Elster, owner, Thomas Elster Co.
Normal F. Ernst, vice president, Ryan & Cable, Inc., general insurance.
Karl E. Felmeden, vice president, J. F. Adams, Co., Inc.
Charles J. Gerber, treasurer, Orchard Park Veneer & Container Corp.
Clay W. Hamlin, general agent, Clay W. Hamlin Co., general agents.
George F. Jebbett, assistant vice president, the Corporation Trust Co.
Edgar G. Lucker, senior partner, Lucker, Kennedy & Felmeden, accountants.
Frank J. Maguire, partner, Albrecht, Maguire, Heffern & Gregg, attorneys.
Vincent G. Mansell, secretary and treasurer, Power Drives, Inc.
Charles E. Metz, secretary, Erie County Savings Bank.
James G. Miller, president and treasurer, Great Lakes Concrete Pipe Co., Inc.
Milton E. Moshier, assistant to general manager, Bethlehem Steel Co.
Lee L. Norton, vice president, Erie County Savings Bank.
R. Vaughn Pierce, president, Pierce's Proprietaries, Inc.
George F. Brunner, executive vice president, Buffalo Real Estate Board.
William L. Clark, treasurer, Buffalo Electric Co., Inc.
Joseph Cottrell, president, Cottrell Bus Service.
Herbert F. Darling, general contractor.
Roderick Potter, president, Ellicott Square Co., of Buffalo.
Claude O. Rainey, secretary and treasurer, Morrison Steel Products, Inc.
William J. Regan, president, Bison Liquor Co., Inc.
John W. Rembold, accountant, Continental Grain Co.
H. E. Riordon, controller, Sylvania Electric Products, Inc. Colonial Radio and Television Division.
W. G. Ritzer, comptroller, Twin Coach Co., Buffalo Division.
John W. Sanborn, partner, Percival G. Bixby & Co., accountants.
Robert P. Schermerhorn, certified public accountant, Robert P. Schermerhorn & Co., accountants.
Weldon D. Smith, president, Oliver Gear & Machine Co., Inc.
Arthur E. Surdam, senior partner, Amen-Surdam & Co., accountants.
Joseph H. Terreberry, agency manager, Marchant Calculating Machine Co.
Mark N. Turner, partner, Brown, Kelly, Turner & Symons, attorneys.

Policy statements of the Buffalo Chamber are thoroughly reviewed by our board of directors composed of leading executives of the Niagara Frontier area. The members of the board who approved the foregoing statement are listed below:

Jack A. Ahern, vice president, Manufacturers & Traders Trust Co.
Charles W. P. Atkinson, vice president and treasurer, the Arner Co., Inc., pharmaceutical manufacturers

Samuel S. Auchincloss, vice president, Pinspotter, Inc., Division, American Machine & Foundry Co.
George R. Bennett, president and treasurer, George R. Bennett Co., Inc., food brokers.
John C. Best, vice president, National Gypsum Co.
Louis R. Botsai, general manager, Westinghouse Electric Corp.
Fred C. Boyd, district manager, New York Telephone Co.
Norman J. Brautigan, general manager, Rock Island Lumber Co., Teachout Division.
Joseph H. Coon, district manager, Sun Oil Co.
Charles H. Diefendorf, president, Marine Trust Co. of Buffalo.
George W. Gleasner, president, the Gleasner Corp., contractors' equipment.
John J. Lee, vice president, Twin Coach Co.
Edmund F. Martin, general manager, Bethlehem Steel Co.
Lee L. Norton, vice president, Erie County Savings Bank.
Albert T. O'Neill, vice president, Niagara Mohawk Power Corp.
John R. Peachey, president, Loblaw, Inc.,. grocers.
Howard W. Pearce, president and treasurer, Pearce & Pearce Co., Inc., builders and real estate.
Ray H. Puffer, laboratory superintendent, Cornell Aeronautical Laboratory.
P. O. Rial, executive vice president and secretary, Weed & Co., hardware, wholesale.
Austin C. Ross, vice president, Worthington Pump & Machinery Corp.
Wade Stevenson, president, Eastman Machine Co.
George E. Taylor, AGFA, New York Central System.
Herbert M. Uline, vice president, Adam, Meldrum & Anderson Co., department store.
Oliver J. Veling, president, Dohn, Fischer & Co., Inc., lumber and millwork.
Herbert J. Vogelsang, president, First National Bank of Buffalo.
Alton A. Way, plant manager, Chevrolet, Tonawanda, GMC.
Keith Williams, president, Pratt & Letchworth Co., Inc., foundry.

REDUCTION IN NONDEFENSE SPENDING

The Buffalo Chamber of Commerce has been the leading exponent in our region in advocating the adoption of the recommendations of the Hoover report to bring about increased efficiency and greater economies in the operation of the Federal Government. In meeting the enlarged expenditures to increase our military strength to defend the Nation from communistic aggression, it is self-evident that the first source to seek those funds should be a prompt and substantial reduction of nonmilitary spending. Qualified reports from within the Government itself have indicated potential annual savings of $6,000,000,000. Curtailment of Federal nonmilitary spending is of prime and immediate importance, first, to check the inflation which it has long been generating; second, to redirect increasingly scarce manpower and materials into the defense effort; and third, to establish on the part of the Federal Government an example for every citizen, organization, and business in the Nation to emulate in shifting from less essential spending to essential military investment and saving for increased economic strength against our Communist enemies. American citizens bitterly resent that the Members of Congress propose to impose sharply higher taxes on the grassroots communities when those same citizens daily observe the wastefulness and squandering of their very substance by Federal Government agencies both in Washington and in the field.

REDUCED SPENDING NEEDED TO CHECK DEPRECIATION OF DOLLAR

It is a classical axiom in Marxism economics that capitalistic societies, of which the American Nation is the highest development in all history, are weakened and destroyed most readily by a rotting currency, that is, by a depreciation in the buying power of money, commonly called inflation. The alarming fall in the buying power of the dollar has resulted from the recurring unbalanced budgets of the Federal Government over the past two decades. This improvident financing of the Federal Government, inspired by short-sighted political considerations, has shown cynical indifference to the long-range health and strength of the Nation. In consequence, although the value of the dollar has already declined more than 50 percent, the prospects for a still further substantial decline under prevailing Government policies has generated since Korea a renewed and violent rise in commodity prices. The Buffalo Chamber,

therefore, clearly foreseeing the disasters lying ahead in the continued depreciation of the dollar, advocates a pay-as-you-fight policy, cost what it may in taxes and deprivations to individual and business taxpayers alike.

In imposing additional taxes as a means to preserve the waning integrity of our dollar, however, the Buffalo Chamber takes the position that the excess profits tax, as proposed by President Truman, is the worst possible form of taxation that could be thrust upon the national economy.

When we were informed by telegram on November 17, 1950, that oral testimony would be admitted to the hearing of the House Ways and Means Committee only on the condition that it would relate solely to kind of details in an excess profits tax bill, we sent the following telegram:

"Mr. CHARLES W. DAVIS,
Ways and Means Committee,
House Office Building, Washington, D. C.:

"The Buffalo Chamber of Commerce acknowledges your telegram received late yesterday, response to our request of October 25. You offer chamber spokesman 15 minutes to present oral testimony at hearing on administration's excess profits tax proposal but impose narrow restrictions limiting admissible testimony solely to kind of details in excess profits tax law. We regard foreclosure of full exposition of defects as unfair.

"Our testimony would explain bad economic consequences of excess profits tax on Buffalo economy, especially with respect to smaller growing enterprises.

"As Buffalo Chamber is not prepared to accept in principle any form of excess profits tax which is always bad, we regret that we are being denied opportunity to present our views, respectfully request that scope of your hearing be broadened to analysis of evils of excess profits tax, alternative ways of raising adequate defense revenue with less injury to general citizenry and our productive economy essential to national defense, and ways to effect savings in Federal nondefense spending. We shall file written statement on these matters trusting that it may be included in the printed record of the hearings."

CHAMBER'S PRIOR CONDEMNATION OF EXCESS PROFITS TAX

The position of the Buffalo Chamber of Commerce in condemning the excess profits tax in principle is one of long standing. Mr. Charles C. Fichtner, then chairman of the taxation committee of the Buffalo Chamber of Commerce, testified in support of repeal of the excess profits tax law on March 20 and 21, 1945, before the select committee of the House of Representatives created under House Resolution 64, Seventy-ninth Congress, to conduct a study and investigation of the national defense program in its relation to small business in the United States. As members of the Ways and Means Committee have access to the printed record of that hearing, reference need be made here only to part 1, pages 6–21 and pages 44–62, for our reasons and evidence leading to the conclusion "the excess profits tax should be repealed immediately," and that "the excess profits tax should not be retained as part of the permanent peacetime tax structure." In other words, our view is that the excess profits tax has no place in the tax structure in wartime or peacetime.

REVENUES OF EXCESS PROFITS TAX EXAGGERATED

The name, "excess profits tax," is supposed to have great political appeal. If so, that is its sole merit. Experience with the levy in two major world wars has proved that only in a very minor degree is it an effective instrument to seize profits caused by war. In so doing, the tax has caused such serious inequities and such uncertainty that the additional cost to the Government far exceeds the small amount in net revenue which can be attributed to it. Moreover, there are other types of taxes which would raise the equivalent revenue without the same deleterious results. That equivalent revenues could have been raised in both world wars without the complications of the excess profits tax by raising the rates of corporate net income tax has been acknowledged by former Assistant Secretary of the Treasury John L. Sullivan and former Director of Tax Research of the Treasury Department, Mr. Roy Blough.

The techniques developed in World War II in renegotiations of war contracts, the repricing of war contracts under title VIII of the Revenue Act of 1943, the profit limitations under the Vinson-Trammell Act, regulations on cost-plus-fixed-fee contracts and other restrictions placed on war profits have proved effective in limiting profits to that minimum needed to cover risk and no more. As

these techniques are now again to be employed, an excess profits tax would seem unnecessary providing the Government meets its responsibility of maintaining a sound and stable currency.

INEQUITIES OF EXCESS PROFITS TAX

The excess profits tax in principle is inequitable. No satisfactory solution has ever been found or ever will be found to the baffling problems encountered in the effort to define "excess profits." One approach is to define "excess profits" as those in excess of the normal rates of return overaged over a period of years. The valution of investments is an exceedingly complicated and highly discouraging undertaking, however, as has been proved in prior experience with the excess profits tax, with property taxation, and with the valuation of public utilities for rate-making purposes. Questions arise as to whether borrowed capital should be included in whole or in part as investments; how good will and intangible values shall be appraised; whether investment values should be revised annually, expressed in historic or current prices, etc. Some corporations have relatively large investments, others relatively small investments, in producing similar gross sales and incomes. If income is derived primarily from personal efforts rather than from investment, should that income be subjected to the same tax formulas measuring excess profits? Executives of many small corporations in Buffalo feel that the income of their corporations arises largely from the efforts of management rather than from capital investment. Personal service corporations, which offer very peculiar problems, have had to be allowed the privilege of being taxed as partnerships in order to meet in part the perplexing question of valuation.

IMPOSSIBILITY OF FIXING "NORMAL PROFIT"

Another difficult problem in the excess profits tax approach is the determination of the normal rates of return upon investments which may be used as a basis for separating "excess" from "fair" profits. Because of the differences in the risks assumed, great variability prevails in the profit ratios among different industries, among enterprises in a particular industry, and among many individual corporations over a period of years. Corporate profits are characteristically uncertain, varying with both general and particular economic conditions. While theoretically certain economic forces should tend to reduce profits toward a common norm, other forces are always at work preventing profits from maintaining a normal relationship to the investment. Consequently, some arbitrary rate of return must be selected as a measure of normality for tax purposes, since it is not feasible to tax every corporation with reference to the rate of return which appears to be normal in view of its peculiar investment, cost, sales, income, and other factors. The ratio of profits in a single year or even in a few years will not provide a suitable basis for determining excess profits unless this ratio, as seldom happens, changes little from year to year. If a long period is adopted, there are usually other fundamental changes in the economy which make the frame of reference in a single enterprise inapplicable.

EXCESS PROFITS TAX WAS BAD IN WORLD WAR II

As a partial offset to the insoluble problems of valuing investments and determining normal profit ratios, the excess profits tax of World War II provided that corporations could be taxed on the income in the tax year in excess of an average income over a base period of years which was presumed to be normal. In that law normal profits were considered to be 95 percent of the average income of the four prewar years of 1936–39, with the illogical implication that the remaining 5 percent represented excessive profits. In the proposal brought to your committee by Secretary John Snyder on November 15, 1950, that average was suggested at 75 percent of income in postwar years. We submit that the implication that the remaining 25 percent in the period of 1946–49 represents excessive profits is arbitrary and illogical.

In World War II most of the smaller and medium-size manufacturing enterprises in the Buffalo area used the average earnings option because it resulted in a lower tax liability and was simpler to calculate. Nonetheless, many of these Buffalo corporations have insisted that their 1936–39 income did not indicate their normal income. Many firms in Buffalo will quarrel violently with

Secretary Snyder's idea that a 75 percent average of their 1946–49 earnings is a proper measure of their current normal earning power. Congress, of course, has recognized by the numerous adjustments permitted under section 722 that this average earning base is not a normal income base for many corporations as well as that the invested capital method is unreliable. In short, in view of the relatively few grants on the many thousands of applications for relief under section 722, the conclusion is inescapable that the problem of measuring excessive profits is wholly insoluble.

ADVERSE EFFECTS OF EXCESS PROFITS TAX ON SMALL BUSINESS IN BUFFALO AREA

Regardless of the method whereby excessive profits may be measured, and whatever modifications may be added to alleviate the harsh burdens of the tax, new growing enterprises will always be penalized by comparison with mature or declining enterprises. The excess profits tax of World War II was a crushing burden on smaller corporations in the Buffalo area, many of which lacked substantial surpluses at the outset of the war which could be used to finance their expansion. Reinvestment of earnings was sorely needed to provide machinery and working capital to produce war materials. The earnings of small business have often arisen chiefly from the efforts of the management in successfully utilizing a small investment of capital. The excess profits which were taxed away were merely a return for personal exertion and ability to produce without drawing on capital equipment needed elsewhere in the defense effort. Since we may assume that the getting of war materials produced is the vital matter, rather than measuring the amount of investment drawn from other alternative uses of that investment, it is clear that the excess profits tax exerts a reverse bearing on incentives and motivations and, therefore, is unsound economically.

Small enterprises, moreover, tend to suffer a double disadvantage because they are penalized either by the invested capital or the base period income method of determining their excess profits. Many have had no adequate prewar record of earnings. It is typical of new enterprises that their early years are loss years. Unlike most larger and older corporations, therefore, they simply have no avenue of escape. This gross inequity is underscored by the statistical record showing that many large corporations with earning ratios on their investments higher than those of smaller corporations have completely escaped payment of any excess profits tax.

The excess profits tax has the further defect in that it offers significant advantages to monopoly enterprises which find themselves in a sheltered position and, thus, can secure higher earnings free from excess profits taxation.

The excess profits tax, therefore, destroys new and small businesses and shelters old and established businesses; it is a tax on initiative and risk taking; it penalizes growth and rewards ossification; it is the enemy of flexibility and adaptability in the economic system.

EXCESS PROFITS TAX IS INFLATIONARY

We have noted that the spokesmen for the labor unions have advocated an excess profits tax even more severe in detail than the one presented by Secretary Snyder. We believe that the motives behind this position must be carefully examined in light of the fact that the high excess profits tax rates weaken the resistance of employers to demands of unions for wage increases. We believe that the unions are asking for an excess profits tax, not because it is anti-inflationary but, on the contrary, because it would be inflationary on wage rates. If wage rates continue to advance, the cost-of-living inflation will not lag far behind.

We hold that the excess profits tax is inflationary, first, because a high tax rate on profits is an encouragement to business spending on any item of cost which is deductible for tax purposes; second, because it adds to the wage-price spiral; and third, because by limiting reinvestment of profits in productive capital and by discouraging incentives to produce, it tends to shrink the production of goods which are necessary to hold down a general price rise on the supply side of the price equation.

A TAX SHOULD NOT BE RETROACTIVE

We also object to the proposal of the labor unions that this tax be made retroactive. One of the cardinal principles of sound taxation is that of certainty.

To impose taxes retroactively to July 1, 1950, or to any other date in the past, violates that elementary principle of fair play and stultifies the integrity of all current corporation financial statements.

SUMMARY

The excess profits tax, in summary, is so rife with inequalities, complexities, and uncertainties that in the judgment of the Buffalo business community, the proposal to use it should be firmly rejected in the interest of not impairing our defenses against communism.

Proposals to write an excess profits tax bill with provisions to exempt certain industries and to set up machinery to alleviate hardships should also be rejected. However devised, it is always a bad tax. World War II was won in spite of an excess profits tax. In the long period ahead of maintaining industry and the military on a war footing, on which Soviet Russia plans to keep us, however, the excess profits tax would be fatal to ultimate victory. Unless the industries of the Nation are permitted to earn a rate of return that will attract capital and permit reinvestment of part of their profits for further growth, industrial production, our greatest source of military strength, must inevitably falter and lag. The issue is not only one of maintaining private enterprise; it is the military security of the Nation itself that is at stake.

STATEMENT OF DUDLEY J. LE BLANC, PRESIDENT, THE LE BLANC CORP., LAFAYETTE, LA.

My name is Dudley J. LeBlanc. I am a State senator and president of the LeBlanc Corp. of Lafayette, La.

This statement is made not only on my company's behalf, but in a sense presenting the cause of many young, vigorous, and growing businesses whose future progresses are endangered by an excess profits tax law. However, please understand that I am not endeavoring to avoid taxation. I am willing to pay any percentage of corporate taxes that we need to support our American way of life. I am also willing, gladly, to pay any amount of personal taxes, but the excess profits tax—due to the fact that we have made no profits during the first 4 years of our existence—would not only necessitate my paying a much higher rate than my competitors but would practically ruin me.

My business is manufacturing a vitamin and mineral tonic known as Hadacol, that has done much to enhance the health of our people. The Korean War, or any other war, has no effect on my business. My company, the LeBlanc Corp., was started 6 years ago on $2,500 of borrowed money. We struggled for 4 years, making little or no profits. In November 1949, however, we had approximately $170,000 in profits for the year. I spent every bit of that in advertising during November and Deecmber 1949. As a result, during the first 6 weeks of 1950 we had sold 2½ million dollars worth of Hadacol—more than we had shipped during the entire year of 1949.

Our profit for 1950, my auditor estimates, will be somewhere between 5 and 6 million dollars. This looks beautiful on the face of it, but since we started without any funds and because of our ambition to expand and grow, it was necessary that we enlarge our facilties in order to take care of the increased volume of business.

We brought a large building in Lafayette from the Reconstruction Finance Corporation. We recently constructed a two-story steel building with improvements that cost over a quarter of a million dollars. We have over 150 trucks that we use to deliver this merchandise. Thirty-seven of these trucks cost over $10,000 each. The trucks alone represent an investment of over $750,000. The storage tanks, machinery, and equipment represent another half million dollars. The raw materials which we have to carry in stock, including bottles, labels, caps, cases, etc., represent over a half million dollars. Our accounts receivable are now 2½ million dollars. We have tied up with the Government in alcohol draw-back over 1 million dollars. So, all of our profits are tied up in the business, which is necessary for its successful operation. The fact of the matter is—notwithstanding the fact that we will show a 5 or 6 million dollar profit this year—it became necessary the beginning of this month to borrow from the Whitney National Bank in New Orleans three-quarters of a million dollars to carry on.

Our business is increasing so rapidly that our purchases of glass and cartons have amounted to so much that the companies manufacturing these products are considering building branch plants in Lafayette to serve us.

Assuming, therefore, that an excess-profits tax is placed on us—in view of the fact that we have never made any profits before, except this year, we would never be able to pay the Government this tax unless we liquidated. The reason for that is obvious.

If we were compelled to pay the Government—let's say, $4,000,000 next year—we would have no funds with which to open up new territories, our greatest source of profits—we would have insufficient funds to carry on a successful advertising campaign, with the results that the business would soon become stagnant and fold up. Our product is a very delicate and sensitive merchandising item and not an actual necessity. The trade is unwilling to stock it unless it is highly advertised, creating a demand for it. While on the other hand, since we are presently operating in only 22 States it would be to our great advantage if we could operate in all of the 48 States, since then we could give part of our advertising to national magazines, coast-to-coast radio programs, and thus cover the 48 States more economically, comparatively speaking.

Our borrowing credit is, of course, very limited, and the problem that confronts us now, if this law is enacted, is—would it be better for me to sell my business for 10 or 12 million dollars, offers that I have already refused, take a capital gain of 25 percent and retire?

If I did that, I have close to 800 employees who helped me make this business what it is and who would probably be thrown out of employment because the purchaser would undoubtedly move it away from Lafayette to a more centrally located distributing point.

On the 7th day of December the citizens of Lafayette and other friends throughout Louisiana are giving me a testimonial dinner on the part I have played in the past year toward improving the welfare of our citizens. The postmaster will be there and can tell you that the postal receipts have increased approximately 90 percent, mainly because I work 100 girls in my direct mailing department. The Ford dealer will be there and can tell you we have brought almost a half million dollars into his business this year through the purchase of trucks, automobiles, accessories, and services. In fact, representatives of almost every Lafayette business and many from throughout Louisiana will be there to bear testimony to what we have done to make Lafayette and Louisiana a better and more prosperous city and State in which to live.

Advertising my product has played an important part in building this business, although the product is very, very meritorious—but, it is continually necessary to take large gambles in the successful operation of a business of this nature in spending huge sums of money for advertising, and it would make it more of a gamble if the Government takes up to 67 percent of my profits when I am right and assume none of the loss when I am wrong.

As an illustration, I recently bought $660,000 worth of billboards and three dimensional terminal signs to be used in 60 days. I have never used this type of advertising so extensively before, and only time can tell whether it will pay off. Then, if it pays off, the Government will step in and take most of what I make—but, if it doesn't pay off the Government is not willing to assume part of the loss.

And this type of gambling is necessary in the promotion of this type of business because we must grow to be successful, and a demand for the item must be created. As it is now, we advertise in almost 850 daily newspapers, in 6,000 weekly papers, and buy ads of a minimum of 4 spots a day on over 700 radio stations. We have trucks all over the South, building and putting up Hadacol signs and doing whatever is necessary to promote the item.

I do not believe that an excess profits tax is the correct solution to the present revenue problem. Regardless of the fact that an excess profits tax now might not achieve the amount of revenue desired, its most important disadvantage is its comparative inequity. It would fall on certain companies much more heavily than on others, most heavily on the companies growing during the base period and through 1950 and subsequently. It would be expensive to administer, in comparison with an income tax rate increase which could produce the same amount of revenue.

I suggest instead an increase in the corporation tax rates from the present 45 percent to 55 percent. It is my sincere belief that this would produce greater revenues than an excess profits tax from which certain corporations with huge earnings would be exempt because of their excess profits credit.

But if of necessity an excess profits tax must be enacted, I feel that provision should be made for companies such as mine. To stultify the growth of my corporation by taking from it the earnings that are needed for expansion and development, may result in a large tax for 1 or even 2 years, but will deprive the Government of the large revenues that would be forthcoming as our earnings increase in the future.

I am here today presenting my problem as a humble American citizen who believes in the American way of life and who wants to continue to build and construct, but I cannot do so if my business is penalized because I have grown and made money this year and made none the years before.

H. R. 9827 as passed by the House of Representatives makes no provision for a business such as LeBlanc Corp. This is a business which started from practically nothing, and as a result of reinvesting its earnings into advertising and promotion, was able to expand rapidly. It did not begin to realize its large potential income until this year. In 1950, the sales will run approximately $20,000,000, and in 1951 are estimated to run more than double this figure. These sales are all the direct result of the development of a new and fine product and to the development of public acceptance of this product. The sales have not been influenced in any manner by the Korean crisis, nor are they affected by a war or defense economy. Profits on these sales, of course, will be substantial in 1950 and 1951. They will reflect entirely the normal growth of the company. The perfect illustration is the fact that "Hadacol" is now being distributed only in about one-half of the States in the United States. It is our plan to expand into the remainder as our working capital will permit.

It is obvious that the LeBlanc Corp. is probably the most outstanding example of "growth companies" in the United States, if not in the world. Such a "growth company" will be severely penalized by the imposition of an excess profits tax with a base period comprising the years 1946 to 1949. The excess profits credit will be virtually zero, and, therefore, all of the corporation's earnings for future years will be subject to the excess profits tax. Thus, the company's excess profits tax will be based upon its normal earnings resulting from its normal development and not on excess profits.

Even the relief provisions in H. R. 9827 do not satisfactorily provide for a "growth company" such as the LeBlanc Corp.

Section 435 (e) which provides for "growth companies," will not help us, since the first year in which the LeBlanc Corp. will realize substantial earnings on development of its product and public acceptance of its product will be 1950, a post-base-period year. Under section 435, growth is limited to mean during the base period. Therefore, its excess profits credit is virtually zero.

Section 443 of the new bill (which apparently substitutes for section 722 of the former excess profits tax relief provision) offers practically no relief since, as I have pointed out, the company commenced with the smallest possible capitalization, and being subject to this excess profits tax, it will not be able to build up its assets in the future to the scale commensurate with other members of our industry. Therefore, to compute what constitutes our normal earnings on the basis of percentage of return on total assets of our competitors who had been able to build up their assets and equity capital over a period of many years when they had not been subject to excess profits taxes is to penalize the company for being a new one. As a new business, as any infant enterprise which is growing rapidly, much of the earnings of the LeBlanc Corp. have been plowed back in advertising and promotion, which is not reflected in its assets as defined by section 443 (c).

Apparently, section 442, applying to "abnormalities during base period," and section 444, applying to new corporations, do not apply to the instant case, and no relief could be gained thereunder. Nor would this corporation qualify under section 454 relating to "abnormalities in income in taxable period."

It should be clear that the computation of relief under section 443 be made in such a way that it would not penalize a corporation that was able to realize a large return on a comparatively small investment. Section 443 concerns itself with the particular industry as a whole. It does not take into account that some companies, due to efficient operation, can realize a greater return on their capital than others. Nor does it provide for those companies which can earn a large income on a much smaller capital than is common to the industry. The LeBlanc Corp. is such a company.

There is a suggestion which may be advanced which may not be completely adequate in relieving "growth companies" such as the LeBlanc Corp., but which is more equitable than either the old section 722 or the present section 443:

It is the purpose of an excess profits tax to tax the increase in earnings for the taxable year over the base period. In the case of corporations whose normal growth extends into the excess profits tax taxable year, only the same proportion of its current year's earnings should be taxed by the excess profits tax which is taxed to all corporate business. Thus, for example, if all corporate earnings have increased 50 percent in the current excess profits tax taxable year over the base period, only 50 percent of the earnings of the "growth company" should be subject to excess profits tax in that year. Such a method would eliminate completely any increase in earnings due to war or defense economy, and would put the "growth company" on the same taxable basis as industry in general. The same method could be applied on an industry basis, since some industries are affected less by the changes in economic conditions than others.

I repeat, we have no objection to paying our just share of taxation, but an excess profit tax, you must remember, would be an incentive to young and old corporations alike to spend unnecessarily and excessively, while an excess profit tax on us would destroy our business, and in that way the Government would not collect any taxes from us whatsoever. In other words, it would "kill the goose that lays the golden egg."

If the excess profits tax bill now under consideration is not substantially changed, it is suggested that provision therein be made for corporations who must suffer an inequitable, unjust, and discriminatory tax based upon its provisions. Since it is impossible to provide in the bill for all contingencies, it is suggested that a board of appeal be set up through which corporations with unusual cases can seek relief. This board could consist of representatives of the Treasury Department, representatives of the bar, independent accountants, and industry representatives. Possibly only those corporations subjected to the maximum over-all tax limitation (67 percent in H. R. 9827) should be permitted to appeal to this board.

I do not believe that the Government should assume a paternalistic attitude toward businesses, but certainly I contend that the Government should lend all assistance possible to small, young, and growing businesses. It should encourage rather than discourage, and, in fact, the lawmakers of this Nation in the past, through their good judgment and wisdom, have enacted legislation that had a tendency to help and assist the small people. For instance, you enacted laws to help the small farmer build himself a home and improve his property so that he could grow. You enacted legislation enabling the poor, ex-serviceman to start out in the world by lending him money to buy small businesses, by lending him money to build a home for him and his family, and I feel confident that in your wisdom and good judgment you will do the same thing for small businesses that are making a sincere effort to grow.

Some Economic Problems of an Excess Profits Tax

(By Lewis Severson)

I shall divide my subject under three headings: (1) Some general problems of any excess profits tax; (2) some particular problems of the last tax; and (3) some problems of a new tax in the present inflated situation.

Almost everyone in this group knows something about the first of these headings; only those who worked upon the last excess profits tax would know anything about its problems; and the problems of a new excess profits tax is in some measure a combination of these two. Therefore, I may bore many of you with commonplaces of excess profits taxes and then talk the incomprehensible language of the last law to nearly all of you. My topics are merely representative and no claim is made that they include even the most important topics.

1. PROBLEMS OF ANY EXCESS PROFITS TAX

The basic problem of any excess profits tax is to establish a reasonable basis of what excess profits means. Obviously, it is splitting off that part of a taxpayer's total profits which is deemed to be excessive and subjecting only that portion to confiscatory taxation, and leaving the nonexcessive residue undisturbed and subject only to ordinary income taxation. Excess profits taxes have been levied only intermittently in times of emergency. Consequently, there has not been continuous inquiry into the meaning of excess profits as there has been into

the meaning of total profits under the continuing income taxes on total income. In fact, insofar as excess profits taxes are levied only in emergency, there is scarcely any thought at all given to the meaning of excess profits. Our handling of intermittent excess profit taxes discloses confusion and inconsistency; and, what is perhaps worse, an unreasoned liberality which confiscates neither excess profits in the extortionate sense nor profits which arise out of the emergency when these are not immoderately high.

There are two general approaches to the determination of excess profits. Both determinations are indirect by determining what part of profits is not deemed to be excessive. One is a conventional rate of return on invested capital and the other is average actual profits in a designated base period which is assumed to be normal for industry in general. Our recent excess profits tax law provided that each taxpayer could choose either one of these that was more advantageous. The invested capital credit was: 8 percent on invested capital of not more than $5,000,000; 7 percent on invested capital from $5,000,000 to $10,000,000; 6 percent on invested capital from $10,000,000 to $200,000,000; and 5 percent on invested capital of more than $200,000,000. Income credit was 95 percent of the average earnings of the 1936–39 base period.

Both invested capital credit and income credit only crudely measure profits which are not excessive. First as to invested capital. It is only one factor of production and of profits. Its validity and productivity depend more on the competence of those who make and manage the investment than on its amount. It ignores this differential competence, and rewards amount of investment and penalizes economy and sagacity in investment. It can be, just as well as not, a proletarian capitalistic method of rewarding incompetence. Indiscreet investment has been too common in American history to be acceptable as a measure of profit productivity. In prosaic and standardized undertakings, such as railroads, public utilities, real estate, banking and insurance, invested capital may measure reasonably well both cost of saving and profit productivity. Such industries used almost exclusively invested capital credit under the last law because it was quite liberal compared to their normal earnings. But invested capital is a poor and inadequate determinant of normal earnings in dynamic industries.

Another and perhaps more serious shortcoming of invested capital credit as a measure of normal profits is that it leaves out of account widely varying risks in different industries. Four percent may be liberal on urban water works or hydroelectric plants, but 8 percent on water shipping or shipbuilding may be confiscatory if it does not even cover risks over a long period. Therefore, credit of 8 percent against excess profits may permit 100 percent more profits than usual for some industries before they pay any excess profits taxes while it may confiscate all profits in other industries if they are crowded into emergency periods as water shipping and shipbuilding tend to be. It is not satisfactory public policy that leading industries with high invested capital paid no excess profits taxes although they made higher earnings than usual during the war period. It is doubtful whether any great industry should be free from excess profits taxes in emergency even if it made only usual and moderate earnings of 3, 4, or 5 percent. It is not justifiable that great industries which earn 5, 6, or 8 percent in emergency should be free from excess profits taxes just because these rates are not immoderate in the usual sense although they are aggregate profits of 25, 50, or 100 percent more than are usually earned in these industries. This is neither acceptable economics nor necessary politics in an emergency.

Next, credit against excess profits based on average base period earnings is also open to serious criticism. All industries combined earned 5.11 percent on net worth during the 1936–39 base period, compared to credit of 8 percent down to 5 percent on invested capital allowed by the statute. But variation in profits among taxpayers within a given industry and among different industries during any designated period is great and continuous. The average rate of profits during a base period, or the rates allowed by the statute for all industry, has only slight relationship to the high and low profits for large parts of the economy. It is as much an average of great profits and great losses as it is a modal rate of profits of all industries.

There are three serious shortcomings of average profits in any period as a measure of normal or nonexcessive profits. First, the average may not correspond to any important part of the economy. It may be merely an average of extremes. Second, some industries, conspicuously those in which free entry is lacking, regularly have profits of 20, 40, or 60 percent on invested capital. Such profits are excessive on either economic or moral grounds whether the

law says so or not. A country at war cannot afford the luxury of such concepts of normal profits whatever its ignorance or patience might endure during peace. Such profits are legitimized, and a blessing is put upon them by earned income credit. Third, if the base period is shifted, average earnings of great groups of industries shift, and normal earnings vary with the choice or accident of the base period.

The problem involved here is one of confusion and duality in the meaning of excess profits, or just what it is that we try to tax or exempt from tax. A return of 6 or 8 percent in either peacetime or wartime is not excessive in the sense that it is extortionate, morally shocking, or greatly removed from what people are accustomed to. Yet it is substantially higher than some large, stable, and highly capitalized industries earn on the average, and in that sense it is both excessive and it arises out of the war conditions. On the other hand, some industries regularly earn 20 percent, 40 percent, or even 60 percent on invested capital in peacetime. These profits are excessive, morally shocking, and largely arise out of monopolization. Credit based on earnings in a base period sanctions such earnings without paying excess profits taxes. Only higher earnings than these are taxable as excessive. Thus 9 percent is excessive for some industries because the maximum invested capital credit is limited to 8 percent; but 25 percent is not excessive in other industries, because they have earned that much in the base period. Thus in our dual meaning and dual measurement of excess profits we exempt from excess profits taxes the most outrageous peacetime earnings of some of our largest industrial fields and tax only such greater excess as arises out of the war. On the other hand, we allow a growth of 25 percent, 50 percent, or 100 percent in the normal earnings in other highly capitalized industries because they are allowed an 8-percent credit whereas they usually earned only 4, 5, or 6 percent. We thus largely exempt the greatest source of excess profits taxes, and we tax neither the excessive profits in the one area where they are usual nor the profits arising from war in the other area when they are unusual. In neither case can the loss of taxes be well defended in time of war. We should not sanction the luxurious profits in wartimes that some industries earn in peacetime nor the higher rate of earnings of the normally low earning industries.

The problem involved in our dual approach to the measurement of excess profits, and in the provision of two different credits against excess profits, is a confusion and duality in meaning of excess profits, and in what we are trying to tax. Are we trying to tax (1) excess profits or (2) profits arising out of the war period? These are entirely different things; and in our groping and granting of a choice of two attractive floors as a credit, we avoid taxing large portions of either excess profits or profits arising out of the war. We should do something better than say that those who never earn more than 4 percent in peacetime may earn 8 percent in wartime without paying excess profits taxes; and that those who earn 9 percent have excess profits although others who earn 25 percent do not have excess profits. The extreme of this situation in my experience was a taxpayer which had profits of 60 percent of its sales, yet we were required by the law to hold that its earnings were inadequate and subnormal and that it was entitled under the law to relief from excess profits taxes. No doubt other cases among the 50,000 pending will exceed that.

2. PROBLEMS OF THE LAST EXCESS PROFITS TAX LAW

The last excess profits tax law provided relief in certain specified circumstances which indicates types of unavoidable and unsolved problems even under a choice of earned or invested capital credit. The law provided relief (1) if normal production was interrupted or diminished during any part of the base period because of the occurrence, either immediately prior to or during the base period, of events unusual and peculiar in the experience of the taxpayer; for example, strike, fire, flood, or price war; or (2) if the taxpayer or the industry of which it was a member was depressed in the base period because of temporary economic circumstances unusual in the case of either the taxpayer or the industry of which it was a member, for example, an industry-wide strike, or price war, a widespread drought, or a war as it would affect export or import industries. In both cases the problem was comparatively simple, and relief consisted of reconstructing income to what it would have been in the absence of the specified adversity. (3) Relief was provided when "the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such

taxpayer to (*a*) a profit cycle differing materially in length and amplitude from the general business cycle, or (*b*) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period."

On the basis of some 2,000 sworn affidavits and claims, every one of the 92 major groups into which the Bureau of Internal Revenue divided American industry had a variant profits cycle. All claimants firmly believed the general business cycle was made by other industries, but each industry one by one disqualified and eliminated itself as a participant and claimed to be a variant. And then if a taxpayer had a strike, price war, or lost its market in competition, didn't that make its profits cycle vary from the general cycle, which did not generally have these adversities? So it was often alleged that any other ground for relief also logically constituted a variant-profits-cycle qualification for relief.

Congress chose the unfortunate words material variation in "length and amplitude." It is doubtful that this provides relief in even the majority of the most harsh and inequitous base-period cyclical situations. The normality of the base period for business generally consisted of reasonably good profits in 1936, 1937, and 1939 and poor profits in 1938. Better considered cyclical relief would have been for taxpayers which were in a different phase of the cycle than for business generally or possibly for those which on historical experience did not have three reasonably profitable years and one poor year in the base period. Against my strong opposition the Bureau tried to write in in its bulletin this phase aspect in a half-hearted, double-talk legislative gesture which probably will have only blame as its proper reward. An administrative agency is usually the whipping boy for legislative ineptitude, and it will gain only an additional group of critics if it tries to stretch a defective law in favor of tax-relief claimants.

Opposite tendencies, rather than differences in length and amplitude, from a general business cycle are characteristic of some industries. For example, makers of smoking tobacco bags make profits in direct proportion to the intensity and duration of general depression and they have little profit when everyone can afford to buy tailor-made cigarettes. Moonshining should profit most in hardest times when the mass man cannot afford store liquor prices which are mostly taxes. Some businesses, possibly railroad locomotive manufacturers, may be genuinely sporadic and have no regular relationship to a general business cycle.

If either the economic or political facts of life require consideration of business cycles and deviations therefrom, there is the elementary problem of identifying a general business cycle. The phrase the general business cycle in the statute is an embarrassment. It is definite, like a particular crack in the plaster or grandpa's picture—only one and not a miscellaneous assortment. Yet, sophomore students should know that a representation of business fluctuations varies as the ingredients of the measured factors vary. When I sought light and guidance from prophets and practitioners of business cycles before the Bureau cast its die, I was asked in amazement if the law said the general business cycle, and by another cycle seer I was told that the law is folklore. In administering this law the Bureau adopted the profits of all corporations as representing the general business cycle because the law requires a comparison of the taxpayer's profits cycle. This was against my advice, and it constitutes one of the unstable elements in the Bureau position, if some taxpayer finds another cycle more advantageous to it. This is another case of administrative legislation to attempt to remedy a defective statute. But the general business can scarcely be made out of corporation profits merely because it would make a defective statute a little less irrational.

The most involved and prolific relief section was when the average base period net income was an inadequate standard of normal earnings because (4) "the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business 2 years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time * * *. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940 * * * shall be deemed to be a change on December 31, 1939, in the character of the business."

This section provides for a new business or an old business with a change in character, such as capacity, management, or a new product, and the base

period does not represent normal earnings due to lack of time. The section contains the famous 2-year push-back rule, the commitment rule, and the curtain rule, each one a practical obstruction to administration. If the earning level at the end of the base period would have been higher had the qualifying factor occurred 2 years earlier, then the qualifying factor is deemed to have occurred 2 years earlier. Tax counsel, unable to calculate the profit of a qualifying factor if it had occurred 2 years before it did, note the result of it 2 years after the end of the base period. But the law specifically prohibits this under another section which tax counsel pretend not to have read which says, "In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939." This is known as the curtain rule—one cannot peak behind the curtain to see what actually happened from a change with 2 years more of time for exploitation. This more effectively makes impossible the administration of a law otherwise quite unenforceable.

Then there is the commitment rule. If a taxpayer was committed to a change in capacity for production by the end of the base period, such change is deemed to be made on December 31, 1939, however much later it actually was made, and since such change could not possibly have produced a level of normal earnings on the very date of its assumed occurrence, it automatically is pushed back 2 years earlier under the push-back rule. Thus, I had a broadcaster which was committed to increased power and network affiliation by the end of the base period, but this was not consummated until 1942 and the first full year of earnings was in 1943. Nonetheless, the law required that we calculate without use of any information after 1939, what the taxpayer would have earned from 1936 to 1939 if it had made these changes on December 31, 1937, or 5 years before it did so. This is how the law provided how excess profits taxes shall be determined, and there are 40,000 to 50,000 cases yet to be determined over ensuing decades.

Problems arising from such statutory provisions as these keep coming to the surface as work in involved cases proceeds. What profit would rayon maker A have made from doubled capacity when each of nine other makers constituting the industry also double capacity? Should the industry capacity be taken as it actually was and only A's committed capacity doubled, or should one calculate the committed capacity for the industry and on this basis calculate A's share and its probable profits thereon when supply is doubled? When you push back a new brake fluid 2 years, it means nothing unless you push back cars with fluid brakes 2 years before they actually appeared. What if the inventor of them was still in prison 2 years earlier and could not invent until he got out? Shall you assume he committed his crime and went to prison 2 years earlier and got out 2 years earlier? But what if, 2 years earlier, the law required a prison sentence which would have been 5 years longer? What is one to push back and where is one to stop? We actually had a case of towel containers installed in British factories during their prewar armament program which seemed to require pushing Hitler's aggression 2 years earlier. These are not nightmares, or, at least, they came during the working day.

A final ground for relief in the last law was for "a taxpayer not entitled to use the excess profits credit based on income" (mainly corporations which were not actually in existence until after the base period) "if the excess profits credit based on invested capital is an inadequate standard for determining excess profits, because" (1) the invested capital of the taxpayer is abnormally low; or the business of the taxpayer is of a class in which (2) intangible assets not includible in invested capital make important contributions to income, or (3) capital is not an important income-producing factor.

One would expect relief in such cases to be a reconstruction of invested capital to an equitable amount; but not so. Relief is by a constructive average base period net income which would be "a fair and just amount representing normal earnings." So, a broadcaster which came into existence as late as 1945 might be entitled to have a constructive income computed for 1936–39. The 2-year push-back is rather modest compared to this. So endeth the general relief provisions, and also so endeth numerous harried men who tried to administer these in concrete situations in terms of dollar taxes in very large amounts.

3. PROBLEMS OF A NEW EXCESS PROFITS TAX LAW

If another excess profits tax law were invoked in the present inflated situation, all foregoing problems would be involved. There would be no practical possibility

of avoiding optional credit based on either invested capital or earning, although it might be hoped that some ceiling would be placed on earned credit, say 10 percent, 12 percent, or double the invested capital rate applicable to a taxpayer. It is not likely that all relief provisions could be avoided, but certainly reconstructed income should be limited to, say, not over 10 percent on invested capital. But the most formidable problem would be to determine a reasonable basis for earned credit and I shall devote my remaining time to that.

Our economy has undergone long, great, sustained, and extremely variable inflation since the 1936–39 base period. Whether inflation will continue or deflation will occur, and, if so, when and how much, are matters upon which there is great diversity of judgment. What period since 1939 or what factor of inflation of 1936–39 earnings, would represent normal earnings and a suitable basis for earned credit? And what earnings should be used—those before taxes, some of which were not touched and others largely confiscated by the excess profits tax, or those after excess profits taxes, under the presumption that excess profits were substantially confiscated under the last law and normal income was left after taxes. An answer is much easier with some simple index of inflation and deflation from 1936–39 basis. I shall illustrate these extreme and varying dispersions.

The excess profits tax ended with 1945. Therefore, subsequent years have full inflated profits subject only to corporation income tax. What were the 1946 corporation profits? I have compared the profits of 76 manufacturing groups before and after taxes with average profits in 1936–39 and in 1940–45. The average in these periods is used as 100 in each case and 1946 profits are shown as a percentage of this average.

Compared to 1936–39, 1946 profits were as follows:[1]

Before taxes:	
Low (automobiles)	17
Quartile 1 (photographic equipment, gum, candy)	142
Median (steel producers without blast furnishes)	211
Quartile 3 (clay products and paper)	338
High (toys and sporting goods)	21, 700
Arithmetic average	166
After taxes:	
Low (aircraft)	32
Quartile 1 (office machines, gum, and candy)	113
Median (food canning and preserving)	154
Quartile 3 (lumber and paper)	243½
High (household utensils)	26, 700
Arithmetic average	137

Compared to 1940–45, 1946 profits were as follows:

Before taxes:	
Low (electrical equipment)	6
Quartile 1 (steel producers without blast furnaces)	62½
Median (chemicals)	98
Quartile 3 (fertilizers and rayon yarn)	135
High (bread and cake)	229
Arithmetic average	
After taxes:	
Low (aircraft)	14
Quartile 1 (printing trades machinery)	86
Median (nonferrous metal products)	129½
High (textile fabrics)	304
Arithmetic average	116

Summarizing these four series, we have for 1946: Lows of 6, 14, 17, and 32; highs of 229, 304, 21,700, and 26,700 medians of 98, 129½, 154, and 211; arithmetic averages of 73, 116, 137, and 166.

So from these data, how inflated or deflated were 1946 profits? I do not know. There are averages to suit every taste and purpose, so tax experts and reformers can step up and take their choice. But the trouble is in the great variations from any average of any series. Any average, as a measure of inflation would greatly and inequitably penalize or reward many industries. Profits for 1947

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[1] Survey of American listed corporations, data on profits and operations, Security and Exchange Commission.

and 1948 do not simplify the matter. The relationship of profits after taxes was approximately as follows:[2]

Using 1940–45 as 100—

1946 was	138
1947 was	193
1948 was	236

It is not apparent from these profits data what period subsequent to 1936–39 base period could be used as a base period for a new excess profits tax, or what inflation factor could be applied to 1936–39 profits, or what inflation or deflation factor could be applied to profits during the excess profits tax years 1940–45 or subsequent years. A substantial part, but we do not know what part, of the present inflation is built in to remain as normal for the future. And we do not know whether the circumstances which might warrant a new excess profits tax would cause an additional inflation from present levels or not. But certainly we cannot carry forward with much reliance 1936–39 profits or even rely upon them for a percentage build-up. Besides the intervening war and postwar inflation, we now have millions of changes in new taxpayers, new products, new capacity, and enlarged resting places for dead and dying taxpayers of that period. Adjustments from 1936–39 cannot be made either realistically or equitably.

In closing, I remind you that my subject is problems, not solutions, of an excess profits tax. Solutions here are lacking mainly because I have none. This is not merely an individual frustration. My final task on excess profits taxes was to consider some of these problems in a small Treasury group. My particular responsibility was bases of credit against excess profits in present inflated conditions, and relief problems. It was the tentative consesus of judgment that no single or scientific basis of credit was possible. Numerous alternative and somewhat arbitrary bases of credit gained tentative approval. For example, 1936–39 profits inflated by some percentage would be politically required to salvage a few dead taxpayers; 1940–45 profits after taxes inflated by some lesser percentage seemed defensible; average profits after 1945 deflated by some percentage, or the highest year deflated by a larger percentage seemed to be possibilities. This is a motley and unscientific list of suggestions; but the present circumstance is motley and unscientific also. It was believed that a choice of any one of four, five, or even six alternative bases of credit would provide more substantial justice than any pretense of a scientific basis and much preferable if it would be in lieu of all relief provisions. But it is doubtful that multiple bases of credit would wholly withstand political pressure for some relief provisions.

American Retail Federation,
Washington, D. C., December 7, 1950.

The Honorable Walter F. George.

Dear Senator George: The retail industry committee would like to file for the record and for your earnest consideration the attached statement which was presented on its behalf to the Ways and Means Committee.

This statement sets forth the reasons why the retail industry objects to an excess profits tax, and also states the provisions which the industry believes should be in any such tax law if one is to be enacted. Since this position is already available to you and to your technical staff we saw no reason to take up your time with an oral presentation.

There is one point, however, which we should like to call to your attention and that is the desirability of deferring final action until taxpayers generally have had an opportunity to study the technical provisions of the House bill.

The main principles of the House bill are fairly well known and understood by taxpayers. We refer to such items as the rate of tax, the ceiling on tax payments, the choice of alternative methods to compute the excess profits credit, and the like.

There are, however, innumerable technical details which are not well known to taxpayers, and with which these taxpayers have not had sufficient opportunity to acquaint themselves. It has been impossible to analyze the meaning

[2] Department of Commerce, all industries, and National City Bank, 1,571 and 3,262 manufacturing companies.

and possible effect of these provisions in the short time that copies of the bill have been available to taxpayers. And yet it is the meaning and interpretation of these provisions which will determine whether the excess profits tax, if enacted, will work undue hardships on taxpayers, or whether the tax will be as nearly equitable as it is possible for a tax of this nature to be.

It has been impossible for many interested taxpayers to obtain and study copies of the bill as it passed the House of Representatives, and these taxpayers know the contents of the bill only in general terms.

Naturally they are confused as to the effect of the bill on their own businesses. For example in retailing, stores expand, enlarge, open at new locations on long-term leases and assume different degrees of risk without substantially alerting their capital structure. These shifts in the amount of risk assumed cause abnormalities in income, both in the base period and in the tax year. Without copies of the bill these retail taxpayers have had no opportunity to apply the provisions of the bill to their own conditions and to determine whether the bill treats all such situations as nearly equitably as is possible.

Without a careful analysis of these and other provisions, in the light of the taxpayer's own experience it becomes virtually impossible to give any well considered opinion as to the merits or demerits of the technical language of the bill.

The retail industry committee earnestly hopes, therefore, that final action on the bill can be postponed until early next year so that sufficient time can be afforded to taxpayers to make these studies and give the Congress the benefit of their experience. As rapidly as criticisms and analyses of the effects of the bill are received from the members of the committee and their associates they will be made available to your technical staff.

A subject which is necessarily as complicated as an excess profits tax should be studied carefully, and no harm, but great good will ensue by delaying final action on the bill for a few weeks in order that taxpayers may have a reasonable opportunity to determine precisely in what manner the bill will affect them.

Sincerely yours,

ROWLAND JONES, Jr.

STATEMENT OF JOHN F. LEBOR, RETAIL INDUSTRY COMMITTEE

My name is John F. Lebor. I am treasurer of Federated Department Stores, Inc., with headquarters at 707 Race Street, Cincinnati, Ohio. I appear representing the Retail Industry Committee, a group of 51 national retail trade associations. A list of the members is attached to the statement filed with your committee.

Let me say first that retailing is in favor of paying for the defense program as we go by tax revenue and all possible economies in nondefense expenditures. Only in this way can we minimize serious inflationary effects with its widespread adverse results to our country, to us as retailers, and to our customers. Although we have been advised that your committee desires to have testimony at these hearings directed primarily to the preferable nature of an excess profits tax, if one is to be enacted, we believe that we would be derelict in our duty if we did not express our view that it is impossible to write an excess profits tax bill that does not create more problems than it solves. The nomenclature "excess profits tax" has appeal in times of temporary emergency. The difficulty comes in defining with any reasonable degree of accuracy what is "normal earnings" and what is truly "excess earnings." The problem becomes more acute when an attempt is made to do so for a period as short as a single taxable year.

We believe that revenue requirements should be met by methods of taxation other than a so-called excess profits tax, for a wide variety of reasons, including the following:

1. The difficulty of defining "normal earnings" for each corporate taxpayer in each year.

2. The difficulty of writing so-called "relief provisions," which in practice as well as in theory provide prompt and equitable relief from abnormalities in both the base period and the year in which the tax is imposed. Abnormalities exist in large numbers.

3. If "normal earnings" of each taxpayer are not equitably measured, the effect of an excess profits tax is that of creating a system of progressive rates of corporate income taxation. Progressive corporate income taxation is undesirable and should not become part of the tax structure, particularly through the "back door" of a so-called excess profits tax.

4. It removes incentive for efficiency at a time when its need is greatest.
5. It is an ill-conceived type of tax to counteract inflation.
6. It is difficult and expensive to administer, and uncertain for decades as to the ultimate revenue produced.
7. It is ill-suited to a period in which enlarged revenue requirements may be needed for a protracted period.
8. It stifles new enterprise and interferes with the expansion and growth of existing enterprise. It is conducive to a static or decadent economy as contrasted to a dynamic economy. We are in a period when a healthy civilian economy is necessary to carry our heavy load of defense requirements.

PRINCIPLES OF EXCESS PROFITS TAXATION

If, contrary to the logic of the situation, there is to be a so-called excess profits tax, the following principles should be reflected therein:

I. Profit equalization should not be an objective

It should not be a device to equalize profits among the efficient and inefficient; the lucky and the unlucky; the progressive and the decadent. Therefore, its determination of the amount of earnings exempt from excess profits rates should not be made by abstract formula unrelated to the individual taxpayer.

II. Credit should be related to specific taxpayer and not determined by abstract formula

The determination of what is "normal" and what is "excess" should be particularized to each individual taxpayer. Earnings exempt from "excess profits" rates should, therefore, depend upon each taxpayer's individual situation, and not upon where he stands in relation to the average performance of all taxpayers. Presumably, the theory behind an excess profits tax is that there is a point at which profits become excessive and abnormal. It is obvious that there is no such point that applies equally to all taxpayers. Profits are simply the rewards of risk; and naturally the greater the risk taken, the greater the profit should be. Risk is variable between industries, between branches of an industry and in fact, between different companies within the same industry. Retailing is a highly competitive business subject to substantial risks. In fact failures are not uncommon. We submit that there is no justice, no advantage to the economy of our country, if the point above which earnings are designated as "excess" is the same for retailing as it is for other industries entailing less risk. The same principle applies within the varying segments of retailing, as well as between dfferent companies operating within the same segment of retailing.

III. Taxpayer should have a choice in designating base years for determination of excess profits tax credit

The taxpayer should be allowed to have a wide area from which to select a determination of his so-called "normal earnings." This will result in a closer approximation to normal than if a narrow, inflexible, and arbitrary formula is imposed upon it. It will also have the important practical effect of minimizing the number of relief claims required to be processed by the internal revenue bureau, agencies such as the excess tax council, the courts, etc.

IV. Taxpayer should have a choice between invested-capital and earned-income credit

The taxpayer should be permitted to elect either an invested-capital credit, with appropriate adjustments, or an earned-income credit.

V. Invested-capital credit

(*a*) *Definition of invested capital.*—If an invested-capital credit is elected, "invested capital" should consist of all stock (common and preferred), all surplus and surplus reserves, and all borrowed capital (with an adjustment to earnings to eliminate all interest paid on borrowed capital). All borrowed capital should be included because as a practical matter it is merely one of the alternative methods of raising capital for the operation of a business, and one which it has been increasingly necessary to rely upon because of the conditions in our markets for equity securities for many years, particularly for small companies. Retailing is characterized by a large number of small enterprises.

Accumulated earnings subsequent to the end of the base period should, of course, be added to the invested-capital base in each year subject to the so-called excess profits tax.

(*b*) *Credit should be allowed at taxpayer's historic rate of return.*—The permissible rate of return on invested capital before earnings are designed as "excess" should be that rate of return which each taxpayer has made on its invested capital during the base-period years. Certainly there is no justification for designating any portion of such amount as "excess earnings." Moreover, there should be a permissible minimum allowable rate of return on invested capital which is sufficiently high to justify the risk assumed, after it is reduced by the application of the normal tax and surtax. It should also be sufficiently high to permit the raising of new capital. In connection with the latter, it is important to be realistic about the relationship between earnings after all forms of taxes and the prices at which corporate securities can be sold in the open market. It is hardly necessary to point out that the 8-percent return allowed on the first bracket of invested capital by World War II excess profits tax results in only a 4.4-percent return after a 45-percent normal and surtax rate. This would require new capital to be provided on the basis of 22.6 times earnings, which, of course, is far in excess of the price-earnings ratios that can be commanded by practically all of the strongest and best-known companies, let alone the average company. This is true irrespective of whether it be engaged in retailing or other competitive activities.

(*c*) *Rate of credit should be flat.*—There should be a flat rate of credit on all invested capital. Large corporations should be allowed to earn as much on their investment as smaller ones, particularly since the larger the corporation the stronger the likelihood that the number of individual stockholders will be greater, and the average investment per stockholder will be smaller. Here, again, the principle of progressive taxation should not be applied to corporations, by reducing the permitted rate of return as the amount of invested capital becomes greater. To do so subjects the corporate stockholder—who bears the brunt of such taxation—to varying rates, depending upon whether his investment is concentrated in a small corporation or diversified among a number of larger corporations. There is no justification for creating competitive advantages or disadvantages, depending upon the size of the taxpayer corporation, but without regard to the size of the stockholdings.

VI. Earned income credit

(*a*) *Base period years.*—If the taxpayer elects the earned-income credit, it should be allowed to select certain years, from a wider range of years, as its base period. The relationship of a given industry, a segment of the industry, or indeed a specific taxpayer within a segment of the industry to its own business cycle or other determinate of its "normal" is likely to be at wide variance from the average of all industries in a specific year, or small number of years. The retailer in a town devoted primarily to manufacturing heavy machinery, for instance, is likely to have quite a different earnings picture in a given year than a retailer located in a textile town. Variances of this kind were particularly noticeable in the reconversions from World War II to the present economy. Moreover, the relationship between a year like 1946 and one like 1949 is quite different for retailing than for many segments of manufacturing.

In order to allow for such wide variances we recommend that a taxpayer should be given the right to elect as its base period any 2 of the 4 years 1946, 1947, 1948, and 1949. We do not dwell on the complete inadequacy of any years prior to this because we believe it is universally accepted that conditions in those years are completely unrelated to post-1945 conditions. Likewise, we would emphasize that the area of selection should be no narrower than 1946–49 because of the varying impact of different years on different businesses.

(*b*) *Base period earned income credit should be adjusted to reflect historic (normal) earnings on changes in invested capital.*—If the taxpayer elects the average earnings base, it should be permitted to add to its base period earnings in an amount equivalent to the earnings normally to be expected on any invested capital added to the business subsequent to the end of the base period. If the amount of invested capital has been reduced in such period, the base period earnings should be correspondingly reduced. The adjustment to be made in the earnings base for such capital changes should be measured by the specific taxpayer's rate of actual earnings on its invested capital during its base period. The definition of "invested capital" for this purpose should be the same as that used if the taxpayer elected the "invested capital" basis instead of the "average earnings" basis. World War II excess profits tax allowed an adjustment in the income base for additions to capital resulting from the sale of equity securities. Presumably, this was because it was recognized that as the amount of capital at work in a given business increases, the dollars of earnings should normally in-

crease correspondingly, and that it would be a rank injustice to tax any such increased earnings as if they were all excess. In this proposal we are therefore merely urging that this principle be extended to recognize that the same is true irrespective of whether the increased amount of capital in the business during the excess profits tax years is derived from (1) the sale of new equity securities; (2) the issuance of other types of securities or obligations; or (3) by the retention in the business of accumulated earnings. Also that the earnings allowed on the additional capital be at the historic (normal) rate of the specific taxpayer instead of at some arbitrary rate. Provisions such as these are of vital importance to a growing company. Therefore, even though the average earnings basis is elected, the taxpayer should be allowed to add to its earned income credit an amount equal to its historic rate of return on the additional capital employed in the business during each year subsequent to the end of the base period. This right should continue so long as the so-called excess profits tax is in effect.

(c) *Excess profits tax should not apply to "normal earnings" measured in a dollar of a changed value.*—We also urge that your committee take cognizance of the fact that the purchasing power of the dollar has changed materially in recent years, and that a dollar of pre-tax earnings does not serve the same purpose at the present time insofar as its use in the business is concerned, as a dollar of earnings in the earlier years. Therefore, we believe consideration should be given to adjusting earnings in the base period years for price changes between such years and any years subject to excess profits tax. Otherwise, "normal earnings" measured in the changed value of the dollar would be taxed as if they were "excess earnings."

VII. Relief provisions

(a) *Should be more specific.*—Relief provisions in any new excess profits tax should be more specific than in the past to assure that the relief for abnormalities intended by Congress is, in fact, promptly and equitably available. Experience with all prior excess profits taxes has indicated that such has not been the result in practice. Undoubtedly, there would be unanimous agreement that if the relief provisions do not provide equitable relief, the tax is not functioning as was intended.

(b) *Section 722.*—Section 722 of the code has undoubtedly had the widest attention among the relief sections of World War II excess profits tax. The philosophy of the section as enacted might seem to prevent injustices, inequities and unjustified penalties. However, in practice such has not resulted. Almost 10 years after its enactment, only a comparatively small number of claims have been disposed of. Taxpayers and the Government alike have grappled with many abstruse and difficult questions which have arisen. In a field of activity in which it is difficult, if not impossible, to arrive at an irrefutable conclusion by statistical or other methods, the taxpayer has frequently had to assume the unfair burden of presenting incontestable proof of certain phenomena, or have his claim denied. This has taken such form as a retailer who expanded its capacity being asked to prove that its business would not have grown if it had not expanded its capacity—or if unable to conclusively prove such fact, have its claim denied. We suggest, therefore, that if the Congress chooses to enact an excess profits tax, that it write into any new legislation specific objective standards to provide the relief they intend to grant for purposes similar to the "qualifying factors" under section 722 of World War II excess profits tax. Past experience indicates that only in this way can the relief intended be protected against arbitrary disallowance.

(c) *Other important relief provisions.*—Numerous other relief provisions similar to those in the last excess profits tax bill are of great practical importance to retail organizations, and should be reenacted in any new bill; these are as follows:

Section 711 (b) which deals with abnormal deductions in the base period.

Section 713 (e) and 713 (f): If a longer base period than 2 years is required for the computation of an income credit.

Section 721 which deals with the elimination of abnormal income in the taxable year.

Section 723 which permits taxpayers to use the sum of its adjusted net assets as of the first day of its excess profits tax year, where it is unable to compute its equitable invested capital under section 718.

Sections 742 and 760 pertaining to acquiring corporations, so as to prevent the earnings of a business, owned by a taxpayer in the taxable year but not during the base period, from all being subjected to excess profits tax rates.

A section that will place taxpayers reporting income on the installment basis on a basis of tax equity with accrual basis taxpayers for purposes of excess profits tax is vitally important to retailing. Section 736 of the last act dealt with this subject. I understand that recommended modifications of the old section 736 are being suggested by other spokesmen for retailing.

It is to be noted that an inequity for installment basis taxpayers is present in any form of taxation designed to recover profits on income accrued during any given period, such as the emergency period. Therefore, 736 (a) type of election to report for emergency tax on the accrual basis should be accorded whether Congress may ultimately adopt a corporate defense or war profit tax in lieu of an excess profits tax.

VIII. Specific exemption

There should be a specific exemption of $10,000. This continues the favored treatment of small business which has been accepted by the Congress in the past, and will eliminate many relief cases which are troublesome and expensive to administer.

IX. There should be a ceiling rate on combined Federal taxes based on income

There should be an over-all ceiling rate for combined Federal taxes based on income. In the opinion of retailing, this ceiling should be very close to the combined total of all Federal taxes based on income during World War II. We understand this was in the vicinity of 50 percent. Adequate incentives are particularly vital to retailing. Profit margins are narrow and profits can disappear very rapidly if there is not an incentive for careful buying, adequate fulfillment of the public's merchandise requirements, and careful expense control. We believe that the loss of incentive and efficiency becomes so great when the taxpayer cannot retain at least half of any improvement in pretax earnings that, if additional revenue is needed, the Congress should resort to other methods of taxation in lieu of higher excess profits tax rates. Business profits must bear their fair share of increased taxation. A flat-rate defense profits tax applied to corporation profits would, in our opinion, be a more effective method of raising such revenue.

X. Expiration date

If a so-called excess profits tax is enacted, it should expire no later than December 31, 1951. It should not be allowed to become a permanent part of the tax structure. If enacted it should be subject to frequent and careful study of its effects. With all of its known defects, Congress should not permit it to become a law without the necessity of subjecting it to an early and thorough review before it is allowed to continue.

XI. Retroactive taxation

In closing, retailing strongly urges that the principle of retroactive taxation be avoided on all occasions. If business is to provide the driving force that it should in our free economy, it must know the rules of the game before the race begins, and not be told at the end of the race that the rules have been changed retroactively.

RETAIL INDUSTRY COMMITTEE

Chairman: Jerome M. Ney, Boston Store Dry Goods Co., Fort Smith, Ark.
Vice chairmen:
- Dr. Paul H. Nystrom, Limited Price Variety Stores Association, 25 West Forty-third Street, New York, N. Y.
- Vincent D. Kennedy, California Retailers Association, 1508 Central Tower, San Francisco, Calif.

Secretary: James C. Lucas, American Retail Federation, 1627 K Street NW., Washington, D. C.

American National Retail Jewelers Association:[1 2]
- Charles T. Evans, secretary, 551 Fifth Avenue, New York 17, N. Y.
- Arthur J. Sundlun, A. Kahn, Inc., 935 F Street NW., Washington, D. C.

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- Charles S. Burr, C. R. Burr Co., Manchester, Conn.

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American Institute of Laundering:
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E. C. Lipman, Emporium-Capwell Co., San Francisco, Calif.[3]
Bruce MacLeish, Carson, Pirie Scott & Co., 1 South State Street, Chicago, Ill.[3]
Stanley Marcus, Neiman-Marcus Co., Dallas, Tex.[3]
Charles B. Dulcan, Sr., vice president and general manager, the Hecht Co., Washington, D. C.[3]
Bernard F. Gimbel, Gimbel Bros., Inc., New York, N. Y.[3]
John A. Goode, Goode's Drug Stores, Inc., Asheville, N. C.[3]
Joseph B. Hall, The Kroger Co., Cincinnati, Ohio.[3]
Clarence Haverty, Haverty Furniture Cos., Inc., 22 Edgewood Avenue, Atlanta, Ga.[3]
Edwin I. Marks, R. H. Macy & Co., Inc., New York, N. Y.[3]
Morton J. May, May Department Stores, Inc., St. Louis, Mo.[3]
Jerome M. Ney, Boston Store Dry Goods Co., Fort Smith, Ark.[3]
Nathan S. Sachs, Sachs Quality Stores, 330 Bruckner Boulevard, New York, N. Y.[3]
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Leon Glenicki, Polonia Coal Co., 5492 Northwest Highway, Chicago 20, Ill.
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Milford Desenberg, care of King Clothing Co., 110 West Forty-second Street, New York, N. Y.
J. Butler, care of H. H. Butler Stores, 44 West Eighteenth Street, New York, N. Y.
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Philip M. Talbott, Sr., vice president, Woodward & Lothrop, Washington, D. C.
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Illinois Federation of Retail Associations:[4] J. T. Meek, executive director, 7 South Dearborn Street, Chicago, Ill.
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Limited Price Variety Stores Association, Inc.:[1 2]
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  A. Q. Smith, F. W. Woolworth Co., New York, N. Y.
  G. L. Ward, S. H. Kress & Co., New York, N. Y.
Linen Supply Association of America:[2]
  Stanley I. Posner, Washington representative, 1367 Connecticut Avenue NW., Washington, D. C.
  George Klinefelter, president, Elite Laundry, Baltimore, Md.
Mail Order Association of America:[1 2]
  Dudley D. Richards, secretary-treasurer, 1194 National Press Building, Washington, D. C.
  M. J. Spiegel, Jr., president, Spiegel, Inc., Chicago, Ill.
  Edward Gudeman, Sears, Roebuck & Co., Chicago, Ill.
  W. R. Voigt, Sears, Roebuck & Co., Washington, D. C.
Master Photo Dealers and Finishers Association:[2]
  R. J. Wilkinson, executive manager, 103 West Michigan Avenue, Jackson, Mich.
  William A. North, Photo Art Co., Inc., 129 North Warren Street, Trenton 7, N. J.
National Appliance and Radio Dealers Association:[2]
  Ira L. Lavin, acting managing director, Merchandise Mart, Chicago 54, Ill.
  Mort Farr, 119 South Sixty-ninth Street, Upper Darby, Pa.
National Association of Chain Drug Stores:[1 2]
  Carl Willingham, secretary-treasurer, 427 Vanderbilt Hotel, New York, N. Y.
  Louis Gundling, director, People's Drug Stores, 77 P Street NE., Washington, D. C.
National Association of Credit Jewelers:[1 2]
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  B. N. Burnstine, Burnstine's, Washington, D. C.
  H. A. Goldberg, Cooper's, Inc., Portsmouth, Va.
National Association of Food Chains:[1 2]
  John A. Logan, president, 726 Jackson Place NW., Washington, D. C.
  A. D. Davis, president, Winn & Lovett Grocery Co., Jacksonville, Fla.
National Association of Ice Industries:[1]
  William T. Jobe, general counsel, 1706 L Street NW., Washington, D. C.
  Guy W. Jacobs, Steubenville Ice Co., Steubenville, Ohio.
National Association of Independent Tire Dealers:[1] W. W. Marsh, general manager, 1302 Eighteenth Street NW., Washington, D. C.
National Association of Music Merchants:[1 2]
  William R. Gard, executive secretary, 28 East Jackson Boulevard, Chicago 4, Ill.
  Earl Campbell, Campbell Music Co., 1108 G Street NW., Washington, D. C.
National Association of Retail Clothiers and Furnishers:[1 2]
  Louis Rothschild, executive director, 1006-10 Munsey Building, Washington, D. C.
  Walter Nordlinger, The Mode, Inc., Washington, D. C.
  Robert B. Underwood, Berry Burke Co., Richmond, Va.
National Association of Retail Druggists:[1] George Frates, Washington representative, 1163 National Press Building, Washington, D. C.
National Association of Retail Grocers:[1] Mrs. R. M. Kiefer, secretary-manager, 360 North Michigan Avenue, Chicago, Ill.
National Association of Retail Meat and Food Dealers, Inc.:[1]
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  Charles Bauer, 4371 West Eighth Street, Cincinnati, Ohio.

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  Edward Atkins, executive secretary, 51 East Forty-second Street, New York, N. Y.
  Mark Edison, Edison Bros. Stores, Inc., St. Louis, Mo.
National Automobile Dealers Association:[1] M. Robert Deo, managing director, 1026 Seventeenth Street NW., Washington, D. C.
National Congress of Petroleum Dealers:[1] Rankin P. Peck, president, 205 East Adams Avenue, Detroit 26, Mich.
National Contract Hardware Association:
  John R. Schoemer, managing director, 420 Madison Avenue, New York 17, N. Y.
  Paul Easby-Smith, Builders Hardware Corp., 1022 Twentieth Street NW., Washington, D. C.
National Industrial Stores Association:[1]
  Hull Bronson, executive secretary, 416 Southern Building, Washington, D. C.
  Paul C. Jamieson, assistant to general manager and merchandise manager, General Stores, Huntington, W. Va.
National Institute of Cleaning and Dyeing:
  Max Feinberg, legal counsel, Silver Spring, Md.
  T. E. Milholland, Zenith Cleaners, Dallas, Tex.
National Luggage Dealers Association:
  A. B. Sheldon, executive secretary, 241 Genesee Street, Utica, N. Y.
  W. A. Tuerke, Jr., Tuerkes, Baltimore, Md.
National Office Machine Dealers Association:[1]
  Harold W. Mann, executive secretary, 1267 North Wilton Place, Los Angeles 38, Calif.
  Edward J. Toussaint, Central Duplicator & Typewriter Co., 511 Broadway, Camden, N. J.
National Restaurant Association:[1] Robert J. Wilson, Washington representative, 2003 I Street NW., Washington, D. C.
National Retail Dry Goods Association:[1 2]
  J. Gordon Dakins, general manager, 100 West Thirty-first Street, New York, N. Y.
  Lew Hahn, 100 West Thirty-first Street, New York, N. Y.
  George Hansen, Chandler & Co., Boston, Mass.
  John Hazen, Washington representative, 808 Kass Building, Washington, D. C.
  Harold Hodgkinson, Wm. Filene's Sons Co., Boston, Mass.
  A. W. Hughes, J. C. Penney Co., New York, N. Y.[4]
  Arthur C. Kaufmann, Gimbel Bros., Inc., Philadelphia, Pa.
  Wade McCargo, H. V. Baldwin & Co., Richmond, Va.
  Dr. Malcolm P. McNair, Graduate School of Business Administration, Harvard University, Cambridge, Mass.
  Charles G. Nichols, The G. M. McKelvey Co., Youngstown, Ohio.[4]
  Harold J. Nutting, Marshall Field & Co., Chicago, Ill.
  Theodore Schlesinger, Allied Stores Corp., New York, N. Y.
  Q. Forrest Walker, R. H. Macy & Co., Inc., New York, N. Y.
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  Charles A. Snavely, Snavely John Deere Equipment Co., Baldwin, Md.
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  M. I. Behrens, Ludwig Baumann, New York, N. Y.
  Maury L. Nee, P. J. Nee Co., 745 Seventh Street NW., Washington, D. C.
  Thomas I. Levitt, Davidson-Boutell Co., Marquette at Fifth, Minneapolis, Minn.
National Retail Hardware Association:[1 2]
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  A. B. Hill, Standard Hardware Co., Portsmouth, Va.

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Clyde Fulton, Colborn Fulton Lumber Co., Charlotte, Mich.
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National Shoe Retailers Association:[1 2]
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Gilbert Hahn, William Hahn & Co., Washington, D. C.
National Sporting Goods Association:[1]
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Shelby D. Himes, Bailey & Himes, Inc., Champaign, Ill.
National Stationery and Office Equipment Association:[1 2]
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Charles Sinisgalli, sales manager, R. P. Andrews Paper Co., First and H Streets SE., Washington, D. C.
National Voluntary Groups Institute:[1] Gerald D. Ungaro, secretary, 77 West Washington Street, Chicago 2, Ill.
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Retail Credit Institute of America, Inc.:[1 2]
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Society of American Florists:[2]
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Granville Gude, 1212 F Street NW., Washington 4, D. C.
Super Market Institute, Inc.:[2]
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James Cooke, general manager, Penn Fruit Co., Philadelphia, Pa.
Virginia Retail Merchants Association:[2] Charles B. McFee, Jr., managing director, room 812, Life Insurance Co. of Virginia Building, Richmond 19, Va.

[1] Member of American Retail Federation.
[2] Member of Retail Trade Advisory Committee of the Department of Commerce.
[3] Member of executive committee, American Retail Federation.
[4] Member of National Conference of State Retail Associations.

SLICK AIRWAYS, INC.,
December 8, 1950.

The honorable the COMMITTEE ON FINANCE,
United States Senate, Washington, D. C.

GENTLEMEN: The problems presented to the all-freight airlines, who are members of the Air Freight Association, and Slick Airways, Inc., in particular, by the proposed excess profits tax bill have not yet been solved. We respectfully ask direct consideration of their situation.

The air-freight industry was a new industry in the base period years, 1946 through 1949, and experienced such tremendous losses, due to peculiar circumstances, that further adjustments ought to be made in the proposed law. In addition, section 446 of the bill should be clarified to assure applicability to members of the industry who have service activities in addition to flight operations.

The air-freight industry was not organized until late 1945 and early 1946. (Slick Airways did not begin business until after January 1, 1946.) The industry grew out of techniques developed during World War II to handle the tremendous movements of air cargo by the Air Transport Command and the Naval Air Transport Service. Many individuals who had participated in these air-cargo operations, or witnessed them at close range, organized companies to carry commercial air freight.

As with almost any new business, it was expected that the initial period of operations would bring either losses or low profits, but that, as volume increased,

substantial profits would appear. Commercial shippers responded well to the salesmanship and service of the new industry. During the last half of 1945, only about 1,000,000 ton-miles of commercial freight moved by air, but in 1946, the new all-freight carriers hauled approximately 27,000,000 ton-miles. During 1946 the established passenger airlines, witnessing this response, began a concerted effort to increase their freight business and to exclude the new companies who had proved their potential. Aided by their mail-pay subsidy, the passenger lines cut rates below cost, driving many of the new companies out of business and causing heavy losses to the others.

As a result of these factors, the air-freight industry lost money throughout the years 1946 through 1949, although its losses steadily declined. During the period 1946 through 1949, Slick Airways operated at a loss every year and the losses totaled almost $2,000,000, of which only about $500,000 can be carried forward for income tax purposes. The correction of the rate situation was not fully completed until May 1950 when the Civil Aeronautics Board issued its directional rate order. In the same month, Slick Airways began showing consistent net profits. A study of the earnings and operating history of this industry demonstrate that substantial profits would have been earned this fall, even in the absence of the Korean situation.

Under the proposal now before you, however, the industry, and this company in particular, would be placed in the position of having very inadequate excess profits credits because it began business during or just prior to the year 1946, and operated at a loss during the base period.

Slick Airways, Inc., has the option of computing its excess profits credit on one of four possible bases: (*a*) average base period net income, (*b*) invested capital, (*c*) idustry base period rate of return for new corporations, and (*d*) regulated public utility credit. None of these methods appear equitable in relation to the losses we have incurred in founding this industry.

The use of a past period as a standard of normal earnings in determining excess profits credit is completely inapplicable to all-freight airlines, since the industry sustained net operating losses throughout the base period.

The alternative of a credit based on invested capital is also completely inadequate. Equity capital was almost totally unavailable during the period 1946 through 1949 because of the uncerain competitive position of the air freight carriers. A large portion of the capital required had to be obtained by debt financing. Moreover, capital requirements were abnormally low when the companies were organized, because of the availability of surplus aircraft and equipment at bargain prices. These planes and equipment must be replaced not only at full prices, but at inflated prices. Even though the bill passed by the House of Representatives provides that invested capital will include the net worth of the business at the beginning of any taxable year, this fails to provide a reasonable base for normal earnings since the net worth of these companies has been greatly restricted by their large net operating losses.

The provision for determining the excess credit of new companies by applying an industry base period rate of return to the total assets of the new company does not help this industry. Net operating losses have depressed the normal increase in asset value and the rate of return for this industry was less than zero. The industry is not comparable to any other industry, and even if the rate of return for the passenger lines was applicable, that too would be a net deficit.

Another method of computing the credit is apparently available to the air freight carriers as regulated public utilities. This credit includes the sum of current income taxes and 5 percent of equity and borrowed capital. It is probably adequate for the regular well-established public utilities since it is designed to allow a return of 5 or 6 percent on equity and borrowed capital, after income taxes, before subjecting a utility to excess profits taxes. The air-freight industry is in a different position, however, in view of the fact of its short existence and its initial operation without profits. The same objections are present in this method as in the invested capital method with respect to equity and borrowed capital. The addition of current taxes into the base merely offsets, to a greater or lesser degree, the reduction in return on capital from 12 to 5 percent.

However, there is a danger that even this method of computing credit may be denied some of the carriers. This provision of the bill (sec. 446) now includes as "regulated public utilities" only utilities "substantially all" of whose excess profits net income for the taxable year is derived from regulated public services. The use of the phrase "substantially all" as a criterion for application is highly undesirable. It leaves the applicability of the section entirely dependent upon

administrative interpretation and is sure to produce great uncertainty among taxpayers and, if strictly construed, a volume of litigation. The language should be changed to a stated percentage of excess profits net income. The percentage should not be in excess of 75 percent, or three-fourths of excess profits net income.

The practical need for this percentage is demonstrated by the situation of Slick Airways. It has for some years maintained a service and supply division, whose chief activity was the modification or reconditioning of surplus aircraft for the armed services of this country, or friendly foreign countries, or for other airlines. Income from these operations may, in the event of large demand for aircraft conversions, amount to 25 percent of the company's total net income. The operations are directly connected with its primary function as a regulated air carrier and are all directly in aid of national defense and the public interest. Yet the income derived from them would not fall within the class of income described in subsection (c) of section 446. If the Treasury should take the position that the remaining three-fourths of the company's excess profits tax net income, derived from sources described in subsection (c), was not "substantially all" of its income, the company would be deprived of its tax status as a regulated public utility and would be penalized because of operations directly in aid of national defense.

The industry does not ask for anything other than an opportunity to offset its initial losses in determining excess profits. We ask only (1) that the industry be permitted to carry over to the excess profits tax years and for excess profits tax purposes the full amount of losses which it cannot presently offset against income tax for 1950, and (2) that it be treated as a regulated public utility so long as its income from service and supply activities does not exceed 25 percent of excess profits net income.

It has been and is difficult to attract equity capital to this high-risk industry because of its heavy losses. An opportunity to recoup them in part would greatly aid in expansion of the industry as a vital adjunct to national defense. The desirability of expansion of new businesses has already been recognized in preparation of the bill. The purpose should apply with multiple force to the air freight industry. It is obvious that we may at any future time be faced with an emergency in which speed and volume of air transport may spell the difference between life and death of thousands, or even millions of our people.

Respectfully submitted.

EARL F. SLICK,
Chairman of the Board.

STATEMENT OF H. L. MASON, CHAIRMAN, PUBLIC UTILITIES COMMISSION OF OHIO

I. REASON FOR APPEARING

The primary duty of the Public Utilities Commission of Ohio is to see that the people of Ohio are adequately served at reasonable rates by their public utilities. This involves, among other things:

(*a*) Allowance of a return high enough to enable the utility to attract sufficient capital to construct the property and plant which it needs to adequately serve the people.

(*b*) Maintenance of a financial position which will insure the lowest possible over-all cost of money in the long run, and thus the lowest possible rates.

In our opinion, the World War II excess profits tax seriously impaired the ability of the regulated utilities in Ohio to do these. A similar tax put in effect now would likewise impair their ability to attract capital and maintain low rates.

During the last excess profits tax period the earnings or profits of the average corporation in the United States increased 51 percent over 1940, while the class A and B Ohio telephone companies profits dropped 8 percent, the nine largest Ohio electric utilities profits dropped 12 percent, and the five largest Ohio gas utilities profits dropped 3 percent from 1940.

Regulated utilities are already carrying more than their share of the Federal income-tax burden. In 1949 the Ohio electric utilities were paying 8.7 percent of revenue in Federal income tax, the Ohio gas utilities 5.9 percent, and the Ohio telephone utilities 8.3 percent compared with 3 percent for the average corporation in the United States.

II. BASIC POSITION

Regulated utilities are not in the same position as a nonregulated industry during periods when war or defense spending can lead to war profiteering. These regulated utilities cannot, in fact, earn excessive profits. If their profits become too high, our job is to lower the rates.

The profits of the Ohio utilities have not been excessive during the postwar years. While the average earnings of all corporations in the United States had increased 172 percent over 1940 during the years 1946 to 1949, the earnings of the Ohio telephone companies had increased only 21 percent since 1940, the earnings of the Ohio electric companies had increased only 39 percent, and the earnings of the Ohio gas companies had increased only 75 percent.

During the years 1946–49 stockholders of the average manufacturing corporation earned 15.5 percent on their investment in equity capital. During the same period Ohio telephone utility stockholders earned only 40 percent as much, Ohio gas utility stockholders only 65 percent as much, and Ohio electric utility stockholders only 73 percent as much. Yet utilities must compete with manufacturing corporations for the stockholders' dollar for use in expanding plant.

III. ALTERNATIVE POSITION

This committee and Congress may decide that it is still possible for regulated utilities to earn excess profits because of lags in regulation or short-term increases in earnings. If so, the following provision should be included in any excess profits tax law to apply specifically to regulated utilities:

"The minimum basic exemption on any base should be not less than 6 percent, after the deduction of normal taxes and surtaxes, of the average stock, surplus and long-term debt during the tax year."

Such a provision will make the excess profits tax exemption of regulated utilities commensurate with their regulation. A similar provision has been endorsed by the National Association of Railroad and Utility Commissioners.

This provision would allow the growth to continue that has seen the Ohio telephone companies increase their investment in property and plant 55 percent since 1945, the Ohio electric companies increase their property and plant 42 percent since 1945, and the Ohio gas companies increase their property and plant 27 percent since 1945.

This provision would not handicap the financial position of the Ohio utilities by drastically lowering the rate on invested capital of 7 percent earned by the electric companies and telephone companies, or 8 percent earned by the gas companies in 1949. The Ohio gas, telephone, and electric utilities all earned less than 6 percent on total investment in property and plant during 1949.

In addition, this provision should not discriminate against the debt capital so necessary to keep the over-all cost of money low, and thus keep rates low. In 1949, Ohio electric utilities had 50 percent of debt capital, Ohio gas utilities had 20 percent of debt capital, and the Ohio telephone utilities 7 percent of debt capital (or 41 percent if Ohio Bell Telephone Co. and Cincinnati and Suburban Bell Telephone Co. are excluded), as compared with 12 percent for the average of all manufacturing corporations.

Excess profits tax legislation data, Ohio electric companies—Equity capital and earnings

Year	Equity capital	Net income	Percent net of equity	Net income index
1940	$365,830,000	$34,951,000	9.7	100
1941	373,744,000	30,122,000	8.1	86
1942	355,868,000	30,218,000	8.5	86
1943	352,525,000	30,194,000	8.6	86
1944	359,107,000	29,027,000	8.1	83
1945	343,860,000	35,232,000	10.2	101
1946	366,896,000	41,747,000	11.4	119
1947	389,093,000	46,312,000	11.9	132
1948	409,845,000	49,919,000	12.2	143
1949	505,206,000	56,422,000	11.1	161

NOTE.—Companies included: Central Ohio Light & Power Co., Cincinnati Gas & Electric Co., Cleveland Electric Illuminating Co., Columbus & Southern Ohio, Dayton Power & Light Ohio Edison, Ohio Power Ohio Public Service, and Toledo Edison.

Ohio telephone utilities—Equity capital and earnings

Year	Equity capital	Net income	Percent net of equity	Net income index
1940	$203, 725, 000	$15, 801, 000	7. 5	100
1941	216, 464, 000	15, 155, 000	6. 8	96
1942	215, 643, 000	13, 854, 000	6. 2	88
1943	216, 059, 000	14, 638, 000	6. 6	93
1944	216, 984, 000	14, 402, 000	6. 4	91
1945	218, 642, 000	14, 862, 000	6. 6	93
1946	238, 705, 000	20, 162, 000	8. 2	127
1947	279, 307, 000	16, 610 000	5. 8	105
1948	317, 240, 000	16, 255, 000	5. 1	105
1949	335, 100, 000	23, 188, 000	6. 7	147

NOTE.—Companies included: All Ohio class A and B companies (35).

Ohio gas utilities—Equity capital and earnings

Year	Equity capital	Net income	Percent net of equity	Net income index
1940	$122, 555, 000	$8, 340, 000	6 8	100
1941	123, 100, 000	6, 223, 000	5. 0	75
1942	124, 390, 000	7, 249, 000	5. 8	87
1943	131, 231, 000	9, 467, 000	7. 2	113
1944	134, 632, 000	8, 187, 000	6. 1	98
1945	136, 653, 000	9, 362, 000	6. 9	112
1946	132, 705, 000	12, 590, 000	9. 5	151
1947	140, 307, 000	16, 821, 000	12. 0	202
1948	155, 181, 000	14, 471, 000	9. 3	173
1949	158, 720, 000	14, 553, 000	9. 2	175

NOTE.—Companies included: East Ohio Gas Co., Lake Shore Gas Co., Ohio Fuel Gas Co., Portsmouth Gas Co., and West Ohio Gas Co.

Ohio electric utilities—Gross plant and gross income

Year	Gross plant	Index	Gross income	Index	Rate of return
					Percent
1940	$785, 292, 000	100	$49, 609, 000	100	6. 3
1941	815, 397, 000	104	44, 013, 000	89	5. 4
1942	810, 196, 000	103	45, 360, 000	91	5. 6
1943	817, 323, 000	104	52, 180, 000	105	6. 4
1944	837, 187, 000	107	97, 410, 000	95	5. 7
1945	855, 525, 000	109	55, 362, 000	111	6. 5
1946	884, 925, 000	112	55, 404, 000	111	6. 3
1947	949, 382, 000	121	59, 469, 000	120	6. 3
1948	1, 093, 853, 000	140	63, 452, 000	127	5. 8
1949	1, 218, 775, 000	155	70, 700, 000	142	5. 9

Ohio telephone utilities—Gross plant and gross income

Year	Gross plant	Index	Gross income	Index	Rate of return
					Percent
1940	$275, 113, 000	100	$16, 565, 000	100	6. 0
1941	299, 391, 000	109	15, 221, 000	92	5. 1
1942	313, 810, 000	113	13, 854, 000	83	4. 4
1943	318, 472, 000	116	14, 643, 000	88	4. 6
1944	323, 765, 000	118	14, 401, 000	87	4. 5
1945	337, 842, 000	123	14, 862, 000	90	4. 4
1946	372, 945, 000	136	20, 162, 000	122	5. 7
1947	409, 662, 000	149	18, 638, 000	112	4. 6
1948	491, 056, 000	179	17, 844, 000	108	3. 6
1949	523, 818, 000	190	24, 646, 000	149	4. 7

Ohio gas utilities—Gross plant and gross income

Year	Gross plant	Index	Gross income	Index	Rate of return
					Percent
1940	$192, 117, 000	100	$9, 435, 000	100	4.9
1941	197, 236, 000	103	7, 442, 000	79	3.8
1942	197, 668, 000	103	8, 340, 000	89	4.2
1943	205, 338, 000	107	10, 343, 000	110	5.0
1944	206, 601, 000	108	8, 984, 000	95	4.4
1945	210, 168, 000	109	10, 310, 000	110	4.8
1946	210, 262, 000	109	13, 159, 000	138	6.2
1947	228, 208, 000	119	17, 386, 000	185	7.6
1948	252, 303, 000	131	15, 323, 000	163	6.1
1949	268, 644, 000	140	16, 012, 000	170	6.0

Major Ohio electric companies—Earnings on total capitalization

Year	Equity	Debt	Total	Gross income	Rate, gross income/total capitalization
1940	$365, 830, 000	$369, 279, 000	$735, 109, 000	$49, 607, 000	6.7
1941	373, 744, 000	382, 674, 000	756, 418, 000	44, 013, 000	5.8
1942	355, 868, 000	379, 602, 000	735, 470, 000	45, 360, 000	6.2
1943	352, 525, 000	376, 611, 000	729, 136, 000	52, 180, 000	7.2
1944	359, 107, 000	368, 704, 000	727, 811, 000	47, 410, 000	6.5
1945	343, 860, 000	370, 985, 000	714, 845, 000	55, 362, 000	7.7
1946	366, 896, 000	365, 249, 000	732, 145, 000	55, 404, 000	7.5
1947	389, 093, 000	394, 299, 000	783, 392, 000	59, 469, 000	7.6
1948	409, 845, 000	501, 462, 000	911, 307, 000	63, 452, 000	7.0
1949	505, 206, 000	512, 268, 000	1, 017, 474, 000	70, 700, 000	7.0
Percent of total	50	50	100		

Class A and B telephone companies—Earnings on total capitalization

Year	Equity	Debt	Total	Gross income	Rate, gross income/total capitalization
1940	$203, 725, 000	$10, 261, 000	$213, 986, 000	$16, 565, 000	7.7
1941	216, 464, 000	15, 537, 000	232, 001, 000	15, 221, 000	6.6
1942	215, 643, 000	21, 503, 000	237, 150, 000	13, 854, 000	5.8
1943	216, 059, 000	12, 475, 000	228, 534, 000	14, 643, 000	6.4
1944	216, 984, 000	12, 282, 000	229, 266, 000	14, 401, 000	6.3
1945	218, 642, 000	12, 239, 000	231, 881, 000	14, 862, 000	6.4
1946	238, 705, 000	16, 691, 000	255, 396, 000	20, 162, 000	8.5
1947	279, 307, 000	18, 318, 000	297, 625, 000	18, 638, 000	6.3
1948	317, 240, 000	29, 262, 000	346, 502, 000	17, 844, 000	6.1
1949	335, 100, 000	25, 542, 000	360, 642, 000	24, 646, 000	6.8
Percent of total	92.9	7.1	100		

EXCLUDING OHIO BELL TELEPHONE AND CINCINNATI & SUBURBAN BELL TELEPHONE

	Equity	Debt	Total
Amount	$37, 098, 000	$25, 542, 000	$62, 640, 000
Percent	59	41	100

Mayor Ohio gas companies—Earnings on total capitalization

Year	Equity	Debt	Total	Gross income	Rate, gross income/total capitalization
1940	$122,555,000	$7,524,000	$130,079,000	$9,435,000	7.2
1941	123,100,000	6,767,000	129,867,000	7,442,000	5.7
1942	124,390,000	4,627,000	129,019,000	8,340,000	6.4
1943	131,231,000	3,818,000	135,049,000	10,343,000	7.7
1944	134,632,000	9,928,000	144,560,000	8,984,000	6.2
1945	136,653,000	8,716,000	145,639,000	10,310,000	7.1
1946	132,705,000	999,000	133,704,000	13,159,000	7.0
1947	140,307,000	1,191,000	141,498,000	17,386,000	12.3
1948	155,181,000	32,008,000	187,189,000	15,323,000	8.2
1949	158,720,000	41,830,000	200,550,000	16,012,000	8.0
Percent of total	79.5	20.5	100		

Income taxes, percent of revenue

Year	Telephone			Gas			Electric		
	Revenue	Tax	Percent	Revenue	Tax	Percent	Revenue	Tax	Percent
1940	$66,447,000	$4,837,000	7.3	$59,945,000	$3,294,000	5.5	$161,681,000	$10,062,000	6.2
1941	73,790,000	9,490,000	12.9	61,630,000	4,011,000	6.6	182,090,000	21,859,000	12.6
1942	80,969,000	13,140,000	16.2	67,961,000	8,492,000	12.5	195,132,000	29,547,000	15.2
1943	91,120,000	17,286,000	19.0	74,617,000	10,721,000	14.4	217,759,000	28,711,000	13.2
1944	97,773,000	20,391,000	21.0	74,186,000	5,347,000	7.2	232,750,000	32,177,000	13.8
1945	106,312,000	20,484,000	19.9	78,644,000	7,826,000	10.0	230,627,000	17,421,000	7.6
1946	117,295,000	11,480,000	9.7	82,568,000	8,821,000	10.7	238,352,000	20,863,000	8.8
1947	127,033,000	10,110,000	8.0	98,974,000	8,998,000	9.1	281,020,000	24,473,000	8.7
1948	143,484,000	10,109,000	7.1	104,477,000	6,612,000	6.3	318,821,000	27,584,000	8.6
1949	162,565,000	13,474,000	8.3	108,597,000	6,379,000	5.9	331,177,000	28,883,000	8.7

(Whereupon, at 5:20 p. m. the committee recessed, to reconvene at 10 a. m. Friday, December 8, 1950.)

EXCESS-PROFITS TAX ON CORPORATIONS, 1950

FRIDAY, DECEMBER 8, 1950

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

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

Present: Senators George, Millikin, Taft, Butler, and Martin.

Also present: Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation; and Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will please come to order.

Mr. Sligh is the first witness to be called on on the list this morning.

Mr. Sligh, will you please be seated and identify yourself for the record.

STATEMENT OF CHARLES R. SLIGH, JR., CHAIRMAN, TAXATION COMMITTEE OF NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY HARLEY L. LUTZ, TAX CONSULTANT, AND JOHN C. DAVIDSON, DIRECTOR, GOVERNMENT FINANCE DEPARTMENT

Mr. SLIGH. My name is Charles R. Sligh, Jr. I am a furniture manufacturer and president of the Charles R. Sligh Co., Holland, Mich. I appear here as chairman of the taxation committee of the National Association of Manufacturers.

I have with me Mr. Harley L. Lutz, tax consultant, and Mr. John C. Davidson, the director of the Government finance committee of the NAM.

I ask your permission, sir, to read a summary of my statement, and submit the full statement for the record.

The CHAIRMAN. Yes, sir; you may do that.

Mr. SLIGH. It is always a privilege to testify before this committee, but especially so at this time. In September Congress, upon your advice, resisted tremendous pressure to enact an excess profits tax patterned after the inflationary and inequitable formula used in World War II. Action was ordered delayed until this highly important proposal could be given adequate study by your committee, and by other congressional and Treasury tax experts.

The delay gave business an opportunity, which it would have been denied had the attempt to put an excess profits tax on the books succeeded, to document the shortcomings of this bad law and to explain them to you.

Our association favors putting all of the increased defense costs on a pay-as-we-go basis. We are not here trying to safeguard the cor-

porate pocketbook from new taxes. We know that this is only a part of the tax load yet to come. Business wants to pay its fair share of this increased burden. But we know—and you know—that business cannot pay it all. All segments of the economy must bear their fair share of the burden, too.

We are here, Mr. Chairman, to help your committee to avoid the repetition of a costly error made in World Wars I and II. We come with an alternative program which will take any specified number of dollars from corporation profits without inflicting irreparable harm especially upon small and growing businesses which are the backbone of our industrial economy.

Mr. Chairman, I offer two documents for the record. One is entitled "A Federal Tax Program for the Period of Defense and Partial Mobilization." The other is a study by Dr. Harley L. Lutz entitled "An Excess Profits Tax Is Against the Public Interest."

(The documents referred to are as follows:)

A FEDERAL TAX PROGRAM FOR THE PERIOD OF DEFENSE AND PARTIAL MOBILIZATION

(October 1950, Taxation Committee National Association of Manufacturers)

FOREWORD

The twin enemies of every American today are communism and inflation. Putting more money in circulation by financing the rearmament effort through deficits would endanger the very foundation of our Nation's welfare and security.

The alternative to deficit financing and more inflation is pay-as-we-go. We can pay as we go—pay for defense on a cash basis—if we start promptly and make proper use of our tax resources.

This means a heavy increase in taxes for all taxpayers. If we, as Americans, are not willing to bear the burden of national defense on a cash and carry basis, then we are condemning ourselves now and our children hereafter to a heavier burden, a vastly more dangerous burden—runaway inflation.

Deficit financing of World War II almost cut in half what our dollars will buy. We can't afford to have this happen again.

Experience shows that price controls and rationing provide no lasting protection against price increases which, sooner or later, come from deficit financing. Deficit financing means more dollars in our pockets than goods on the counter. This soon means goods under the counter, and eventually a higher general price level. The low income and fixed income groups, have no protection against either black markets or steady price increases; they would suffer a much heavier and more lasting burden under further inflation than they would under pay-as-we-go taxation.

In a practical sense, at the core of our culture, wealth, and civilization is a sound, stable currency system. In terms of that currency we measure income, prices, savings, insurance policies, and all our worldly goods. The intangible values, the most prized aspect of our culture and economy, are dependent on this basic monetary stability. A sure road to demoralization and despair is the steady depreciation of a nation's money and the disappearance of the material and moral benefits of sound money.

Disregard for these dangers, inherent in a steady rise of the public debt, is an effective way of playing the enemy's game, for he would far rather we destroyed ourselves than that he be forced to do it. Socialism and communism feed upon weakness and poverty. The immense volume and wide diffusion of our wealth have so far effectively immunized us against these isms. But these bulwarks will protect us only while they have the vitality of a money and credit system strong enough for confidence, and sound enough for sacrifice.

CHARLES R. SLIGH, Jr.,
Chairman, Taxation Committee,
National Association of Manufacturers.

FEDERAL TAX POLICIES FOR THE PERIOD OF DEFENSE AND PARTIAL MOBILIZATION [1]

1. The financing of defense should be placed immediately on a pay-as-we-go basis.

2. Pay-as-we-go requires diversion of private income equal to government's diversion of product.

3. To achieve a pay-as-we-go basis, the division of private income must be universal; no groups should be protected against the diversion of income while other groups bear the brunt of such diversion.

4. Diversion of private income can be effectively done only through a variety of taxes, not through any one tax.

5. The diversion of private income must be so done, certainly in all stages short of all-out total war, as to preserve as much as possible of the economic incentives to produce at the lowest cost. The tax recommendations for initial defense financing, as included in the Revenue Act of 1950, are inadequate in that they provide for tax increases in both of the income taxes, but for no increase in the excises except for adding a few classes of goods to the taxable list.

6. Under peace, defense, or war conditions, the present discriminatory Federal excise system is not a sound revenue instrument—the first essential step, needed under peace conditions but even more so in the defense financing, is to revise the existing excise tax situation by substituting a uniform excise tax on all end products of manufacture except food and food products, to replace all existing excises except those on alcoholic beverages and tobacco, which would continue to be taxed separately and would not be subject to the uniform excise. This uniform excise tax would be at a moderate rate and become in principle a permanent feature of Federal taxation.

7. An additional uniform excise rate should be imposed, to be especially identified as a defense charge.

8. As part of the special emergency financing, the following services now taxed (telephone, telegraph, cable; leased wires; local telephone; transportation of persons; admissions) should be subjected to a uniform excise tax rate at such level as may be established for the combination of basic and defense emergency uniform excises recommended in paragraphs 6 and 7.

9. Since excise taxes on alcoholic beverages and tobacco are still at the highest level imposed during World War II, there should be no increase of excise taxes on these products in connection with the defense financing.

10. The procedure for initial readjustment of the individual income tax, recommended by the President and included in the Revenue Act of 1950, is approved; namely, repeal of the percentage credits against the basic tax provided in the Revenue Acts of 1945 and 1948.

11. If and when greater revenue should be required from the individual income tax, the rate change should be made in such a way as to include an advance in the first bracket, which would increase the tax of all income taxpayers. A supplemental procedure to be considered only if the need for more revenue should become very great would be to lower the exemptions from $600 to the World War II level of $500.

12. The taxation of corporate income at progressive rates must be steadily opposed from every standpoint. Following the recommendation of the President, the Revenue Act of 1950 employs a rate structure which is the entering wedge for full progressive taxation of corporate income (the new rate schedule is 25 percent on all normal tax net income and 20 percent on surtax net income above an exemption of $25,000).

13. Experience with an excess profits tax during World Wars I and II shows that this method of taxation is unsound. Abnormal profits from sales to civilians can most effectively be prevented through pay-as-we-go taxation. In the case of Government contracts, abnormal profits can most effectively be prevented through efficient procurement policies. An excess profits tax contributes to inflation because it tends to reduce the incentives for management and government to control costs and make the most efficient use of materials and manpower. It is economically unsound because there is no sound basis for determining the profit return necessary to continued growth of industry, especially new and small business. It is administratively unworkable. It requires excessive compliance costs and involves years of costly examination and litigation before the final tax

[1] Approved by the board of directors of the National Association of Manufacturers, on recommendation of the association's taxation committee.

liability is determined. Finally, the additional revenue that can be realized from this unsound method of taxation has been grossly exaggerated.

14. In lieu of an excise profits tax with its inevitable inflationary consequences and administrative difficulties, the tax contribution from corporations toward the pay-as-we go tax program should be made through an addition to the corporation income tax to be known as the corporation defense tax. To effect a clear distinction between the income tax and the corporation defense tax, and to avoid imposing too heavy a burden on small business, the standard corporation income tax rate should be set at 38 percent by changing the normal tax rate in the Revenue Act of 1950 from 25 percent to 18 percent, while leaving the surtax rate at 20 percent. The corporation defense tax should be imposed as a flat percentage of the amount of the corporation income tax.

A Federal Tax Program for the Period of Defense and Partial Mobilization

During the years that have elapsed since the end of the shooting of World War II, the major concern of all private agencies that have been studying the Federal finances has been the reduction of public spending and the development of taxation methods that would supply the necessary public services and at the same time distribute the tax burden so as to involve the least impediment to the growth and efficiency of the productive forces. The sudden emergence of a state of war in Korea, with an accompanying condition of grave uncertainty as to the future peace of the entire world, has compelled a swift reversal of all financial planning. Instead of spending less, the United States now faces the obligation, for an indefinite period ahead, to spend much more on military and related purposes. Instead of a prospect of lower taxation, the people now face the certainty of heavier taxation.

Many of the basic principles and proposals of the NAM Federal tax program as heretofore developed are still sound. Among them are such matters as the treatment of business net losses, the recommendations respecting depreciation, etc., the equal taxation of all business organized and operated for profit, and various other points. It is not necessary to repeat all of these established policy positions here. The present purpose is to discuss the immediate problems of financing the defense effort. Such a discussion necessarily involves reference to some aspects of public spending as well as to the particulars of increased taxation.

WE SHOULD PAY-AS-WE-GO FOR THE DEFENSE COSTS

The first point to be made in connection with the financing of defense is that it should be paid for as we go. The Federal debt is now about $257,000,000,000. As a consequence of short-sighted and improvident policies of debt management, there is now an immense volume of short-term or floating debt, and also a huge amount of other debt, consisting of both Treasury bonds and savings bonds, that will mature in the near future. The task of handling the necessary refinancing operations without resort to arbitrary policies that would impair public confidence in the integrity of the Government's intentions will be extremely difficult without the added complication of large new financing. An illustration of such arbitrary action is at present in the rumor stage only. It is that the Treasury may attempt pressure on holders of maturing savings bonds to accept new bonds rather than cash.

Entirely apart from the problems of debt management, however, is the question of further inflation. Here is the most serious and important reason for putting the defense program on a pay-as-we-go basis and keeping it there. The people are disturbed and excited over the prospect of more inflation. Many do not understand the real cause and they see only the ultimate manifestation of inflation, which is a rise of general prices. The damage will have been done, long before this final inflation indicator has become visible, by floating large, new Government loans with the banks. But such inflationary financing is inevitable unless there is prompt action to provide and maintain tax receipts sufficient to cover all of the Government spending.

Reduce nondefense spending

It is self-apparent that the first step in assuring a cash payment basis for the defense effort from the beginning is through the reduction of nonmilitary expenditures. Even with the most prompt and diligent effort to introduce tax increases, there will be a certain time lag before these increases can begin to show additional receipts. The reduction of spending can be effective almost immedi-

ately, and it is the first line of defense against inflation. The extent to which this can be done, and the manner of doing it, are discussed in the report of the Government spending committee.

If it be assumed that extensive reductions be made in the civilian expenditures, there would still be a deficit because of the increase in military spending, the amount of which is simply not determinable at this time. The President has already requested some $12,000,000,000 of additional funds for military purposes, and an increase for arms aid of $4,000,000,000 over and above the $1,678,000,000 for this purpose in the general appropriation bill. It is possible that additional requests will be transmitted to, and acted upon by, the present session of Congress before it adjourns. When the Eighty-second Congress convenes, in January 1951, there may be more and larger estimates of the military need, but the application of these appropriations will fall mainly in the fiscal year 1952 and later years. The more urgent and immediate problem, now, is the probable budget deficit for the fiscal year 1951.

If, without additional revenues, all of the additional funds already asked for were to be voted and spent before June 30, 1951, there would be a deficit of at least $16,000,000,000, even assuming that the economies recommended by the Government spending committee were to be introduced. To whatever extent these economies are not made, the deficit would, by so much, exceed $16,000,000,000, up to a possible $21,000,000,000. There is, however, an offset factor, namely, the lag in the actual spending of the military appropriations. The bulk of these apropriations must first be obligated through contracts for military matériel, and in numerous cases, production under these contracts cannot proceed without preliminary conversion and adaptation of plant facilities. In other cases, of course, procurement will involve heavier purchases of the kinds of goods now in production.

There is no way of ascertaining, even approximately, how the goods required will divide between those already in production and those which will involve conversion delays. If it be assumed, solely for illustrative purposes, that it would be a 50–50 division, then it is possible that as much as half of the additional military appropriations would be spent in the current fiscal year. On this basis the deficit would be at least $8,000,000,000, plus the margin in the regular budget, up to $5,100,000,000 that was not covered by drastic economies in the prospective nondefense spending.

Current plans for tax increase

At the time of this writing the Senate is debating the tax bill reported out by the Senate Finance Committee. This committee had deleted the excise tax reductions in the bill passed by the House (H. R. 8920),[2] and otherwise converted it into a bill to provide increased revenues, following the pattern which had been laid out by the President in a communication to the chairmen of both congressional taxation committees on July 25, 1950. Minor additions were made in the list of excise taxes; the credits against individual tax authorized by the 1948 act were reduced by 25 percent for the tax year 1950, and eliminated for subsequent tax years; and the top rate of corporation tax was raised to 45 percent, effective as to the second half of the year 1950. The House bill provisions for accelerating corporation-tax payments were retained, but the withholding tax on dividends was dropped. The Finance Committee's estimate of the additional revenue, at current national income levels, was $4,508,000,000 in a full year, and $2,957,000,000 in the fiscal year of 1951. This committee recognized that the additional revenue would not be sufficient to offset the new defense and related expenditures, but it stated that the bill accomplished all that could be done quickly.

In view of the time required to prepare new withholding tables and print the necessary forms for use by October 1, the case for prompt action is evident. Whether the bill contained all that could have been enacted at this time is a matter of political judgment, and the congressional leaders possess undoubted competence in this field. On the other hand, the President's letter, mentioned previously, pointed the way by expressing concern over the added impetus that a growing deficit would give to inflationary forces. Even the briefest consideration of the present distended state of the economy, by comparison with the situation in 1940 when substantial defense programs were inaugurated prior to World

[2] Hereinafter referred to as the Revenue Act of 1950.

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War II would reveal that we now have a far greater obligation to step up the revenues rapidly. The following comparisons will illustrate the point:

TABLE I

	1940	1950 (6 months)
Wholesale Price Index (1926 base) ... percent..	78.6	153.8
Industrial production (FRB 1935-39 base)	125	189
Unemployment (thousands)	8,120	3,874
Unemployment of civilian labor force ... percent..	14.6	6.2

In view of these and other readily available facts, it is a matter of real regret that the tax program proposed by the President and accepted by the Congress is not more extensive.

Can we pay-as-we-go for the defense program?

The important financing question before the country is whether or not we can pay cash as we go for the defense program. The answer to this question involves the relation of the additional military burden to the productive capacity of the economy. For an understanding of this relationship there is presented, next, a brief discussion of the economics of how the private economy supports the Government.

THE ECONOMICS OF GOVERNMENT SPENDING AND THE PRIVATE ECONOMY

The most elementary proposition is that both the people and the Government must derive their support at all times from current production. We cannot eat, today, next year's food crop, nor wear the clothing and shoes that will be made next year. We cannot today fabricate steel from ore to be mined next year, nor construct buildings and highways with next year's cement.

It follows that everything that Government requires in a given year must be drawn from the product available in that year, whether its scale of operations be the moderate one appropriate to peace conditions or the expanded one which intensive defense, or war, may require. In either case, supplying the Government involves a diversion of part of the current product from private to public use.

Federal budget balance protects the price level

Under normal, peacetime conditions and a sound fiscal policy, the diversion of goods and services to public use is accomplished by a parallel diversion of private income through taxation, supplemented in small degree by nontax receipts from private income such as fees, fines, interest, penalties, sales of public property, and various miscellaneous charges. Government must pay for the goods and services which it buys, and while the budget is in balance, this is done by drawing off the necessary amount of private income.

Here is the reason why the combination of taxing and spending under a balanced budget is neither inflationary nor deflationary. Government income reduces private income, but Government spending replaces private spending. The proviso of a balanced budget is essential to the argument, for the creation of new purchasing power through bank loans would leave relatively more income with the people than would be needed to absorb the share of produced goods and services available to them, at the existing price level. The competitive use of this extra money will force prices up. As long as the Government pays all of its bill with money collected from the people, the combination of taxing and spending is neutral so far as the general price level is concerned.

Inflation caused by Government borrowing

But when the Government fails to mtaintain this balance between diversion of product and diversion of private income, and instead, creates its own means of payment by selling its bonds to the banks in exchange for new deposit credits, then there is an excess of total purchasing power in relation to the goods currently available for private use. Government has taken part of the current product, but it has not correspondingly reduced the current income in the possession of the people. Rather, it has added to their purchasing power. The

obvious consequence is that prices are forced up. As prices rise, there is greater pressure for wage increases to keep up with the rising cost of living. The cost of the goods and services needed by Government goes up, and it soon becomes necessary to step up the rate of fresh borrowing in order to pay the bills. Thus the familiar, and dreaded, spiral of inflation, leading to still more inflation, gets under way.

The principal action that will prevent inflation is for the Government to avoid the creation of new funds through bank loans and to draw off, by the various tax methods, enough private income to pay for the goods and services bought. The crux of the matter is in the question whether or not it is possible to do this, and where, if at all, is the limit to a pay-as-we-go policy for defense—or war.

Current product only source of payment

As a first approach, it should be noted that Government always has and exercises the prior claim to current product. It takes whatever may be required (or whatever loose and improvident procurement policies determine is required) and the people must get along on what is left. This explains why economists have always insisted that the real economic burden of war falls on the war generation. The people who live and work during the war years must undergo the privations ensuing from an abnormal diversion of product to Government use. It is they who must put up with shortages, the complete disappearance of some items formerly abundant, with the rationing, controls, and the many inconveniences caused by the regimentation that always emerges in modern, all-out war effort. This regimentation, in all of its aspects, will become necessary sooner if inflationary means of payment are used by Government than would be the case if the enlarged program were kept fully, or more nearly, upon a cash basis. Even though we are not now dealing with all-out war, but only with a defense program far short of total war, the economic facts are the same. To the extent that there are inroads upon the volume of goods for private use as a result of the expanded defense program the curtailment of private consumption must be endured now. It cannot be postponed to later years.

We can pay-as-we-go

An important reason why it has never been possible, in this country at least, to proceed on a cash basis of defense—or war—financing has been that in every case the emergency has been precipitated so suddenly that appropriate and adequate changes in the Federal tax structure could not be made in time to supply even the funds needed for the initial increase of production. Once borrowing on a substantial scale has begun, the impossibility of gearing up the tax system rapidly enough to cover the rising expenditure requirements has usually served as an excuse for not making a serious effort in that direction.

This excuse is not valid today, for the Nation is on notice that increased military expenditures are ahead, not only for this year, but for some years beyond. There is still time for a constructive reshaping of the Federal tax system, and for a release of tax revenue to the military purposes by a drastic pruning of nonmilitary spending, to get the total spending and taxing off to a fairly even start. It is not necessary this time to plead the obstacle of insufficient time to put our financial house in order before the storm breaks.

The basic economic character of the diversion process and its effect in depriving civilians of goods is not altered by the fact that there may be a substantial increase of total product during an intensive war effort. All, or a very large part of the increased production under such circumstances will consist of military matériel, or of food, clothing, and other supplies purchased by the Government. We had a demonstration of this in the last war. Gross national product rose from $101,400,000,000 in 1940 to $215,200,000,000 in 1945, but it was nevertheless necessary to introduce rationing of many goods and strict allocations of basic materials.

Some idea of our capacity to carry the increased cost of the defense program on a cash basis may be had by reference to the latest available national income statistics. The components of gross national product for the year 1949 and the first half of 1950 were as follows:

TABLE II.—*Components of gross national product, 1949 and 6 months, 1950*

[Billions]

	1949	1950 (annual rate, 6 months)
Personal consumption expenditures	$178.8	$183.4
Gross private domestic investment	33.0	42.2
Net foreign investment	.4	−2.0
Government purchases of goods and services	43.3	41.4
Gross national product	255.5	265.0

After deducting from gross national product the capital charges and costs of business, and business tax and nontax liabilities, the remainder is national income. The components of national income for the same period were as follows:

TABLE III.—*Components of national income, 1949 and 6 months, 1950*

[Billions]

	1949	1950 (annual rate, 6 months)
Compensation of employees	$140.6	$144.4
Business and professional income and inventory adjustment	21.0	21.8
Income of farm proprietors	13.4	12.2
Rental income of persons	7.3	7.2
Corporation profits and inventory adjustment	29.9	28.4
Net interest	4.7	5.0
Total national income	216.9	219.0

Source: Data in tables II and III from Midyear Report of the Council of Economic Advisors, July 1950

These figures include the existing budget transactions for military and civilian purposes. The present dimensions of the additional defense program are of the magnitude of $16,000,000,000. As the Government spending rises the first effect would be to reduce the supply of materials available for personal consumption and for business plant and equipment. If the additional spending were paid for with funds taken from current income, the amounts remaining as disposable personal income and corporation profits after taxes would be smaller. The further expansion of total product, if any, would come from a more complete utilization of existing plant and manpower, or from such new plant as might be constructed for the defense program needs.

With the economy operating at its present high levels, the absorption of the presently proposed and prospective increases of defense spending should not involve a degree of hardship too great to be endured. The important point to be emphasized is that the primary impact of the diversion should be on personal consumption rather than on investment in the productive plant and equipment. Above all, it is essential that the Nation's productive facilities be maintained and, where possible, enlarged, for there is no way of telling when the military demands upon them may be very greatly increased. Preservation of the productive plant at a high level of operating efficiency will also permit the continued production of a substantial flow of consumer goods for as long as the military demand does not curtail too greatly the allocation of basic materials to such production. And, as long as capital formation is allowed to continue on a large scale, the diversion from civilian to military consumption will be correspondingly offset in the years ahead.

Some general rules applicable to cash basis financing of the defense program

The expansion of revenue receipts in sufficient amount to cover the growing defense needs and to make possible the avoidance of inflationary deficits must be done in accordance with certain rules or principles, both to be effective and to assure a proper distribution of the burden. The following rules are suggested:

1. *The diversion of private income must be universal.*—To the degree that the greater diversion of product involves deprivation, the incidence of this deprivation should be general, and it follows that there must be a general incidence of the levy on private income or purchasing power. The whole purpose of avoiding price distortion would be defeated if one group were compelled to make all of the surrender of income while other groups were left in possession of their entire income and were free to use it in bidding up prices. Hence, no groups should be protected against the diversion of income while other groups bear the brunt of such diversion.

2. *The diversion of private income can only be effectively done through a variety of taxes, and not through any one tax.*—The basic reason for this is that there is no one tax that would apply with sufficient universality to all private income to accomplish the first objective set out above. At first glance, it may appear that the individual income tax is sufficiently broad to serve the purpose. But the fact is that as taxable income is now determined, there is a large number of recipients and a large volume of personal income that are not touched, and cannot be touched, by this tax.

According to statistical data supplied in connection with Secretary Snyder's statement of August 2 before the Senate Finance Committee, the total net income in taxable individual returns at 1950 income levels would be $140,819,000,000, and the taxable income in these returns would be $82,461,000,000. The gap of untaxed and untaxable income is $58,358,000,000. If to this there be added the income in nontaxable returns, the total of personal income not subject to tax at all would probably be as much as $75,000,000,000. In 1949 the total of personal consumption expenditure was $178,832,000,000. The individual income tax would not apply at all to some 60 percent of the income available for such expenditure.

For similar reasons it would not contribute to the important result of inflation control to undertake the collection of enough additional revenue from corporation profits alone to cover the deficit. In 1949 corporate income after existing taxes was $17,024,000,000, and dividends were $7,821,000,000. Complete confiscation of the remaining net income of more than $9,000,000,000 would probably cover the first year's deficit, but such a policy would be so completely destructive that it could not be repeated.

3. *The diversion of private income must be so done, certainly in all stages short of all-out, total war, as to preserve as much as possible of the economic incentives to produce at the lowest cost.*—Maintenance of a high level of production is essential to the rapid supply of the necessary military material, and it will, of course, hold to a minimum the deprivations which civilians must endure while the defense program is being developed. High-level production will generate a correspondingly high volume of income, and this, in turn, will make possible the payment of taxes to cover the Government's share of the product without involving as heavy a burden as would be necessary at a lower level of output and income. It is only when a nation has become engaged in a life and death struggle, and all civilians have been reduced to a subsistence level, that it can afford to eliminate further capital formation for nondefense production purposes. Short of that point of extreme sacrifice, there must be some provision for sustained civilian production. The best way to get this result is through recognition of the profit incentive.

TAX METHODS FOR DEFENSE FINANCING

The foregoing foundation of economic and fiscal principles supplies the basis for presentation of the details of a defense tax program to be financed on a cash basis. The principal forms of taxation available to the Federal Government are already well known, for all of them are now in use. They are: the excises, the individual income tax, and the corporation income tax. In the budget estimates for 1951, these taxes would produce 97.22 percent of total Federal tax revenue. The estate and gift taxes, and the customs, accounted for 2.78 percent. Miscellaneous nontax revenues were estimated at $1,095,000,000.

The guiding rules set out previously, lead to the conclusion that there should be increases and in each of the three major Federal taxes. The tax program for financing essentially the first year of the defense program, as proposed by the President and accepted by the Congress, is defective in that it provides for tax increases in both of the income taxes, but for no increase in the excises other than the trivial amounts to be obtained by adding a few classes of goods to the taxable list, such as television sets and deep-freeze units. The omission is serious, for a prompt increase in excise tax yield is the only way by which Treasury

changes of income tax rates and the response to these changes in tax collections. The Senate Finance Committee estimates of the results of the Revenue Act of receipts can be expanded quickly. There is a serious time lag between the 1950 indicate that whereas the corporation tax rate increases would produce $1,500,000,000 in a full year, they would bring in only $1,120,000,000 in the fiscal year 1951, including $800,000,000 from accelerated tax payment. Similarly, the increases of the individual income tax would produce $2,745,000,000 in a full year, but only $1,624,000,000 in the fiscal year 1951. In both cases, the great bulk of the 1951 yield will not be realized until some time in the calendar year 1951. Thus this legislation necessarily leaves the financing of the first 6 to 9 months of the defense program on a deficit basis, with all that is involved toward the development of a fresh inflationary situation.

Excise taxes

The existing NAM position on excise taxation was formulated in anticipation of continuing peaceful conditions and of the possibilty of reduction in Government spending and taxes. This position asserted, first, that there should always be a substantial reliance upon excise taxes at the Federal level because of the contribution which such taxes make toward the maintenance of budgetary stability; and, second, that there should be uniformity in the distribution of the excise taxes, except for those on alcoholic beverages and tobacco, in order to put all producers on a par in competing for the consumer dollar and to put all consumers on a par in making their choices among consumption goods. Accordingly the NAM position called for repeal of all existing excises except those on alcoholic beverages and tobacco, and in substitution therefor the introduction of a uniform excise on all consumer products except foods and food products, to be levied at the final stage of manufacture. It was further recommended that the rate be such as would produce a revenue equivalent to that now obtained from the selective excises to be repealed, namely, some $4,000,000,000, and at current production levels it was estimated that a rate of 5 percent would suffice.

In face of the enlarged defense requirements, the principal issue involved is to determine, first, how much more than the replacement revenue of $4,000,000,000 should be obtained from excise taxes; and, second, how best to accomplish whatever revenue result may be determined upon.

No finally conclusive answer can now be given to the first of these questions, since there can be no present determination of the extent of the financial need. Tentatively it would appear that there should be at least another $4,000,000,000 from these taxes, and possibly more. The answer to the second question may throw further light on this matter.

In answer to the second or procedural question, the following suggestions are made:

Present inequities need correction

It is clear that in peace, defense, or war conditions, the Federal excise system as it stands in 1950 is not a proper sort of revenue instrument. It is discriminatory, illogical, and inequitable. It cannot be defended as being merely a set of luxury taxes, for there is no generally acceptable distinction between luxuries and other goods in a free economy, where free persons may spend their own income in any way, for any purpose, that appears good and sensible to them. In origin it was not designed primarily to conserve manpower and materials, as has often been asserted, for an examination of the reports of the Ways and Means Committee on the tax bills of 1942 and 1943 will reveal that the committee was careful to point out, in connection with virtually every tax dealt with in those bills, that there would be on adverse effect from the tax on the volume of sales. The first essential step, needed under peace conditions but even more badly needed in the defense financing, is to equalize the existing excise tax situation by extending it across the board at a uniform rate. We cannot justify making the consumers of certain products and services contribute to the defense cost while leaving the consumers of all other products exempt from a part of this burden.

Basic uniform rate essential

The first recommendation respecting the excises is the repeal of the existing taxes and the substitution of a uniform tax on all end products of manufacture. As noted above, this recommendation does not apply to alcoholic beverages and tobacco, both of which have been taxed for many years separate and apart from the general excise system. For the purposes of the long-range future, this uniform tax at a moderate rate should be regarded as the basic Federal excise,

to be carried through into the period beyond the defense program, or even a third war, as a permanent feature of Federal taxation.

Additional specific defense recommendations

Since there should be additional revenue from the excises during the emergency, the second recommendation is that an additional uniform rate be imposed, to be expressly identified as a defense charge. If the basic rate of 5 percent would produce replacement revenue of $4,000,000,000, a special defense tax rate of another 5 percent would produce upward of the same amount, or, say, $3,500,000,000 of additional revenue for defense purposes.

As part of the special emergency defense financing, the taxes on certain services should be retained at such level as may be established for the combination of basic and defense emergency uniform excise. Table IV contains a list of these services now taxes, with actual and projected tax yields.

TABLE IV.—*Services now subject to excise tax, rates of tax, actual and projected yields*

[Thousands]

Service	Rate	Yield, 1949	Projected yield at 10 percent [1]
	Percent		
Telephone, telegraph, cable	25	$289,321	$115,728
Leased wires	25	22,059	8,824
Local telephone	15	224,531	149,688
Transportation of persons	15	251,389	167,592
Admissions	20	384,071	192,035
Total		1,171,371	633,867

[1] The projected yield at 10 percent is a straight adjustment proportionate to the 1949 yield at present rates In some cases there may be a somewhat higher return at the lower rate.

Source: Annual report of the Commissioner of Internal Revenue, 1949, table I.

There should be no increase of the excise taxes on alcoholic beverages and tobacco in connection with the defense financing. The historic policy has been to segregate these classes of commodities for special, and usually, heavy tax treatment. The present Federal taxes are, by far, the highest ever imposed; and, in addition, there are substantial State and local taxes. In the case of the liquor taxes, it is well understood that the tax rates can be so high as to defeat the revenue purpose by inviting large-scale illicit production and distribution.

Potential excise revenue

For the requirements of the defense program, it would appear that a total excise revenue, aside from the taxes on alcoholic beverages and tobacco, of $8,000,000,000 to $8,500,000,000 could be realized. Including $3,500,000,000 from these sources, on the basis of 1949 yields, the total excise revenue could thus be brought up to $12,000,000,000 during the emergency.

Character of uniform excise levy

There are some points about excise taxation that should be cleared up.

First, the recommended manufacturers' uniform excise tax is not a new form of Federal taxation. The excise taxes which the President recommends for retention include not less than 20 classes of goods that are taxed on the basis of the final manufacturer's price. In 1949 the yield from these taxes was $1,771,500,000, or nearly half of the total revenue received from all Federal excises excepting those imposed on alcoholic beverages and tobacco.

Second, the tax would be levied in all cases at the final point of manufacture. This point would be determined, for all taxable goods, as it now is under the present manufacturers' excises. The procedure is that the seller does not include the tax if the buyer can furnish an exemption certificate, obtainable from the Bureau of Internal Revenue on a showing that the buyer ordinarily uses the materials purchased in some further process of manufacture.

Third, it is not feasible generally to provide that the tax be shown as a separate item and thus invoiced through the subsequent stages of the distribution process. The actual tax payment will be made by the final manufacturer who

has collected it at the time of sale, and there will be an eventual reimbursement from the final consumer as the goods are sold to him.

It should be remembered that the people have been living with exactly this kind of tax for many years and under it they have been contributing a large amount of revenue through the levy of a wide range of rates on a limited list of taxable goods. All that is proposed here is that the list be extended to include everything except foods, and that the rate be uniform across the board. This rate should be such as would produce, during the emergency, more revenue than that provided by the present excises to be repealed.

The "pyramiding" argument

Another point likely to be brought up is that the tax will be pyramided. It will be said that after the tax is paid, it becomes a cost to be carried forward, and that each middleman in the distribution chain will compute his mark-up on the tax as part of his cost. Hence, by the time the article is sold at retail, it is alleged that the consumer will pay much more than the tax by reason of the percentage increases.

Some of the present manufacturers' excise taxes are at a rate of 25 percent. There was no testimony before the Ways and Means Committee in regard to the excessive prices paid by the consumers of these goods on account of a pyramid of the taxes through to the consumers.

So far as can be learned, there has been no serious complaint on this score with respect to the 20 classes of goods now taxed at the final manufacturing level. The extent of pyramiding has been exaggerated. If it were to occur consistently, the practical result would be that profits at the several distribution levels would be greater than they would be if there were no such tax because inclusion of the tax would create a larger cost base for computing mark-ups. And it would follow, also, that the higher the rate of tax, the greater the middleman profits would be. This view disregards the source and reason for profit, which is a return that is gained from the successful performance of a service that others are willing to pay for. In the field of merchandise distribution, this service consists essentially of supplying to consumers the kinds and qualities of goods that they want, at prices they are willing to pay. The value of this service from the consumer standpoint, is not enhanced by the fact that the various middlemen are acting, in turn, as relays in a tax collection process. The competition for the consumer dollar in which all of the thousands of merchants and other distributors are engaged is the effective determinant of the profit rewards which any of them will get. The issue involved is not whether the consumer will bear the burden of the tax, but rather one of how much more than the tax he will pay because of the actual pyramiding. It is evident that whatever the consumers pay, over and above the tax, would consitute enhanced middleman profits. The position taken here, on the basis of economic logic, is that competttion throughout the distributive mechanism will tend to prevent any abnormal surcharge above the tax, because the mere relaying of the tax is not a service which the consumer would value enough to pay for.

The point that has been exaggerated is that there will be an abnormal expansion or blowing up of the original tax by the time it gets to the consumer. If it were really true that all distributor profits would be materially enhanced because of this tax-collection service, the middleman groups should logically demand a high tax rather than a low one or none at all. Actually, they know that a high tax would diminish both their sales and their profits. The advantage of an across-the-board tax is that it tends to keep the general competitive situation in a state of balance, so far as concerns all classes of goods, all producers, and all consumers.

The fact that this, as well as all other excise taxes, must be borne by consumers is not a valid argument against such taxes. All taxes come out of income, either as it is received or as it is spent. Regardless of where or by whom the original tax payments are made, their burden falls ultimately on the income of the people. This ultimate burden cannot be escaped by avoiding excise tax and concentrating the levies upon income. To some extent such levies are shifted promptly, and in any event the final result of excessive income taxes will be to hamper the formation of capital to a point where the consumers will be forced to foot the bill in higher prices or lower living standards.

The "Regressivity" Argument

Another point is likely to be the objection that such a tax would be "regressive." As the term is used by the academicians, it means that a given amount of tax is a larger proportion of a small income than the same amount of tax would be

of a large income. Being a matter of arithmetical relations, this criticism can be brought against many taxes, but the argument is always advanced most vociferously when the contestant is opposing a tax. If he happens to like a tax, this point is soft-pedalled.

The fact that is usually overlooked in such arguments is that the purchase price of a given article is itself a larger proportion of a small than of a large income. In other words, the complaint which is lodged against the tax, usually a small part of the total price, could, with even greater force, be lodged against the whole system of market prices. There is no practical way in a free economy by which the system of prices can be so modified as to produce a different result. The implication of the criticism directed against the excise taxes as being regressive is that there is involved some sort of unique oppression of those with small incomes. By this standard there is a far greater degree of oppression in the whole price system than there can be in taxes which are ordinarily only a small proportion of the price. And if this line of argument were valid, either as to its major or its minor applications, there should be some indication of this oppression somewhere in the economy. There is no such indication. On the other hand, the Nation has grown and prospered under a regressive price system.

Tax consciousness regarding excises

Another point to be mentioned briefly is the concern of some that the people will not be aware of paying excise tax. It is true that complete awareness would require of the citizen an encyclopedic knowledge of the tax law and of the economic theories of tax shifting and incidence. Very few persons carry such details in their heads, and hence very few are likely to be aware whether or not there is an excise tax on a given article; and if so, what is the rate of tax. It can be said of the proposed uniform excise that since there is only one rate, applicable across the board, there would be very much less excuse for people generally not having knowledge of it than under the present complicated system.

Advantages of flat excise proposals

The plan offers the following advantages in peace as in war:

First, it will put all consumers on an equality in their buying and it will put all producers on an equality in competing for such consumer dollars as may be available for consumption spending.

Second, it will end the obvious discriminations in the distribution of the defense or war cost, and in the deprivations which the people must endure.

Third, it will obviate the need for as high income tax rates as would otherwise be necessary, a consideration that is always of prime importance, but particularly so during the partial mobilization and the conversion period, when large amounts will be required to finance the transition from civilian to military production.

Fourth, it will drain off income from all segments of the population and thus be a more effective restraint on the competitive bidding up of prices across the consumer field than the present excise system can be.

Fifth, it will be an effective and necessary complement to the income tax as an inflation restraint. Data were given above to show that some 60 percent of present personal consumption expenditure could go on out of income which cannot be touched by the personal income tax, regardless of how high the rates of that tax are set. Excise taxation is the only way of distributing a part of the defense burden over this portion of individual incomes, and of imposing upon it some restraint in consumption spending.

The individual income tax

The second phase in the development of an effective and sound tax program to put the budget, including the defense spending, on a pay-as-we-go basis, is a readjustment of the individual income tax. The procedure for doing this that was recommended by the President, and accepted by the Senate Finance Committee, is approved. In effect, the result is a greater increase of the first bracket rate than for any other rates, because the credits against tax which are to be repealed were largest at the bottom of the scale. Secretary Snyder put the case as follows in his statement to the Senate Finance Committee: "Moreover, a relatively small increase in the rate in the lowest brackets contributes more revenue than a larger increase at the higher income levels. For example, a 1 percentage point increase in the first bracket rate is equivalent in revenue to a 3 percentage point increase for all other brackets together."

The arithmetic underlying the result stated by Mr. Snyder may not be generally understood. To provide a basis for the subsequent discussion, it will be helpful to separate the rate scale into its elements as shown below.

Taxable income brackets	Basic or or first bracket rate	Surtax element	Total rate
	Percent	Percent	Percent
$0 to $2,000	20	0	20
$2,000 to $4,000	20	2	22
$4,000 to $6,000	20	6	26
$6,000 to $8,000	20	10	30
$8,000 to $10,000	20	14	34
$10,000 to $12,000	20	18	38
$12,000 to $14,000	20	23	43
And so on to the top bracket, which is over $200,000	20	71	91

This analysis of the tax rate scale into a basic or first bracket rate and the successive increments which are the true progressive surtax elements, demonstrates that the great bulk of the tax yield must be the product of the basic rate. As stated previously, it is this rate that applies clear across the board. Its large yield comes not merely from the concentration of incomes into the low-income brackets, but from the fact that it is the only part of the rate scale that applies to all income, in whatever income bracket it may be. Mr. Snyder's statement regarding the relative revenue productivity of the first bracket rate may be tested by following calculations employing data from his statement already cited:

TABLE V.—*Estimated taxable income, 1950, yield of first bracket rate, and total tax yield, under present law and under the President's plan*

[Millions]

Taxable income	$82,461
Present law:	
Total tax	16,495
First bracket [1]	13,689
Surtax [2]	2,806
The President's plan:	
Total tax	19,660
First bracket [3]	16,492
Surtax [4]	3,168

[1] The first bracket rate under present law is the effective rate of 16.6 percent, being the statutory rate of 20 percent, less the 17 percent credit now allowed.
[2] The yield of the surtax elements is the difference between total tax and the product of the basic or first bracket rate.
[3] The first bracket rate under the President's plan would be the statutory rate of 20 percent, since the credit is to be disallowed.
[4] See note 2.

Under present law, the first bracket rate would account for 83 percent of the total yield, and under the Revenue Act of 1950 this proportion would rise to 83.8 percent. The return from the first bracket rate would rise by $2,803,000,000 as a result of the change, while the return from the surtax elements of the rate would rise by $362,000,000.

These data clearly point the way to increase further the yield of the individual income tax, if and when a greater revenue should be required from this source. The rate change should obviously be made in such a way as to include an advance in the first bracket which would increase the tax of all income taxpayers. A supplemental procedure to be considered only if the need for more revenue should become very great would be to lower the exemptions from $600 to the war level of $500.

The corporation income tax

The corporation income tax is the one part of the Federal tax structure that is least likely to be approached and dealt with in an attitude of objective consideration of fiscal need and economic consequences. There is always a certain foundation of prejudice against business as such, and corporations in particular. And on top of this foundation there is a further degree of prejudice and misunderstanding with regard to the current level of corporation profits which, though large in dollar amount by comparison with previous peacetime records, are no greater in relation to sales after taxes are deducted than they were prior to World War II. And finally, there is a certain element of hysteria over war

profits. In view of this combination of sentiment, semantics, and prejudice, it is the more necessary that the problem of obtaining a larger revenue through the corporation tax be dealt with dispassionately and solved satisfactorily. In particular, it is essential that especial regard be given to the long-range as well as to the immediate aspects of the case.

All sensible persons, regardless of their occupation or station in life, are fully aware of the waste and futility of war. It destroys lives, interrupts careers, erodes capital, exhausts scarce natural resources, and provides no final settlement of the issues involved. And if it is not paid for out of current income, it always leaves a mountain of debt which must eventually be repudiated by inflation if not by direct action because it cannot be repaid.

The key to the manner whereby the tax contribution of corporations to the defense effort and to the pay-as-we-go tax policy is to be handled is found in the third of the guiding principles proposed on pages 6–7. This principle is that the diversion of private income which must occur in order to pay for the defense program as we go must be done so as to preserve as much as possible of the private incentives to produce at the lowest cost. Short of all-out last-ditch war for survival, there must be continued capital formation for the twofold purpose of supplying the needed military matériel rapidly and at minimum cost and also of supplying the civilian population with the goods requisite to the maintenance of an adequate standard of living. These production goals can be met only through continued recognition of the incentives to achieve maximum production at minimum cost, and the most important of these incentives is the profit motive.

This standard provides a test as clear and decisive as the litmus test of alkaline and acid reaction for distinguishing between the bad and the good way of increasing the corporation tax burden during the defense period. The two methods most likely to receive consideration that are demonstrably injurious to the whole economy are (1) taxation of corporation income at progressive rates and (2) an excess profits tax. These unwise, injurious forms of corporate taxation will be dealt with briefly in turn.

Progressive taxation of corporation income

Wherever a justification of the use of tax-rate progression is offered, it is always based on the assumption that such rates exemplify and apply taxation according to ability to pay. And when the term "ability to pay" is thus used, it invariably refers to individuals and the income at their disposal. Some persons have confused a large corporation income with a large individual income and have concluded that if size indicates greater ability to pay taxes in the case of the individuals it must also indicate greater ability in the case of the corporation.

This would be true only if the corporation existed and operated solely for its own corporate purposes and were entirely free to retain and dispose of its entire income in support or furtherance of these purposes. The concept of legal personality does not extend this far. Every corporation is an association of individuals who, collectively, own the capital stock and whose investments have made the corporate activity possible. Fundamentally, the corporation is a form of business organization which exists to earn income for its stockholders. The amount of income earned, as such, shows nothing whatever regarding the ability of the several stockholders to pay taxes, or regarding the amount of tax which any one of them should pay as an individual. All of the large corporations in this country have many thousands of stockholders. These persons have, at one extreme, incomes so small as to be exempted entirely under the personal income tax, and at the other extreme incomes so large as to be subjected to the maximum rate of that tax. The levy of progressive taxes on large corporation incomes would result in a most inequitable taxation of these widely varying personal incomes, with no regard whatever to the basic conditions of other sections of the income-tax law and, indeed, in violation of the clear intent of these other provisions.

In another respect, also, the taxation of corporation income at progressive rates is unsound, and it could be actually destructive of the structure of American business. Under normally competitive conditions, profit margins in relation to sales tend toward uniformity within a given industry, and the aggregate amount of profit becomes dependent mainly upon sales volume. When the tax is applied to the total income at progressive rates, it follows, that there is a progressively deep cut into the profit margin as sales volume increase. This would strike directly at management's effort to expand sales volume, and when the tax rates become heavy enough the distortion of the competitive situation would compel dismantlement of the large companies. Let us recognize that the country

needs a larger number of prosperous small businesses, but let us not forget that it also needs some large businesses, and that small and large business need each other. Taxation of corporation incomes according to size at progressive rates would destroy the business structure which is the basis of our prosperity and national strength.

An excess profits tax

The demand for an excess profits tax is always based on emotional and political considerations rather than on those of economic fact and fiscal need. It provides a convenient cloak for those whose real purpose is the imposition of heavy taxes on large amounts of profits, and for those others who would put the destruction of American business before every other objective. The ostensible purpose of such a tax is to take away the profits from war business, but there is no definite way of distinguishing, in all cases, between true war profits and any other profits, so the statute always ends up by using the amount of profit, in relation to some arbitrary standard of normal profit, as the base of the excess profits tax. In other words, it is always a tax on relatively large profits and not on war profits *per se.*

An excess profits tax is subject to the following major objections. First, it is economically unsound because there is no generally applicable measure of what constitutes a normal profit. Profit is the result of good management and the successful assumption of risk. There is no possible way of determining how much profit should be earned by a given company or by all of the companies in a given industry in order to evoke the best efforts of management to keep costs down and promote sales, or in order to compensate investors for the risks involved. The tax law must set rigid, arbitrary standards, and the difficulties involved were recognized, during World War II, by the extraordinary provisions of sections 721 and 722. The inadequacy of these relief provisions is established by the immense number of appeals for adjustment.

All of these inadequacies and distortions will be magnified as time passes and the established base period for measuring normal profit recedes into the past. Recognition of the unreality of a prewar base period for measuring normal profit in the postwar period was a powerful consideration in the repeal of the last excess profits tax. It should be an equally powerful consideration now against the repetition of the experiment.

As a revenue measure the excess profits tax has been vastly overrated. There is a general impression that this tax was the primary source of large revenue from the corporations in World War II, and that without such a tax the yield of the corporation tax would have been very meager. The facts are as follows:

TABLE VI.—*Corporate net income, income tax, and excess profits tax, 1940–45*

[Millions]

Year	Net income	Income tax	Excess profits tax	Total income and profits tax liability	Rate of flat tax to produce same yield (percent)
1940	$11,203	$2,145	$374	$2,519	22.5
1941	18,111	3,744	3,359	7,103	39.2
1942	24,052	4,338	7,852	12,190	50.8
1943	28,718	4,479	11,291	15,770	55.0
1944	27,124	4,354	10,432	14,786	54.6
1945	22,165	4,183	6,557	10,740	48.4
Total	131,373	23,243	39,863	63,108	48.4

Source: Preliminary Statistics of Income, 1947, pt. 2, summary data.

The significant part of this exhibit is the final column, showing the equivalent flat rate on net income that would have been required to produce the same total revenue as was actually produced by the combination of ordinary tax and excess profits tax. Carrying this point a step further, it is found that for the entire 6-year period, a flat rate of 48.4 percent would have produced as much as the combination of taxes yielded.

Superficially, it would appear from table VI that the excess profits tax produced almost two-thirds of the entire amount of taxes paid by corporations.

This was, however, essentially a result of terminology. The ordinary rate of corporation income tax, normal tax and surtax combined, was 40 percent during the years 1942 through 1945. If a rate of 40 percent had been imposed over the whole period, it would have produced $52,692,000,000. Since the actual total of both taxes was $63,108,000,000, the true net advantage from the excess profits tax was $10,416,000,000, or an average of $2,083,000,000 per year.

The second ground for objection to an excess profits tax is that it is administratively unworkable. This condition stems from its arbitrary character, which in turn makes necessary a variety of relief and escape provisions. The interpretation of these provisions and the determination of the exact extent of their applicability to thousands of different business cases involve years of research during which taxpayer and the Government are at great expense, returns are held open, uncertainty continues with regard to final tax liability, and quite frequently, cases can be closed only by rulings which are either accepted out of sheer exhaustion or are carried into the courts for final adjudication.

The third ground for objection is that the excess profits tax contributes to inflation. The reason ties back to its economic unsoundness. The tax undermines the incentives to control cost by coming, eventually, to virtually complete confiscation of the excess profits net income. The record of the rates in World War II shows how rapidly the confiscation policy can develop. In the act of 1940 the rates on excess profit net income ranged from 25 percent on the first $20,000 to 50 percent on all such income above $500,000. The 1941 act added 10 percentage points throughout the scale, but the act of 1942 went to a flat 90 percent tax on all excess profit income, with an 80 percent limitation on the combination of income and profits taxes. In later years this rate was 95 percent with a 10 percent refund.

Rates of 80, 90, or 95 percent obviously will tend to decrease managerial attention to costs, and when costs are not watched very carefully they are certain to rise. The Government must pay more for military goods and the civilians must pay more for their supplies, because of the rising costs. The end result is a larger volume of deficit financing and hence a greater inflationary pressure on prices.

A corporation defense tax

Instead of resorting to methods of taxation that would be positively destructive and indefensible on both economic and administrative grounds, it is submitted that there is a procedure whereby the revenue from corporations can be increased with a minimum of disturbance to the economy and its productive incentives. This alternative method will first be stated summarily and then explained. In substance, it is a percentage increase of the ordinary corporation income tax, this increase to be identified as a corporation defense tax. To provide the proper base on which to compute and add the percentage increase, the basic or standard rate of income tax should be established at 38 percent by changing the normal tax rate in the act of 1950 from 25 to 18 percent, leaving the surtax rate at 20 percent as now provided in that act.

The case for this approach to the problem includes the following points:

(1) Assuming that a corporation income tax will always be a part of the Federal tax structure, it is necessary to look beyond the period of defense financing and when this is done it becomes clear that the 45-percent rate of the act of 1950 is too high. This rate was set, upon recommendation of the President, as a feature of the defense financing, but there was no clear and definite indication of the distinction that should be made between the permanent long-range tax and the temporary additions thereto. The establishment of the rate at 38 percent is intended to provide a basis for this necessary distinction, and to make entirely clear that such additional tax as may be necessary during the defense period is for the purposes of the defense program and is in no sense to be regarded as a permanent increase. In the absence of emphasis on this point, there is every likelihood that the 45-percent rate of the 1950 act may become the floor of the future corporation tax.

(2) Having assured that, as the permanent, long-range policy, there should be a corporation tax rate of not more than 38 percent, the next step relates to the manner of increasing the corporation tax during the emergency defense period. It is proposed that this be done, for all corporations, by determining the tax liability at the rates of 18 percent normal tax and 20 percent surtax, and then adding thereto such percentage increase of the tax as may be fixed by the tax law. This percentage increase could be 20 percent, or whatever per-

centage might be set. It should be the same percentage increase across the board, for small and large corporations alike.

(3) The manner of the long-range tax rate adjustment would be of particular advantage to the small corporations with net incomes up to $25,000. It would substitute a tax rate of 18 percent for the rate of 25 percent which these companies must pay under the 1950 Revenue Act.

(4) Some idea of the effect of various percentage increases may be had from the following: An 18-percent increase would be approximately the equivalent, in revenue, to the amount that would be collected under the rates of the act of 1950, and a 30-percent increase would be the approximate equivalent of a 50-percent standard rate. When it is recalled that the average rate of 48.4 percent would have produced as much revenue during World War II as was actually collected from the combination of income and excess profits taxes, it becomes clear that a 30-percent addition to the tax as determined under the new rates of 18 percent normal tax and 20 percent surtax is about the maximum. Table VII illustrates the tax liability of corporations with net incomes of $25,000, $100,000, and $1,000,000 under the Revenue Act of 1950 and under the proposed corporation defense tax. It will be noted that for a corporation with $1,000,000 of net income, a 20-percent corporation defense tax rate would result in slightly greater tax liability than under the Revenue Act of 1950, columns 2 and 7, and that a 30-percent rate would result in total tax liability of approximately 50 percent of net income, columns 1 and 9.

TABLE VII.—*Corporation income tax*

Taxable net income	Revenue Act of 1950—25 percent normal, 20 percent surtax	NAM plan						
		Basic tax—18 percent normal, 20 percent surtax	Corporation defense tax at—			Total income and corporation defense tax at—		
			20 percent	25 percent	30 percent	20 percent	25 percent	30 percent
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
$25,000	$6,250	$4,500	$900	$1,125	$1,350	$5,400	$5,625	$5,850
$100,000	40,000	33,000	6,600	8,250	9,900	39,600	41,250	42,900
$1,000,000	445,000	375,000	75,000	93,750	112,500	450,000	468,750	487,500

(5) Finally, the difference in the effects on incentive should be noted and emphasized. Under the plan recommended here, the basic tax plus the percentage increment would in no case take more than half of the corporation income. Under the last excess profits tax there was a net rate, after the refund, of 85.5 percent with an over-all limit of 80 percent for the combination of income and excess profits tax. It is obvious that the plan recommended here will provide a far greater incentive to keep careful control of costs, and it will therefore be a far greater contribution to the prevention of inflation than any excess profits tax is capable of being. The recommended plan will involve no additional administrative or compliance problems, for it would affect in no way the administration of the existing corporation income tax. There would be no postwar period of prolonged delay, expensive investigation and litigation, and uncertainty with respect to final tax liability.

Conclusion

It is possible to put the defense program on a cash basis if we set about it promptly and if we make the proper use of our tax resources. There will be an increase of tax burdens, but they will be measurable increases, determined by the advances of tax rates. If we do not push through a cash-and-carry program we still shall not save ourselves from the burden of the defense program, for the necessary diversion of goods will occur anyway and it will be paid for by new purchasing power created through inflationary bank loans. Rationing and price controls are not an adequate defense for the low-income groups as experience has shown. The pressure of large amounts of inflationary purchasing power will force an outlet into black markets, with even more than proportionate shortages of essential goods at the official prices. The low-income groups, and those living on fixed incomes, have no protection against black

markets, and they would suffer an even heavier burden than they would under an orderly system of taxation and its concomitant, and orderly system of prices. The cash basis of defense financing would avert the flood of new purchasing power and thus prevent, or materially discourage, black and gray markets.

There are other and even more serious issues involved which need to be soberly considered in facing a decision on the proper method of defense finance. The principal reason for building up our defenses and engaging in war to resist aggression is the desire and need to preserve our ideals, our standards, and our way of life. In part, these are intangibles, though none the less important for all that. In part, however, they are tangible and practical.

In the concrete, practical sense, the basis of our culture, our wealth, and civilization is a sound and stable currency system. In the terms of that currency we measure our income, our prices, our savings, our insurance policies, and all of our material well-being. The intangible values that comprise the most prized part of our culture and civilization are dependent on this basic monetary stability. A sure road to the chaos of demoralization and despair is the steady depreciation of a nation's money and the disappearance of the material and moral values which are measured in money. Socialism and communism feed upon poverty and discontent. The immense volume and wide diffusion of wealth and income have effectively immunized us, thus far, against these "isms." These bulwarks will continue to protect us only while they have the vitality which springs from a money and credit system strong enough to sustain confidence and real enough to make sacrifices for. Continuing and seemingly contemptuous disregard for the dangers inherent in a steady rise of the public debt is an effective way of playing the enemy's game, for he would far rather we destroyed ourselves than that he be forced to undertake it.

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AN EXCESS PROFITS TAX IS AGAINST THE PUBLIC INTEREST

(By Harley L. Lutz, tax consultant to the National Association of Manufacturers, and professor emeritus of public finance, Princeton University)

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CORPORATION DEFENSE TAX[1]

1. Experience with an excess profits tax during World Wars I and II shows that this method of taxation is unsound. Abnormal profits from sales to civilians can most effectively be prevented through pay-as-we-go taxation. In the case of Government contracts, abnormal profits can most effectively be prevented through efficient procurement policies. An excess profits tax contributes to inflation because it tends to reduce the incentives for management and government to control costs and make the most efficient use of materials and manpower. It is economically unsound because there is no sound basis for determining the profit return necessary to continued growth of industry, especially new and small business. It is administratively unworkable. It requires excessive compliance costs and involves years of costly examination and litigation before the final tax

[1] Policy position approved by the board of directors of the National Association of Manufacturers upon recommendation of the association's taxation committee.

liability is determined. Finally, the additional revenue that can be realized from this unsound method of taxation has been grossly exaggerated.

2. In lieu of an excess profits tax with its inevitable inflationary consequences and administrative difficulties, the tax contribution from corporations toward the pay-as-we-go tax program should be made through an addition to the corporation income tax to be known as the corporation defense tax. To effect a clear distinction between the income tax and the corporation defense tax, and to avoid imposing too heavy a burden on small business, the standard corporation income tax rate should be set at 38 percent by changing the normal tax rate in the Revenue Act of 1950 from 25 to 18 percent, while leaving the surtax rate at 20 percent. The corporation defense tax should be imposed as a flat percentage of the amount of the corporation income tax.

Summary

It is shown that an excess profits tax is against the public interest because it is economically unsound, administratively unworkable, and contributory to inflation.

The fact remains that during a period of defense or actual war there must be a substantial increase of tax revenue, and the corporation income tax is a logical source of a part of this increase.

The most important, and also the most difficult, matter in making decisions about the corporation income tax is that of attitudes. It is so easy to yield to the clamor incited by prejudice, so difficult to hold to the hard, though unpopular, facts of experience. Corporations are essentially tax collectors, not tax bearers. The actual bearers of any corporation tax include, in part, the consumers, and in part the investors who own the company. In an important respect, a corporation tax is a choice of methods, being one way of levying more on consumers, stockholders, or both. Nevertheless, since it is a very convenient method, it will doubtless always be used, and we may expect an increase of the tax rate as a feature of emergency financing.

Another fact of experience is that there is no way of making a clear and sharp distinction between war profits and other profits. Any profit at all that a company may earn from a Government contract during war is a war profit. In a certain sense all of the profits earned in a war economy are war profits, whether they come from munitions contracts, renting hotel rooms, or selling goods and services to the civilian population. The most intelligent course to pursue in approaching the problem of increased revenue through the taxation of corporations is to forego the whole futile effort at a distinction between the sources of profit, or in the character of profit, and to provide for an increase of the tax load on all corporation profit without regard to origin or amount.

It is submitted that the corporation defense tax which is outlined on page 3 of this document resolves all of these problems. It recognizes that more corporation tax must be paid during a defense or war emergency, and it applies the increase to all corporation income without regard to its origin in war business or other business. It escapes the administrative and compliance difficulties of an excess profits tax, and it will provide whatever additional revenue may be required from this tax source without impairing the incentives of management and without bleeding the economy white so far as concerns continued capital formation. In particular, it will be much less severe as applied to small business than an excess profits tax is likely to be.

The duration of the present defense emergency, and of the heavy tax load that must be assumed, cannot now be forecast. On the most optimistic basis of calculation, however, the emergency and the increased tax burden will endure for some years. It is therefore of the gravest importance that the measures taken for accomplishing the financial task be such as will make possible some further growth of the Nation's productive capacity rather than freezing and sterilizing our national economic potential.

An Excess Profits Tax Is Against the Public Interest

The emotional aspects

The clamor for an excess profits tax has developed since the outbreak of the war in Korea. There has been a certain amount of insistence upon such a tax, even in peacetime. But the general view has been that there is no justification for taxing so-called excess profits during peace. Now, however, in a situation which was certainly far short of full-scale war, the pressure developed so rapidly

and so strongly that congressional leaders were able to keep such a tax out of the 1950 Revenue Act only by including in that act instructions that the tax-writing committees should proceed to draft and report an excess-profits tax bill.

While there appears to be a fairly general public demand for an excess profits tax, the source and inspiration of this demand are special pressure groups. The general public is not sufficiently informed regarding the particular problems and difficulties involved in this tax to grasp its full implications, and the basis of its response is obviously emotional rather than a thoughtful consideration of facts. The time has come to emphasize the facts and to state some of the arguments against excess profits taxation. Such is the purpose of the present memorandum.

The realistic aspects

At the outset it must be said that industrial leadership does not want war. All sensible persons, regardless of their occupation or station in life, are fully aware of the waste and futility of war. It destroys lives, interrupts careers, erodes capital, exhausts scarce natural resources, and provides no final settlement of the issues involved. The arguments against excess profits taxation presented here are in no sense offered as a defense or protection of exorbitant profits to be made out of war as such.

The case against excess profits taxation rests on the following grounds:

1. The conviction that such taxation is, on every count, economically unsound;
2. The record of the impossibility of proper administration that was made in World Wars I and II;
3. The evidence of its contribution to inflation and the cost of the military effort.

These points will be discussed in order.

1. AN EXCESS PROFITS TAX IS ECONOMICALLY UNSOUND

The elusive excess profit

The presumption underlying the concept of an excess, or excessive, profit is that there is a clear, sharp dividing line between a fair, normal, or reasonable profit for a given industry or business concern, on one hand, and an unfair, abnormal, or excessive profit on the other. No such dividing line exists as an economic reality. Profit is the economic return, or reward, for the successful assumption of risk. There are all degrees of risk among the great multitude of business enterprises in a flourishing economy. Every new business venture involves risk; so does every new industry; and even the oldest, strongest, best-established companies face the risk that their very age and apparent strength may not be adequate in a trial against young, vigorous competitors. Risk, in some degree, pervades all private, competitive enterprise.

It is impossible, by any statutory device, to weigh and measure the variables of risk. The managers and investors whose jobs and capital, respectively, are dependent upon the wisdom of their decisions can do this only imperfectly. That they make many mistakes is evidenced by the numerous instances of business failure.

Any statutory definition of an excess profit must necessarily be arbitrary and inadequate. In view of the wide differences in the profit return required to offset the particular risks involved and to assure the necessary flow of capital funds into the immense array of business ventures which make up our economy, an arbitrary measure of excess profit may in some cases allow a greater return than the risk may warrant, and in other cases set an altogether too low ceiling on profits. Such ceiling will ordinarily affect most adversely the new industries, the rapidly growing concerns, and enterprises that should keep all of their earnings in order to exploit the competitive opportunity that may lie before them.

Statutory discrimination

In addition to discrimination arising out of the basic economic differences in risk, there is also a certain discrimination which results from the differences in applicability of the formulas used to different company experiences. For example, companies with high earnings in the base period will fare better than those with low earnings in that period. The conservatively capitalized companies will be harder hit than those with liberal capitalization under the invested capital method. There is given, in table I, a summary of all corporation returns with net income and all excess profits returns in the years 1940–45.

TABLE I.—*All corporation returns with net income, and excess profits returns, 1940–45*

[Dollar amounts in millions]

Year	All returns with net income		Excess profits returns	
	Number	Net income	Number	Excess profits net income
1940	200,977	$11,203	13,440	$2,998
1941	264,628	18,111	42,412	12,073
1942	269,942	24,052	54,002	17,084
1943	283,735	28,718	68,202	22,307
1944	288,904	27,124	55,912	20,472
1945	303,019	22,165	52,097	14,165

Source: Statistics of Income, pt. 2, for the several years.

The difference between total corporation net income and excess profits net income is much greater than would be accounted for by the specific exemption of $5,000, which was raised to $10,000 for 1944 and 1945. There is no way of determining, now, the extent to which the corporations not subject to excess profits tax simply did not have earnings sufficient to bring them under this tax, or the extent to which the particular statutory formula used allowed them to have substantial earnings without being in the excess profits tax category.

Insofar as the use of an arbitrary formula for measuring normal or standard profits does set too low a ceiling on profits, it penalizes growth, expansion, bold adventuring into new business fields. In this respect it favors, relatively, the established, well-financed concerns and thus it tends to create conditions leading to monopoly by stifling the growth of potentially effective competitors.

Small corporations hit hard

It is commonly supposed that only the larger corporations have to pay excess profits tax. The facts are otherwise, as revealed by World War II experience. Table II shows, for the years 1940 through 1945, the number of corporations with net income up to $50,000, and the amount of excess profits tax paid by them.

TABLE II.—*Number of corporations with net incomes up to $50,000, excess profits net income and excess profits tax*

[Dollar amounts in thousands]

Year	Number	Adjusted excess profits tax net income [1]	Excess profits tax after credits against tax [2]
1940	11,408	$114,373	$29,032
1941	28,360	360,113	128,982
1942	37,877	489,543	365,052
1943	48,720	552,555	488,499
1944	34,850	501,592	428,059
1945	36,388	501,885	394,637

[1] Adjusted excess profits net income was the income on which excess profits tax was levied. It was derived from normal tax net income by deducting the specific exemption, the excess profits credit, and some other items. The specific exemption was $5,000 through 1943 and $10,000 in 1944 and 1945.

[2] Certain credits were allowed against excess profits tax as computed, such as an allowance for debt retirement, the postwar refund, and in lieu of the latter a straight reduction of 10 percent of the tax in the later years of its application.

Source: Statistics of Income, pt. 2, for the several years.

The significance of the number of corporations in the above table may be seen from the fact that in 1940 the total number of excess profits tax returns was 13,440, of which only 2,032 were in the net income classes above $50,000. The largest number of returns filed was 68,202 in 1943, of which less than 20,000 showed net income above $50,000. The decline in number of returns, excess profits net income, and excess profits tax, in 1944 was produced by an increase of the specific exemption from $5,000 to $10,000 for that year.

The revealing thing about the table is the kind of squeeze that the excess profits tax put on the small companies. It clearly put a very serious limitation on their capacity to expand through retention and investment of earnings. It is hardly too much to say that the damage done them was far worse than that done to the large companies.

Relative aspects of the profit picture

The recent record of business profits will be cited by some advocates of excess profits taxation in the attempt to show that these profits are large enough to warrant taxation a rates above those now imposed, or in such a way as to exact more taxes from the concerns having profits above some arbitrary standard or limit. In this connection, also, the course of prices is likely to be mentioned as evidence of peacetime "profiteering." The record and its meaning require some attention.

General advance of the economy.—The powerful inflationary impulse of the war financing carried on into the postwar years despite the sharp decline of Government spending and of deficit financing.[2] It is inevitable that such an inflation should manifest itself in various ways and that the dollar amount of profits should be influenced, as it always is, by an inflationary expansion of the economy. Some pertinent data are presented in table III.

TABLE III.—*Pertinent indicators of the growth of the economy, 1946–50 (6 months)*

[Billions of dollars, except columns 6 and 7]

Year	National income	Consumer expenditures	Compensation of employees	Corporation profits before tax	Business and professional income	Index of industrial production	Index of wholesale prices
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1946	180.3	146.9	117.1	23.5	22.4	170	121.1
1947	198.7	165.6	128.0	30.5	21.3	187	152.2
1948	223.5	177.4	140.2	33.9	22.5	192	165.1
1949	216.8	178.8	140.6	27.6	20.3	176	155.0
1950 [1]	219.1	183.4	144.4	30.1	22.6	189	153.8

[1] Figures for the first 6 months of 1950 are preliminary estimates of annual rates.

Source: Midyear Report of the Council of Economic Advisers, July 1950.

The selected data shown in table III illustrate, in a general way, how the forces of supply and demand have been operating since 1946. The indicator of supply, namely the FRB index of production, shows how the output of goods has expanded with the completion of reconversion after World War II. In the period beginning with 1947 the level of output has become established on a definitely higher plane than in 1946. The preliminary estimates of annual rates for the first half of 1950 show a recovery of almost all of the ground lost in the leveling off in 1949.

On the demand side we have the national income, which in the first half of 1950 was at an annual rate some 38.8 billion dollars above the 1946 amount. The compensation of employees, business and professional income, and corporate profits are included to show the trend of some of the important elements in national income.

The forces of demand and supply meet in the market place, and the outcome is (1) the total of consumer spending and (2) the level of prices. These factors are interactive, for prices are a determinant of the amount of spending, while the amount of income that people are willing to spend is, in turn, a determinant of prices. The total of consumer spending was certain to rise with the increase of available income, and the movement of total national income shows the scope of this increase. Prices, as indicated by the wholesale-price index, rose rapidly through 1948, and they have declined since then.

In all, we have here a record of reasonably consistent good business, high-level production, and a growing volume of income. The continuing large volume of

[2] See H. L. Lutz, Public Spending and the Private Economy, NAM, 1949.

consumer purchasing is in part a product of the expanding needs of a rapidly increasing population, and in part an indication that there is still an accumulation of shortages from World War II. Neither of these factors would have supported the spending, however, if the increase of income and purchasing power had not occurred. In view of the actual situation that prevailed, namely, insistent demand backed by ample purchasing power, price reductions by primary producers would not in all cases have inured to the advantage of final consumers, but would have led to the expansion of black and gray markets in the distributive fields.

Increase of corporate profits misunderstood.—It is not surprising, nor remarkable, that corporation profits should have increased as part of the general advance of the economy. Their failure to do so would have been the basis for far more serious concern about the future. The assumption, so often made as a reason for excess profits taxation, to the effect that a large dollar total of profits is in itself evidence that profit is excessive or exorbitant is a case of looking too closely at only one of the elements in the growth of the economy. If the data in table III were extended back into the prewar years, it would be found that all elements in the national income had experienced a substantial expansion. As this expansion occurs, the dollar volume of business sales will increase, and total profits may be expected to rise even with a constant ratio of profits to sales. For such light as may be shed on the subject, there is given in table IV the relation of profits to sales for all manufacturing corporations since 1936.

TABLE IV.—*Percentage of profits to sales, before and after corporation income tax, 1936–50, all manufacturing corporations*

Year	Percentage of profit to sales		Year	Percentage of profit to sales	
	Before income tax	After income tax		Before income tax	After income tax
1936	8.7	7.4	1944	11.6	9.7
1937	8.3	7.0	1945	8.4	7.0
1938	7.3	6.2	1946	8.6	5.0
1939	7.2	6.9	1947	11.0	6.7
1940	9.6	7.5	1948	11.1	7.0
1941	12.2	9.6	1949	9.3	5.9
1942	12.6	10.7	1950 [1]	10.1	6.2
1943	12.5	10.8			

[1] Annual rate in first quarter.

Source: Data for years 1936 through 1945 from Statistics of Income, pt. 2, for the respective years. Data for the years 1946 through 1950 from annual reports of the Council of Economic Advisers.

The selection was limited to manufacuring corporations in order to obtain a consistent series from 1936. The Council of Economic Advisers has limited its comparison to this group, and their reports are the only source of such data for the years not covered in the published statistics of income. The only deduction for taxes is the corporation income tax, which was levied, at some rate, through the period. The excess profits tax of the war years was not considered since it was not applicable throughout the period.

The relation of profit to sales before income tax may be of interest to some, but the more significant comparison is that of profit with sales after tax, since it is a fairly definite and certain fact that corporations will aways be subjected to some kind of tax on income. And the important question that is presented by this over-all record is whether or not the return, after ordinary income tax, during the war period was so much in excess of the return in the prewar and postwar periods as to afford a warrant for calling it an exessive return. The average percentage of profits to sales for the five prewar years 1936–40 was 7 percent; for the five war years, 1941–45, the average of profits to sales was 9.5 percent; and in the five postwar years, 1946–50 (3 months) it was 6.1 percent. The full record for 1950 will of course modify the average for this last period.

The differential of some 2.5 percentage points between the war and the nonwar periods covered in the table is the result of taking into account only the ordinary corporation income tax paid during the war years. Had there been no excess profits tax, the rate of the corporate income tax would undoubtedly

have been higher and the result could very well have been to reduce the sales-profit ratio of the war years below the range of the nonwar years.

The steadiness of the ratio in the general range of 6 to 7 percent in the prewar and postwar periods is striking. This outcome is to some extent haphazard rather than planned, because of the substantial difference in the rates of corporation income tax before and after the war. It does suggest, however, that business pricing and selling policies have been fairly successful in holding the line of the sales-profit ratio despite rising costs and higher taxes. A definite inference is provided that the higher taxes have been passed along, for otherwise the tax increase would have been registered as a decline of this ratio.

The conclusion appears warranted from the above record that there was no such wide difference between the relation of profits to sales in the prewar and postwar periods and the relation that prevailed during the war years to justify as defective a taxing instrument as an excess profits tax. Every revenue purpose sought through this tax could have been better achieved by other methods of corporate taxation, and the great volume of complaints, litigation, and expense created by this tax could have been avoided. There is no question, here, of whether or not the corporation taxes should have been increased, for this is both logical and necessary in a period when the Government's needs are greater and taxes are being increased at other points.

Inflation profits unreal.—In view of the actual course of prices during and after the war, there is one respect in which the dollar amount of all business profits is unreal. This is in the fact that as prices rise, the replacement cost of capital equipment is in excess of the amounts which are currently allowed as depreciation charges against earnings in determining tax liability. Adjustments for price-level changes were not considered during the war, and at that time there were some who forecast depression, unemployment, and price decline as soon as the shooting ended. None of these things happened, Instead, prices continued to advance, though with some breaks and irregularities. The national income accounts contain an adjustment against corporate profits for changes in inventory valuation,[7] but none for the difference between original cost and replacement cost in the category of capital assets other than inventory. Some idea of the magnitudes involved may be gained, however, by noting the relation of the inventory adjustments to total profits. This is shown in table V.

TABLE V.—*Corporation profits and inventory valuation adjustment, 1946–50*

[Billions of dollars]

Year	Corporation profits before tax	Inventory valuation adjustment	Profits after adjustment [1]
1946	$23.5	−$5.2	$18.3
1947	30.5	−5.8	24.7
1948	33.9	−2.0	31.8
1949	27.6	+2.2	29.9
1950 [2]	30.1	−1.6	28.4

[1] Rounded figures do not add to totals.
[2] Preliminary estimates of annual rates in first 6 months.

Source: Council of Economic Advisers, op. cit.

In view of the immense investment by industry in depreciable assets other than inventory it is evident that any recognition of an adjustment for their higher replacement costs during a prolonged inflation would lead to a further reduction of the real, as against the reported, profits.

This is not the place to deal with the various solutions that have been offered for the problem of depreciation and the price level. The problem itself is germane, nonetheless, to the charge that corporate profits have been so high as to warrant the imposition of a crippling, punitive excess profits tax.

Purpose and effect of excess profits taxation

This raises the issue of the purposes to be achieved through an excess profits tax. There are, evidently, one two major purposes namely (1) to get additional revenue, or (2) to penalize the companies that are most successful in earning profits through their capaciy to produce for military or civilian needs.

Revenue aspects of an excess profits tax greatly exaggerated.—The general belief is that an excess profits tax is necessary if a substantial increase in corporation tax revenue is required. In the popular view, this tax is the big mule that will pull the larger part of the corporate tax load. And there is an equally strong belief that without an excess profits tax the revenue collectible from corporations would be quite meager.

Both of these ideas are erroneous. The published records suggest that the excess profits tax produced the major part of the corporation tax revenue during the second world war. The same records indicate that an equivalent revenue could have been obtained in the years 1940–45 by a flat rate of 48.4 percent on all corporation income. The data are given in table VI.

TABLE VI.—*Corporate net income, income tax, and excess profits tax, 1940–45*

[Millions]

Year	Net income	Income tax	Excess profits tax	Total income and profits tax liability	Rate of flat tax to produce same yield
					Percent
1940	$11,203	$2.145	$374	$2,519	22.5
1941	18,111	3,744	3,359	7,103	39.2
1942	24,052	4,338	7,852	12,190	50.8
1943	28,718	4,479	11,291	15,770	55.0
1944	27,124	4,354	10,432	14,786	54.6
1945	22,165	4,183	6,557	10,740	48.4
Total	131,373	23,243	39,865	63,108	48.4

Source: Preliminary Statistics of Income, 1947, pt. 2, Summary Data.

The superficial impression conveyed by table VI is that the excess profits tax accounted for almost two-thirds of the total corporation tax revenue during the war years. This impression comes from the terminology and the technique employed. The real test of its net revenue advantage is in a comparison with other tax methods. For example, the rate of corporation income tax was advanced to 40 percent in the Revenue Act of 1942. If the only tax on corporation income through the period 1940–45 had been a rate of 40 percent, it would have produced a total revenue of $52,692,000,000. Since the combined yield of income tax and excess profits tax in this period was $63,108,000,000, it follows that the bona fide net gain from excess profits tax, over what would have been collected at a flat rate of 40 percent on all corporation income was only $10,416,000,000 ($63,108,000,000 minus $52,692,000,000).

It is not necessary here to enter into all of the details whereby taxable excess profits net income was determined. The point is that having determined such net income, a tax was imposed on this segment of income that rose closer to complete confiscation as the war progressed. The relationship of corporation net income adjusted excess profits net income, and excess profits tax, is shown in table VII.

TABLE VII.—*Corporate net income, adjusted excess profits net income, and excess profits tax, 1940–45*

[Millions]

Year	Net income	Adjusted excess profits net income	Excess profits tax	Percent, tax to adjusted excess profits net income
1940	$11,203	$912	$374	41
1941	18,111	6,335	3,359	53
1942	24,052	10,495	7,852	75
1943	28,718	14,553	11,291	77
1944	27,124	12,936	10,432	80
1945	22,165	8,368	6,557	78

Source: Statistics of income, pt. 2, for the several years

It is seen from table VII that the adjusted excess profits net income, the base on which the excess profits tax was levied, was never as much as half of the total corporation net income. There is no evidence to show that this adjusted excess profits net income was solely or exclusively war profits, and we know, from table II, that it was not imposed exclusively on large corporation incomes. What the record does show is that the tax absorbed an increasing percentage of such income as happened to be defined by the law as "adjusted excess profits net income" because of the tax rate increases that were made.

But table VI contains some other facts which are illuminating. The final column of that table shows the equivalent flat rate of corporation income tax that would have been required to produce a revenue equal to the combined yield of the corporation income and excess profits taxes. The highest rate of such tax was 55 percent in 1943 and as an average for the entire period, a rate of 48.4 percent would have sufficed.

If such a result would have been obtained during the Second World War, it is reasonable to suppose that a comparable one would follow from a repetition of the experiment, assuming that anything like the same kind of excess profits tax law were to be enacted. Because of the enormous advantages from the utilization of the established corporation income base for the Bureau in administering the tax, and for the taxpayers in complying with it, there is every reason to avoid the complexities and hardships of an excess profits tax in view of the small net revenue gain that is in prospect.

Penalty purpose of excess profits taxation.—The net revenue advantage from excess profits taxation over that provided by other ways of increasing the taxes to be paid by corporations is too small to make a case for this tax on revenue grounds. In fact, there is no intent to make such a case, and no desire for it. The demand for an excess profits tax does not rest on facts but on a compound of sentiment, semantics, and prejudice. Inflammatory slogans such as "Take the profits out of war," "Draft dollars along with men," "Corporation profits are already too high," have a wide appeal. They are designed to suggest the contrast between some of our people being killed in battle and others being comfortable and prosperous at home, but they make no contribution to a sound, genuinely productive tax program. Rather, they illustrate the nonfiscal attitude toward the use of the taxing power, in which the main purpose is to inflict a penalty or to exercise a control without regard to the effect of such measures upon the productive forces or upon the tax revenue which can legitimately be obtained from them without too serious impairment of their vigor. In submitting to the influence of suggestions like those set out above, the people are likely to be injuring rather than promoting the chances of their young men who must do the fighting. The fact is that fewer of our men will be killed in battle in proportion as they are provided with the best possible equipment for offense and defense, in whatever quantity may be necessary for the job. The job of industry and of those who remain at home is to produce enough so that the men in uniform can have as much as they need, when and where it is needed, and also enough more so that the people for whom these men are fighting can be safeguarded, to the extent possible, against the long-run bad effects of a severe decline of living standards. It would be pointless to force the civilian population to live in foxholes and subsist on packaged rations because the men in battle must accept these conditions. It is foolish to talk about drafting everything and everybody because the Armed Forces must fill their ranks by a selective-service draft. The emphasis should be, instead, upon the greatest possible productive effort, the greatest possible conservation of scarce manpower and materials, and the provision of the goods required for both military and civilian use at the lowest possible cost.

Excess profits taxation strangles the economy.—The necessary expansion of production cannot and will not occur without the maintenance, or even an increase, of capital investment. The tax system must be so devised, in every stage short of an all-out, last-ditch struggle for national existence, as to permit the continued growth of our productive facilities. An excess profits tax will hinder rather than promote this objective. No one knows for certain just how much profit can and should be taxed away during war without defeating the great national objective of maximum production at lowest cost. If the Government were to be successful in taking all of the profit out of war, it would very likely be successful to about the same degree in taking away the incentive to conserve manpower and materials and to get the output at the lowest cost.

The economic unsoundness of an excess profits tax is thrown into sharper focus by the prospect of a prolonged period of large military spending and partial mobilization. This tax is a method of economic strangulation. It sets arbitrary

ceilings beyond which economic growth can be only slow, feeble, and haphazard. With the passage of time any base established for determining standard or normal profit would become increasingly inadequate, and eventually entirely obsolete. In its report on the 1945 bill which repealed the excess profits tax, the Senate Finance Committee said: [3]

"The primary reason for advocating the repeal of the excess profits tax as of the first of 1946 is the belief that this tax is a major obstacle in the way of reconversion and expansion of business which are essential for the attainment of a high level of employment and income. The tax takes such a large portion of corporate profits that most businesses are not willing to take the risk of expanding their business while this tax is in operation."

Among other reasons given for the repeal is the following:

"The longer the excess profits tax is retained the less the income of 1936–39 base period is a proper measure of 'excessive' profits. This base period will be a particularly poor measure of earnings in the postwar period when many corporations will be entering new fields of enterprise or expanding their businesses."

This reasoning is as valid today as it was in 1945. The acceptance of a static base for the measurement of normal or excess profit over an extended period would be as damaging for the future years after 1950 as the Senate committee realized it would be for the years after 1945. A high duty of both business and political statesmanship is to cooperate in developing a system of Federal taxation which will supply the needed revenues and at the same time impose the minimum of restraint and hindrance upon the full and free development of our capacity to produce and to consume. An excess profits tax is wholly unworthy of consideration as part of such a tax system.

Excess profits tax promotes lax procurement.—A further contribution which the excess profits tax makes to unsound economic policy is in the promotion of laxness in procurement. Military purchasing, even under peace conditions, has never been characterized by a high regard for the value of money. Under the pressure of an emergency, this laxity becomes much more pronounced. Yet the lack of prudence, often reinforced by an insufficient knowledge of industrial processes and costs among military procurement officers, has been the principal cause for contract terms that would afford large profits on individual contracts. The knowledge or belief that a drastic excess profits tax might siphon off much of the extra profit too often serves as an excuse to avoid sharp, or even careful, bargaining. What is not so clearly perceived is that the siphoning is also operative against cost control on the part of management, with the result that the cost of both military supplies and civilian goods is materially increased.

2. AN EXCESS PROFITS TAX IS ADMINISTRATIVELY UNWORKABLE

It was pointed out above that any definition of an excess profit, by statute, is necessarily arbitrary, and hence incapable of being adapted to the myriad conditions which arise throughout industry in the private quest for profit. It becomes necessary, if the law is to operate at all, to introduce variations and exceptions from the standard pattern. But the ramifications of variations in actual business practice and experience are so numerous that no statutory classification can possibly cover and apply to all of them. The result is, inevitably an immense amount of complaint and litigation. There is something seriously wrong with any tax law that creates issues between the Government and the taxpayers which involve years of long-drawn-out, expensive controversy. Both of the previous excess profits tax laws were prolific sources of such controversy.

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[3] Report of the Senate Committee on Finance to accompany H. R. 4309 (the revenue bill of 1945), 79th Cong., 1st sess., p. 19.

The Commissioner of Internal Revenue reported as follows at the end of the fiscal year 1949:

TABLE VIII.—*Applications for excess profits tax relief (sec. 722), cumulative, 1942–49*

[Dollar amounts in millions]

Item	Number	Excess profits tax reduction		Increase in income tax
		Claimed	Allowed	
Net receipts of applications (excluding transfers and reopened cases)	53,651	$6,231		
Disposals:				
Allowed in whole or in part	7,791	240	$91	$37
Disallowed	10,659	430		
Withdrawn	9,865	697		
Eliminated [1]	3,055	6		
Total disposals	31,370	1,373	91	37
On hand, June 30, 1949	22,281	4,858		

[1] Applications eliminated upon agent's finding that no tax liability existed.

Source: Annual Report of the Commissioner of Internal Revenue, 1949, p. 30.

The significance of the data in this table may not be generally appreciated. It appears that during the 7-year period 1942–49, there were 53,651 applications for relief under section 722. The relief provisions of that section related only to excess profits returns made on the average base period income method. In these appeals the total amount of tax involved was $6,231 million, which was 15.6 percent of the entire collection of excess profits tax during the operation of the law through 1945. On June 30, 1949, there were still 22,281 unsettled cases involving $4,858 million of contested excess profits tax. The final closing of these cases could very well drag on for years longer, with all of the expenses and uncertainty of ultimate tax liability that are involved.

Table VIII summarizes the record of proceedings before the Excess Profits Tax Council, a special agency established in 1946 for the following purposes:

(1) To issue interpretative rulings with respect to section 722 for the guidance of the field committees and taxpayers generally.

(2) To review determinations made by the field committees with respect to all claims, irrespective of whether or not agreement with the taxpayer had been reached.

(3) To make determinations in cases in which agreement was not reached by the field committees and taxpayers, and in cases where the Council did not approve the field committees' determinations.

In commenting upon the task of the Council, the Commissioner said, in his 1949 report:

"Disposition of these claims must be made under an admittedly complex statute. In addition, the work involves extensive research in the fields of economics, statistics, and related subjects in order to determine the constructive average base period net income. The results of such studies must be translated into net income figures, which will require a mass of analytical accounting work."

This brief description of the nature of the work to be done in resolving the differences between the Government and the taxpayers in determining excess profits tax liability reveals that such work is so extensive, intricate, and esoteric as to be virtually impossible of accomplishment except by arbitrary findings which are either accepted by both parties out of sheer exhaustion, or are eventually referred to the courts.

All of this, and more, may be expected from a third experiment in excess profits taxation. And, as is conclusively shown by the data in table VI, none of the administrative fumbling with economic and business issues too complicated for official disentanglement, and none of the delay and abnormal expense of research into these issues, are necessary. Every revenue objective of an excess profits tax can be achieved with a minimum of additional expense and delay for both the Government and the taxpayers by making appropriate adjustment in the rate of the ordinary corporation income tax.

3. AN EXCESS PROFITS TAX CONTRIBUTES TO INFLATION

The third basis for opposition to an excess profits tax is that it contributes to inflation. This result stems from its economic unsoundness. The arbitrary application of unnatural and artificial measures of allowable normal or standard profit undermines the incentives to assume risks and to hold production costs down. It was pointed out above that the essence of economical, that is, prudent management is production at the lowest cost. The incentive to keep costs down is the other side of the profit incentive shield. A very good way to increase profits is to reduce costs. Industry is often attacked for seeking profit, but seldom praised for its effort to reduce costs. Yet the two attitudes are closely, even inseparably, connected.

Costs rise when profit motive is impaired.—The consequence of undermining the profit incentive is also to undermine the cost control incentive. When management fails to give diligent attention to costs they rise, for cost is the economic analog of the spirit of evil in theology, which is always abroad in the land except as it is restrained by the superior force of good. Exorbitant taxation that impinges on profit will inexorably take its toll of higher cost. The sequence of cause and effect leads directly from disregard of production cost to larger total payments by government for its military matériel, and thus to acceptance of the view that payment can be made only by resort to credit inflation. The chain reaction of credit inflation on price compels ever larger use of credit and both the government and the people are seriously affected by the spiral. At the termination of the emergency they are burdened with debt and always exposed to the political temptation to escape this burden by partial or complete repudiation. The mere fact of debt increase is, in itself, a dilution of the dollar as the basic standard of value, and hence a cancellation of some part of the values originally represented by all savings, investments, annuities, and similar benefits.

Waste of manpower and materials.—Disregard of cost means inefficient use of manpower and materials. This is what it would mean in peacetime, and of course the same result would follow during war or other emergency. Careless and inefficient use of manpower, particularly when the available labor force is virtually fully employed, limits by so much the possible scope of production. Less goods will be turned out and if the military preempts its established quota, the full impact of the shortage will fall upon the civilian population. It is possible that a sufficient waste of manpower may occur to affect even the volume and the quality of the materials and supplies needed by the Armed Forces. Inefficient use of materials cuts more rapidly than would otherwise be the case into the stockpiles of scarce and strategic materials, and into the irreplaceable reserves of our natural resources.

The logic of the effect of severe impairment of the profit incentive upon cost control is inescapable. The slackening of this control would find expression in manifold ways, some open and others devious. Increases of wage and material costs would be accepted with greater complaisance, and with a shortage of manpower, there could ensue an active competition to hold workers. This would redound to the advantage of those workers whose favor was thus being courted but it would also be reflected in higher wage costs without there being, necessarily, a corresponding increase of productivity. During World War II there were numerous instances, some of which had a considerable notoriety, of large bonuses, abnormal expenditures for advertising and for the promotion of unavailable products to retain consumer good will, padded travel and entertainment expenses, and so on.

High excess profits tax rates demoralizing.—The demoralizing aspect of an excess profits tax lies not only in the arbitrary character of the statutory definition of an excess profit, but also in the extreme rate or rates that are likely to be levied upon such profit as defined. During World Wor II this rate was eventually raised to 95 percent, with a refund of 10 percent paid in non-interest-bearing bonds which were made redeemable on and after January 1, 1946. Even the net tax rate of 85.5 percent was an effective discouragement to any concern against seeking greater profit in the excess profit zone by careful attention to cost. There were substantial totals of excess profit reported and taxed during the war years. These were the product of large Government orders, given on a far larger scale than necessary because of the lavish appropriations, and the lax standards of military procurement. The point that is emphasized here is that the certainty of a net tax rate of 85.5 percent on excess profit left very little incentive to show an increase of that excess by careful control of costs. Hence, the excess profits tax contributed to higher production costs, and thus to a larger volume of credit inflationary financing.

Inflation of war cost.—The thesis advanced here is that the excess profits tax contributed to the inflation that occurred during World War II. The primary source of that inflation was, of course, the creation of bank credit through loans to provide a substantial part of the purchasing power which the Government used to pay its bills. The tax policy led to higher costs and hence compelled a larger volume of borrowing than would have been required if the costs had been lower. A crude indication of the degree to which inflation increased national defense costs is provided by converting the dollars of actual expenditure into equivalent 1939 dollars. This is shown in table XI:

TABLE XI.—*National defense expenditures, converted to 1939 dollars*

[Dollar amounts in millions]

Year	National defense actual	National defense 1939 dollars
1941	$6,370	$6,078
1942	26,847	21,881
1943	70,267	53,375
1944	83,766	62,460
1945	84,569	62,157
1946	45,134	32,251
Total	316,953	238,202

The difference is $78,751,000,000, or about 25 percent of the cost in actual dollars. Wesley C. Mitchell estimated that the cost of the Civil War was increased by about 25 percent through the inflationary influence of the greenbacks.

There is at this time a general dread of further inflation, and fairly widespread indications of support for a strong, vigorous policy of taxation that would keep the Government's revenue in balance with its outgo. To do this will require prompt, decisive action to increase taxes, because the full impact of the spending program will not be felt before the fiscal year 1952 or 1953, and because time is required to get the necessary tax machinery in motion to produce larger revenues.

CONCLUSION AND RECOMMENDATION

It has been shown that an excess profits tax is against the public interest because it is economically unsound, administratively unworkable, and contributes to inflation.

The fact remains, however, that during a period of defense or actual war there must be a substantial increase of tax revenue, and the corporation income tax is a logical source of a part of this increase.

In view of these consideration, it is submitted that the corporation defense tax which is outlined on page 3 of this document resolves all of these problems. It recognizes that more corporation income tax must be paid during a defense or war emergency, and it applies the increase to all corporation income without regard to its origin in war business or other business. It escapes the administrative and compliance difficulties of an excess profit tax, and it will provide whatever additional revenue may be required from the corporation tax without impairing the incentives of management and bleeding the economy white so far as concerns continued capital formation. In particular, it will be much less severe as applied to small business than an excess profits tax is likely to be.

The duration of the present defense emergency, and of the heavy tax load that must be assumed, cannot now be forecast. On the most optimistic basis of calculation, however, the emergency and the increased tax burden will endure for some years. It is therefore of the gravest consequence that the measures taken for accomplishing the financial task be such as will make possible some further growth of the Nation's productive capacity rather than freezing and sterilizing our national economic potential.

Mr. SLIGH. Let me repeat that we have advocated and shall continue to advocate a pay-as-we-go policy. There are some who doubt that this is possible, in view of the prospective budget programs.

These persons say that there are no tax methods that would produce the needed revenue, and that the people will not tolerate tax burdens of the indicated magnitude. We maintain, first, that a Federal tax program can be geared to meet the budget requirements of the defense period, and, second, that with a vigorous campaign of educational activity and statesmanlike leadership, the people will respond. No body of men in this country except the Congress of the United States can spearhead such a campign.

The plan which we recommend for the increase of corporation taxes in the present emergency is as follows:

First, determine the ordinary corporation income tax by imposing a rate of 18 percent on normal tax net income, and a rate of 20 percent on surtax net income in excess of $25,000.

Second, impose a corporation defense tax to be determined as a flat percentage increase of the ordinary income tax as ascertained by the combination of rates proposed in the preceding paragraph, namely, 18 percent normal tax and 20 percent surtax above an exemption of $25,000.

The first point to be noted is that this plan rolls back the maximum rate of the ordinary corporation income tax from 45 percent to 38 percent. This involves a change in a recent enactment, but precedent exists for this in the replacement of the corporation tax provisions in the Revenue Act of 1935 by those in the Revenue Act of 1936 before the rates of the earlier act had become effective. The reason for the proposed roll-back of the rates is this:

The corporation income tax will always be a part of the Federal revenue structure, and when we look beyond the present defense emergency, it is highly important to have, for that eventual peacetime period, a definite benchmark in the tax law that indicates a ceiling on the corporation tax. Even a 38 percent maximum rate is too high for the long-range good of the economy, and consequently it is vitally important to hold the line there. The increase of the maximum rate by 7 percentage points to 45 percent in the act of 1950 was done because of the increased requirements of the defense program, but the mere substitution of one maximum for another made no direct reference to this fact, and the effect was to obliterate from the law any evidence that the 7-percentage-point increase was in the nature of a temporary increase for defense purposes. In time, without such evidence, the rate of 45 percent will become the accepted floor for the corporation tax.

The first objective of our plan is, therefore, the preservation in the tax law of a basic maximum rate, or ceiling, on the ordinary corporation income tax. This, we hold, can be accomplished only by retaining this ceiling in the law throughout the period of emergency financing.

The second feature of our plan—the corporation defense tax—provides for an increase of the total to be paid by any corporation, through a flat percentage increase of the tax as determined by the basic rates. This percentage mark-up of the basic tax can be set at whatever figure the Congress may determine. The actual percentage is readily adjustable to the total revenue requirements and the proportion of that total which it is deemed proper that corporations should bear.

The operation of this plan is illustrated in the table which follows:

Illustration of the proposed corporation defense tax

Taxable net income	Tax at 1949 tax law	Act of 1950—25 percent normal, 20 percent surtax	Basic tax—18 percent normal, 20 percent surtax	NAM plan					
				Corporation defense tax			Total income and corporation defense tax		
				At 30 percent	At 33⅓ percent	At 40 percent	At 30 percent	At 33⅓ percent	At 40 percent
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$25,000	$5.750	$6, 250	$4, 500	$1, 350	$1. 500	$1, 800	$5, 850	$6, 000	$6, 300
$100,000	38, 000	40, 000	33, 000	9, 000	11, 000	13, 200	42, 000	44, 000	46, 200
$705,000	267, 000	312, 250	262, 900	78, 870	87, 600	105, 160	341, 770	350, 500	868. 060
$1,000,000	380. 000	445. 000	375, 000	112, 500	125, 000	150, 000	487, 500	500, 000	525, 000
$10,000,000	3, 800, 000	4, 450, 000	3, 750, 000	1, 125, 000	1, 250, 000	1, 500, 000	4, 875, 000	5, 000, 000	5. 250, 000

In this table we show, for selected corporation incomes, the tax that would have been paid under the tax rates applicable in 1949, the tax payable under the 1950 law, and the tax that would be payable under our recommended combination of basic income tax and corporation defense tax overlay. The entire table is instructive, but I would direct your attention particulary to the columns which show the result of a percentage overlay of 33⅓ percent—columns 6 and 9. At the net income of $25,000, this overlay results in a somewhat lower tax than would be paid under the 1950 act. Even with a 40 percent overlay, the tax on $25,000 is just about equal to that of the 1950 act. At the $100,000 net income level, the effective rate on total income resulting from the 33⅓ percent overlay is 44 percent. This effective rate becomes about 50 percent of a net income of approximately $705,000, and remains near 50 percent thereafter, with an overlay of 33⅓ percent of the basic tax. An overlay of 40 percent results in an effective rate of around 52 to 53 percent from about the $705,000 net income level upward.

We recognize that similar results in terms of the tax burden on corporations and in terms of the revenue collected would be obtained by changing the surtax rate upward. We do not approve this method, and we strongly urge consideration of our way of doing the job, for these reasons:

First, an increase of the surtax rate would perpetuate the obliteration of the long-range ceiling on the corporation income tax that has already occurred in the act of 1950. As stated above, we consider it highly important to preserve in the law a record of the fact that there is such a ceiling for ordinary times and conditions.

Second, a mere advance of the surtax rate does not provide a clear identification of a part of the tax as being imposed for defense purposes. Our plan does this by using a label which definitely earmarks the increase as caused and justified by the defense program.

Third, by imposing the defense tax as a superstructure upon the regular tax, it will be easier to remove the overlay than it might be to secure a reduction of a tax rate which after some years may have become accepted as the normal level of the corporation tax.

I submit that our plan will produce fully as much revenue, and potentially more revenue, as would be obtained through any sort of conventional excess profits tax. It would provide the minimum disturbance to production, and hence, in the long run, the maximum tax base. Further, it is entirely flexible as to yield because of the ease with which the percentage of tax overlay can be changed.

In addition to the revenue potential, the plan has the following further advantages:

1. It will apply to all corporation income and not merely to some arbitrarily determined segment thereof. It involves no artifical, inequitable segregation of profits into normal and excessive profits. There will be no question of undue favoritism or penalty because of the wide differences in the way any given normal income base would apply to different corporations.

2. It will involve no administrative or compliance difficulties beyond those now presented by the ordinary corporation income tax. There will be no vast accumulation of appeals for settlement at great expense in future years.

3. It provides a beneficial advantage to small corporations through reduction of the normal tax rate from 25 percent to 18 percent. It provides, as no excess profits tax can, for fair taxation of new and growing business, by levying on their income, if they have income, without regard to amount, source, or other special characteristics. When the basic ordinary corporation income tax is determined at reasonable rates and by procedures well established and generally understood, it is right and proper that all corporations, small and large, new and old, should contribute to the defense program. There should be no exemptions, and there would be need of none.

4. It establishes a clear demarcation between the ordinary, basic, long-range corporation tax burden and the special levies made necessary by the emergency.

5. It retains a reasonable incentive to expand production, to conserve scarce manpower and materials, and to control costs. All of these are essential to continued national growth during and after the emergency.

It is evident that the revenue that can be obtained under the recommended combination of basic tax and percentage overlay is flexible within any reasonable limits. An important question is: How much should be collected from corporation income?

This question cannot be answered adequately from the standpoint of any particular company, or even from that of the Government's budget. If we are to hold fast to the objective of continued national growth, we must face and seek to answer the question in the light of the over-all, national situation. For this purpose, let us assume that Secretary of the Treasury Snyder is correct in assuming total

corporation profits of $37,000,000,000 in the calendar year 1950. Now, let us compute the taxes on this total:

Computation of total corporation taxes at (1) 1950 rates plus House bill increase, and (2) NAM alternative plan

1. Tax on $37,000,000,000 at 1950 rates:	
$37,000,000,000 at 25 percent normal tax	$9,250,000,000
$32,000,000,000 at 25 percent surtax [1]	6,400,000,000
Total income tax	15,690,000,000
Add excess profits tax, Ways and Means Committee estimate	3,000,000,000
Total income and profits tax	18,690,000,000
2. Tax on $37,000,000,000 at NAM plan:	
Basic or ordinary income tax:	
$37,000,000,000 at 18 percent normal tax	6,660,000,000
$32,000,000,000 at 20 percent surtax	6,400,000,000
Total basic or ordinary income tax	13,060,000,000
If percentage overlay is 33⅓ percent, add	4,340,000,000
Total income tax plus 33⅓ percent overlay	17,410,000,000
If perceintage overlay is 40 percent, add	5,224,000,000
Total income tax plus 40 percent overlay	18,284,000,000

[1] The exemption of $25,000 from surtax excludes all income of corporations having not more than $25,000, and also the amount of $25,000 for each corporation having income subject to surtax. It is estimated that the total of these exemptions from surtax would be about $5,000,000,000 at the corporation income level of $37,000,000,000.

It is seen that the tax at 1950 rates, plus an additional $3,000,000,000 would exceed one-half of total corporation income by $190,000,000, while the NAM plan with a 40-percent overlay would fall short of one-half of $216,000,000. A percentage overlay of 43.1 percent would produce as much revenue as the act of 1950 plus the Ways and Means Committee estimate. It would require an overlay of 50.7 percent to produce $4,000,000,000.

It now remains to consider the over-all corporate position after taxes, for this is the real milk of the coconut. In view of the close approximation of the two methods in the matter of tax yield, the outcome would be of the same order of magnitude under either tax method. The results are as follows:

Corporation position after taxes

[Millions]

	Act of 1950 [1] plus Ways and Means increase	NAM plan with 40-percent overlay	NAM plan with 50-percent overlay
Assumed total corporation income	$37,000	$37,000	$37,000
Total tax as calculated above	18,690	18,284	19,690
Income after taxes, available for corporate purposes	18,310	18,716	17,310
Dividends at 4 percent of national income	9,000	9,000	9,000
Balance available for plow-back	9,310	9,716	8,310
Average plow-back of earnings, 1946–49	9,850	9,850	9,850

[1] In the years 1946–49, dividends averaged about 4 percent of national income, as against a longer historical average of 5 percent or more. See attached chart.

It is evident that with total corporation income at $37,000,000,000, a tax that would take much more than half of the total, by whatever method or combination of methods imposed, would shortly become self-defeating. If the tax is further increased directly on corporations at the expense of dividends, it would shortly not be a net revenue gain because of the tax loss on the diminished dividend component of individual incomes. If the tax increase were to be paid at the expense of retained earnings available for corporate reinvestment, or plow back, there would result rather promptly a decline of total corporate income and earnings because of the inability to maintain and expand the capital equipment which enables business to earn income.

In conclusion, we submit that we have a plan of corporation taxation for the defense period that is capable of producing as much revenue as it is safe to take out of the collective corporate till, if we expect and intend that the national economy shall continue to grow in strength. It is a plan that is simple, effective, involving no added difficulties to interpretation or administration, and no postdefense period headaches for Government and taxpayer. It is an additional tax on all profits, whether gained from defense contracts or other business. Except for the label of "excess profits tax," to which even Secretary of the Treasury Snyder objects, it can be regarded as an adequate and conscientious fulfillment of the directive which the Congress issued to itself in section 701 of the Revenue Act of 1950.

Thank you, sir.

The CHAIRMAN. Thank you very much.

Are there any questions by members of the committee?

You may place your brief for the record with the reporter.

(The statement submitted by Mr. Sligh reads in full as follows:)

STATEMENT OF CHARLES R. SLIGH, JR., CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS, PRESIDENT, CHARLES R. SLIGH CO.

My name is Charles R. Sligh, Jr. I am a furniture manufacturer and president of the Charles R. Sligh Co., Holland, Mich. I appear here as chairman of the taxation committee of the National Association of Manufacturers.

It is always a privilege to testify before this committee, but especially so at this time. In September Congress, upon your advice, resisted tremendous pressure to enact an excess profits tax patterned after the inflationary and inequitable formula used in World War II. Action was orered delayed until this highly important proposal could be given adequate study by your committee, and by other congressional and Treasury tax experts.

The delay gave business an opportunity, which it would have been denied had the attempt to put an excess profits tax on the books succeeded, to document the shortcomings of this bad law and to explain them to you.

Our association favors putting all of the increased defense costs on a pay-as-we-go basis. We are not here trying to safeguard the corporate pocketbook from new taxes. We know that this is is only a part of the tax load yet to come. Business wants to pay its fair share of this increased burden. But we know—and you know—that business cannot pay it all. All segments of the economy must bear their fair share of the burden, too.

We are here, Mr. Chairman, to help your committee to avoid the repetition of a costly error made in World Wars I and II. We come with an alternative program which will take any specified number of dollars from corporation profits without inflicting irreparable harm especially upon small and growing businesses which are the backbone of our industrial economy.

Mr. Chairman, I offer two documents for the record. One is entitled "A Federal Tax Program for the Period of Defense and Partial Mobilization." The other is a study by Dr. Harley L. Lutz entitled "An Excess Profits Tax is Against the Public Interest."

Dr. Lutz' study demonstrates that this kind of tax is inflationary; it is economically unsound; it deadens incentives; it penalizes the efficient and patriotic while leaving plenty of room for malingering at the public expense; it is wasteful of manpower and materials; it is enequitable and involves endless administrative complexities; and finally, it is not notably efficient as a revenue producer, for as much, or more revenue can be obtained from corporations by other means without incurring all of these evil consequences.

The bill now pending before this committee is, in essence, a repetition of the World War II type of profits tax. It is dressed up with some different language, and contains some different gadgets, but it contains the faults and defects that so conspicuously characterized the earlier legislation. Because these obvious shortcomings cannot be corrected, I prefer to lay it aside and to place before you the plan which we recommend for increasing the tax on corporation income during the defense period.

Let me repeat that we have advocated and shall continue to advocate a pay-as-we-go policy. There are some who doubt that this is possible, in view of the prospective budget programs. These persons say that there are no tax methods that would produce the needed revenue, and that the people will not tolerate tax burdens of the indicated magnitude. We maintain, first, that a Federal tax program can be geared to meet the budget requirements of the defense period, and second, that with a vigorous campaign of educational activity and statesmanlike leadership, the people will respond. No body of men in this country except the Congress of the United States can spearhead such a campaign.

It cannot be emphasized too strongly, however, that this costly defense program must be accompanied by sharp reduction in nonwar spending. The Nation will not grumble about higher taxes to assure its security if the people know those tax dollars are not being wasted on projects or services which we simply cannot afford during this crisis.

The particular part of our over-all tax program that I shall present here relates to the recommendations for increasing the tax on corporation income. It has been formulated in full recognition of the need for a great increase in Federal revenue during the defense period, but with emphasis also upon the importance of preserving the capacity of the Nation to grow sufficiently to carry its heavier burden without being overwhelmed by it. The demand for goods and services by Government for the purpose of defense and the military effort means a corresponding diversion of current product from private to public use. Paying as we go for the larger share of current products taken by Government involves an equivalent diversion of private income. On the point that we must increase our economic strength as the burden increases I quote from our Federal tax program as follows:

"The diversion of private income must be done, certainly in all stages short of all-out, total war, as to preserve as much as possible of the economic incentives to produce at the lowest cost. Maintenance of a high level of production is essential to the rapid supply of the necessary military material, and it will, of course, hold to a minimum the deprivations which civilians must endure while the defense program is being developed. High level production will generate a correspondingly high volume of income, and this, in turn, will make possible the payment of taxes to cover the Government's share of the product without involving as heavy a burden as would be necessary at a lower level of output and income. It is only when a nation has become engaged in a life and death struggle, and all civilians have been reduced to a subsistence level, that it can afford to eliminate further capital formation for nondefense purposes. Short of that point of extreme sacrifice, there must be some provision for sustained civilian production. The best way to get this result is through recognition of the profit incentive."

We are not yet in the stage of all-out, total war. We still have the dual responsibility of changing the nature and stepping up the volume of production to supply Government with the military goods required, and also of sustaining a sound civilian economy, both to safeguard health and well-being and to avoid too great deterioration of civilian morale. These heavy production requirements will fall, in large degree, upon American corporations, for they supply, in the aggregate, a large proportion of the Nation's total output. To the extent that they are unduly or improperly restricted and impeded in the performance of their economic function of production, the Government, and the soldiers, and the people at home alike will suffer the consequences.

The plan which we recommend for the increase of corporation taxes in the present emergency is as follows:

First, determine the ordinary corporation income tax by imposing a rate of 18 percent on normal tax net income, and a rate of 20 percent on surtax net income in excess of $25,000.

Second, impose a corporation defense tax to be determined as a flat percentage increase of the ordinary income tax as ascertained by the combination of rates proposed in the preceding paragraph, namely, 18 percent normal tax and 20 percent surtax above an exemption of $25,000.

The first point to be noted is that this plan rolls back the maximum rate of the ordinary corporation income tax from 45 percent to 38 percent. This involves a change in a recent enactment, but precedent exists for this in the replacement of the corporation tax provisions in the Revenue Act of 1935 by those in the Revenue Act of 1936 before the rates of the earlier act had become effective. The reason for the proposed roll-back of the rates is this:

The corporation income tax will always be a part of the Federal revenue structure, and when we look beyond the present defense emergency, it is highly important to have, for that eventual peacetime period, a definite bench mark in the tax law that indicates a ceiling on the corporation tax. Even a 38 percent maximum rate is too high for the long-range good of the economy, and consequently it is vitally important to hold the line there. The increase of the maximum rate by 7 percentage points to 45 percent in the act of 1950 was done because of the increased requirements of the defense program, but the mere substitution of one maximum for another made no direct reference to this fact, and the effect was to obliterate from the law any evidence that the 7 percentage point increase was in the nature of a temporary increase for defense purposes. In time, without such evidence, the rate of 45 percent will become the accepted floor for the corporation tax.

The first objective of our plan is, therefore, the preservation in the tax law of a basic maximum rate, or ceiling, on the ordinary corporation income tax. This, we hold, can be accomplished only by retaining this ceiling in the law throughout the period of emergency financing.

The second feature of our plan—the corporation defense tax—provides for an increase of the total tax to be paid by any corporation, through a flat percentage increase of the tax as determined by the basic rates. This percentage mark-up of the basic tax can be set at whatever figure the Congress may determine. The actual percentage is readily adjustable to the total revenue requirements and the proportion of that total which it is deemed proper that corporations should bear. The operation of this plan is illustrated in the table which follows:

Illustration of the proposed corporation defense tax

Taxable net income	Tax at 1949 tax law	Act of 1950—25 percent normal, 20 percent surtax	NAM plan						
			Basic tax—18 percent normal, 20 percent surtax	Corporation defense tax—			Total income and corporation defense tax—		
				At 30 percent	At 33⅓ percent	At 40 percent	At 30 percent	At 33⅓ percent	At 40 percent
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$25,000	$5,750	$6,250	$4,500	$1,350	$1,500	$1,800	$5,850	$6,000	$6,300
$100,000	38,000	40,000	33,000	9,000	11,000	13,200	42,000	44,000	46,200
$705,000	267,000	312,250	262,900	78,870	87,600	105,160	341,770	350,500	368,060
$1,000,000	380,000	445,000	375,000	112,500	125,000	150,000	487,500	500,000	525,000
$10,000,000	3,800,000	4,450,000	3,750,000	1,125,000	1,250,000	1,500,000	4,875,000	5,000,000	5,250,000

In this table we show, for selected corporation incomes, the tax that would have been paid under the tax rates applicable in 1949, the tax payable under the 1950 law, and the tax that would be payable under our recommended combination of basic income tax and corporation defense tax overlay. The entire table is instructive, but I would direct your attention particularly to the columns which show the result of a percentage overlay of 33⅓ percent (columns 6 and 9). At the net income of $25,000, this overlay results in a somewhat lower tax than would be paid under the 1950 act. Even with a 40 percent overlay, the tax on $25,000 is just about equal to that of the 1950 act. At the $100,000 net income level, the effective rate on total income resulting from the 33⅓ percent overlay is 44 percent. This effective rate becomes about 50 percent at a net income

of approximately $705,000, and remains near 50 percent thereafter, with an overlay of 33⅓ percent of the basic tax. An overlay of 40 percent results in an effective rate of around 52 to 53 percent from about the $705,000 net income level upward.

We recognize that similar results in terms of the tax burden on corporations and in terms of the revenue collected would be obtained by changing the surtax rate upward. We do not approve this method, and we strongly urge consideration of our way of doing the job, for these reasons:

First, an increase of the surtax rate would perpetuate the obliteration of the long-range ceiling on the corporation income tax that has already occurred in the act of 1950. As stated above, we consider it highly important to preserve in the law a record of the fact that there is such a ceiling for ordinary times and conditions.

Second, a mere advance of the surtax rate does not provide a clear identification of a part of the tax as being imposed for defense purposes. Our plan does this by using a label which definitely earmarks the increase as caused and justified by the defense program.

Third, by imposing the defense tax as a superstructure upon the regular tax, it will be easier to remove the overlay than it might be to secure a reduction of a tax rate which after some years may have become accepted as the normal level of the corporation tax.

I submit that our plan will produce fully as much revenue, and potentially more revenue, as would be obtained through any sort of conventional excess profits tax. It would provide the minimum disturbance to production, and hence, in the long run, the maximum tax base. Further, it is entirely flexible as to yield because of the ease with which the percentage of tax overlay can be changed.

In addition to the revenue potential, the plan has the following further advantages:

(1) It will apply to all corporation income, and not merely to some arbitrarily determined segment thereof. It involves no artificial, inequitable segregation of profits into normal and excessive profits. There will be no question of undue favoritism or penalty because of the wide differences in the way any given normal income base would apply to different corporations.

(2) It will involve no administrative or compliance difficulties beyond those now presented by the ordinary corporation income tax. There will be no vast accumulation of appeals for settlement at great expense in future years.

(3) It provides a beneficial advantage to small corporations through reduction of the normal tax rate from 25 to 18 percent. It provides, as no excess profits tax can, for fair taxation of new and growing business, by levying on their income, if they have income, without regard to amount, source, or other special characteristics. When the basic, ordinary corporation income tax is determined at reasonable rates and by procedures well established and generally understood, it is right and proper that all corporations, small and large, new and old, should contribute to the defense program. There should be no exemptions, and there would be need of none.

(4) It establishes a clear demarcation between the ordinary, basic, long-range corporation tax burden and the special levies made necessary by the emergency.

(5) It retains a reasonable incentive to expand production, to conserve scarce manpower and materials, and to control costs. All of these are essential to continued national growth during and after the emergency.

It is evident that the revenue that can be obtained under the recommended combination of basic tax and percentage overlay is flexible within any reasonable limits. An important question is: How much should be collected from corporation income?

This question cannot be answered adequately from the standpoint of any particular company, or even from that of the Government's budget. If we are to hold fast to the objective of continued national growth, we must face and seek to answer the question in the light of the over-all, national situation. For this purpose let us assume that Secretary of the Treasury Snyder is correct in

assuming total corporation profits of $37,000,000,000 in the calendar year 1950. Now, let us compute the taxes on this total:

Computation of total corporation taxes, at (1) 1950 rates plus House bill increase, and (2) NAM alternative plan

	Million
1. Tax on $37,000,000,000 at 1950 rates:	
$37,000,000,000 at 25 percent normal tax	$9,250
$32,000,000,000 at 25 percent surtax [1]	6,400
Total income tax	15,690
Add excess profits tax, Ways and Means Committee estimate	3,000
Total income and profits tax	18,690
2. Tax on $37,000,000,000 at NAM plan:	
Basic or ordinary income tax:	
$37,000,000,000 at 18 percent normal tax	6,660
$32,000,000,000 at 20 percent surtax	6,400
Total basic or ordinary income tax	13,060
If percentage overlay is 33⅓ percent, add	4,340
Total income tax plus 33⅓ percent overlay	17,410
If percentage overlay is 40 percent, add	5,224
Total income tax plus 33⅓ percent overlay	17,410

[1] The exemption of $25,000 from surtax excludes all income of corporations having not more than $25,000, and also the amount of $25,000 for each corporation having income subject to surtax. It is estimated that the total of these exemptions from surtax would be about $5,000,000,000 at the corporation income level of $37,000,000,000.

It is seen that the tax at 1950 rates, plus an additional $3,000,000,000, would exceed one-half of total corporation income by $190,000,000, while the NAM plan with a 40-percent overlay would fall short of one-half by $216,000,000. A percentage overlay of 43.1 percent would produce as much revenue as the act of 1950 plus the Ways and Means Committee estimate. It would require an overlay of 50.7 percent to produce an additional billion dollars.

It now remains to consider the over-all corporate position after taxes, for this is the real milk of the coconut. In view of the close approximation of the two methods in the matter of tax yield, the outcome would be of the same order of magnitude under either tax method. The results are as follows:

Corporation positio nafter taxes

[Millions of dollars]

	Act of 1950[1] plus Ways and Means increase	NAM plan with 40-percent overlay	NAM plan with 50-percent overlay
Assumed total corporation income	$37,000	$37,000	$37,000
Total tax as calculated above	18,690	18,284	19,690
Income after taxes, available for corporate purposes	18,310	18,716	17,310
Dividends at 4 percent of national income	9,000	9,000	9,000
Balance available for plow-back	9,310	9,716	8,310
Average plow-back of earnings, 1946–49	9,850	9,850	9,850

[1] In the years 1946–49, dividends averaged about 4 percent of national income, as against a longer historical average of 5 percent or more. See attached chart.

It is evident that with total corporation income at $37,000,000,000 a tax that would take much more than half of the total, by whatever method or combination of methods imposed, would shortly become self-defeating. If the tax is further increased directly on corporations at the expense of dividends, it would shortly not be a net revenue gain because of the tax loss on the diminished dividend component of individual incomes. If the tax increase were to be paid at the

expense of retained earnings available for corporate reinvestment, or "plowback," there would result rather promptly a decline of total corporate income and earnings because of the inability to maintain and expand the capital equipment which enables business to earn income.

In conclusion, we submit that we have a plan of corporation taxation for the defense period that is capable of producing as much revenue as it is safe to take out of the collective corporate till, if we expect and intend that the national economy shall continue to grow in strength. It is a plan that is simple, effective, involving no added difficulties of interpretation or administration, and no postdefense period "headaches" for Government and taxpayers. It is an additional tax on all profits, whether gained from defense contracts or other business. Except for the label of excess profits tax, to which even Secretary of the Treasury Snyder objecs, it can be regarded as an adequate and conscientious fulfillment of the directive which the Congress issued to itself in section 701 of the Revenue Act of 1950.

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Senator BUTLER. It is your opinion that your proposed plan would be fair to all business firms, regardless of whether they are small firms or large firms?

Mr. SLIGH. Yes, sir, that is my contention, and I happen to be the president of a very small firm myself. We feel that it would be fair to small firms.

I might say in that connection that the NAM is made up of over 15,000 members. Eighty-three percent of those members have less than 500 employees. I have yet to find anyone in the National Association of Manufacturers that does not approve this plan.

Senator MILLIKIN. I am sorry that I did not hear the first part of your testimony, Mr. Sligh, but in looking over the manuscript, I noticed that you say you favor putting all of these defense costs on a pay-as-you-go basis. Do you think that is feasible?

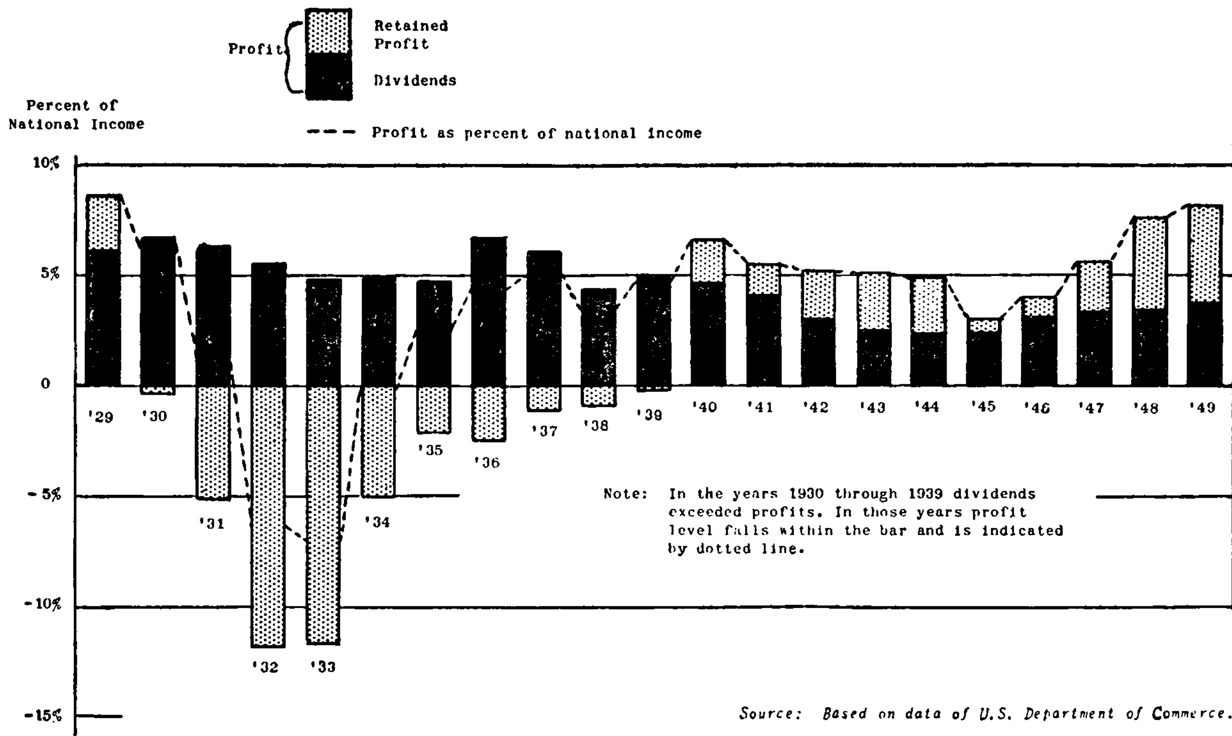
Mr. SLIGH. We do, sir, during the period of defense. We feel it cannot be done, of course, if it is not distributed fairly over all segments of the economy.

Senator MILLIKIN. Assume a fair distribution, and assume that in the fiscal year 1952, commencing the middle of next year, that we had to have, say $20,000,000,000 to balance the budget. Would you take that much more out of the economy on a pay-as-you-go basis?

Mr. SLIGH. We feel that in the long run we pay as we go in one way or another anyway.

CORPORATE PROFITS AND DIVIDENDS IN RELATION TO NATIONAL INCOME

(All U. S. Corporations Except Banks and Insurance Companies)



Senator MILLIKIN. But keep our mind right on the pay-as-you-go by taxes.

Mr. SLIGH. Yes. I say we feel it should be done through taxes, and we feel that the American public is ready and willing that it should be done through taxes.

Senator MILLIKIN. In putting the question to you, I am trying to get your judgment on whether, if we require from fifteen to twenty billion dollars, let's say, in the fiscal year 1952 to balance the budget, whether you think you could add that much taxes without seriously injuring our economy.

Mr. SLIGH. Our answer to that would be "Yes."

I would like to call on Dr. Lutz, if I may, if he has any further statement in that regard.

Senator MILLIKIN. What do you think, Doctor?

Mr. LUTZ. Yes; I think you can do that, Senator. As Mr. Sligh has said, it has to be done by a comprehensive overhauling and readjustment of the entire Federal tax structure. You cannot get that much additional money out of corporation profits without destroying the business section of the economy, obviously.

Senator MILLIKIN. Of course, take a look at your progressive income tax and study it from the middle on up. How much more then would you add to that?

Mr. LUTZ. There is not a great deal more room in the upper brackets of income, in individual income taxes. Obviously, if you are going to get a great deal more additional revenue out of the individual income tax, you have to do it by increasing the rates at the bottom of the scale.

Senator MILLIKIN. Do you think that is feasible?

Mr. LUTZ. I think it is.

Senator MILLIKIN. To the extent of 15 or 20 billion dollars?

Mr. LUTZ. I would not try to get that all out of the individual income tax, either.

Senator TAFT. It could be done. Why not? The only trouble is, will the people accept the reduction of the standard of living made necessary by the war. I do not think they will unless you impose controls. It is conceivably feasible, I would think. Whether you want to do it, is the question.

Mr. LUTZ. That is very likely the case, Senator.

Senator TAFT. What is the total individual income today?

Mr. LUTZ. The total taxable income is about 82 to 85 billion dollars, as I remember the Treasury figures.

Senator TAFT. But individual income is what?

Mr. LUTZ. Two hundred and fifteen to two hundred and twenty billions.

Senator TAFT. Out of which we take today 20 in taxes, or 10 percent.

Mr. LUTZ. Yes, 10 percent.

Senator TAFT. Conceivably, in theory you can take 10 percent more.

Mr. LUTZ. Quite obviously.

Senator TAFT. But whether you can get away with it, that is another question.

Senator MILLIKIN. Well, theoretically, you can take everything. The question is what happens to your economy, and what happens to your social order.

Mr. LUTZ. I know, but the thing that you have got to bear in mind is that the people are with you to a surprising extent, because there is not anything in our domestic situation that they are more concerned about than inflation.

Senator MILLIKIN. If you had been beating the bushes recently to get yourself close to what the people are thinking, you will find they have a certain allergy to increased taxes. They are willing to pay them, but they couple that with demands for limiting waste.

Mr. LUTZ. We would subscribe to that.

Senator MILLIKIN. There is not this hysterical yearning for more taxes that many theorists think there is, and that yearning will become less as the impact of these taxes is felt.

Mr. LUTZ. I do not suppose anybody ever yearns to pay more taxes, but it seems to me that when you consider the millions of people who have insurance policies and savings deposits and savings bonds, and other forms of investment, that sort of thing, which will simply melt away if we get another disastrous inflation, that it should be possible to bring home to them the hard choice they have got to make. They have either got to see the whole thing wiped out by inflation, which is what you will get if you pay for it that way, or preserve the value of their dollars by paying the bill now as we go along.

Senator MILLIKIN. I think there is quite general agreement on that. What I mean to say is I think everyone recognizes if you do not balance your budget, approximate it, you are destroying the value of your dollar. That has taken us to a 50-cent dollar already, and the same process can take it to a no-cent dollar.

Mr. LUTZ. As far as the French franc is.

Senator MILLIKIN. The question remains: How much, as a practical matter, how far toward balancing that budget, can you go? That involves more than just an operation with a pencil; that involves public thinking, public willingness to sacrifice. Part of that relates itself to the type of taxation which you propose.

This is a very practical business that we are in here.

Mr. LUTZ. That is right, but I think the people are pretty practical minded, too, when you get the whole story before them so that they see what is involved on both sides of the issue.

Senator MILLIKIN. You would be surprised at the apathy which often greets sound economic arguments.

Mr. LUTZ. Well, I do not know whether it is any greater than that which greets unsound economic arguments, Senator. I would rather try to give them sound arguments.

Senator MILLIKIN. You would be surprised at the enthusiasm that often greets unsound economic arguments.

Senator TAFT. In fact, this is not very different from just increasing the corporate rate on everybody, this proposed plan?

Mr. LUTZ. Yes, it is, Senator.

Senator TAFT. You add a percentage to the tax paid.

Mr. SLIGH. Percentage of the tax liability figured under the 38 percent rate.

Senator TAFT. Is that very different from just increasing the rate, the additional defense rate?

Mr. LUTZ. In dollars of revenue, it would not be different.

Senator TAFT. I mean, does it affect a particular corporation differently?

Mr. LUTZ. No, but we think there is a very sound reason for approaching it the way we have proposed, which is that under our method we keep in the law a record of what the ordinary——

Senator TAFT. Yes; I understand that approach. I am talking about the practical payment in dollars of any corporation. That would be about the same as if you increase the rate?

Mr. LUTZ. Yes, and they would have about the same effect, of course.

Senator MILLIKIN. When you add a uniform percentage all the way along the line, that in itself carries certain discriminations, because there is a vast difference as you ascend from your base in the ability of corporations to pay that added tax. Because you add a uniform tax does not mean that you are going to have a uniform result so far as corporations are concerned. With a uniform tax, there might be, for example, much more inability to carry a uniform increase as far as the smaller businesses are concerned than the more profitable larger businesses.

Mr. LUTZ. Well, I think that raises some questions about the relative profitability of the large and small businesses that would have to be explored.

Senator MILLIKIN. Of course. That is exactly what I am talking about. I mean we have not got any little one-pill cures for our whole taxation problem.

Mr. LUTZ. No; this is only one of the pills.

Senator MILLIKIN. By doing the thing one way everybody gets into a sort of a tax utopia, and by doing it another way everything goes to the devil

I am simply making the point that we are accustomed to making flat increases around here, and we are accustomed to the results. I am simply pointing out to you that a flat increase does not produce uniformly equitable results to recipients of the increase. It depends somewhat on the state of the individual business.

Mr. LUTZ. I think that is a matter that could be debated so far as any imputation of the ability to pay taxes of corporations is concerned. I do not think that is a field where you can talk about ability to pay at all. If there is any meaning to the meaning of ability to pay, it is adaptable only in connection with individuals, not a corporate entity as such.

Senator MILLIKIN. That is something business leaders should keep strongly in mind. Perhaps that is a little hint I am trying to drop into your heads.

The CHAIRMAN. Thank you very much for your appearance, Mr. Sligh, and your associates.

Mr. SLIGH. Thank you.

The CHAIRMAN. Mr. Ellsworth Alvord. You may be seated.

Mr. ALVORD. Thank you, Senator. I will probably stand for a while.

The CHAIRMAN. Please identify yourself for the record.

STATEMENT OF ELLSWORTH C. ALVORD, WASHINGTAN, D. C., APPEARING AS CHAIRMAN OF THE COMMITTEE ON FEDERAL FINANCE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. ALVORD. Mr. Chairman and gentlemen, I regret it has been impossibe for me to prepare a written statement for presentation to you this morning. I would like, in lieu thereof, to do two things: I would like to file presently for the use of the committee the statement I made before the Committee on Ways and Means of the House, which was not included in their record of the hearings. I would also like to file, if I can prepare it before the hearings are printed, a detailed discussion of the bill.

The CHAIRMAN. You may do so. You may file what you have ready now. We hope to have the full record printed early next week.

Mr. ALVORD. Yes, sir. I will do my very best to prepare a detailed statement. Time simply has not been available.

(The statement presented before the Committee on Ways and Means is as follows:)

STATEMENT BY ELLSWORTH C. ALVORD, CHAIRMAN, COMMITTEE ON FEDERAL FINANCE, CHAMBER OF COMMERCE OF THE UNITED STATES

INTRODUCTION

My name is Ellsworth C. Alvord. I appear before you as chairman of the committee on Federal finance, Chamber of Commerce of the United States. We appear primarily to assist your committee in analyzing the problems involved in defining "excess profits" and to assist you in your endeavor to formulate policies designed to segregate "excess profits" from "normal profits" and to tax "excess profits" at rates higher than can be imposed upon "normal profits."

OUR BASIC POLICY

The American people have united upon a basic policy: Resistance to the spread of communism—at home and abroad.

The keystone of this policy, as we have so frequently stated, is strength—economic strength, fiscal strength, spiritual strength, moral strength. Only with such strength can we build and maintain unprecedented military strength, adequate to protect us from military aggression. With strength throughout the indefinite period ahead of us we shall succeed. With weakness during any portion of that period we shall fail.

DANGERS AHEAD

The American people know the dangers involved in our resistance to the spread of communism:

(1) When we have built that extraordinary military machine necessary to protect and defend us, we must not become an aggressor nation.

(2) We must build and maintain the necessary military machine without regimentation and a dictatorship.

(3) We must stop inflation.

The American people also know that the fiscal policies of their Government have had, and will continue to have, direct effect. The fiscal policies of the administration and of the Congress can, and will, lessen the dangers and help avoid them, or can and will force aggression, regimentation, and inflation. The problems involved are above politics. Faith, determination, courage, and confidence are required.

FISCAL OBJECTIVES

Your committee on many occasions has accorded us the opportunity to present our fiscal objectives. We are, of course, happy that they have now been recog-

nized by the administration. Secretary Snyder, on page 2 of his statement before your committee on November 15, says:

"The President has a threefold objective: First, to contribute to meeting the increased cost of defense; second, to help check inflationary pressures and enable the Government to maintain a strong financial position; and, third, to tax the high profits resulting from the defense program."

SUMMARY OF THE TREASURY'S POSITION

Our study of Secretary Snyder's statement and of the facts upon which it is based gives us the following summary:

(1) There are no "high profits resulting from the defense program" during 1950—a statement founded upon fact, for defense expenditures so far this year are actually less than during 1949.

(2) There will probably be no "high profits resulting from the defense program" during 1951—a prediction with which we agree, for scheduled expected deliveries of "hard goods" for use of the military in 1951 are only about $9,000,000,000.

(3) The best definition at this time of "excess profits" is "high profits resulting from the defense program"—a definition which we accept.

(4) It is impossible to devise a workable excess profits tax to raise $4,000,000,000 in additional revenues, as recommended by the President—a conclusion with which we are in complete accord.

(5) There will be no "cash" deficit this fiscal year; a conservative estimate predicts only a relatively small "book" or "budgetary" deficit, and there may be no deficit—predictions with which we agree, with perhaps more emphasis upon the possibility of no deficit.

(6) A balanced budget each year is now vital—a principle from which we have never departed, and which is now finally adopted by the Treasury after financing deficits during 19 of the last 21 years.

(7) Corporate profits during the third and fourth quarters of this year are much higher than in previous years—a statement which disregards the 50-cent dollar (resulting from the inflationary policies of the administration), fails to consider the fortunate consequences of the $100,000,000,000 industrial expansion since 1945, gives no credit for success in lowering costs, overlooks the fact that the ratio of corporate profits to national income is remaining constant, blinks the well-known fact that investors do not now receive, and for many, many years have not received, a return upon their investments adequate to meet the risks involved, and forgets that our governments are now taxing corporate profits at rates (aggregating about 50 percent) never before dreamed of, and tax them again when distributed as dividends.

(8) The needs for additional revenues justify a tax of 75 percent upon normal profits of corporations—a recommendation with which we disagree exactly 100 percent. If, for a fairly indefinite period into the future, the fires of inflation are to be fought and not fanned, if rigid regimentation is to be avoided and not required, if the people and not the military are to be the master, if strength and not weakness is the objective, then certainly there can be no dispute about one of the essentials: Production, more production, ever-increasing production; expansion, more expansion, ever-increasing expansion; volume, more volume, ever-increasing volume. (Time does not permit of discussion at this time of other essentials.)

The Treasury by its proposal is opposing the specific objectives just enumerated, and flies directly in the face of the President's threefold objective quoted above.

OUR POSITION

In addition to the position we have taken with respect to basic policies and objectives and with respect to Secretary Snyder's statement and the Treasury's proposal, we summarize:

(1) As the first step in preparing to finance the military program, the administration and the Congress should reduce nonmilitary expenditures by at least $6,000,000,000.

(2) The administration and the Congress should guard zealously against waste, whether in the military or the nonmilitary.

(3) The taxation of paper profits resulting from inflation is a tax upon capital and must be avoided.

(4) A Federal tax in excess of 50 percent upon the normal profits of corporations cannot be justified, and a 50-percent rate can be carried for only a limited period of time.

(5) We accept Secretary Snyder's definition of "excess profits" as "high profits resulting from the defense program."

(6) We agree with Secretary Snyder that currently there are no excess profits and there probably will be none during 1951.

(7) There is no necessity for, and no justification of, any excess profits tax applicable to any portion of 1950 or to 1951.

(8) The consequences of inflation are too gruesome to play with—even though it is frequently said that inflation in its early stages is popular.

(9) The military program, for as long as possible, must be kept on a pay-as-we-go basis.
(as they doubtless will be in 1952 and subsequent years), every possible source must be explored and tapped, including a considerable increase in our revenues from excises.

(10) If and when additional revenues are necessary for the military program (as they doubtless will be in 1952 and subsequent years), every possible source must be explored and tapped, including a considerable increase in our revenues from excises.

THE TROUBLES WITH AN EXCESS PROFITS TAX

Everyone with experience knows that a so-called excess profits tax must not be designed to produce substantial revenues, and that no excess profits tax has yet been devised which—

(1) Is a reliable revenue producer;
(2) Can be administered;
(3) Applies fairly and without discrimination;
(4) Encourages growth, expansion, new industries, new products;
(5) Promotes competition and lower prices;
(6) Contributes to economies and encourages decreasing costs;
(7) Rewards ability, ambition, risk taking, and progress;
(8) Gives industry the elbow room it needs;
(9) Creates financial independence and stimulates sound financing;
(10) Grants to youth the opportunity to build a business;
(11) Builds strength.

THE JUSTIFICATION FOR AN EXCESS PROFITS TAX

On the other hand, in times of war and grave emergency, requiring high military expenditures, and after effective price and wage controls have been imposed, an excess profits tax will—

(1) Discourage war profiteering;
(2) Make price and wage controls more palatable;
(3) Keep on about the same profit level war industries and the nonwar industries which realize exceptional profits from a war economy.
(4) Produce substantial revenues if excessive profits are not otherwise controlled.

OUTLINE OF BASIC POLICIES FOR AN EXCESS PROFITS TAX

If a so-called excess profits tax must be considered at the present time, we urge that it be based upon the following general policies (a detailed discussion of which, to the extent that time permits, will follow):

(1) It should expire by its own terms in 2 years.
(2) Normal profits must be carefully defined and not be taxed as excess profits.
(3) Reasonable profits from expansion, increased production, increased volume, decreasing costs, and new products must be determined after adequate experience and should not be taxed as excess profits.
(4) Capital gains should not be taxed as excess profits.
(4) Capital gains should not be taved as excess profits.
(5) Profits from foreign sources should not be taxed as excess profits.
(6) Profits technically taxable during the taxable year but attributable to prior activities (such as profits from installment sales, payments accruing after a dispute, settlements made, facts affecting income which could not be determined, etc.) should not be taxed as excess profits.
(7) The principle that normal profits during the taxable year should be measured by either prior earnings or a fair return on invested capital should be preserved and improved.
(8) Earnings during any period during which there are no "high profits resulting from the defense program" will usually reflect normal profits.

(9) The earnings base must be adjusted to exclude unusual costs, expenses, and losses, and to exclude costs and expenses technically deductible but attributable to prior activities.

(10) Statutory formulas should be adopted to replace, as far as possible, the general relief provisions of the prior law (sec. 722).

(11) Normal profits following consolidations, mergers, or acquisition of assets, whether or not taxable, should not be taxed as excess profits.

(12) There should be no denial of the use of unused excess profits tax credit—backward and forward—during the period of application of the excess profits tax and for a reasonable period thereafter. There should be a 5-year carry-forward and a 2-year carry-back of operating losses for all corporations, and 100 percent credit for intercorporate dividends.

(13) Many corporate profits have been declining since 1945 and should be permitted to return to the 1946 level, for example, before they are taxed as excess profits.

(14) Corporations which have had losses or small profits since 1945 should be protected by a credit of not less than 150 percent of their credit under the prior law, which should not be subject to a reaudit.

(15) There can be no excess profits until after the normal tax has been paid.

(16) The so-called Vinson-Trammell Act should be repealed.

(17) Renegotiation under the present act, or under a new act of more general application, should be after taxes.

(18) The formulation and adoption of an excess profits tax will be greatly simplified when it is realized that about 50 percent of the corporation's profits will be taken by the Treasury in any event.

SPECIFIC PROVISIONS

We recommend the adoption of the following specific provisions:

Base period earnings

(1) The base period should include the years 1946, 1947, 1948, 1949, and 1950. If an excess profits tax is imposed for a portion of the year 1950, the first 6 months of 1950 should be doubled.

(2) The credit should be the amount of the net income for any one of the base years adjusted for the "net capital addition" or "net capital reduction."

(3) Discounting the earnings (the 95-percent rule of the prior law and the 75-percent rule suggested by the Secretary of the Treasury) has no justification. Secretary Snyder offered none, except as a device to tax normal profits at the excess profits tax rates; and no one has attempted to justify the 95-percent rule, except as a compromise in reaching an agreement to accept prior earnings as a yardstick for measuring normal profits.

(4) The adoption of 1 year out of the 5 will remove many of the complications of the prior law; the growth formula (sec. 713 (f)) will not be necessary; a new growth formula in reverse will not be necessary to protect corporations with declining earnings during the postwar period; the 75-percent rule (sec. 713 (e) (1))—in fact, all of section 713 (e)—can be eliminated; adjustments to base period incomes (sec. 711 (b)) will be simplified; and, of immeasurable importance, most of section 722 (the general relief provisions) goes out the window.

(5) The net capital addition (sec. 713 (g)) should include all contributions to capital, all borrowed capital, and all accumulated earnings and profits during the period from the end of Word War II to the taxable year, and the base period earnings should be appropriately increased in computing the credit (sec. 713 (a) (1) (B)). A similar adjustment should be made in the case of a net capital reduction (sec. 713 (a) (1) (C)).

(6) In no event should the earnings credit be less than the earnings credit computed under the prior law for 1945 (adjusted for capital changes) increased by 50 percent, to offset the effects of inflation. Reviews and reaudits should be prohibited.

(7) Normal profits from increased capacity or new products (if normal profits are greater than the adjustment for the net capital addition) should be exempt from the excess profits tax. Thus an adjustment to base period earnings will not be necessary—and more of section 722 goes out the window.

(8) Adjustments to base period income of the nature prescribed by section 711 (b) must be made but should be liberalized. For example, base period earnings should be increased by the full amount of unusual losses, costs, and expenses which are allowable as deductions—even though they are not abnormal. The

use of 1 year out of 5 will eliminate the necessity of an adjustment to prevent penalizing taxpayers who elected to continue amortization of emergency facilities after September 29, 1945.

The essentials of a flexible base

(1) As we have stated, an excess profits tax will shackle and freeze industry to the preemergency level unless flexibility is injected into the definition and determination of normal profits. Otherwise, all profits from increased volume, increased capacity, new ventures, and new products will be considered and taxed as excess profits. In the prior law, the Congress made a sincere effort to provide partial solutions. Unfortunately, the solutions were in large measure inadequate and ineffective—not only because they were but partial, but also because of the administrative application, or misapplication, of them.

(2) The statutory concept of normal profit per unit of production for the mining industry (sec. 735) needs revision.

(3) A new concept of normal profit per unit of production should be formulated and applied wherever possible. For example, the earnings of the transportation industry are derived from the operation of a known number of cars, busses, trucks, or planes. Suppose an air transport company operated 100 planes during its base period and 150 planes during the taxable year. Certainly, all the profits from the additional 50 planes are not excess profits. And certainly no company could possibly increase its transport capacity if the resulting profits are to be taxed as excessive profits. A nomal profit per unit can readily be computed and applied to the additional planes, with an appropriate adjustment for overhead.

(4) A ratio of net profits to payroll, or perhaps a ratio of net profit to gross sales, should be a proper measure of normal profits in cases of increased volume and increased capacity.

Invested capital

(1) Although exceedingly complicated, we suggest the retention of the computations of invested capital (including the 125-percent adjustment for new equity capital) prescribed by the prior law (sec. 714). For example, the invested capital should be based upon the computation for 1945, and then brought down to date. But review and reaudit of that computation under the prior law should be prohibited.

(2) However, 100 percent of borrowed capital should be included, rather than only 50 percent.

(3) The credit should be a flat 8 percent of the invested capital—assuming that the normal tax is first deducted, as we have recommended. A very much larger credit must be prescribed if the segregation method of the 1942 act is followed.

Supplements A and C

Supplements A and C of the prior law must be extended to include taxable reorganizations and transactions so that both the earnings credits (Supp. A) and the invested capital credit (Supp. C) of the acquiring corporation will be appropriately increased to reflect normal profits from the newly acquired assets. In our opinion, a corresponding adjustment to the credit of the transferor corporation is not of particular importance, for normally a business enterprise parts with assets only when it expects to derive greater profits from the proceeds. Nevertheless, if an appropriate adjustment can be devised, we would recommend its adoption.

Effective relief

(1) Experience has established the ineffectiveness of section 722. We believe the entire section can be discarded and adequate and effective solutions substituted.

(2) Interruptions to production (resulting from fires, floods, lack of raw materials, transportation tie-ups, strikes, etc.) during the base period require adjustments. The period of the interruptions should be excluded, and the balance of the year placed upon a 12-month basis. The selection of 1 year of the base period greatly simplifies the adjustment and in many cases eliminates it entirely. Thus most of section 722 (b) (1) can be forgotten.

(3) The balance of section 722 (b) (1) and all of section 722 (b) (2)—unusual temporary depression—and all of section 722 (b) (3)—depression in the taxpayer's industry, as distinguished from business generally, and feasts and famines—are eliminated by the selection of 1 year for the base period and the adoption of the old base as a protective basement.

(4) Section 722 (b) (4) was intended to meet the problems of new ventures (together with sec. 722 (c)), new products, increased production, increased capacity, and new management. We recommend that efforts to measure increased normal profits resulting from new management be abandoned. We believe that our recommendations with respect to the determination of normal profits from increased production and increased capacity adequately dispose of those problems. The problem of measuring normal profits for new products and new ventures remains.

(5) Normal profits for new products can be determined. Actual experience over a reasonable period of time (adjusted for volume increases) can be used—if high profits resulting from the defense program are not involved. Experience from similar products will frequently do the job. The few remaining cases will be discussed shortly.

(6) Similarly, normal profits for new ventures can be determined. Again, actual experience can be used—if high profits resulting from the defense program are not involved. But many cases will require another solution.

(7) The determination of normal profits for new products and for new ventures requires a businesslike consideration of precisely the same factors that businessmen and bankers consider every day. Their decisions are normally reached promptly. Why not let the taxpayer present his facts to an independent committee (designated, for example, by the Governor of the Federal Reserve Bank for his district)? Such a committee can give him its opinion without delay. If he accepts it, it will be controlling. Otherwise, he will face the necessity of proving his own case to the Bureau or the Tax Court. In either case, he knows what to expect.

(8) Section 722 (b) (5) is all that remains. It can be forgotten. It already has been. Even the cross reference to section 735, in section 722 (f), is not necessary; and, of course, section 722 (g) will not be necessary.

(9) In our opinion, it is not yet too late to remedy retroactively most of the defects of section 722.

Adjustments to net income during the taxable year

(1) Under the World War II excess profits tax, certain adjustments of a corporation's net income, defined in sections 711 (a) and 721, were permitted to be made in computing its excess profits net income. All of these should be continued under any new excess profits tax.

(2) Capital gains should be excluded from excess profits net income in their entirety. The old law excluded only long-term capital gains. Short-term capital gains as well as long-term capital gains do not constitute business income and are properly outside the scope of an excess profits tax.

(3) All income from foreign sources should also be excluded from excess profits net income. By its very origin this income cannot be attributable to the defense program. Furthermore, the application to such income of the confiscatory excess profits rates contradicts the program for the encouragement of American enterprise abroad.

(4) More liberal depreciation practices should be allowed under an excess profits tax. The tax benefit rule should be applied in order to permit corporations to deduct in computing this tax the full amount of their costs of depreciable property not previously deducted from taxable income.

(5) The adjustments for abnormalities provided in section 721 should be continued and expanded. The general purpose of the adjustments is to avoid subjecting to the tax income properly attributable to other years if technically realized in the taxable year by reason of the taxpayer's accounting method, the recovery of a judgment or the settlement of a dispute, or the completion of business operations extending over a long-term period. The application of the section should be expanded by eliminating the requirement that the abnormal income be in excess of 125 percent of a 4-year average, and by permitting the accrual of deductions such as liability for vacation pay for which the taxpayer establishes a reserve.

AMORTIZATION

We regret that we are compelled to advise your committee that the amortization provisions adopted in the Revenue Act of 1950 require immediate amendment. The Congress did not intend that the postemergency or the post-5-year value of the facility should be considered in determining the amount of the costs to be amortized.

CONCLUSION

There are many other factors and problems which should be considered in framing an excess profits tax, but time is not available to develop them on this occasion. Finally, all our statements should be considered in the light of the action of the Chamber board of directors last Friday in recommending against enactment of an excess profits tax applicable to either 1950 or 1951. The reasons in support of that action are summarized in a Chamber press release which I am filing as part of this statement.

Mr. ALVORD. I confess that I am wholly unprepared to discuss this bill. I have only had it since last Saturday. There are innumerable provisions in it which I do not understand; and most of the provisions which I think I understand, I cannot understand the policy behind them.

Our committee urges this committee to take time enough to review the budgetary requirements of the Government, so that you, the Congress, can determine how much must necessarily be raised.

After all, the budget for 1952 will be with you in about 3 weeks, and it would seem as though there should be two fundamental questions: (1) How much can you eliminate from the so-called nonmilitary expenses? I leave military out, because I am quite confident that the Congress will provide adequate funds for the military program, and I trust that military program does not reach the point where others will conclude that we are becoming an aggressor nation.

Senator TAFT. Of course, this committee has a pretty definite mandate that it must report a bill. The Congress might determine that policy, but this committee's hands are pretty well tied by the fact it says we have to report.

Mr. ALVORD. During this session of Congress.

Senator TAFT. Yes; during this session of Congress.

Mr. ALVORD. I might mention that the mandate does not require you to report the bill favorably, nor does it prohibit you from studying the requirements for revenue.

Senator TAFT. As far as the bill.

Senator MILLIKIN. It was thought better to report the bill in December than to report a bill made before we left in September.

Mr. ALVORD. That, I appreciate, Senator, very much.

I might, while we are on that point, point out to you that Senator George and Senator Millikin were very careful to write into their substitute for the O'Mahoney amendment a specific provision directing a study of how to tax high profits resulting from the defense program. This bill does not meet that mandate, nor, so far as I know, any other requirement.

Somewhere someone decided that you should raise $4,000,000,000 more from corporations, regardless of what the revenue requirements are, despite the fact, I am confident, that you can eliminate $6,000,000,000 from the nonmilitary functions of your Government, and despite the fact that we still do not know, we have no conception of the military requirements for the fiscal year 1952.

Senator MILLIKIN. At the time the subject came up in the Senate, it was thought that $4,000,000,000, together with the other things that had been done or were being done at that time, would balance the budget for fiscal 1951. Of course, that was being very unrealistic, but at the time it was done it was thought that $4,000,000,000 more would balance the budget for that fiscal year. So at that time there was a

rational reason—perhaps a rational reason—for a $4,000,000,000 increase.

Mr. ALVORD. I do not remember, Senator, that a $4,000,000,000 increase in addition to the 1950 act was discussed back in September. It may have been. I am not sure about it, but I do not think so.

Senator MILLIKIN. It was not necessary—well, of course, it was valuable to discuss it; but whether or not $4,000,000,000 was specifically mentioned, it has been brought out in the testimony here that had the anticipated budgetary requirements of the Treasury Department had validity in them, $4,000,000,000 would have balanced the budget. But the whole situation has changed. There is no sanctity, as I see it, in this $4,000,000,000 figure. Perhaps we ought to make it 6, or perhaps we ought to make it 7 Perhaps $4,000,000,000 is a very modest approach to our tax problem.

Mr. ALVORD. In that connection, let me give you my picture of the fiscal situation. For fiscal 1951, you will——

Senator MILLIKIN. I might add that perhaps it should be only three.

Senator TAFT. I think you could leave that out.

Mr. ALVORD. Of course, it depends upon what fiscal year we are talking about and really what our revenue requirements are. I do not think we know today. Certainly, I do not.

For fiscal 1951 which has but 6½ months still to go, there will be no cash deficit. The Secretary has estimated expenditures at about $45,000,000,000 and receipts at about $43,000,000,000. That means a budget deficit of $2,000,000,000, but no cash deficit.

It is possible that expenditures for fiscal 1951 will be stepped up. I do not see much income in the picture. It is difficult to make expenditures until you know what you want and get it. So far as I know there are virtually no new defense contracts outstanding or in the process of being let.

My guess is that the burden of your defense program or cash outlay will not appear until the latter part of calendar 1951 and 1952, and on into 1953 and 1954.

Senator MILLIKIN. When will you commence to take in cash from this bill, assuming it passes?

Mr. ALVORD. You may make this bill effective, even though it is passed next year, any date you wish.

Senator MILLIKIN. When will the cash come in, under the shortest possible time?

Mr. ALVORD. There will be practically no cash in fiscal 1951.

Senator TAFT. March 1952.

Senator MILLIKIN. By March 1952 there will have been contracts let. A number have been let on which at least partial payment will have to be paid. Is that correct?

Mr. ALVORD. Yes, sir. If you provide for the same effective date of the act, you will get just as much cash in calendar 1952 as you would if you passed this bill now.

Senator MILLIKIN. That is true.

Mr. ALVORD. And you can get just as much cash in calendar 1951 as you would if you passed this bill now.

Senator MILLIKIN. And you would get as much cash if you passed it now.

Mr. ALVORD. That is true, sir.

Senator MILLIKIN. That is right.

Mr. ALVORD. From the cash position point of view, there is no necessity for haste. It seems to me that with the emergency with which we are confronted there is all the more necessity for proceeding rather slowly, with absolutely sound judgment and after we have some idea as to where we want to go and where we are going.

The bill is entitled "A bill to impose a corporate excess profits tax." It does not do it. It is a bill to impose confiscatory rates upon normal industrial profits. I am inclined to think, if I were giving a title to the bill, I'd call it a bill to define success and progress, to make success and progress a crime, and to impose appropriate penalties therefor.

Senator MILLIKIN. It comes with heavy impact on me considering that I have voted many times to avoid confiscation of the business of the payroll makers to find that I am engaged in a process which is confiscatory and which will destroy our economy. I do not think I am engaged in anything of that kind.

Mr. ALVORD. I am sure you are not, sir.

Senator MILLIKIN. And I would not unless——

Mr. ALVORD. Otherwise you would not be considering this bill.

Senator MILLIKIN. Otherwise I would not be considering this bill.

Mr. ALVORD. I honestly think it will take more time than this committee has to perfect the bill to impose an excess profits tax. I would like to point out some of the things I see in the bill.

Senator MILLIKIN. I invite your attention that more time might cause more extreme ideas as to what should be done in the way of a so-called excess profits tax bill.

Mr. ALVORD. If that is true, Senator, my guess is those extreme ideas will prevail next session of Congress as well as this.

Senator MILLIKIN. But you do not want them to prevail in the next session, and I think that you have got to take into consideration the psychology of these things.

Mr. ALVORD. That I appreciate, but it is my understanding——

Senator MILLIKIN. It is much better to have one this time than to have one the next time because the full impact of many things that are happening when the public gets those impacts, you are going to have some reactions that no one can anticipate, but they will not be in the direction of less taxes.

Mr. ALVORD. That I realize, and it is my understanding that this is but a second supplementary step and we can expect a third one next year.

Senator MILLIKIN. And how.

Mr. ALVORD. My guess is, that psychological attitude which you say may exist next year is going to exist anyhow. The fact you pass this bill now, even though it is more moderate than the bill that would be passed next year, does not mean that this is the bill that is going to be enforced.

Senator MILLIKIN. I would say if there is time enough in this session, it will be in force.

Go ahead with your argument. I am sorry to have interrupted you.

Mr. ALVORD. That is quite all right, sir.

There are two or three general propositions I would like to discuss before I begin to discuss the specific provisions of the bill.

I say it is not an excess profits tax because under the standards of 701 (b) of the Revenue Act of 1950, which you, Senator Millikin, and the chairman, drafted, under those standards and under the standards suggested by the Secretary of the Treasury, there are no excess profits in 1950, and there will probably be none in 1951. That standard is "high profits from the defense effort." There are none. As a matter of fact, your deliveries during 1950 of hard goods, the stuff from which excess profits are supposed to flow, and your defense expenditures are less during 1950 than they were during 1949.

Senator MILLIKIN. You do have a stimulation of your economy due to the fact that everyone knows we are going into a greater mobilization.

Mr. ALVORD. You have somewhat of a stimulation. I am not sure that did much in stimulating profits. It may have in a few lines but I doubt it. At most, it probably did not more than to increase some current profits at the expense of future profits.

Senator MILLIKIN. I think Senator Taft made a very wise observation the other day when he said that independent of war we are in a period of inflation where profits, so-called profits, would increase. I do not think you can unscramble the eggs completely. I do not think you can say that all profits now are war profits or that any particular part of the profits are now war profits. No one has brains enough to say, "This is nonwar. This is war."

But I do think it is true that basically there will be war profits and basically there is a great stimulation of the economy entirely aside from inflationary processes due to war.

Mr. ALVORD. That is certainly true, sir, and that stimulation, I assume, will be seriously increased when we begin shelling out the billions of dollars that are contemplated. I do not think there has been much stimulation to date. There is some scarce buying and advance buying, but to the extent that there was advance buying it should result in less buying in 1951.

As a matter of fact, I would be a little worried about corporate incomes in 1951. With allocations, priorities, and controls, plus taxes, it may very well be that corporate incomes for 1951 will decline.

Senator MILLIKIN. In the interest of our country I hope that is not true.

Mr. ALVORD. So do I, sir.

Senator MILLIKIN. Because it would indicate that we are not mobilizing fast enough.

Mr. ALVORD. This is what you are confronted with in mobilization. It is almost essential to curtail civilian production before defense production begins. It takes a year, a year and a half, 2 years, to get into active defense production, and in the meantime a certain portion of the raw-material requirements must be diverted nevertheless and taken away from civilian production.

Senator MILLIKIN. Well, what you are saying is that if your war expenditures do not equal the lessening of your civilian economy, you might get yourself into a tailspin.

Mr. ALVORD. That is right.

Senator MILLIKIN. And I think that is entirely possible, if, roughly speaking, what you add to your economy for war does not equal that which you have taken out of your normal civilian economy.

Mr. ALVORD. And on the inflationary point, Senator, I merely point out to you that we are playing with a 50-cent dollar today. In some fields it is a 40-cent dollar. I think it is highly important that we not permit inflation to take more than 50 percent of the savings, the income, the insurance, and the homes of the American people if we can stop it.

Senator MILLIKIN. That is right.

Mr. ALVORD. And the plans by which this defense productive program are to be financed will determine in very large part whether we have the 50-cent dollar or, conceivably, a 10-cent dollar.

We have in the bill an effort to define "excessive" but not "excess" profits. Not high profits resulting from the defense effort. but an arbitrary definition of "high" profits. The purpose is to impose a 75-percent tax upon a very substantial portion of normal profits.

It is done in this way very briefly: We take 1946, '47, '48, '49 as normal years. Now, gentlemen, they were not normal years. They were probably the most abnormal years in the history of this country. Every type of accident which has ever happened to industry has happened during the period 1946, '47, '48, '49. Even if we take 3 out of the 4 years as suggested in the bill, that is not going to define normal profits in the slightest. Even if you were to take 2 out of 4 years, it will not define normal profits.

Senator MILLIKIN. What would you suggest as a base?

Mr. ALVORD. For an earnings base, I would make this suggestion, if any part of this tax is to be imposed on 1950 incomes——

Senator MILLIKIN. Assume that it will be just for discussion's sake.

Mr. ALVORD. Yes, sir.

I would use as a base no more than two years of the base period, and I would include just as soon as I could 1950 in the base period. It must be admitted that up to July 1, 1950, there were no defense profits because, after all, Korea occurred on the 25th of June.

Senator MILLIKIN. Do you see any difficulties in including the first half of 1950?

Mr. ALVORD. I see no difficulties at all. It is not going to be fair to all companies, but I see no reason at all why it should not be permitted. And the moment we get into 1951 tax I would include all of 1950 because there just are not any defense profits in 1950.

But, in any event, I think that 2 out of those 4 or 5 years will be much fairer to industries and businesses which have had incomes during the latter part of this base period.

Let me remind you that there are corporations, of course, which have had fairly steady incomes during the so-called base-period years. I do not know of any, but there must be some. There are corporations which have had increasing incomes. The provisions of the bill are, let's say, reasonably fair to them, leaving out the growth provision for the moment.

There are corporations that have declining earnings. The provisions of the bill are unusually unfair to them.

There are corporations which have had either no income or have had losses during 2, 3, or 4 years of your base period. Those corporations will be crucified.

I would suggest for that type corporation a prior base-period earnings basement.

Senator LUCAS. What is that?

Mr. ALVORD. A World War II base-period earnings basement.

Senator MILLIKIN. You mean a reconstructed base?

Mr. ALVORD. I would say that in no event shall the average earnings base under this new bill be less than the average earnings base under the World War II Act, increased by, say, 50 percent, as an inflation adjustment.

That will not be fair, but it will at least protect those corporations which have had no incomes or have had losses throughout 1946 to 1949. There are many of them. There are a great many of them. They are corporations which normally survive by earnings power rather than by invested capital.

For the declining earning corporation, 2 out of the 4 or 5 years will protect them. Certainly it is unfair to say to a corporation which has had declining profits since the war, declining because of conditions beyond their control, the period being certainly abnormal, that they should not get back up to a level of 1946 or 1947 profits, for example, before we start calling them excess profits. Under the theory of excess profits, they should have a chance to come back.

Two out of the four or five years will make your growth provision unnecessary.

Senator MILLIKIN. If you include 1950?

Mr. ALVORD. If you include 1950.

Senator MILLIKIN. Yes.

Mr. ALVORD. It will give you a chance to provide what I call a flexible base so that you do not freeze everything as of the end of 1949, or as of the end of July 1, 1950, or December 31, 1950.

This flexible-base concept, it seems to me, is important.

Senator BUTLER. How about a 1-year base?

Mr. ALVORD. A great deal can be said, Senator, for a 1-year base. From 1946 through 1950 there were no defense profits. Although we were spending 12, 13, or 14 billion dollars on defense, a very substantial portion of that was for compensation, food, clothing, and transportation, and very little for matériel and equipment.

Furthermore, you know the Navy still has renegotiation in force and the Vinson-Trammell Act is still in force. I trust that that act will at least be suspended. It ought to be repealed. When you consider renegotiation, I trust it will be after taxes.

A 1-year period of earning is what I advocated before the Committee on Ways and Means. I felt at the time, and I still feel, there is a great deal to support it. If this committee feels otherwise, I certainly believe that you should not go beyond 2 out of the 4 or 5 years.

There may be, as you know, some extraordinary profits in 1950, and you may not want to include all of 1950. There might be justification for 85 percent of 1950 earnings. There is no justification for less than 100 percent of earnings of the other years. 1949 was less than 1948. It may be that you won't want to include both 1948 and 1950. If you do not take the 1-year basis, you might want to take 2 years, or perhaps 2 consecutive years, out of the 5.

But in any even I certainly would use a standard which will be reasonably fair to those corporations which had incomes. Two out of four, or a two out of five would be reasonably fair to corporations having declining incomes, and there a tremendous number of them. Mr. Stam can tell you all about them.

There are a tremendous number of corporations which had either no income or actual losses, and the only way to protect those corporations, so far as I know, the only general scheme I have been able to evolve is this basement idea, which says: In any event, give us our base period earnings under the World War II Act.

I see no reason why fiscal-year corporations should not be treated on a fiscal-year basis well on into 1950. You recognize that corporations with a fiscal year ending during the first quarter of 1950 may include their fiscal years, but obviously the same principle goes right straight on to June 30. I do not know of any reason why it should not go straight on through the year with an allocation back, perhaps, for the first 6 months, if that is the way you want to do it.

Now we come to the invested-capital provision of this bill. The only thing I can tell you about them is that they stun me. I have not the slightest conception of what they do.

You recall that we had an invested capital concept in the First World War Act which was basically cash paid in for stock, property paid in for stock, that is, its value at the time paid in, and accumulated earnings and surplus.

The World War I Act said to take March 1, 1913, value for value of assets paid in for stock prior to March 1, 1913.

Those computations were determined for many thousands of corporations after many years of effort.

Now we come to the World War II Act. We very wisely—I say wisely in quotation marks and with a big question mark—abandoned everything we knew under the World War I Act and said kick out the March 1913 values and go back to original cost.

Those World War II Act cases are in the process of computation and determination. It will be a few more years before final decisions are reached, but I know of no reason for abandoning the computations as reached.

I know of no reason why invested capital cannot be defined as invested capital at the end of 1945, when the excess profits tax was repealed, adjusted down to date. It is perfectly simple to do. But we do not do that. We take somebody's concept of invested capital that is this:

Take the balance sheet of any corporation, take the total assets, subtract your total liabilities. Now, if we stop there, then we would have a concept of net worth, a concept that has often been suggested for invested capital but never adopted. But we don't stop there. We immediately adjust the asset side to tax basis for determining gain, which again includes March 1, 1913, value, and then we add back certain liabilities. In adding back liabilities, bear in mind, you do not take care of your deficit corporation, your operating loss corporation, prior to 1946.

What the computation ultimately will be I do not think anybody knows. I will make this prediction: that equity capital under this bill will not be determined for any sizable corporation within 15 years. I think I am being conservative. Now, selfishly, I only have about 25 more years to practice law, and that will take care of 15 years of them. But it is foolish to do it.

What I would do is to——

Senator MILLIKIN. You mean 25 years from now we are not going to have the pleasure of having you before us?

Mr. ALVORD. I trust you will be here, Senator, but I am afraid I will not be.

Senator MILLIKIN. I was counting on that. Well, that is the worst impact we have had today. It shocks me.

Mr. ALVORD. We have had three tax bills in 1950, you know. We started in on a tax-reduction bill. You will recall that even on the 5th day of July the Secretary of the Treasury was still willing to have a tax-reduction bill, provided you pushed up corporate rates somewhat to make up for the reduction in excises. About a week after that we came out for no reduction at all, and a short while after that the President and the Secretary of the Treasury came out for no reduction at all. Then we started in on a tax-increase bill, which I fear most everybody has forgotten until they come to pay it.

The CHAIRMAN. They will be reminded.

Mr. ALVORD. Now we have another one.

Invested capital is an impossible computation in any event. It will be used much less under this bill because there are many of the provisions of the earnings credit which are definite improvements over the old law. But invested capital under the World War II Act should be frozen. Do not even let them reaudit. Let's take the thing and go on. It will cost more to reaudit and redetermine, I think, than we will get out of the effort.

I would like now to start with a page-by-page discussion of the bill. I will move just as fast as I possibly can.

On page 2, lines 19 and 20, it seems highly improper, in computing the 67 percent over-all, to deny to public utilities and to Western Hemisphere corporations their so-called exemption (which was changed in the 1950 act to a credit) from surtax.

Section 433, page 9, lines 2 and 3:

This ties in with corresponding adjustment on page 17, lines 9 and 10. The effect of the two adjustments is to adopt the provision that was in the revenue bill of 1950 as it passed the House and was promptly eliminated by this committee, eliminated by the Senate, and eliminated in conference.

That had to do with the denial of losses on the sale of capital assets used in the business. In theory it was not quite a denial. Under 117 (j) of the code, if you have a loss on the sale of capital assets used in the business that loss will be considered an ordinary loss.

The House wanted to make them a capital loss, and, in effect, to practically everybody that meant denying the loss.

The two provisions of the House bill say we exclude 117 (j) losses on sale or exchane from both the base period and the taxable year, which, I think, is improper and should not be done. If they are ordinary losses, as the law says, they should be ordinary losses during the base period, and they should be ordinary losses during the taxable year.

Now, I am not sure what effect another provision has which says we shall also exclude, unless they comply with certain rules, losses on abandonment and the loss of useful life of business assets. That is described as a section 23 (f) loss, but it might conceivably affect abandonment losses under section 117 (j).

The relation between those two sections ought to be studied pretty carefully. In any event, certainly a loss on sale, exchange, or abandonment of a business asset ought to be a normal loss, and an allowable loss.

On page 9, lines 19 on, we have a new provision which says that we don't get losses on the retirement of bonds.

I do not understand why we do not. It is quite true that under the old law an adjustment of that nature was made to the base period, but the loss was allowable in the taxable year. This says it is not allowable in the taxable year, and there is a corresponding adjustment to the base period.

But you see what happens is this: if I have none of those losses in the base period, I am denied my taxable year loss in full, if you put them both back in. I think the original law was right, and I think a loss on retirement of bonds should be allowed.

I am only hitting a few of the high lights of this bill.

Now we come to abnormal deductions in the base period. They begin on page 20, section 433.

I call your attention to some changes in the old law and some unfairness in the present provision.

The first change I want to call your attention to is that all casualty losses covered by paragraph (C) on pages 20 and 21, lines 1 through 5, were restored unconditionally under the old law to base period earnings. In other words, you just added them back in computing your base period earnings.

Under this bill they are subject to the abnormal loss conditions. This means, among other things, that they must exceed 115 percent of the average amount of deductions of that class for the four previous years and must also exceed 5 percent of the excess profits tax net income for the base period.

Let me tell you the effect of that. First, casualty losses should be added back in without limitation and without condition. They are strange, extraordinary losses. There is no reason for any limitation or condition.

Suppose, for example, that you happen to have a fire in one year and a flood the second year. This provision denies the loss entirely, as I read it. It must exceed 115 percent of the average of the losses of the four previous years, and if you have two or more of these extraordinary losses you will not do so.

I also point out to you that this four-previous-years average, which is taken out of the old law, takes you right back into the war years. I do not know why we should go back into the war years, but that is what this requires.

Another similar situation which this "four thing" will do: Suppose I pay two judgments, one in one year and one in another. This 115 percent rule, I would guess, in practically all the cases, would deny the restoration of the amount of those judgments.

Now we come to another of the provisions of which I think I understand the wording, but of which I do not understand the policy.

On page 22 it says with respect to these abnormal losses you do not get any of them; you have got to keep them in your base period and depress your base period earnings by the full amount unless the total exceeds 5 percent of the average excess profits net income during the base period years.

The only purpose of that provision, so far as I can see, and I cannot believe it is the policy, is: If you happen to have a corporation of fairly substantial size so that its excess profits net income during this base period, which isn't the same as excess profits net income dur-

ing the taxable year; but its excess profits net income during this base period is large, it is denied all abnormal deductions just ipso facto, because abnormal losses in the case of a fairly large corporation with a large income will not exceed 5 percent of its net income. It must be in here solely to say to the larger corporations, the corporations you are going to depend upon for your defense effort, you do not add back your abnormal losses even though they are admittedly abnormal. Only the other fellow can do that. You cannot.

On page 22, lines 16 and 20, we have a new word added.

In reaching my conclusions, I tell you that I have studied the Ways and Means Committee report as much as I could in the time available, and I have read what they say, but I do not understand.

There are certain tests as to whether these abnormal deductions during the base period will be restored. One of the tests under the old law is that the taxpayer must establish that this abnormal deduction was not a "consequence" of increased gross income, decreased deductions, or of a change in type, manner of operation, size, et cetera, of the business.

In the new bill it is proposed to add that the taxpayer must also prove that the abnormal deduction is not a "cause," for example, of a change in the size of the business.

Well, let's apply the provision to a fire which, I suppose, is about as abnormal a deduction as you could expect. We prove the excess all right. But can we prove that the excess is not a cause of a change in the type, manner of operation, size or condition of the business?

Here is a simple case: A plant burns. It is reconstructed, it is made larger, it has different facilities. It has to be. And conceivably it might be used to produce a few different things. Will the deduction be restored? It certainly should be, and I cannot believe that the provision was intended to provide otherwise. Whether it does or not, I do not know.

On page 27, I merely point out to you again, that there is no reason why we should not go at least to July 1, for the fiscal years in the base period. I know of no reason why you should not use all fiscal years ending in 1950. You may allocate back if you decide to take the first 6 months of 1950, for example.

Now, I have already discussed putting 1950 in. I have discussed the average base period earnings under the old law. I ask again: Why 85 percent when 100 percent is proper?

I come to page 29. We find a normal growth provision which is a little strange. Again, I can read the bill, I can read the committee report, but I just do not understand it.

This provision says that you cannot be a growing corporation if your total assets exceed $20,000,000. It does not say your equity capital, but your assets.

If there is anything in this country that you gentlemen want, I think it is to encourage normal growth regardless of assets, particularly in this period of time that is ahead of us, normal growth for defense purposes and normal growth for civilian purposes. I cannot understand where the $20,000,000 limitation came from. I know of no statistics to support it. I do not understand why it is there, except as indicated in the beginning of my statement. It is intended to stop progress, to stop growth. Life stops at 20.

Senator MILLIKIN. Mr. Chairman, may I ask Mr. Stam what is the genesis of that provision?

The CHAIRMAN. Yes.

Mr. STAM. I might say, Senator, that the growth provision was viewed somewhat as a relief provision, and it was thought that some of these very large corporations, with very large base period incomes, were not really concerned too much about relief, and that, therefore, unless you had some limitation like this on it that you would be further upsetting the competitive situation between the smaller corporation and the larger corporation. In view of the fact that the larger corporation, by and large, had a pretty fair base period experience, it was thought necessary to have some limitation in there so as to not upset further the competitive situation existing between the big corporation and the smaller corporation. That was the philosophy back of it.

Mr. ALVORD. That pretty much confirms my guess. I cannot believe that that is a sound reason. We will need all businesses during the period ahead of us, and the competitive situation will not be nearly as important as productive power, productive capacities.

Growth is a very difficult, perhaps impossible, thing to handle in an excess profits tax. It was taken care of only in a fair way in the last act. It can be taken care of now in a fair way if your excess profits tax is going to be of limited duration. But one of the objections to an excess profits tax, and I am saying a real excess profits tax now, and certainly a stronger objection to this bill, is that it freezes things at the end of your base period.

This bill has made some very substantial improvements in the old law, in putting capital additions in, at 12 percent, including a fraction of borrowed capital, and including accumulated earnings and profits. Putting them into the average earnings credit is very, very helpful, and very sound. But it does not take adequate care of growth.

You have two real problems on growth. One is growth during the base period. The other is growth during the taxable year. This provision on page 29, except for its strange $20,000,000 limitation, does a fair job on growth during the base period. Except for the limited capital adjustment provisions, however, there is nothing to take care of growth during the taxable year. Something should be done to take care of growth during the taxable year.

I might point out in passing, that another way to take care of the corporations with declining earnings during the base period would be to apply the reverse of the growth formula, so if the first 2 years of the base period exceeded the third year, you could take the first 2 years' average, or the first year if higher.

I have already discussed the invested capital concept. I mentioned that the recent loss adjustment does not go back of 1946. I do not know why. It is my recollection that there were quite a few deficit corporations during the depression, and it is my recollection there are quite a few loss corporations during both the depression and the war. But for some reason, we do not consider those as recent losses.

I can jump over now, hitting a few high spots, to the very familiar subject of inadmissible assets.

I know of no reason at all why at least under this concept of invested capital we adjust by a ratio of inadmissibles to total assets. We

should permit no adjustment for inadmissibles, and add back the income from them.

I also point out that in the public utilities section—section 446, page 73—the adjustment for inadmissibles is wrong. It reduces the entire excess profits tax credit by the ratio or inadmissible assets to total assets. Correctly, the adjustment should only be the amount computed under paragraph (b) (2)—that is the sum of the adjusted aggregate capital to average borrowed capital. I believe this is a clerical mistake. I assume the experts will correct it.

Now I shall discuss abnormalities—section 442, page 58.

I think the experts have done an excellent job, on the whole, on substituting mathematical adjustments for the adjustments which were intended to be made by section 722 of the old law, but which have not yet been made, and probably will never be made.

I merely raise a few questions. On line 16, page 58, why the prior to January 1, 1946, test? If it stays in, I point out to you that the poor little corporation that begins business on February 1, 1946, for example, gets no relief anywhere in the bill. That also, I think, is just a clerical drafting mistake. I think they designed it to have the two provisions precisely mutually exclusive. But they are not.

Senator MILLIKIN. May I ask, Mr. Stam, whether it is a clerical mistake?

Mr. STAM. Those were organized after January 1, 1950?

Mr. ALVORD. In the first quarter of 1946.

Mr. STAM. January——

Mr. ALVORD. I thought I said February 1, 1946. I meant any corporation which begins business during the first quarter of 1946, for example, gets nothing under sections 442, 443, or 444.

Mr. STAM. The corporations that commenced business in the base period are supposed to get the new corporation treatment.

Mr. ALVORD. They do not get that.

Mr. STAM. Those prior to January 1, 1946, of course, do not get the new corporation treatment, so they get this treatment.

Mr. ALVORD. A corporation which begins business—and this is purely a clerical mistake I am sure—which begins business during the first quarter of 1946 will not get 442, 443, nor 444.

Mr. STAM. We will look into that.

Mr. ALVORD. And will not get 444.

Mr. STAM. The general thought back of it was that those covered under the new corporation treatment would not be covered under the abnormality.

Mr. ALVORD. I am sure that was intended, but you will find a gap in there.

I merely ask a question with respect to paragraph (a) (1), which has to do, for example, with a strike. It normally happens in case your plant is shut down by a strike that your income does not immediately cease. There are a lot of goods on the shelves that are being sold, and a lot of goods in transit being sold, and there are a lot of goods on the shelves of your distributors that are being sold. Your income is not affected until your inventories of finished products are depleted, in effect.

I am not sure whether this says that we adjust for the period of strike, or whether we adjust for the period affected by the strike.

Certainly it should be the latter. That same comment applies to most all of these paragraph (1) adjustments.

Now I confess to you that I like the solution, I think it is better than the solution I suggested—I like the solution of using the industry index.

I might point out to you that it is very possible—I think Mr. Stam would know the cases. I can only imagine one or two—it may very well be that the industry index may be for an industry which itself was depressed during this base period, whereupon you get no relief.

Now what can be done about that, I do not know, unless you go back to my solution, with which Mr. Stam is familiar.

Now we get over to section 443. I point out to you that the year 1946 is excluded in determining whether there was a change in products. I do not know why. Of course, there is nothing with respect to 1950 or subsequent years, and there should be.

The subsequent year problem is one that certainly must be covered. I do not know why 1946 is excluded, because all the income from these new products, starting in 1946, will not necessarily be coming in and be properly reflected in the base period.

The committee report says that we will know pretty much what the substantial change in products, or in the services-furnished clause means. It says all we have to do is go back to the experience under section 722, and that will tell us.

I point out to you this situation in 722, where, as was very normally the case, you had increased capacity, as well as new products. The Treasury took the position that your adjustment had to be limited to the increased capacity judgment, and not to the new product.

Are they going to do the same thing here? I am afraid that the committee report of the House might be interpreted as confirming that practice.

Furthermore, it will not be as easy to determine what new products are, as the committee report indicates, I fear.

I also point out that it seems to me that income from a new product should be related to the industry index for that product, and not for the product of the taxpayer as a whole. That new product may be wholly unrelated to other products. If I have a product which is a new product, the industry index for that product is what I should get on and not what I get based on the larger part of my income.

Now, it seems to me that this new product adjustment can well be carried on into the taxable year. I do not know of any reason why we should stop. The same industry indexes are available. If I bring out a new product in 1951, 1952, or 1953, it seems to me as though I am entitled to a normal profit on that new product. Are we to discourage new products? I think the principles of this bill can be made applicable to that situation without difficulty.

Page 75. The fact that I am omitting much of the bill does not mean I either understand or approve it. I am trying to hit a few of the high spots.

I merely ask, who do you think can conceivably carry on or enter into the air-transport business on the basis of a 5 percent return? Air transport is probably one of the most hazardous of regulated industries.

I do not know where the 5 percent came from. I understand that the Civil Aeronautics Board tries to allow 8 percent. But I also know,

from reading published reports, there are very few air transport companies that had anything approaching 8 percent during the base period. I think the industry as a whole lost money.

There are only a few other comments that I might make.

I assume on the public utility definition, which requires substantially all the assets be from public utility services, that means consolidated income in case a consolidated return is filed. I am quite sure it does, but I was asked the question, and I said, "I am sure it does, but it ought to be specific." The Finance Committee report will be enough to make it specific.

And in that connection, it just occurs to me that if there is a member of the affiliated group which, by reason of the requirement that substantially all income be from public utilities, and if by including that corporation in the affiliated group it means that the group is outside the public utility provision, they should be privileged to kick that corporation out of the group and to include only those corporations substantially all the income of which is from public utility services.

Now, while I am on consolidated returns, let me point out a provision that I just do not understand at all. We have the exemption of the Western Hemisphere corporation, exemption from excess profit tax—there are times when Western Hemisphere corporations are included in the consolidated return, and there are times when they are not.

For some strange reason, way over on page 143, we find, as I read it, that a Western Hemisphere corporation must be included in a consolidated return if at any time for the taxable year or for any other back to December 31, 1943, it filed a consent to be included in consolidated return. It must be included now without consent. I do not know why the provision is there. I trust it is a mistake. It seems baseless.

Now we get over to part 2, which has to do with reorganizations.

I want to point out two things which I think should be covered.

The committee report says that split-ups are covered by the provisions of the bill. However, if you read the provisions of the bill, you find that only split-ups under 112 (b) (5) are covered. Many split-ups are made under 112 (b) (4). They also should be covered.

Then I cannot understand why part 2 does not apply to a corporation which, for example, has purchased all the assets of another corporation during the base period for cash.

I can make that position go further by saying that if you only purchase part of the assets, I think there ought to be a carry-over of the income on that part of the assets. But certainly there should be an inclusion of the earnings base attributable to the assets, when all the assets are sold, not in a nontaxable reorganization, but in a taxable acquisition. Certainly that should be true where the old corporation immediately liquidates or liquidates shortly thereafter, as would normally be the case.

I can recognize that if only part of the assets of a corporation are required, the Treasury would say, "Well, we will have to do an allocation; we have to take away part of the base-period earnings of the selling corporation, in order to add to the base-period earnings of the acquiring corporation."

I do not think that is necessary, but I would be perfectly willing to say let that be done under regulations of the Secretary of the Treasury.

Incidentally, on the blocked-currency provision, I just do not believe it is sound to make the provision subject to regulations of the Secretary of the Treasury. He has a very doubtful mimeograph on the subject. Maybe he is striving to give that legality, I do not know. But in any event he could, under those regulations, prescribe the same conditions which the mimeograph prescribes and come out the same way.

Now, I will end with just one more comment on a provision which is not in the bill.

You gentlemen recall, I think, with substantially no opposition you included a new amortization provision in the Revenue Act of 1950. During your consideration of that provision the Treasury suggested that the amortization should be based upon the difference between the cost and the postwar value. They went back to adopt the concepts of amortization of the First World War Act.

Your World War II Act said, "No; write off the whole cost over the 5-year period. We will forget about value after the war," which is a sound rule. That is the rule this committee thought it was adopting.

You went to conference, and it was again suggested that the amount should be limited to the difference between cost and postwar value. That was again rejected on the theory that the entire cost should be written off.

Now, we come to the regulations, and we find in the regulations a provision that says, "Consideration shall be given to the value of the facility after the 5-year period."

That is precisely the policy which you gentlemen refused to adopt, precisely the policy which the conferees refused to adopt, precisely the policy which the Congress refused to adopt.

Senator MILLIKIN. Mr. Stam, are you familiar with that regulation?

Mr. STAM. No; I am not, Senator. I will be glad to look into it.

Senator MILLIKIN. I think it is very serious.

Mr. ALVORD. I have it here. I will read it for the sake of the record.

This is title 32 (a), National Defense Act, appendix, chapter 4, subparagraph (c), of paragraph 600.2:

> In determining the portion of the facility attributable to defense purposes, consideration will be given to the probable economic usefulness of the facility for other than defense purposes after 5 years.

Now you see what that means. You wrote into the amortization section the provision, which I thought was sound at the time, giving to the certifying authority the power to prescribe percentages, so that if he thought that the entire facility was not necessary for war purposes, which, under the old War Act, included civilian purposes, too, that then he could determine the percentage of the cost which was allowable. Under this paragraph, the certifying authority is compelled to discount and allow only a percentage based upon his estimated value of the facility after the 5-year period.

For example, in the case of land, I assume he can take land out entirely, even though it was a highly essential acquisition for the war facility, because I suppose he might say that the land at the end of the 5-year period must have the same value as it had at the beginning of the 5-year period.

Mr. Chairman, that is all. I hope I will have time to make this statement——

Senator MILLIKIN. Will you connect that up with the excess profits bill now?

Mr. ALVORD. Yes, sir.

The reason the amortization provision went into the Revenue Act of 1950 was twofold——

Senator MILLIKIN. I understand that. I am simply asking you to complete your case by connecting what you said with the bill before us.

Mr. ALVORD. The amortization allowance, of course, is essential in computing taxable net income. Taxable income is a factor in determining where your excess profits tax is going to apply, and the amortization deduction is allowed in the computation of your normal tax net income. Therefore, it is allowed in the computation of your excess profits net income.

I have been reminded there are cases where the accelerated write-back of amortization at the end of the last war was not taken, and those amortization deductions will appear in the base period. They ought to be considered abnormal deductions, and rejected.

Did I answer that question adequately, Senator Millikin?

Senator MILLIKIN. Yes.

Mr. ALVORD. Mr. Chairman and gentlemen, that is as far as I am prepared. I will be very happy to answer any questions.

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

If you prepare an analysis of the bill, which you asked the privilege of doing, the committee will be very glad for you to get that in, if possible, by Monday of next week.

Mr. ALVORD. I will do my very best over the week end.

The CHAIRMAN. Thank you very much for your appearance, and those associated here with you.

Mr. ALVORD. Thank you.

(The following detailed statement, referred to above, was later submitted by Mr. Alvord:)

STATEMENT OF ELLSWORTH C. ALVORD ON ANALYSIS OF H. R. 9827

INTRODUCTORY COMMENT

On the authority of both the Congress and the Secretary of the Treasury, the proposed tax is definitely not an excess profits tax. In section 701 of the Revenue Act of 1950, the so-called excess profits tax mandate, Congress indicated its understanding of the term "excess profits' 'as those profits "accruing to corporations as a result of the national defense program in which the United States is now engaged." In his testimony before the Committee on Ways and Means on November 15, Secretary Snyder indicated a similar understanding of the term. It is clear that in this sense there will be no excess profits in 1950. Furthermore, the bill would tax not only 1950 profits but, in the case of many fiscal year corporations, some 1949 profits. Even in later years, a very substantial part of the tax will be paid on profits less in amount than those of the base period. For this reason Secretary Snyder has insisted on referring to this bill as one for profits taxes. The true nature of the bill is that of a progressive corporate tax, the rate graduation under which must be stated in 148 pages instead of a table.

INCIDENCE

The tax is to apply to all corporations having adjusted excess profits net income, except corporations which are expressly exempt (sec. 430 (a)).[1] The

[1] Section references, unless otherwise indicated, are to sections of the Internal Revenue Code as it would be amended by H. R. 9827, as passed by the House.

classes of corporations exempt from this tax are the same as those exempt under the 1945 excess profits tax with one exception (sec. 452). The exempt classes include corporations exempt under section 101 of the Internal Revenue Code, foreign corporations not engaged in trade or business within the United States, and domestic corporations whose income is largely from business sources outside the United States. The exception is the former conditional exemption of the mail pay of airlines, which is not allowed by this bill. No corporation is exempt, whatever its nature, if it is a member of a group filing consolidated returns.

COMMENT

Corporations taxable only on Supplement U income (that is income from an unrelated business or a Supplement U lease) under the Revenue Act of 1950, but otherwise continuing to be exempt under section 101, would appear to be exempt from this tax.

EFFECTIVE DATE

The tax is applicable to all taxable years ending after June 30, 1950 (sec. 101 of the bill). Where a taxable year begins before July 1, 1950, the tax is computed as if it applied to the entire taxable year, and is then reduced to that fraction of such total which the part of the taxable year after June 30, 1950, bears to the entire year (sec. 430 (b)).

Comment

As suggested heretofore, this results in the taxation in the case of many fiscal year corporations, of 1949 profits. In the case of all corporations it will result in the taxation of pre-Korea profits, sometimes when the post-Korea profits are lower than the allowable credit.

RATE AND RELATION TO NORMAL TAX

The rate of the tax is 30 percent (sec. 430 (a)). This rate is applied only to the adjusted excess profits net income, which is that part of the corporation's net income in excess of the sum of the excess profits credit and the unused excess profits credit adjustment based on other years (sec. 431). Unlike the situation in 1945, the corporate normal tax and surtax will continue to apply to the entire corporate net income, and the 30 percent rate of the excess profits tax will be superimposed upon the 45 percent rate of the corporate normal tax and surtax, making an aggregate rate applicable to excess profits of 75 percent. A ceiling limits the over-all rate on the entire net income to 67 percent (sec. 430 (a)). In order to avail themselves of this ceiling, public utilities and Western Hemisphere trade corporations are required to forego the credit heretofore allowed them in section 26.

The tax would become subchapter D of chapter 1 of the Internal Revenue Code. This would make it a part of the same chapter of the code as that imposing the corporate normal tax and surtax.

Comment

The relationship of this tax to the other corporate income taxes, while technically different from the two-basket approach of the 1942–45 law, reaches substantially the same result as to the amount of tax liability. The new method permits a simplification of procedures relating to interest computations, to application of the statute of limitations, and to the assertion of deficiencies.

It is not clear why either public utilities or Western Hemisphere trade corporations should be denied their section 26 credits in computing the 67 percent ceiling. The denial as to the latter group is new with this tax.

It is impossible to understand how any corporation can have excess profits until after its normal tax and surtax have been paid.

EXCESS PROFITS NET INCOME

The base on which the tax is imposed is the adjusted excess profits net income. As has been stated, this is the amount by which the net income exceeds certain credits. The net income for the purposes of this computation is not the same as that for purposes of the normal tax or surtax. The excess profits net income is the normal tax net income of section 13 of the code with certain specified adjustments (sec. 433 (a) (1)).

Many of these adjustments are similar to those provided in the 1945 law, such as (a) the exclusion of income derived from the discharge of an indebtedness at less than its face amount, (b) the exclusion of income attributable to the recovery of a bad debt for which a deduction was allowed in a non excess profits tax year; and (c) the exclusion of income attributable to a refund of taxes paid under the Agricultural Adjustment Act of 1933.

Certain adjustments have been modified, however, and others added—

(1) Short-term, as well as long-term, gains and losses from sales and exchanges of capital assets will not be allowed, nor will there be allowed gains or losses from the sale or exchange of business properties;

(2) The unlimited credit for dividends received will be allowed with respect to the dividends of foreign as well as domestic corporations;

(3) Deductions on account of retirement of bonds will be disallowed, this rule having applied under the 1945 law only as to base period years;

(4) Where property is held under a long-term lease executed prior to July 1, 1950, by the terms of which the lessee is required to pay any part of the lessor's taxes, the lessee will not be allowed a deduction with respect to such payment and the lessor will not be required to include the payment in its income, this provision along with related provisions pertaining to base period income and a reallocation of excess profits credits between the lessor and lessee being necessary in order to prevent an unwarranted increase in the lessee's ultimate liability;

(5) Income will be excluded which would have been includible in the taxpayer's gross income for a year prior to the effective date of this tax except for foreign monetary, exchange, or other restrictions, and deductions chargeable against such income will also be excluded—this exclusion being limited, however, to income "derived from sources within any foreign country."

Other adjustments which were formerly allowed by section 721 are largely revived, but not entirely. Under the old law, if a certain class of income was "abnormal" in kind or amount, such parts of it as were economically attributable to previous or future taxable years might, under certain circumstances, be attributed to such years for the tax purposes. Under the bill (sec. 454), the amount which is considered "abnormal" and permitted to be attributed to other years is that in excess of 115 percent of a 4-year average, rather than 125 percent. The bill revives the express definition of certain classes of income, including (*a*) income arising out of a claim, award, judgment, or decree, (*b*) income includible in the current taxable year because of a change in accounting period, (*c*) income from exploration, discovery, or prospecting, and (*d*) income from sale of patents or processes developed over a period of more than 12 months. But it drops any reference to income from research or development, and also to that resulting from a termination of a lease.

Comment

The disallowance of losses on the sale of business properties in without justification. It will be recalled that the Treasury Department asked for the disallowance of these losses for income-tax purposes at the time the Congress was considering the Revenue Act of 1950. The proposal was rejected by the Committee on Finance, the Senate, and the conference committee. The logical consistency that similar losses would also be disallowed in base period years is of no benefit to the taxpayer which had no such losses in the base period, or which does not use the base period earnings credit. Losses of this character clearly reduce net income equally as much as inventory or any other losses.

The same comment is pertinent as to the justification of disallowing deductions on account of the retirement of bonds. Although this deduction was disallowed in the old law as to base period years and would also be disallowed in such years in this law, these facts are small comfort to a taxpayer which does not have equivalent deductions of this character in its base period.

The limitation on the exclusion of certain unblocked foreign income to that "derived from sources within any foreign country" may have an entirely unintended effect as to much of the income to which the provision would be expected to apply. Section 119 prescribes rules as to the "source" of income under which, for example, one-half of the income from the sale in a foreign country of goods manufactured within the United States is from sources within the United States. The result would seem to be that the exclusion would apply only to one-half of the proceeds of such a business operation, even though the entire proceeds had been received in the form of a blocked foreign currency. In my opinion, this provision (all of par. (M) on pp. 13–14) should be eliminated. The proposed "cure" is worse than the disease.

It is not clear why income from research or development or that from the termination of a lease, if abnormal should not be subject to reallocation as it was under section 721 of the old law. This subject is discussed hereinafter.

ALTERNATIVE CREDITS

The bill provides four alternative methods of computing the excess profits credit, two of which are available to all corporations, and two only to certain limited classes of corporations (secs. 434, 435 (e), and 446). The taxpayer may, in any case, use whichever available method results in the least tax. These four methods are: (1) the invested capital method; (2) the average earnings method; (3) the growth method, for small corporations; (4) a legal-return-after-taxes method, for regulated public utilities.

Comment

The first two of these are counterparts of methods permmitted by the old law. The third is designed to stop growth and would succeed. The fourth is new.

INVESTED CAPITAL CREDIT

The invested capital credit is computed from an equity capital element and a borrowed capital element. That part of the credit allowed on the equity capital element is at the rates of 12 percent on the first $5,000,000, 10 percent on the next $5,000,000, and 8 percent on that over $10,000,000. These brackets are applied without reference to the amount of borrowed capital (secs. 436, 437 (a) and (b)).

The amount of the equity capital subject to these rates is determined by reference to three items:

(1) The total of the taxpayers assets reduced by the total of its liabilities as of the beginning of the year, each asset other than money being included at its depreciated basis (sec. 437 (b) and (c));

(2) Plus the "capital addition" or minus the "capital reduction" for the taxable year, these items representing the money or property (also at its depreciated basis) actually paid in during the year for stock or as a contribution to capital, and that distributed during the year otherwise as a dividend, respectively, weighted in each case according to the proportion of the year it was in the hands of the corporation (sec. 437 (d) and (e);

(3) Plus a "recent loss adjustment," representing the aggregate excess, if any, of the net operating losses during either the period 1946-49 or 1940-49 over operating income for the same period, this being intended to protect against the effect of capital depletion attributable to such recent losses (sec. 437 (f)).

So much of the taxpayer's capital as represents an increase in its capital through contributions of money or property to the corporation made after the beginning of the taxable year, or so much as represents such an increase through contributions of capital and the accumulation of earnings after the beginning of the first taxable year, is permitted to increase the taxpayer's credit at the 12-percent rate whether or not the taxpayer's total equity capital is in the 10-percent or 8-percent bracket. Contributions of capital for the purposes of this provision do not include contributions by certain corporate affiliates, or by any other corporation in a tax-free transfer (secs. 436 and 438).

In all these computations no stock dividend is deemed to be either a contribution to capital or a distribution of earnings, and distributions of cash or property in the first 60 days of a taxable year are to be treated as having been made from accumulated earnings in the preceding year.

The part of the credit allowed on the borrowed capital element is an amount equal to one-third of the taxpayer's allowable interest deduction for the year on its "borrowed capital." The 1945 definition of "borrowed capital" is enlarged to include condiitional sales contracts. This element of the credit is subject to a ceiling equal to 3 percent of the average borrowed capital for the year and a floor equal to 1 percent, the amount of borrowed capital for purposes of determining this latter limitation not being deemed to include obligations of an original maturity of less than 5 years (sec. 439).

Finally, the sum of the equity capital credit and the borrowed capitl credit is reduced in that proportion of the entire sum which "inadmissible assets" bear to the total assets of the corporation. "Inadmissible assets" are, as before, defined to include corporate stock on which a 100-percent dividends credit is allowed, and Government obligations, the interest on which is exempt under sec-

tion 22 (b) (4). No election to treat Government obligations as "admissibles," and include the interest from them in gross income, is permitted (sec. 440).

Comment

The method of determining the equity capital element is a novel one. Under the World War I excess profits tax, the 1913 value of properties was used for invested capital purposes. Under the World War II excess profits tax, the original cost of properties was used. Much time and money has been devoted by the Government and its taxpayers to determining the amount of invested capital under each of these two methods in succession. The bill now proposes that they should make a determination under an entirely different method, devoting much more time and money to this further task.

Why not 'freeze" the World II computations, prohibit reaudit, and bring them down to date?

The adjustment for "inadmissible assets" under the old law was made through the application to the invested capital otherwise determined of a ratio of "inadmissibles" to total assets. A better method, however, and one which would entirely avoid discriminating against corporations according to whether their liquid funds are carried in the form of cash or of equity or Government investments, would be to permit the taxpayer to include all dividends and interest on "inadmissibles" in its income and make no reduction for "inadmissibles" of any sort. This was permitted under the old law with respect to Government obligations.

AVERAGE EARNINGS CREDIT

The excess profits credit computed according to the average earnings method is composed of four elements:

(1) 85 percent of the "average base period net income,"

(2) Plus the "base period capital addition,"

(3) Plus 12 percent of the "net capital addition" or minus 12 percent of the "net capital reduction,"

(4) Plus an addition or minus a reduction for changes in borrowed capital (sec. 435).

The "average base period net income" is computed from the taxpayer's excess profits net income during the base period (secs. 435 (b), (c), and (d)). It may be roughly described as being the average of the taxpayer's excess profits net income for any three of the four base period years. The base period is the four calendar years 1946–49, unless a taxable year of the taxpayer ended in the first quarter of 1950, in which case it is the 48-month period ending with the close of such year. The base period average is computed by reducing the excess profits net income for each taxable period entirely or partially within the base period to an average monthly amount, either eliminating from the base period any 12 consecutive months or retaining in the base period any 36 consecutive months, and dividing the aggregate of the income for each of the retained 36 months by 3. In making these base period computations, the income for any month during which the taxpayer was not in existence, and income for any month which appears in a deficit amount, is treated as zero.

The "base period capital addition" is an amount intended to reflect growth in the latter half of the base period (sec. 435 (f)). It is computed from 12 percent of the capital addition or reduction occurring during the last two taxable years in this period, and one-third of the increase or decrease during the period in the taxpayer's annual interest obligations. Such amount of the increase or decrease in each of these items as occurs in the first year is taken into account only to the extent of 50 percent; that occurring in the second year is taken into account in full. The net increase, if any, becomes the "base period capital addition." If there is a net decrease, it is disregarded.

The "net capital addition" or "reduction" as the third element in this credit is a figure intended to reflect the increase or decrease in the taxpayer's equity capital after the close of the base period (sec. 435 (g)). It is computed by aggregating the increase or decrease in the taxpayer's equity capital between the end of its base period and the beginning of the taxable year with contributions to or distributions from capital made during the taxable year, the latter weighed according to the time of the year at which they occurred.

In determining both the "base period capital addition" and the "net capital addition" or "net capital reduction," the amount of any addition to or reduction in capital must be offset by the amount of any additions to or reductions in "inadmissible assets."

The additions and reductions in borrowed capital are similarly intended to reflect changes in the taxpayer's borrowed capital occurring subsequent to the base period (sec. 435 (h)). This figure is computed by multiplying the average interest rate for the taxable year times one-third the increase or decrease in the average amount of borrowed capital for the year as compared with the amount at the end of the base period. There is a ceiling on both additions and reductions equal to 3 percent of the increase or decrease in borrowed capital, but no floor.

Comment

The reduction of the average base period net income by 15 percent subjects normal earnings to a progressive rate of tax.

Elimination of 1 of the 4 years in the base period is no more than necessary to cut out the height of the reconversion period. Many fiscal-year corporations, it must also be remembered, will have 1945 experience reflected in their base period under this bill. It would be necessary to eliminate a second of the 4 years if it were desired merely to eliminate the eccentric abnormalities of 1945 and 1946.

The number and magnitude of the abnormalities affecting business in general during the past 5 years have been such that many first will not show even 2 years of normal experience within this period. The least protection that could be afforded them would be to permit the use (as a "basement") of the average base period earnings under the old law—1936–39—adjusted for capital additions since 1939 and increased by 50 percent, for example, to adjust for the subsequent inflation.

Furthermore, there are many taxpayers which, unfortunately, suffered declining earnings throughout the base period. Certainly they should be encouraged to restore their profits to the highest level of the base period, without confiscation or penalty.

The formula for the determination of the "base period capital addition," in taking the taxpayer's "last two taxable years" preceding its first excess profits taxable year as the period during which capital expansion will be recognized for this purpose, seriously prejudices the firm which has recently changed its taxable year. Such a firm might not get this type of credit for capital additions in more than 13 months instead of the 2 years which are generally contemplated.

An intelligent and fair selection of base period years will eliminate many problems. 1950 should be included, for example, in the base period for the 1951 tax. There simply were no high profits in 1950 from the defense program. There were, however, in some cases, unusually high profits during 1950. A 15 percent discount of 1950 earnings might, therefore, be justified. But there is no justification for discounting the earnings of 1946, 1947, 1948, or 1949.

The earnings of 1 year during the base period years are unquestionably the best measure available of "normal" profits, and should be used. In no other way can confiscation of normal nondefense earnings be avoided. And other adjustments discussed hereinafter are essential to exempt from the proposed tax normal profits resulting from growth, increased efficiency, expansion, and new products.

The method prescribed for reducing excess profits net income to a monthly average will seriously prejudice corporations which were on a fiscal-year basis in 1945–46. Under section 13 (a) (2) as amended by the Revenue Act of 1942, the excess profits credit was subtracted from a corporation's net income in order to arrive at its "normal tax net income." This was changed by the Revenue Act of 1945, but only as to taxable years beginning on and after January 1, 1946. Thus, a corporation then on a July 1 fiscal year will have, under this bill, a base period income for the first half of 1946 which is its actual income for that period less its excess profits credit under the old law. This, I trust, is merely a clerical error which will be corrected.

BASE PERIOD NET INCOME

The figure representing anual net income for the purpose of computing "average base period net income" is "normal tax net income" adjusted in certain specifieu respects (sec. 433 (b)). These adjustments are, in the main, the same as those used in converting normal tax net income into excess profits net income for excess profits tax years. There are, however, certain differences for the base period years—

(1) The net operating loss deduction is not allowed;

(2) The disallowance of gains and losses with respect to business properties applies in the case of theft, seizure, or destruction of such properties as well as in the case of sales and exchanges;

(3) Certain repayments of processing taxes to vendees are disallowed, as in the 1945 law, this being complementary to the exclusion in taxable years of income attributable to a refund of AAA taxes;

(4) Casualty and abandonment losses are disallowed but, contrary to the 1945 rule, are subject to the restrictions applicable to the disallowance of certain "abnormal" deductions;

(5) A deduction is allowed for various classes of "abnormal" expenses or losses, but the "old" rules have been modified—(*a*) the amount disallowed is that in excess of 115 percent, rather than 125 percent, of a 4-year average, (*b*) the disallowance is contingent upon the amount of the deduction exceeding 5 percent of the average base period excess profits net income computed without such deduction, and (*c*) the "abnormal" deduction must be shown by the taxpayer not to be a "cause" (as well as not to be a "consequence") of an increase in the gross income of the taxpayer during its base period, or a change in type, manner of operation, size, or condition of the business.

Comment

Under the old law, casualty and abandonment losses were disallowed for base period years without regard to their "abnormality." Insofar as a taxpayer has sustained such losses in the base period, its experience in that period is obviously distorted from the "normal" in any reasonable sense, and there is no justification for arbitrarily prohibiting the exclusion of 15 percent of these losses. There is less justification and no logic whatever in ruling that a taxpayer which has had a series of such losses can exclude none of them, which is the effect of the 4-year average limitation. There is also no justification in making the disallowance contingent upon the amount of the deduction exceeding 5 percent of the average base period net income. This is simply a discrimination between taxpayers on the basis of their size.

The purpose of the condition to the disallowance of "abnormal" deductions that they should be shown not to be a "cause" of an increase in the taxpayer's gross income is not clear. The report of the Ways and Means Committee, page 12, incorrectly states that this condition was also present in the old law. It would seem to have the anomalous effect of denying a casualty deduction to the extent that the taxpayer increased its income in future years through rebuilding a more modern plant than the one which was destroyed.

Another type of "abnormal" loss for which an adjustment should, but is not, made is illustrated by the postwar experience of many businesses. For example, it was not uncommon for a business to lose money, or to make insignificant profits, during 1 or 2 or even 3 years following World War II, on contracts entered into ill-advisedly. Its experts on civilian business had not returned from the war and the substitutes were inexperienced. If the losses actually realized on business operations (even though the over-all business was not in the red) exceeded losses actually realized on similar business operations over a 10-year period, they should certainly be disregarded in computing normal base period earnings. As in the case of many other adjustments, this proposed adjustment will not be necessary, however, if 1950 is included in the base period years and if one year is selected for the earnings credit.

ALTERNATIVE CREDIT BASED ON GROWTH

The growth formula of the 1945 law has not been revived. Instead, a corporation qualifying for a new growth method is permitted to use as a credit its net income during the last year of its base period, or the average of its last 2 years, increased or decreased by reason of equity capital and borrowed capital additions or reductions since the beginning of its first taxable year (sec. 435 (e)). In order to qualify for this method the taxpayer must—

(1) Have commenced business before the beginning of its base period;

(2) Have total assets as of the beginning of its base period not in excess of $20,000,000; and

(3) Show in the last half of its base period an increase over the first half of 30 percent of total payroll and 50 percent of gross receipts.

Comment

The $20,000,000 limitation is obviously and expressly aimed at the larger corporations. The growth formula in the old law was available to all corpora-

tions whose history showed the required justification for the formula. There is no justification for the proposed limitation. The production of aureomycin and ACTH should not be restricted.

On the other hand, growth during the base period is appropriately reflected, of course, if the earnings credit is based upon 1 or 2 years of the base period; and no special formula is necessary.

Growth after the base period, however, is a problem which requires solution unless the growth of America is to be stunted. This problem is discussed hereinafter.

ALTERNATIVE CREDIT FOR PUBLIC UTILITIES

Section 446 of the bill prescribes a new alternative credit for regulated public utilities. This credit is in an amount equal to the sum of (*a*) the normal tax and surtax and (*b*) a certain percentage of total capital, reduced by (*c*) the interest deduction for the year on borrowed capital. The percentages for local transportation companies and for telephone, telegraph, electrical energy, gas, water, and oil and gas pipeline companies are 6 percent, and for interstate railroad and air transport companies, 5 percent. The capital of such utilities is defined for the purposes of this credit as the sum of equity capital and borrowed capital for the year, the former including the "recent loss adjustment." To qualify as such a utility, "substantially all" of the taxpayer's excess profits net income must be derived from such sources.

Comment

The problem presented is, What kind of a job do you want the public utilities to do during the emergency or defense period ahead of us? They will unquestionably do their best. But their best will be determined by what will be left after taxes. The rates of return to be prescribed must be determined accordingly. Certainly one of the most glaring inadequacies is the allowance of only a 5-percent return to airlines, the history of which as shown this to be one of the most hazardous of business undertakings. Furthermore, our air transport system of today and tomorrow is an essential part of our national defense.

As to all utilities, a 12-percent credit for new capital additions should be allowed, as in the case of other industries.

As I pointed out in my oral testimony, the adjustment for "inadmissible assets" is celarly wrong. In fact, there should be no adjustment, and the income from inadmissibles should be included. But if an adjustment is to be made it should be made to the amount computed under paragraph (b) (2), not by reducing the "regulated public utilities credit" as is now provided in paragraph (a) of section 446.

Furthermore, if the inclusion in a consolidated return of one of more affiliated corporations would produce a consolidated "excess profits net income" which does not meet the "substantially all" test of paragraph (d) on page 75, then such corporation should be excludible and a consolidated return permitted for the remaining corporations.

Section 117 (j) losses are disregarded in computing excess profits net income (sec. 443), but deducted in computing normal tax net income. In effect they are subjected to both excess profits tax and normal and surtax—section 446 (b) (1)—for the deduction for normal tax and surtax purposes is virtually wiped out.

MINIMUM CREDIT AND CREDIT CARRY-OVER

The bill contains no fixed exemption comparable to the $10,000 exemption in the 1945 law. Instead it provides a minimum credit in the amount of $25,000 (sec. 431).

The unused excess profits credit adjustment includes a carry-back of an unused credit for 1 year and a carry-over for 5 years. No part of the $25,000 minimum credit may contribute to an adjustment for other years, however (sec. 432).

RELIEF PROVISIONS

There are three relief provisions aimed at permitting a reconstruction of base period income. Each of these utilizes a concept of an average rate of return in the industry of which the taxpayer is a part. These rates will be determined through publication by the Secretary of the Treasury of a classification of taxpayers by industry, and of an average rate of return for each industry classification for the calendar years 1946–49. The classification is to be generally that

used by the Treasury Department in compiling published statistics from corporation income tax returns, and the rate is to be the sum of the aggregate net income and aggregate interest deduction for all corporations in each industry classification divided by the aggregate of total assets for such corporations. The Secretary is to publish by March 1, 1951, tentative rates of return for each industry classification, which are to be used until final base period rates are published (sec. 445).

Section 442

The first relief provision applies to taxpayers which commenced business prior to the base period, whose normal production or operation was interrupted by "events unusual and peculiar in the experience of such taxpayer," or whose business was depressed because of "temporary economic circumstances unusual in the case of such taxpayer." A taxpayer suffering such an abnormality either in 1 or 2 years of its base period may reconstruct its income for those years by bringing it into the same relative proportion to its income for its normal year or years in the base period which obtains between the industry rates of return for such years. This reconstruction may be made, however, only if it increases the taxpayer's income by at least 10 percent.

Section 443

The second relief provision, also applying to taxpayers which commenced business before the base period, permits a reconstruction of income on the part of a taxpayer showing during the period 1947–49 "a substantial change in the products or in the services furnished." It is a condition of this relief that during 1 of the 3 years following the year of such change more than one-third of the taxpayer's net income be attributable to the new products, and its entire net income be more than 25 percent greater than the average of that for the period from 1946 until the change occurred. The reconstruction is made by multiplying the base period rate of return for the taxpayer's industry by the taxpayer's total assets at the end of the year in which it shows the required amount of net income from the new products, or on December 31, 1949, whichever is later.

Section 444

The third relief provision permits a new corporation commencing business after the beginning of the base period to use for each of the first 3 years of its existence (or such of them as are taxable years) an average base period net income computed by multiplying the amount of its total assets on the last day of the taxable year by the base period rate of return for the industry. For succeeding taxable years a similar computation may be made, using the amount of assets on the last day of the third year or on December 31, 1949, whichever is later.

Under both sections 443 and 444, capital additions or reductions may be made only for periods subsequent to the date on which the taxpayer's assets are aggregated in order to be applied to the industry rate of return.

Relief must be specially applied for under each of these provisions. However, if the amount of relief claimed is in excess of 50 percent of normal tax net income, payment of the amount of the claim is permitted to be deferred until the relief is finally determined, unless the industry rates on the basis of which the claim is computed are tentative, in which case only 80 percent of the claim may be deferred (sec. 430 (d)).

Jurisdiction to try these claims is not limited to the Tax Court.

Comment—general

Provisions for "relief" are designed to cover only one class of cases: Where both the invested capital and the base-period earnings are inadequate to measure the taxpayer's "normal" income. Similarly, there is only one basic problem: To exempt "normal" profits from the confiscatory rates of the excess profits tax. If we focus upon this class of cases and upon this problem, practical and sensible solutions are much more simple to work out.

The basic "relief" provisions of the World War I act (special assessment) and of the the World War II act (sec. 722) relied upon administrative decisions. The results under both were bad. The provisions of the bill are a decided improvement but are inadequate.

There are obviously two approaches: (1) To correct the base period, or (2) to determine normal profits during the taxable year and exempt them from the excess profits tax. The relief provisions of the bill use approach (1). In my opinion, both approaches should be used, just as both are used elsewhere in the bill—to correct "abnormal" losses in the base period, for example, and

to give a deduction (called an adjustment) for certain "abnormal" income during the taxable year.

The following examples (definitely far from an all-inclusive list) are illustrative of the types of cases for which relief is necessary:

(1) A plant, or a portion of it, is shut down during a part of the base period, as in the case of a strike, flood, extensive repairs, lack of raw materials, or lack of normal business. If one or conceivably two years of the base period are to be used, substantially all cases of this type disappear. In any event, section 442 can be eliminated. The only remaining class of cases provided for are those where the business throughout the base period was abnormally low. The only solution for this type of case is the protection afforded by the "basement" provision previously discussed—in no event should the taxpayer's average earnings under the new law be less than his average earnings under the World War II law. This "basement," of course, should be adjusted upward by say 50 percent as a result of the subsequent inflation; and the appropriate adjustments already provided in the bill (for capital additions or reductions, for reorganizations, etc.) can readily be made applicable.

(2) The taxpayer's volume increases, because he was on a one-shift basis during the base period and is an a three-shift basis during the taxable year. There is no provision in the bill to meet this situation. However, it should be very simple to determine the taxpayer's "normal" profits based on his base-period volume and apply that determination to this increased volume during the taxable year. Perhaps the simplest method of increasing production is to increase hours of production. It seems foolhardy to say that we want increased production and concurrently to penalize it.

(3) The volume of services increases because of an increased number of units. The best illustration of this is perhaps found in the field of transportation services. An airline, for example, may be using 100 planes on the average during the base period and 150 during the taxable year. Its normal profit per unit during the base period can readily be determined (although unquestionably it will be necessary to use its experience during 1950 to avoid the losses and subnormal profits of the industry during the postwar years). This normal profit per unit can then readily be applied to the 150 planes in use during the taxable year, thus encouraging the company to continue to increase its services—with facilities which also will be available for national defense.

(4) The taxpayer has expended considerable sums of money in research and development in the production of new or better products, or new or better services, and the results of his work do not appear (or appear only partially) during the base period. Television broadcasting is a typical illustration. This type of case is not covered by section 443 of the bill—which applies only in the case of substantial change during 1947, 1948 or 1949, for example. This type of case requires the double approach above referred to: (1) The expenditures devoted to research and development (whether or not they put the taxpayer "in the red") must be disregarded in computing the taxpayer's average earnings and (2) the normal profits derived from the new or better product (or new or better services) must be exempt from the excess profits tax. This second approach is similarly necessary when income is derived from new or better products (or new or better services) during the taxable year—whether or not deductible expenses were previously incurred. The industry-index approach in section 443 is probably as practical and as fair as can be prescribed. Care should be taken, however, to make certain that the proper industry index is used—that is, the index applicable to the new or better product or new or better service, regardless of the nature of the taxpayer's other income. It will, of course, be difficult at times to determine the proper industry index and appropriate examples should be given in the committee report. The discovery or development of another aureomycin or another ACTH or of a cure for cancer during the taxable year must be encouraged and not penalized. The benefits to mankind justify a millionfold the time required to adopt appropriate provisions.

(5) The taxpayer's volume increases or his costs decrease during the taxable year by reason of efficiency—new or better facilities, for example. There is no provision in the bill to meet this situation. On the contrary, the bill undeniably penalizes efficiency. It should not be difficult to measure the savings involved. The taxpayer himself should assume the burden of proving his volume increases resulting from efficiency and of establishing the profit resulting therefrom. The same is true in the case of decreased costs. He need go back only to a period prior to the effective date of his increased efficiency—whether or not this takes him back into his base period.

Appropriate provisions covering the above cases will encourage increased production and decreased costs. In addition, they will, when coupled with other relief provisions discussed hereinafter, give taxpayers the opportunity to pay at least a portion of the tax through ever-increasing production, ever-increasing efficiency, and I trust through increasing his profits.

Whether the 12-percent credit for new capital is adequate to encourage increased capacity is questionable. The normal tax and surtax promptly reduces this credit to about 6 percent. But the provisions of the bill in this respect are a decided and definite improvement over old section 722.

Comment, section 442

The section can and should be eliminated—by giving an earnings credit based on 1 (or perhaps 2) years of the base period; by doubling the first half of 1950 and including it in the base period; and by including all of 1950 in the base period (reduced perhaps by 15 percent) for the 1951 tax. I repeat: Everyone admits that there are no defense profits in 1950.

If the section is retained, however, the adjustment should be made to the period the profits of which are affected. As I pointed out in my oral testimony, profits will usually continue long after a shut-down of the producing plant begins—and the effect of the shut-down will not be felt until the inventory of finished goods is seriously depleted.

Comment, section 443

Section 443 is comparable to part of old section 722 (b) (4). Its inadequacies have already been discussed.

The basic test of its applicability—whether there is a substantial change in the products or in the services furnished—is one which would seem to require further elaboration. The report of the Ways and Means Committee states only that this concept has been well developed under the prior law—and it is doubtful that either the Government or many taxpayers would join in this assertion. (See, Bureau Bulletin on sec. 722, pp. 55–58.)

The requirement that more than one-third of the taxpayers net income within 3 years after the change be attributable to the new products makes the provision unavailable to taxpayers with a diversified line of products.

The industry ratio applicable in any particular case should be that of the industry to which the new product belongs.

The following additional questions are prompted:

(1) Why the 36-month period, in (a) (1)?

(2) Why must the change be made during the base period?

(3) Why not let us see the tentative industry classifications and rates of return before we are compelled to pass judgment?

(4) Why the test of gross receipts, in paragraph (d), on page 65, if we are seriously striving to determine normal profits for the new product?

(5) What relief will be granted if the entire industry is depressed?

Comment, section 444

Section 444 is comparable to part of old section 722 (b) (4).

It was obviously intended that all corporations, so far as the date of their establishment is concerned, should be eligible for either section 442 and section 443 relief, or for section 444 relief. The sections do not perfectly dovetail however. For instance, a corporation which commenced business in January 1946, would not be eligible for relief under any of the three sections if its taxable year ended in the first quarter of 1950.

REORGANIZATIONS AND LIQUIDATIONS

In the case of certain exchanges during or after the base period, mostly in connection with corporate reorganizations, the prior earnings experience of the transferor corporation or partnership may be availed of by the transferee corporation for the purpose of determining its average base period net income (sec. 461–465). The provisions apply only to so-called tax-free exchanges, i. e., those on which gain or loss is not recognized for income-tax purposes. But all tax-free exchanges are not covered. The types of exchanges which are covered are those which were similarly treated under supplement A of the old law, except that the bill adds a new clause covering transfers of part of the properties of a corporation or partnership to which section 112 (b) (5) is applicable.

The provisions of the bill dealing with intercorporate liquidations (sec. 470) requires that a corporation which receives the assets of another corporation in

a tax-free complete liquidation subject to section 112 (b) (6) of the code shall include such assets in its equity capital for purposes of the invested capital credit at a substituted basis derived from the basis of the transferee corporation in the stock given up on the liquidation. This substituted basis is to be adjusted for depreciation of the properties from and after the date on which the transferee corporation acquired ownership of 80 percent of the transferor's stock.

Comment

The new clause covering transfers of a part of the properties of a corporation or partnership is said in the report of the Ways and Means Committee to be intended to permit a carry-over of the earnings experience of the predecessor after a so-called corporate split-up. Section 112 (b) (5) of the code has frequently been held not to apply, however, to transfers of assets followed by the transferor's distribution to its stockholders of the transferee's stock. Thus, the new clause may cover only those split-ups in which the transferor continues in existence as a parent corporation. Split-ups under section 112 (b) (4) and 112 (g) (1) (D) should be brought within the new provision.

It is also desirable to extend the right to the earnings experience of a predecessor corporation to corporations purchasing assets for cash. Although some problem might be involved in this proposal where the selling corporation transfers only a part of its assets and continues in existence, there is no possible objection to the proposal where the transferor sells all of its assets for cash, for example, and then dissolves.

CONSOLIDATED RETURNS

As under the old law, an affiliated group of corporations may file a consolidated return for the purposes of this tax. The same return will be filed for both the income tax and the excess profits tax. Only one $25,000 minimum credit is allowed for the entire group. Personal holding companies, and domestic corporations doing most of their business outside the United States (including Western Hemisphere trade corporations), which have filed a consent for a taxable year since 1943 to be treated as an includible corporation, are required to continue as a member of the affiliated group if consolidated returns are filed.

Comment

The denial to domestic corporations most of whose business is done outside the United States of the privilege of making a new election whether to join in the consolidated return has the effect of denying such corporations the exemption from excess profits tax allowed them by section 452. The December 31, 1943, cut-off date is carried over from the old law, having originated in the Revenue Act of 1942 at a time when such corporations still had an opportunity to make an effective election.

The exclusion from a consolidated return of corporations with nonpublic-utility income has been discussed under section 446.

The reference to section 452 (g) on page 143, line 4 of the bill, is erroneous, as that subsection was eliminated by a committee amendment in the House.

ACCOUNTING METHODS

Taxpayers reporting gains from installment sales as and when payments under the contracts are received are permitted to elect the accrual method with respect to these sales for purposes of this tax. Such election, if made, applies also to base period years, and is irrevocable (secs. 443 (b) (7) and 453 (a)).

Likewise, taxpayers on the completed contract method are extended the right to make an irrevocable election of the percentage of completion method for purposes of this tax. This election also applies to base period years (secs. 433 (b) (8) and 453 (b)).

All banks, including those which use the reserve method of accounting for bad debts for income tax purposes, are required in the computation of their excess profits net income, both for base period and excess profits tax years, to follow the section 23 (k) method of deducting bad debts as they become worthless (sec. 433 (a) (1) (L) and (b) (12)).

Comment

The references on page 101, line 7, of the bill to section 432 (b) (7) and (8) should be to section 433 (b) (7) and (8).

SHORT TAXABLE YEARS

In the case of a short taxable year, the excess profits net income of the short period is annualized mathematically in order to determine the amount of such income in excess of the allowable credit, and the tax computed on such excess is reduced to that proportion of the tax so computed which the length of the short taxable year bears to a full 12-month year. Alternatively, the tax for a short year may be computed by using the taxpayer's actual income for the 12-month period beginning with the first day of the short period (sec. 433 (a) (2)).

RETURNS FOR THE FIRST YEAR

For any taxable years ending prior to December 31, 1950, the due date for the return and for the payment of the tax is March 15, 1951, and any payment of normal tax or surtax prior to that date will be credited against the tax shown to be due at that time (sec. 205).

ADVERTISING EXPENDITURES

As under the old law, an election may be made within 6 months after the date for filing the return for the first excess profits tax taxable year to charge to capital account certain expenditures for advertising or the promotion of good will made during the base period. If such an election is made, it applies for purposes of both the income and excess profits tax for all base period and subsequent year (sec. 449, and sec. 203 of the bill).

STRATEGIC AND CRITICAL MINERALS

An exemption is provided for income derived from the mining of a strategic or a critical mineral (sec. 448). The amount of the exemption is computed as was a similar exemption under the old law so that the amount of tax payable is only that fraction of the tax otherwise computed as the taxpayer's income from other sources bears to its total income. The list of strategic minerals under the old law has been extended to include a number of others, such as cobalt and uranium by name, and also to permit additional minerals to be added to the list upon certification by the Defense Minerals Administration that they are essential to the defense effort and not normally produced in appreciable quantities within the United States.

The category of "critical" minerals is very properly extended to include those minerals the additional production of which the Defense Minerals Administration certifies are "essential for the defense effort," and which are mined from a property which was economically submarginal as of June 25, 1950.

This provision also extends the exemption to a lessor's income attributable to the mining of such minerals.

EXTRAORDINARY DEPLETION

The same special deduction as in the old law is allowed for extraordinary mineral and timber depletion. In order to avail itself of this deduction, the taxpayer's output in excess of normal must exceed 5 percent of its estimated reserves. The amount of the deduction is proportionate to the fraction of its reserves which is depleted within the taxable year (sec. 451).

The American Mining Congress has submitted several suggestions which merit adoption.

ADJUSTMENTS FOR INCONSISTENCIES

The bill revives practically intact the provisions of section 734 of the code, authorizing adjustments to be made in certain cases in which the treatment of an item or transaction for excess profits tax purposes is inconsistent with the prior treatment of the same item or transaction for income tax purposes, correction of the earlier treatment being prevented by the statute of limitations or the principle of res adjudicata (sec. 450).

FOREIGN CORPORATIONS AND INCOME

Foreign corporations may use the average base period income method only if throughout the base period they have been in existence and doing business in the United States. Their average income credit is merely a straight 85 percent of their average base period net income (secs. 434 (b), and 435 (a) (2)).

The invested capital credit for both foreign corporations and "section 251 corporations" (domestic corporations which derive most of their income from United States possessions) is only a percentage of the taxpayer's average equity capital for the taxable year, including in the computation of equity capital only United States assets and liabilities "which are directly related to its United States assets." The average of the equity capital so computed is reduced by the percentage of United States "inadmissibles," but these corporations are not granted any special benefit for new capital nor any borrowed capital credit (sec. 441).

A foreign tax credit as defined and limited in section 131 of the code is allowed against this tax to whatever extent it is not used against the normal tax and surtax in the same manner as under the old law (sec. 202).

MERCHANT MARINE ACT CONTRACTS

As under the old law, Government contractors subject to the Merchant Marine Act of 1936 with respect to contracts completed within the taxable year, are permitted to include in their income any amounts required to be refunded to the United States by the Federal Maritime Board under such contracts, and to reduce the amount of their excess profits tax by the amount of the refund (sec. 455).

Comment

Relief is also required for shipping companies which during 1946–49 have chartered and operated Government vessels through the Federal Maritime Administration, but which have not received until 1950 a part of their prior earnings on the operations of these vessels because of the delay entailed in the formulation by the Maritime Board of accounting instructions and formulas under which the companies' share of the profits were to be determined. These companies should be permitted to reallocate such income to the years of the operations to which it is attributable.

AMORTIZATION

My comments on amortization in my oral statement are adequate.

Whether section 124A should be amended by striking out the "percentage" provision, or by denying the use of possible "post emergency" value is questionable. I would prefer the former.

CONCLUSION

The foregoing analysis, comments, and suggestions are made in the hope that the Committee on Finance will find them helpful in correcting many of the "bad" provisions of the bill, in adopting sound policies as substitutes for the "bad" policies in the bill, and in formulating new policies upon which growth and progress can continue.

I merely add that the 2 days available have not been adequate. But I've done my best.

An outline summary of my suggestions follows.

OUTLINE SUMMARY OF SUGGESTIONS

Effective date

Change it to October 1, 1950 (p. 1, line 8).

Rate ceiling

(1) A 67 percent rate is "pretty stiff" for the beginning of an emergency.

(2) Permit public utilities and "Western Hemisphere trade corporations" to use the section 26 (b) and (i) credits in computing the "ceiling" (p. 2, line 13).

Taxable year adjustments

(1) Losses on business properties (sec. 117 (j) of the code) (p. 8, line 22) should be deductible. This will automatically correct the error in the public utilities credit (p. 73, lines 16 and 17).

(2) Loses on retirement of bonds (p. 9, line 19) should be deductible.

(3) Delete the provision on "Blocked foreign income" (p. 13, line 3; p. 14, line 9).

(4) Income from prior research and development should be restored as a class of income which may be adjusted if abnormal.

(5) Gains resulting from the foreign-war-loss provisions of the code (sec. 127) should be excluded.

Invested capital credit

(1) Return to the World War II method of computing the amount of equity capital on which credit was to be allowed (p. 43, line 10).

(2) Permit taxpayers to include the income from admissibles and not reduce their credit by an admissibles ratio (p. 42, line 11).

Base period earnings credit

(1) Base period should include 1950 (perhaps discounted by 15 percent) for the 1951 tax; and earnings to July 1, 1950, for the 1950 tax.

(2) Allow 100 percent of base-period earnings instead of 85 percent (p. 26, line 7).

(3) Permit the use of earnings experience in any 1 or 2, instead of 3, years in the base period (p. 27, line 4).

(4) Add an average earnings credit basement derived from the taxpayer's credit under the World War II law (p. 24, line 6).

(5) Exclude the section 26 (e) credit under the old excess profits tax law in computing excess profits income for fiscal year taxpayers in early 1946 (p. 28, line 4).

(6) Allow credit for base period capital additions with respect to last 24 months of base period instead of last two taxable years (p. 33, line 1).

Adjustments to base period income

(1) Allow casualty and abandonment losses without regard to abnormality (p. 20, line 25).

(2) Remove limitation of 4-year average in disallowing abnormal losses (p. 21, line 8).

(3) Remove condition to disallowance of abnormal losses that they must exceed 5 percent of net income (p. 22, line 3).

(4) Remove condition to disallowance of abnormal losses that they must not be a cause of an increase in gross income (p. 22, line 16).

Growth formula

(1) Remove $20,000,000 limitation on amount of assets (p. 29, line 15).

(2) Provide a similar allowance (in reverse) for corporations with a declining earnings record in the base period (p. 29, line 8).

Public utilities

(1) Increase percentage of return allowed airlines (p. 75, line 3).

(2) Provide a 12-percent allowance for new capital (p. 73, line 4).

(3) Correct the application of the ratio for inadmissibles to the credit for normal tax and surtax (p. 73, line 8).

(4) Permit income for inadmissibles to be included in gross income, and the inadmissibles ratio not applied (p. 73, line 8).

(5) Where participation of several public utilities in a consolidated return would cause section 446 status to be lost because one of the corporations had substantial non-public-utility income, permit such corporation to be excluded from the group (p. 73, line 4).

(6) The use of book figures rather than equity capital is much simpler—and provides a tax credit corresponding to the financial credit.

Relief provisions

(1) Require the use of only 1 or 2 years of earnings experience as a base, and include 1950 in the base period (p. 58, line 12).

(2) Permit an increase in the excess profits credit proportionate to the taxpayer's expansion in physical volume of production subsequent to the base period (p. 58, line 12).

(3) Permit an increase in the excess profits credit proportionate to the taxpayer's increase in its physical facilities, or, in other words, recognize a normal profit per unit (p. 58, line 12).

(4) Accord recognition to research and development of new products by disregarding expenditures for this purpose during the base period and allowing normal profits from the products in later years (p. 58, line 12).

(5) Allow an addition to credit equal to reduction in costs of production (p. 58, line 12).

Reorganizations

(1) Correct reference to split-up reorganizations by citing section 112 (b) (4) and 112 (g) (1) (D) (p. 110, line 5).

(2) Permit use of earnings experience of predecessor in case one corporation purchases all the assets of another corporation (p. 110, line 13).

Consolidated returns

(1) Consolidated returns should be encouraged—the 2 percent penalty should be eliminated.

(2) Permit domestic corporations operating abroad to make a new election as to participating in a consolidated return (p. 143, line 7).

(3) See, also, recommendation for public utilities (No. 5).

Accounting methods

Change the reference from "section 432" to "section 433" to correct a clerical error (p. 101, line 7).

Federal maritime contracts

Permit income under these contracts to be allocated to the year in which earned (p. 108, line 7).

Amortization

Section 124A of the code should be amended either (1) by striking out the so-called percentage provision in the first sentence of paragraph (e) (1), or (2) by making certain that probable future value (whether postemergency or after 5 years) shall not be a factor in determining the amount to be amortized.

The CHAIRMAN. Mr. Henry Fernald.

Will you please come around and have a seat? You may identify yourself for the record.

STATEMENT OF HENRY B. FERNALD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS, WASHINGTON, D. C.

Mr. FERNALD. Mr. Chairman and and members of the committee, I am Henry B. Fernald, of Monclair, N. J., chairman of the tax committee of the American Mining Congress. I am appearing to speak briefly for the mining industry regarding the excess profits tax bill of 1950, H. R. 9827, which is before you.

We are conscious of the revenue problem you face, and the emergency expenditure demands. A first need is to reduce to the minimum all expenditures of every kind not immediately essential for the emergency. Nonessential expenditures should not be made. The Government should set an example to its people of curtailing nonessentials to meet emergency needs.

The paramount problem is not that of getting or spending dollars. It is to get needed production and to get that production with maximum efficiency—with minimum consumption of materials and labor. This is true all along the line, but particularly true of mineral production. Most of our metals and minerals are in short supply. Of some we have little or no domestic production, and we depend almost entirely on foreign supply which may be cut off or curtailed by hostile action. Of others we have substantial domestic production but quite inadequate to meet defense demands and to provide the contemplated civilian consumption, even though that is brought under rigid control.

No desire for revenues should be permitted to lead to taxation which will defeat or discourage production needed for the emergency, nor production which we should have to prevent uncontrollable inflation. Nor should we have taxes which by their impact will defeat the creation of incomes from which revenues otherwise would flow.

All of this has a very direct bearing on the excess profits tax problem before you.

The desire for an excess profits tax which gave rise to the instructions in the Revenue Act of 1950, on which you are acting, was for a tax to be imposed upon excess profits which are the result of the emergency situation. That thought is directly contrary to any imposition of the penalty tax on what are only the reasonable profits from the production of goods or services. The entire principle of a tax to be imposed on excessive profits is violated if the tax is imposed on profits which are not excessive.

We wish taxpayers to increase production, to do this with maximum efficiency and economy, keeping to the minimum consumption of materials and services. We should not then establish for any taxpayer some fixed point beyond which any further profits which come from increase in production or from economies and efficiency in use of labor and materials will be condemned as excessive and penalized. It is not necessary that we should do so.

It is from this standpoint that I present, first, the special mining problems.

THE SPECIAL MINING PROBLEMS

To prevent the effect which the excess profits tax, if unmitigated, might have on mineral production, our prior law included section 735, which is continued as section 451 of the pending bill.

The situation to be met is very simple. A mine consumes its capital in its mineral production. If it makes merely a reasonable profit per unit of production it should not be considered as making excessive profits. If in response to demands for mineral production it increases its output, the mere increase in income in a single year, if that income is still no more than a reasonable profit per unit, should not be considered as representing excessive profits. If the mine produces in 1 year what it would normally produce in 2 years, but still earns only a reasonable profit per unit it should not be charged with making excessive profits, and should not be subjected to excess profits tax.

Senator MILLIKIN. Where your standard is reasonable profit, do you have an incentive for exploration?

Mr. FERNALD. I think so, sir, if we can get a reasonable profit allowance.

Now, of course, what is a reasonable profit in any case must take into account the risk and difficulties involved.

Senator MILLIKIN. Yes.

Mr. FERNALD. That problem was recognized by section 735 of the prior law with its provision for allowing a mine to exclude from its excess profits net income the income from excess output over that of the base period at the same profit rate per unit as it earned in the base period. That was its essential provision. If the profit per unit earned in the taxable year was greater than the unit profit of the base period that excess would remain to be subjected to the excess profits tax.

It also contained various special provisions which we need not here discuss.

Senator MILLIKIN. That applies rather peculiarly to established mining concerns with a rather long history of production, does it not? It would be useless for a new venture.

Mr. FERNALD. That is the point, sir.

Senator MILLIKIN. Yes.

Mr. FERNALD. I am coming to that here.

Senator MILLIKIN. All right.

Mr. FERNALD. I want first to call attention to the fact there were also limiting provisions in section 435, still included in 451, which we urge should now be eliminated.

These were the provisions in paragraphs (10) and (11) of the section which would make reduction in allowable unit profits on the basis of certain relationships between excess output and remaining ore reserve. The amendment which we propose, which is submitted as exhibit A herewith, would remove this limitation.

Senator KERR. Where in the bill do you find the limitation to which you refer?

Mr. FERNALD. It is section 451, on pages——

Senator TAFT. Ninety-two.

Mr. FERNALD. It starts on page 92. You see it gives a whole scale of percentages running from 100 down to 20 percent, but with a possible total exclusion if your relationship is too low.

Now there is no relation between a reasonable profit per unit, and the question of what is the relationship of your excess output for the year to your remaining ore reserves. It is purely an artificial thing. It is no fair standard. It never should be included in there, and we ask that it be eliminated.

Does that answer that question?

Senator KERR. I believe it does.

Mr. FERNALD. Briefly, we would eliminate paragraphs (10) and (11), and modify paragraph 1 of subsection (b), the general rule to make that effective.

The attached amendment, with its accompanying memorandum, I think will make clear what we propose.

Senator MILLIKIN. I hope sometime before you finish you will tell us in summary fashion, at least, what it is that you propose.

Mr. FERNALD. I am coming to that, sir. Now I am answering your prior question.

When section 735 was adopted, it was recognized that it would not meet the problem of mines which were not operating during the base period, or which had unsatisfactory base period experience. Provision was made in a former law for these to be covered by the special relief of section 722. That section has not worked out at all satisfactorily, as the present bill recognizes. It is thus necessary to make some other provision for those cases of mines not operating in the base period, or not making a reasonable base period profit per unit, as well as cases where improvements in operating methods or equipment make base period earnings not a fair standard for measuring reasonable profits on current production. The amendment we submit includes a provision whereby a constructive determination of nontaxable income for exempt output may be made. It will not be difficult to make a reasonable determination there called for. It is something which is in the ordinary experience and customary procedure of mining engineers, and is regularly done. It involves some exercise of judgment and opinion, but no more so than is required in the ordinary solution of many other tax problems, such as the determina-

tion of ordinary and necessary expenses, reasonable allowances for depreciation, property valuation for income-tax or for estate- and gift-tax purposes, et cetera. All through our law there are the provisions that call for exercise of judgment and opinion.

We urge it as a fair and reasonable method of dealing with the situation specified in the amendment.

The amendment which we submit herewith also deals with certain other rather technical features which are explained in the accompanying memorandum, exhibit A–1.

If the amendment we propose is written into the law, it will give encouragement with respect to additional production whether the mine is one previously operating or whether it is a new mine—whether it is one which has or has not a satisfactory base period experience. At the same time, it will still leave subject to the excess profits tax any profit in excess of reasonable profit per unit. The tax can then apply as a true excess profits tax, and can apply to taxing excessive profits but without being imposed on profits which are no more than reasonable.

May I a little later go more in detail on the provisions of that amendment, if you wish?

Another mining condition which to some extent was recognized under the prior law and which is more fully and satisfactorily dealt with in the present bill is that with respect to strategic and critical minerals for which provision is made by section 448 of the bill as passed by the House. This deals with some very special situations for minerals essential for defense purposes. The provisions are very carefully limited. We urge your approval of this section as it now appears in the bill.

Senator MILLIKIN. Mr. Chairman, may I ask whether the gentleman who testified in behalf of molybdenum got in touch with the technical staff? The molybdenum people were objecting to the section you are now discussing.

Did they get together with you, Mr. Stam?

Mr. STAM. Not yet. We would be glad to talk to them. I think the problem would be covered by the point that Mr. Fernald is making.

Mr. FERNALD. I do not know just what their particular point was, sir.

We also urge the adoption of an amendment which we submit herewith as exhibit B, with respect to payments to encourage exploration, development, and mining for defense purposes.

Senator MILLIKIN. Will that take care of Government money?

Mr. FERNALD. That is what I mean.

Senator MILLIKIN. I understand the Bureau of Mines has a plan which it hopes will stimulate the development of more strategic and critical minerals. Will that take care of the money that comes into the enterprise from that source?

Mr. FERNALD. I have not had the details of just what plan they propose. I believe this amendment will meet the essential problem, but I shall be very glad to have them check that over in accordance with a plan which they have to see if it does fully meet the situation.

In brief, while we are proposing——

Senator MILLIKIN. Do you know Mr. Wilkinson over in the Bureau of Mines?

Mr. FERNALD. I know him very well, sir.

Senator MILLIKIN. Would it be an undue imposition on your time if you contacted him to learn, if possible, what their plan is?

Mr. FERNALD. I should be very glad to do that, sir, to give that information to you and your staff.

Senator MILLIKIN. Thank you.

Mr. FERNALD. But the essential point we have in mind is this: We are satisfied that that money which is paid over to the mining companies in pursuance of a plan in the public interest to encourage exploration, development, and so forth, should not be considered as taxable income when the money is received. Yet, under a prior exploration-premium plan, you remember, there was a position taken by the Bureau that any such money was taxable income of the taxpayer when received, even though it was received under a requirement that if not spent in accordance with the approved plan it must be returned to the Government, and the Bureau under this regulation held, however, that if it was received in 1 year, but returned in a subsequent year or expended to the Government, it was, nevertheless, taxable income in the year of receipt, and a deduction in the year when returned.

Senator MILLIKIN. That is rather silly on the face of it. A subsidy is not to provide the mining company with income to pay out to its owners; it is money to try to put the mine in shape to produce income.

Mr. FERNALD. Yes, sir. We feel it was an entirely false standard. If it was meant for the exploration, the Bureau wanted it capitalized, but with taxable income.

Senator MILLIKIN. And it might not have resulted in income at all. It might have been lost.

Mr. FERNALD. Yes.

But let me illustrate. I am not at all confident that any such regulation can ever be sustained, but the fact that it has been made is going to make any taxpayer aware of that hesitant to receive or cooperate under such payments because, if that rule is applied, you can see what it will do.

Suppose a taxpayer received $50,000. That money must be spent only in accordance with the approved plan. It could not be used to pay any income taxes.

Senator MILLIKIN. Of course.

Mr. FERNALD. Therefore, you must put yourself in the position of receiving $50,000 on which the Government may require you to pay from other funds $22,500, or if the excess profits tax can be attached to that, $37,000 of your other money in order to get this money which may prove a loss to you in some subsequent year.

Senator MILLIKIN. It may not produce any income at all.

Mr. FERNALD. That is perfectly true.

Senator MILLIKIN. It is perfectly obvious.

Mr. FERNALD. Or maybe you can get a loss in 2 or 3 years from now to establish under the technical rulings of the Bureau. I am sure that is never what Congress intended to do, and all we are asking is that a simple amendment stating that fact be included, not as a part of the excess profits tax but under the income tax amendments which appear under title 2 of your bill.

Senator MILLIKIN. Does it not come to this? I am not talking about your particular amendment. But if an amendment covering the principle that you have raised is not incorporated, there will not be any encouragement to the development of ore deposits; is that not correct?

Mr. FERNALD. It seems to me that is unavoidable, sir.

Senator MILLIKIN. Yes.

Mr. FERNALD. As to the general provisions of this bill: I wish I could speak more definitely about the general provisions of this bill and what they will mean in practical application. I have been studying this bill and the committee report thereon as carefully as I could in the few days since it was available. I am wholly unable to form any clear judgment of what some of its provisions mean and how they will work out in practice. I have found others experienced in taxation likewise doubtful and uncertain.

This is true of even such a basic provision as section 437 and its related sections regarding invested capital. The definition of equity capital in section 437 (c) is wholly different from anything we have had in any of our prior laws. I have found it almost impossible to reach any concept of what it will mean as applied to various situations with which I am familiar. Perhaps it will work out fairly; perhaps it will be very unfair; I do not know. Others seem equally at a loss.

Similarly I might cite other sections, including various relief provisions, on which I am not yet able to pass any fair judgment.

I cannot feel that you should rush through an enactment of a bill so radically new without opportunity for adequate consideration. No question of trying to raise some additional revenue can compensate for the damage to the entire defense effort which may come from enactment of provisions whose practical application and effect are so uncertain. A little more time for consideration, to be able to understand them better and note their defects or unfairness, will certainly mean no such revenue loss as warrants the threatened dangers to our economy of unwise legislation.

No one charged with business planning and administration can proceed with any confidence as to future operations in a fog of uncertainty as to what this bill will mean. The mere uncertainty will hamper the very forward movement in production which we wish.

There is one particular recommendation which we wish to make, and we think this should certainly be done.

You can at least give assurance to taxpayers that they will not be worse off under this bill than they were under the prior law. There should be included a provision that any taxpayer shall be entitled to have at least the same credit as was allowed under prior law, subject only to adjustment for any subsequent additions to or reductions from that credit.

Of course, any changes since the prior period would have to be taken into account, but at least it will enable the taxpayer to take the previously applied basis, bring that up to date, and use that without having to go to all the tremendous work this bill might require to make an entirely new computation.

We believe this should be done, and urge that it be done.

I mention only a few of the points here. Most of those have been more fully covered by Mr. Alvord in his presentation. I will not try to duplicate them.

I would like to point out, if I may, two particular points.

First, I thoroughly agree with what he said to you about amortization. If that amortization plan is adopted subject to the regulations, to try to bring in a postwar value question, I think it will fail of its objective. I think that is very serious indeed.

Senator KERR. Would not that just be a process of self-cancellation to the extent that it would apply?

Mr. FERNALD. Well, the trouble is—let me bring it right down to——

Senator KERR. Would it not cancel the law to the extent that it was applied?

Mr. FERNALD. Well, I think it is worse than that. It is the uncertainty and the doubt and difficulty of even trying to get such a standard.

Now, take this provision. They want to encourage the opening up of a new mine or increasing the capacity of an existing mine. As we stand today, we have not the slightest certainty how long there will be real demand for that production, how valuable it will be. We do not know what our future capacity demands may be. So we are wholly uncertain as to whether or not we will have any profitable business beyond the 5-year period.

Senator KERR. I understand that.

Now, the general fear and the uncertainty is an added factor, but you are certain of this—that to the extent that they do apply anything under that regulation, they thereby cancel the law.

Mr. FERNALD. Yes, sir.

Senator KERR. You know there is a minimum of that much of the capital, do you not?

Mr. FERNALD. Of course, we would have to put in our applications, as I understand these regulations, then we will get back a certification of some percentage as determined by the authority here. Then we are in a position to say, "Will we go ahead under such a plan or will we not?"

Now, that is not merely the decision you meet, that you have to make, after you know what they propose to do. It is just a feeling, "Is it worth while to go in at all and even start under a consideration and a plan of that kind if you must feel that you are going to come out with something that does not amount to anything anyway?"

You see, I am tracing it back. It is not merely what they may do after you have filed your application and they have gone over it, it is just the feeling, "Is it worth while to try to go in at all?"

As you say, it virtually cancels the intent of the amortization provision.

Senator KERR. It does cancel it to the extent that they apply the formula included in the regulation.

Mr. FERNALD. Yes. I was just going a step beyond that.

Senator KERR. I see.

Mr. FERNALD. The mere existence——

Senator KERR. What I wanted to make clear was what you are saying is over and beyond that.

Mr. FERNALD. Yes.

Now, one other point I do want to raise, and that is with respect to the industry statistics. I quite approve of the general plan proposed, but they should not include the statistics for loss corporations. The losses of loss corporations are no standard to be applied as to what a reasonable profit is. It just does not work out that way. In the statistics the corporations, the taxpayers, with no net income, which are regularly stated separately should not be included in arriving at the percentage.

Mr. Chairman, I have tried to sketch briefly what I have here. I would ask that my entire presentation be included in your record together with accompanying amendments, and I would like to ask that if we are able on further study to note other points on which the bill, we feel, should be improved and this bill is still pending before you, we may have opportunity to submit that.

The CHAIRMAN. You may do so, and your whole statement will be included because you have your two suggested amendments here you wish to submit.

Mr. FERNALD. Thank you.

(The statement submitted by Mr. Fernald reads in full, as follows:)

STATEMENT BY HENRY B. FERNALD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr Chairman and members of the committee, I am Henry B. Fernald, of Montclair, N. J., chairman of the tax committee of the American Mining Congress. I am appearing to speak briefly for the mining industry regarding the excess profits tax bill of 1950, H. R. 9827.

We are conscious of the revenue problem you face, and the emergency expenditure demands. A first need is to reduce to the minimum all expenditures of every kind not immediately essential for the emergency. Nonessential expenditures should not be made. The Government should set an example to its people of curtailing nonessentials to meet emergency needs.

The paramount problem is not that of getting or spending dollars. It is to get needed production and to get that production with maximum efficiency—with minimum consumption of materials and labor. This is true all along the line, but particularly true of mineral production. Most of our metals and minerals are in short supply. Of some we have little or no domestic production and we depend almost entirely on foreign supply which may be cut off or curtailed by hostile action. Of others we have substantial domestic production but quite inadequate to meet defense demands and to provide the contemplated civilian consumption, even though that it brought under rigid control.

No desire for revenues should be permitted to lead to taxation which will defeat or discourage production needed for the emergency, nor production which we should have to prevent uncontrollable inflation. Nor should we have taxes which by their impact will defeat the creation of incomes from which revenues otherwise would flow.

All of this has a very direct bearing on the excess profits tax problem before you.

The desire for an excess profits tax which gave rise to the instructions in the Revenue Act of 1950 on which you are acting was for a tax to be imposed upon excessive profits which are the result of the emergency situation. That thought is directly contrary to any imposition of the penalty tax on what are only the reasonable profits from the production of goods or services. The entire principle of a tax to be imposed on excessive profits is violated if the tax is imposed on profits which are not excessive. Such a tax is false to its purpose and intent and ceases to be an excess profits tax.

The greatest vice of an excess profits tax is that it may fix in any case a definite point of limitation beyond which any further profits, even though reasonable, will be subjected to a penalty tax. However, the point may be determined, whatever standards may be applied, the excess profits plan tends in one way or another to fix a profit limitation on business enterprise and with that a limitation on its activities.

We wish taxpayers to increase production, to do this with maximum efficiency and economy, keeping to the minimum consumption of materials and services. We should not then establish for any taxpayer some fixed point beyond which any further profits which come from increase in production or from economies and efficiency in use of labor and materials will be condemned as excessive and penalized. It is not necessary that we should so do.

It is from this standpoint that I present, first, the special mining problems.

THE SPECIAL MINING PROBLEMS

To prevent the effect which the excess profits tax, if unmitigated, might have on mineral production, our prior law included section 735, which is continued as section 451 of the pending bill.

The situation to be met is very simple. A mine consumes its capital in its mineral production. If it makes merely a reasonable profit per unit of production it should not be considered as making excessive profits. If in response to demands for mineral production it increases its output, the mere increase in income in a single year, if that income is still no more than a reasonable profit per unit, should not be considered as representing excessive profits. If the mine produces in 1 year what it would normally produce in 2 years, but still earns a reasonable profit per unit it should not be charged with making excessive profits, and should not be subjected to excess profits tax.

That was recognized by section 735 of the prior law with its provision for allowing a mine to exclude from its excess profits net income the income from excess output over that of the base period at the same profit rate per unit as it earned in the base period. That was its essential provision. If the profit per unit earned in the taxable year was greater than the unit profit of the base period that excess would remain to be subjected to the excess profits tax.

It also contained various special provisions which we need not here discuss.

There were also limiting provisions in conflict with its general plan, which should not have been included and which we urge should now be eliminated. These were the provisions in paragraphs (10) and (11) of the section which would make reduction in allowable unit profits on the basis of certain relationships between excess output and remaining ore reserve. The amendment which we propose, which is submitted as exhibit A herewith would remove this limitation.

When section 735 was adopted it was recognized that it would not meet the problem of mines which were not operating during the base period, or which had unsatisfactory base period experience. Provision was made for these to be covered by the special relief of section 722. That section has not worked out at all satisfactorily, as the present bill recognizes. It is thus necessary to make some other provision for those cases of mines not operating in the base period, or not making a reasonable base period profit per unit, as well as cases where improvements in operating methods or equipment make base period earnings not a fair standard for measuring reasonable profits on current production. The amendment we submit includes a provision whereby a constructive determination of nontaxable income for exempt output may be made. It will not be difficult to make a reasonable determination there called for. It is something which is in the ordinary experience and customary procedure of mining engineers. It involves some exercise of judgment and opinion but no more so than is required in the ordinary solution of many other tax problems, such as the determination of ordinary and necessary expenses, reasonable allowances for depreciation, property valuation for income tax or for estate and gift tax purposes, etc. We urge it as a fair and reasonable method for dealing with the situations specified in the amendment.

The amendment which we submit herewith also deals with certain other rather technical features which are explained in the accompanying memorandum, exhibit A-1.

If the amendment we propose is written into the bill it will give encouragement with respect to additional production whether the mine is one previously operating or whether it is a new mine—whether it is one which has or has not a satisfactory base period experience. At the same time it will still leave subject to the excess profits tax any profit in excess of reasonable profit per unit. The tax can then apply as a true excess profits tax, and can apply to taxing excessive profits but without being imposed on profits which are no more than reasonable.

Another mining condition which to some extent was recognized under the prior law and which is more fully and satisfactorily dealt with in the present bill is that with respect to strategic and critical minerals for which provision is made by section 448 of the bill as passed by the House. This deals with some very special situations for minerals essential for defense purposes. The provisions are carefully limited. We urge your approval of this section as it now appears in the bill.

We also urge the adoption of an amendment, which we submit herewith as exhibit B, with respect to payments to encourage exploration, development, and mining for defense purposes. The nature and scope of this amendment and the reasons for it are explained in the accompanying memorandum. We believe there is no question that Congress intended that the payments it has authorized to be made for the encouragement of exploration, development, and mining should not be treated as taxable income and that expenditures therefrom should not be considered as taxpayer's deductions nor as additions to the taxpayer's

basis for property. As explained in the memorandum, to treat them in this way would largely nullify their objective. Yet there are Bureau rulings under which they might be so treated. The status should be clarified by amendment in this bill to be included among the income-tax amendments in its title II. We are confident that the Defense Minerals Administration would be glad to confirm to you the need for and merit of this amendment.

AS TO THE GENERAL PROVISIONS OF THIS BILL

I wish I could speak more definitely about the general provisions of this bill and what they will mean in practical application. I have been studying this bill and the committee report thereon as carefully as I could in the few days since it was available. I am wholly unable to form any clear judgment of what some of its provisions mean and how they will work out in practice. I have found others experienced in taxation likewise doubtful and uncertain.

This is true of even such a basic provision as section 437 and its related sections regarding invested capital. The definition of "equity capital" in section 437 (c) is wholly different from anything we have had in any of our prior laws. I have found it almost impossible to reach any concept of what it will mean as applied to various situations with which I am familiar. Perhaps it will work out fairly; perhaps it will be very unfair; I do not know. Others seem equally at a loss.

Similarly I might cite other sections, including various relief provisions, on which I am not yet able to pass any fair judgment.

I cannot feel that you should rush through to enactment a bill so radically new without opportunity for adequate consideration. No question of trying to raise some additional revenue can compensate for the damage to the entire defense effort which may come from enactment of provisions whose practical application and effect are so uncertain. A little more time for consideration, to be able to understand them better and note their defects or unfairnesses, will certainly mean no such revenue loss as warrants the threatened dangers to our economy of unwise legislation.

No one charged with business planning and administration can proceed with any confidence as to future operations in a fog of uncertainty as to what this bill will mean. The mere uncertainty will hamper the very forward movement in production which you wish.

We may, however, make certain recommendations and raise certain points for your consideration. These we note as follows:

ALOWANCE OF CREDIT GRANTED BY PRIOR LAW

One thing which certainly should be done is this: You can at least give assurance to taxpayers that they will not be worse off under this bill than they were under the prior law. There should be included a provision that any taxpayer shall be entitled to have at least the same credit as was allowed under prior law, subject only to adjustment for any subsequent additions to or reductions from that credit. This is a simple provision to make. It will be fair, it will give everyone assurance of at least that minimum credit. In very many cases it will avoid the tremendous amount of work which is going to be required to work out the entirely new computations specified under this bill. This should be done and we urge that it be done.

BASE-PERIOD CREDIT

The base-period credit should be allowed 100 percent.

THE GROWTH ALLOWANCE

The $20,000,000 limitation on the "growth" allowance under section 435 (e) (1) (B) should be eliminated. The limitation based on payroll or on gross receipts does not seem reasonable.

ADJUSTMENTS UNDER SECTION 433 (B) (9)

These authorized adjustments seem largely canceled by the provisions of section 433 (b) (10) (C). Also the limitation to 5 percent of excess profits net income by subparagraph (b) seems quite inappropriate and unreasonable.

There are unquestionably other points which should be raised. If we are able, on further study, to develop these while the bill is still pending before you, we respectfully request permission to submit further memoranda regarding them.

EXHIBIT A

PROPOSED AMENDMENTS TO SECTION 451, H. R. 9827, AS PASSED BY THE HOUSE

(1) Add at the end of paragraph (6) of subsection (a) (definition of "mineral property") the following:

"Where two or more tracts or parcels of land were operated by the taxpayer as an operating unit, the taxpayer shall be permitted to include its interest in such tracts or parcels of land as a single 'property' for the purpose of this section."

(2) Omit paragraphs (10) and (11) of subsection (a) with respect to estimated recoverable units and percentages determined with respect thereto; and amend paragraph (1) of subsection (b) to read as follows:

"(1) GENERAL RULE.—For any taxable year the nontaxable income from exempt excess output of a mineral property shall be (A) an amount equal to the excess output for such year multiplied by the normal unit profit (but such amount shall not exceed the net income computed with the allowance for depletion attributable to the excess output for such year) or (B) the amount determined in accordance with subsection (c) hereof, whichever in any case is greater."

(3) Add to section 451 a new subsection (c) as follows:

"(c) CONSTRUCTIVE DETERMINATION OF NONTAXABLE INCOME FROM EXEMPT OUTPUT.—

"(1) The taxpayer shall be allowed a reasonable profit exempt from excess profits tax computed as provided in paragraph (2) under any of the following conditions:

"(A) As to new mines or as to other mines which for any reason were inactive during the base period or produced a wholly or partly different product.

"(B) As to mines for which the profit per unit during the base period is less than a reasonable normal profit per unit, because production was lower, costs per unit were higher, or the sales value attributable to the grade of the product was lower, than the reasonable normal expectancy for the property.

"(C) As to mines for which the profit per unit during the base period is less than a reasonable normal profit per unit for the production in the current taxable year because—

"a. There has been an increase in the average grade of ore or minerals mined in the taxable year.

"b. New or improved facilities or methods of mining, handling, or treating ores or minerals or other circumstances or conditions of operation existed in the taxable year, which, if effective during the base period, would have given a lower base-period cost or yielded a higher-priced product.

"(2) If, in any such case, the average profit per mineral unit for the base period is less than a reasonable profit per mineral unit on the production of the taxable year, the taxpayer shall be entitled to make a constructive determination of the reasonable profit per unit of output according to the peculiar conditions in each case; such determination to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In no case shall the constructive reasonable profit per mineral unit thus determined be less than a reasonable unit profit based on the standard of prices and production costs existing during the base period, but shall be sufficient to allow to the taxpayer a reasonable profit on the production of the taxable year, whether or not the production of the taxable year was more than the production which was or would have been produced under the conditions existing during the base period or whether the reasonable profit per mineral unit is more than was realized or would have been realizable in the base period. The nontaxable income from exempt excess output of such mineral property shall be an amount determined by multiplying the total number of mineral units recovered in the taxable year by the constructive reasonable profit per mineral unit as determined under this subsection, less an amount, if any, equal to the average annual mineral units which were recovered in the base period multiplied by the average profit per mineral unit for the base period."

(Present subsections (c) and (d) should then be made subsections (d) and (e).)

(4) Amend paragraph (12) of subsection (a) and paragraphs (2) and (4) of subsection (b) as follows:

(A) Change "coal or iron ore" to "minerals" and change "coal mining property" or "iron mining property" to "mineral property" wherever these expressions occur in these paragraphs.

(B) Add at the end of paragraph (4) the following: "or an amount determined under paragraph (1), whichever the taxpayer elects in accordance with regulations prescribed by the Secretary."

(C) Change the heading of paragraph (2) to read "ALTERNATIVE RULE FOR MINES IN OPERATION DURING BASE PERIOD".

(D) Change the heading of paragraph (4) to read "ALTERNATIVE RULE FOR MINES AND TIMBER PROPERTIES NOT IN OPERATION DURING BASE PERIOD."

EXHIBIT A–1

MEMORANDUM REGARDING PROPOSED AMENDMENTS TO SECTION 451, H. R. 9827, EXEMPT EXCESS OUTPUT

The purpose of the proposed amendments to section 451 is to provide that the reasonable profit per unit of mineral production shall not be taxed as excessive profits.

Section 735 of our prior excess profits tax law was intended to accomplish this general objective for cases where base period income represented the normal profit per unit (although certain limitations were imposed). It also made certain limited provisions for further relief for coal and iron mines. Otherwise it contemplated relief through section 722 for cases where the base period did not give the fair and reasonable standard.

The purpose of the proposed amendments is—

First: To make section 451 more fully effective so that exempt excess output determined on base period experience should be exempt from excess profits tax where base period experience gives an adequate standard for the exemption.

Amendment (1) would add further wording to the definition of "mineral property";

Amendment (2) would omit paragraphs (10) and (11) of subsection (a)—thus eliminating estimated recoverable units and percentages with respect thereto as limitations on the allowances to be made—and would correspondingly reword the "General Rule." It would also make the appropriate reference to the constructive determinations referred to below.

Second: To bring directly into section 451 provisions for constructive determination in the cases there specified so that the reasonable normal profit per unit on production of the taxable year should not be subject to the excess profits tax.

Amendment (3) provides for such determination to be made by the taxpayer according to the peculiar conditions in each case and under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary (following in this regard the wording of the law with respect to computation of the reasonable allowance for depletion under section 23 (m)). The amendment further specifies that the allowance shall not be less than a reasonable allowance based on the standard of prices and production costs existing during the base period but shall be sufficient to allow a reasonable profit on the production of the taxable year.

It makes clear the intent that any reduction of income for the taxaple year should not duplicate any allowance made in the excess profits credit for profits earned on such production during the base period. The intended scope of this provision can be illustrated by a case where, for example, 50,000 units might have been produced during the base period by a mine—under development or under adverse conditions—at a profit of only 1c a unit, or $500; whereas in the taxable year the reasonable profit determined on a production of 110,000 units would be 2 cents a pound, or $2,200. The $500 includible in base-period credit should be applied to reduce the $2,200 of reasonable profit attributable to the taxable year so that the credit for nontaxable income from exempt output to be allowed pursuant to section 451 would be $1,700.

(The amendments here presented provide only for constructive determination for mines. This is not intended in any way as an objection to similar constructive determinations for other natural resources if that is deemed desirable.)

Third: To extend to other minerals the alternative provisions allowed to coal and iron ore, and to increase the percentage thus allowable with respect to properties not in operation during the base period from one-sixth to one-third of the net income for the taxable year.

Section 451 includes certain provisions (as they were included in sec. 735 of the prior law) which make special allowances with respect to coal and iron mines as alternative to the allowances under the general rule of paragraph (1) of subsection (b) if the taxpayer so elects. These alternative provisions are very simple. Such mines if in operation during the base period are by paragraph (2) granted an allowance for excess output computed at one-half of the unit net income for the taxable year; or, if not in operation during the base period, are by paragraph (4) granted an allowance for excess output equal to one-sixth of the net income for the taxable year. Paragraph (12) of subsection (a) contains the appropriate definition of unit net income for such computations.

There is no question that the alternative rules do greatly simplify computation. They make no more than fair allowances. It is desirable that these alternative rules should be extended to other minerals as well as to coal and iron ore and the proposed amendments so provide.

The allowance of one-sixth of the taxable year's net income is very low and should be increased to one-third and the amendment so provides.

EXHIBIT B

PROPOSED AMENDMENT TO ADD SECTION 206 UNDER TITLE II OF H. R. 9827 AS PASSED BY THE HOUSE

Add at the end of Title II—Miscellaneous Amendments and Provisions, a new section as follows:

"SEC. 206. PAYMENTS TO ENCOURAGE EXPLORATION, DEVELOPMENT, AND MINING FOR DEFENSE PURPOSES.

"Amounts paid to a taxpayer by the Government (or any agency or instrumentality thereof) for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the Government (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency shall not be included in gross income and any expenditures thereof shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale or for computing depletion or depreciation."

EXHIBIT B–1

MEMORANDUM REGARDING PROPOSED AMENDMENT TO ADD SECTION 206 TO H. R. 9827, PAYMENTS TO ENCOURAGE EXPLORATION, ETC.

The Defense Production Act of 1950 authorized provision to be made "for the encouragement of exploration, development, and mining of critical and strategic minerals and metals." Under this authority the Government may provide funds for approved specific projects of exploration and development which afford promise of increased mineral production. It is contemplated that this will be done.

Funds thus provided will presumably be subject to requirements such as those which existed with respect to exploration payments under the premium price plan, as provided for by Public Law 548, Seventy-ninth Congress, approved July 25, 1946. Such funds could be used only for expenditures in accord with approved plans for exploration and development and any amounts not so expended were required to be returned to the Government. Full reports on expenditures, the results of exploration and development, etc., were required to be made, as a report on and accounting for these funds.

The entire principle warranting the Government in providing these moneys was that it was in the public interest and that the public benefit would be promoted by such exploration and development. The moneys received were simply trust funds in the hands of the receiving corporations or individuals, to be expended as the Government directed. They were not funds which should be

considered as income of the taxpayer; and per contra the expenditures made therefrom should not be considered as deductions from taxable income, nor should they increase the basis to the taxpayer for any property for or with respect to which the expenditures were made. This is believed to be the correct rule which Congress intended should be applied to any funds received and expended under present authorization.

Yet the Treasury held, as to payments under the 1946 authorization, that the amounts received were to be taken up as taxable income by the recipient and expenditures therefrom would be deductible only when a loss was sustained on abandonment of the project, or when expenditures capitalized were to be charged off in accordance with ordinary rules. Under this ruling, if the money was received and was expended and loss determined—or if it was received and returned to the Government unexpended—within the same year, the taxpayer would be free of liability for income tax payments. But if the money was received in one year and was returned unexpended to the Government in a succeeding year—or if it was received in one year and loss was not determined until a subsequent year—the tax payment would have to be made, even though there might be possible later offset or recoupment. None of the funds thus received could be used for payment of taxes but must be expended solely in accordance with the approved project. Consequently, a taxpayer receiving any such moneys must be prepared under this ruling to pay out of his other funds the amount of income tax thereon. In the event the taxpayer was not able to establish under Bureau rules a loss on abandonment at the conclusion of the work, he might find himself out of pocket by the full amount of the tax.

The Treasury's position seems of doubtful validity. Yet the fact of such interpretations having been stated by the Treasury will make taxpayers hesitant to receive such payments and incur the obligations under them, and the highly important work of exploring for and developing new mineral sources will be seriously hampered.

It should be manifest that when Congress authorizes such payments, which can only be used for particular purposes in the public interest, it does not intend that they should be subject to tax payments which the recipient must be prepared to pay out of other funds. If such receipts are to be taxable, the corporation that receives, say $50,000 of such funds, would need to have $22,500 of other moneys available with which to pay the income tax thereon at a 45-percent rate—or $39,500 if subjected also to the excess profits tax.

To avoid any question, there should be included in the pending bill, among its income tax amendments, an amendment such as that here proposed which would make definite statement that the funds do not constitute gross income when received, and that expenditures therefrom are not allowable deductions nor do they increase the taxpayer's basis for property. Such an amendment, we believe, is essential to enable the Defense Minerals Administration to achieve success in the endeavor to encourage exploration, development, and mining of critical and strategic minerals and metals as directed under the Defense Production Act.

The CHAIRMAN. Mr. Arthur Packard. You may identify yourself for the record, please, sir.

STATEMENT OF ARTHUR J. PACKARD, PRESIDENT, PACKARD HOTELS CO., MOUNT VERNON, OHIO, ON BEHALF OF THE AMERICAN HOTEL ASSOCIATION, ACCOMPANIED BY LOUIS TOTH

Mr. PACKARD. I am Arthur J. Packard, president of the Packard Hotels Co., Mount Vernon, Ohio, owning and operating a chain of small hotels in that State. I am also vice president of the American Hotel Association, and a member of the governmental affairs committee of that organization.

I am grateful for this opportunity to appear before you today as a representative of the hotel industry.

The hotel industry fully understands that the world crisis which faces us today requires that the Congress enact additional revenue measures. It has been our feeling that an excess profits tax presented

numerous weaknesses, and might contribute to the existing inflationary spiral. However, your committee will be best able to determine the type of revenue legislation needed at this point. The hotels, as the Nation's seventh largest industry, want to pay their full share of whatever sums the Congress needs to levy in the form of taxes in order to finance the Nation's defense requirements.

We do feel that it is proper to invite your attention at this time, however, to two basic inequities in the present revenue code, which prove particularly burdensome to our industry. Whether you are increasing the corporate levies, or enacting a new excess profits tax law, we do hope that you may examine these two inequities with a view to correcting them if the time is propitious.

The first of these deals with the problem of consumer goods which this industry uses up in substantial quantity. During a period of short supply in civilian goods, hotels are not able to make their normal replacements of china, glass, silver, and linen, and similar products. These are items which must be replaced annually, or sometimes even more frequently. The Bureau of Internal Revenue normally treats these replacements as regular business deductions. However, when these items are not available, a hotel is obliged to use up its existing inventory, and even permit its services to deteriorate. The result is that the expense which is actually incurred by using up these assets cannot be recorded in the books until the emergency is over, and replacements can actually be made. Thus, the profit of hotels during the emergency is overstated, and hotels are obliged to pay taxes on nonexistent profits.

This situation could be remedied by a simple amendment to section 23 of the code that would permit a taxpayer, in years of such emergency, to make adequate deductions for replacements of short-lived equipment even though such equipment is not available, provided that the taxpayer has been deducting such replacements in prior years, and provided that any sums so deducted, but not expended during the year, would be set aside to be used for such replacements subsequently, in accordance with regulations to be prescribed by the Commissioner of Internal Revenue.

A second deficiency, or inequity, in the existing code which peculiarly affects hotels springs from the Virginia Hotel Co. decision by the Supreme Court (319 U. S. 523). Under this decision, hotels generally have been deprived of a substantial amount of surplus capital credit. Under this 5-to-4 decision of the Court, whenever it is determined that depreciation has been taken at an excessive rate, and the life of an asset extended, the adjusted basis of the asset is reduced by the excess depreciation taken, even though this depreciation was taken in years when the taxpayer had losses and received no tax benefit from the excessive deduction.

As a result, thousands of hotel owners have been deprived of a substantial amount of their depreciable asset basis for which they have received no tax benefit. This problem is particularly important at this time, when we are facing an excess profits tax, because the decision of the Supreme Court reduces not only the current depreciation charge, but also the value of the invested capital on which the excess profits credit is based. The Hobbs bill, reintroduced on several occasions since 1946, proposed to correct this inequitable situation in the

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code. I hope earnestly that at the earliest possible date this present weakness in the existing code can be remedied.

I am accompanied here by representatives of the two nationally known accounting firms who represent the hotel industry. They have studiously analyzed H. R. 9827. In the main they find that an excellent job of drafting has been done, and we do believe it is a bill to which business generally can subscribe. However, we would like to question the section which deals with abnormalities of the base period. For instance, the first year and one-half of the 4-year base period found hotels still under rent control. Some hotels are still under Federal, State, or local rent control. You can scarcely regard it as a free market when rigid rent ceilings are imposed upon an industry, at least for purposes of determining an appropriate base period.

Senator KERR. Are they under rent control here in the District?

Mr. PACKARD. I think that you have in the District a certain branch of hotels under rent control. I am informed in certain residential hotels.

Senator KERR. Are you talking about residential hotels?

Mr. PACKARD. In New York City, yes; residential, semitransient. All transient rooms have been taken out, but a big section of our industry is residential and semitransient hotels.

Senator MYERS. Is there a price limit on that? Is that residential under a certain monthly rental?

Mr. PACKARD. That is right, depending on the percentage of rooms they may have for transient occupancy.

Senator MYERS. Do you have any idea how many rooms might be under rent control and how many are out of control?

Mr. PACKARD. May I refer that to Mr. Toth?

Mr. Toth, do you have any figures on that?

Mr. TOTH. In 1947, in New York City the Federal control was replaced by city control. We had about 48,000 units that went under city control, and about half of those were released because they were vacated. We still have 20,000 or more units under control.

Senator MYERS. How many?

Mr. TOTH. 20,000.

Senator MYERS. In New York City?

Mr. TOTH. Yes.

Mr. PACKARD. May I ask, is that rooms or units?

Mr. TOTH. Units.

Mr. PACKARD. Secondly, the hotel industry expended the greatest sum in its history for past due repairs and maintenance during the years from 1946 to 1949. You will recall that we were unable to buy materials and supplies with which to maintain our properties until late in 1945. Therefore, the ratio of dollar income during the years 1946 to 1949 that was expended for repairs and maintenance, especially in residential hotels, far exceeds that of the preceding 18 years.

We believe, gentlemen, that these two situations comprise abnormalities in the base period, and we urge that the bill as finally enacted permit the Treasury to so construe that section.

As to the provisions of H. R. 9827, we have some minor objections, but we do not want to take your time with them now. However, we want to call your attention to one provision in H. R. 9827 which we think is iminently unfair to many corporations engaged in the hotel business. These are the provisions of section 437 which prescribe the

excess profits tax credit based on invested capital. In the old excess profits tax law a corporation was entitled to a credit of 8 percent of the capital originally invested in the corporation, including all cash and property paid in for capital stock. We thought that this provision was fair for taxpayers such as hotel corporations, where the investment is a long-term investment, and is made with the expectation that during the life of the corporation there will be many good years and many bad years. Briefly, the old excess profits tax law did not penalize a corporation because it happened to have losses during the period preceding the effective date of the excess profits tax. This bill would penalize the taxpayer for previous losses.

Section 437 allows an excess profits tax credit of 12 percent on the present value of the equity capital, or present net worth, which may be adjusted only by losses that the corporation may have suffered since 1940. Many hundreds of our finest hotels were built in the late twenties, and they suffered very serious losses in the thirties. The economic depression, so far as hotels were concerned, lasted much longer than the economic depression in other industries. Eighty-one percent of all hotel mortgages were in default in 1933. Many of the equities have been reduced substantially, but of course the investors in the capital stock of these companies have hoped that some day they may make up for their losses.

Just as hotels began coming out of the depression the war came, and Congress imposed rent controls. Transient hotels which had a low occupancy at the beginning of the war, could prosper even under rent control because much of their capacity was available for the business that came to them in 1940. But the residential hotels, which were already 80 percent or 90 percent full, never had a chance to turn the losses into real profits, even up to this present day. We had Federal rent control until the middle of 1947 and many residential hotels, such as those in New York City, were put immediately under local control when the Federal control lapsed, and are still under control. Corporations that own these hotels still have on their books a large part of the losses that accumulated in the thirties, and they are still hoping that they will some day reach a normal period when they can receive a fair return on their original investment. Section 437 of this bill proposes to allow them an excess profits tax credit only on what is now left of their original investment, adjusted only by any losses they may have suffered since 1940, but omitting any consideration of the much greater losses they suffered in the decade before 1940.

Let me take a theoretical example. If the stockholders of a hotel company invested originally $1,000,000, and during the depression of the thirties had a loss of $800,000, under the old excess profits tax law they would still be entitled to an excess profits tax credit of $80,000. Under this bill they would be entitled to an excess profits tax credit of 12 percent of $200,000, or only $24,000.

Senator KERR. I think the bill exempts the first $25,000.

Mr. PACKARD. I beg your pardon?

Senator KERR. Does not the bill exempt the first $25,000 of any corporation?

Mr. PACKARD. That is correct.

The CHAIRMAN. It allows a credit up to that.

Senator KERR. Up to $25,000.

Mr. PACKARD. Yes, up to that.

The CHAIRMAN. But if the credit exceeds that by $2.50, they do not get it.

Senator KERR. I see, but I noted in the example, it was $24,000, and I thought it might be some measure of comfort to you that the first $25,000 was exempt.

Mr. PACKARD. Perhaps in this particular instance it would be, but not as a yardstick by which to measure our industry.

In other words, this bill tells these investors that any profit they may now make over 2.4 percent of their original investment is excess profits, on which they should pay a 75 percent tax.

We did not have an opportunity to do much research to illustrate the real importance of this point, but I have a record of a few actual cases. I know of a residential hotel in Detroit which, as a result of its past losses, has liabilities of $140,000 in excess of its assets. A residential hotel in Cleveland has total assets of $600,000 and total liabilities of $630,000. Another residential hotel, in New York City, has total assets of $2,350,000 and total liabilities of $2,800,000. None of these hotels would get any excess profits tax credit based on the substantial original investment in the corporation, and they would have to rely on whatever profit they happen to produce in the post-war years, which in many cases was not even sufficient to pay the maximum rate, usually 4 percent, on their income bonds. One of the prominent hotels in New York City, of 500 rooms, with a mortgage of more than $1,700,000, has an equity capital left today of less than $40,000. A survey of all of the residential hotels in the country would bring forth many similar examples.

In order to remedy this situation, I ask you, in the name of the hotel industry, to amend section 437 of H. R. 9827 either by providing an alternate credit based on original invested capital, as in the last excess profits tax law, or, which would technically be simpler, by permitting an adjustment for losses not only for the period from 1940 to 1949, but for the period of 1930 to 1949, in the first half of which most of the losses of hotels were incurred.

Thank you, gentlemen, for this opportunity to appear before you.

The CHAIRMAN. Are there any questions?

Thank you very much for your appearance.

Mr. PACKARD. Thank you, gentlemen.

(Mr. Packard later submitted the following supplemental statement:)

SUPPLEMENTAL STATEMENT SUBMITTED FOR AMERICAN HOTEL ASSOCIATION BY MR. ARTHUR J. PACKARD, VICE PRESIDENT

Section 437 of H. R. 9827 introduces a completely new philosophy in the computation of equity capital, namely, present net worth as opposed to the old philosophy in the former statute which began with money or property paid in for capital stock. The report of the Committee on Ways and Means on page 10 of its report states its reason for inaugurating this change in philosophy as follows:

"Your committee's bill shifts from the historical capital approach to the asset approach because it is believed that it will be much easier for the taxpayer to determine the basis of his present assets than to determine the amount originally paid in for stock and surplus. A special advantage of the particular asset basis used is that the basis for gain is readily available for depreciable assets."

In other words, the reason given for this shift is that it will be much easier for the taxpayer to determine the basis of its present assets than to determine the amount originally paid in for stock and surplus. The quoted statement in this respect is contrary to fact. Corporations have recently completed the determination of money or property originally paid in for capital stock under the World War II excess profits tax. This figure for practically all corporations is already known. The computation under the new method is the one which is unknown and yet remains to be determined.

Actually the real purpose in inaugurating this shift in philosophy is given further on in the report of the Ways and Means Committee on page 10, wherein it states:

"The provision in the bill is believed preferable because it removes, as to recent deficits, discrimination between corporations with previously accumulated earnings and those without such earnings, because it tends to favor new corporations somewhat more than the old law, and because current stockholders of corporations with a net-deficit position established some time ago are likely to have discounted this deficit position in buying their stock."

In other words, the proposed bill on the point in question totally disregards any stockholder who made his investment between the years 1930 to 1940 or prior thereto. There are undoubtedly many investors who are still holding their investments in the equity of a corporation for more than 10 or 20 years. Furthermore, this philosophy violates the fundamental philosophy of corporate taxation wherein the corporation is treated as a separate entity from its stockholders.

For the foregoing reasons, it is our opinion that the fundamental philosophy prompting this shift from the historic capital approach to the asset approach should be either abandoned or rectified by permitting a third alternative period in the computation of the recent loss adjustment provided for in section 437 (f), so as to include a period beginning in 1930 and ending in 1949.

The CHAIRMAN. Mr. Carroll Wilson.

Are you prepared to go on and finish within the next 10 or 15 minutes?

Mr. WILSON. If you prefer, Mr. Chairman.

The CHAIRMAN. Yes. We will be glad to hear you. You may have a seat and identify yourself for the record.

STATEMENT OF CARROLL L. WILSON, REPRESENTING THE AMERICAN PAPER AND PULP ASSOCIATION

Mr. WILSON. Mr. Chairman and Senators, I am Carroll L. Wilson, of Hamilton, Ohio. I am director of finance of the Champion Paper & Fibre Co. and an officer of that corporation. Today I represent the American Paper and Pulp Association.

In our consideration of our position on the excess profits tax, Mr. Chairman, we have given little, if any, attention to its possible effect on us in the immediate future. We believe that if the emergency should rise to its potential height here that the burdens which would be imposed on all of us would be so great that even the tax burden, the total tax burden, might be a minor factor in the sacrifices that we and other Americans may be required to make.

In such an event, the worse excess profits tax might be merely a pinprick.

We have been concerned, Mr. Chairman, primarily with the potential long-run effect of such a tax on our economy, on the markets we serve, and on our defense program.

For the most part, our reasons in opposition to such tax parallel those which have been already stated before you by many other witnesses. We feel, however, that possibly the witnesses up to this point have not exposed the core of the problem.

We would like to discuss with you briefly that matter after filing, with your permission, our formal statement for the record.

The CHAIRMAN. You may do so. File it with the reporter.

Mr. WILSON. Mr. Chairman, an excess profits tax such as that proposed in the bill of the House Ways and Means Committee may provide only pinpricks in a dire national emergency for the immediate future, but we believe that in the principle of that tax you have the possibility of injecting a slow poison into our national economy.

I am not an expert in the mechanics of taxation at all, but, like many other citizens, I have recently given much sober and anxious thought and some sleepless nights to the future of this country.

One principal factor in that anxiety is a growing conviction that the injection of the excess profits tax principle into our tax system could, in the long run, work irreparable harm to our future security.

On Tuesday Mr. Ruml reminded you of the effect of the cheap expense dollar established by an excess profits tax in reducing management's cost incentive. Later Mr. Du Mont and other witnesses spoke of the difficulties to which new businesses might be subjected by such a tax.

I will not attempt to repeat what these gentlemen have said, but I wonder whether they have up to this point fully developed what those two factors might do to us.

We are facing a gigantic barbarian enemy which is implacably determined to go on expanding its force against us. That enemy has at this time the advantage of vastly greater numbers of men; it has the advantage of being willing to keep practically its entire population in slavery in order to expand its fire power. Already we know that Russia is devoting a substantially greater part of its total national effort to the expansion of its economy than we are in this country.

Therefore, it seems to me quite clear that we must in the future expand our economy, not only faster than we have, but we must be smarter in it. We will have to work harder now and sacrifice to meet the present emergency. We will have to work harder and smarter in the future to get ahead of Russia and to stay ahead of her.

Now, sir, there are two principal weapons that we have to use. I believe those weapons are not available to anywhere near the same degree to our enemy. They happen to be the two tools with which this economy was built. The first is an incessant and unrelenting grinding down of the man-hour costs of production in this economy day after day and year after year. That has been going on all over this country in every business and in every form from many years back, and all that we have today in our high standard of living has been primarily dependent on that way of life that we have injected into our business concerns, and into all our enterprises, including our farms.

That is our first weapon—the incentive to cut costs all the time. So in a factory, everybody from the foreman up to the president has in mind that he is not satisfied with the way he is doing things today, but he is trying to get those costs down.

My company was built completely from the beginning on the basis of our founder's belief that the way to grow and develop and grow strong is to buy the best tools and get your costs down.

You have to live that way. This country has been living that way.

So that, as I say, is our first weapon. It is not a secret weapon, but I do not think the Russians can use it.

Our second weapon has been to create a climate in which a man with an idea could meet a man with money and willingness to take a chance and go ahead against the sober judgment of most of the experts and create something new for us. That is also where our standard of living came from.

Those two tools which we have used can be our prime weapons in the future.

Now, I do not believe that there is any possibility of substituting, shall we say, Government financing of our future expansion for the free use of private funds which has made the use of these tools possible.

I will not labor that point, but we all know that the restriction which it is necessary to place upon Government funds for the safety of the public money would be such that in the long run management would not be free to do those things which would be necessary to cut costs, and the man starting out with a new idea against the judgment of the experts would not be able to get it cleared.

Therefore, we must preserve, I think, intact the maximum freedom which we have to use those weapons. We must improve on the use of those weapons.

Some people will say to you, perhaps, that the reduction in cost incentives and the hindrance to new enterprise will stop our growth. I am sure you would be skeptical of that. I do not believe it myself. But we must not be misled by the mere fact that a bad excess profits tax bill now would be only a pinprick into assuming that its long-run effect would be of a similar magnitude.

Suppose, for example, that in the future the action of that tax and the restrictions which would necessarily be placed on new enterprise by a zealous Treasury Department were to deter or to discourage or to stop only a few creators of new products. Among those you might find a Simon Lake, you might find a Billy Mitchell of industry, or an Adna Chaffee. You may well prevent the development of the future decisive weapon if you restrict in any way the freedom of people to develop what is new and to put it to the use of the country, which use may well be the defeat of our enemy.

It is easy to get confused by statistics. It seems so easy to write mild provisions into an excess profits tax bill and bring it down to a point where it appears to affect only a few now, but let me examine that with you for a moment.

Let's suppose, for example, that the reduction in management-cost incentive amounts to only something on the order of a half of 1 percent, we will say, in management's determination to cut costs. The whole growth of our economy up to this time has been founded on and inseparably connected with a very small expansion, a very small increase in productivity year after year, something like 2½ percent. The experts talk about that sort of magnitude.

Now, 2½ percent does not sound like much, but it has given us all we have.

Let's just suppose, for example—perhaps you will grant me that the imposition of this extremely complex new experiment in the control and regulation of industry, because that is what an excess profits tax

long continued would have to become—let's suppose that the imposition of that mass experiment on us where only to reduce that growth from 2½ percent a year to 2 percent a year. It still does not sound like much, but, Senator, over a 25-year period the difference that would develop out of that would mean a reduction in our annual productive power, or if you wish, our fire power at the end of that time, if my calculations are reasonably correct, of something on the order of one-quarter of our present total gross national annual product, or about 70 to 75 billion dollars a year annual fire power at that time.

I would request that you seriously consider whether we can afford to take a risk of even a fraction of that order of magnitude.

Is there anything to be gained in meeting the immediate emergency which would justify accepting that kind of a risk? If there is, that's another question. Personally I cannot conceive of any gain we could get now through the adoption of this type of principle in our system which would justify that risk.

Senator KERR. I do not want to interfere with the witness. He can say anything he wants to. I am wondering if he is aware of the fact that we are sitting under a mandate of Congress not to determine whether we bring in an excess profits tax bill or not, but to try to formulate the best possible one we can bring in under the mandate of the Congress to bring one in.

Mr. WILSON. Senator, I am entirely aware of that mandate, but I am not aware that the public or the Congress have been fully aware of what this thing can mean in the long run.

I just wanted to close by saying that the members of my association, like other Americans, have a very deep faith in the wisdom and the courage of the Senate. We know that you will place national security ahead of all other considerations even to the exclusion of other considerations in your efforts in this emergency, and we have confidence that you will do the best you can in developing a financing program which will encourage the future growth of our country, and will strengthen to the maximum extent, that you can, our future capacity to stand off our enemy and to destroy him if necessary.

The CHAIRMAN. We thank you, Mr. Wilson.

(The statement submitted by Mr. Wilson reads in full as follows:)

MEMORANDUM DEFINING POSITION OF AMERICAN PAPER AND PULP ASSOCIATION IN RESPECT OF PROPOSED EXCESS PROFITS TAX LEGISLATION

The American Paper and Pulp Association, representing the paper and pulp industry of the United States, hereby records its opposition to the enactment of a corporate excess profits tax for the reason that there are more efficient and equitable methods of raising revenue, which should be applied.

An excess profits tax is not only inefficient and inequitable but also dangerous, for the following reasons:

1. It would give a sharp upward impulse to current inflationary trends because it reduces incentives and promotes extravagance in manpower and materials.
2. Accordingly, the enactment of an excess profits tax would inevitably tend to cause the imposition of rigid wage and price controls.
3. It could not possibly be applied equitably.
4. The record has proven the administrative difficulty of such a tax. (On June 30, 1949, there were still 22,281 unsettled cases involving $4,858,000,000 of contested excess profits taxes arising under the excess profits tax which was repealed in 1945.)
5. The additional revenue which could be obtained from corporations by an excess profits tax could more readily and equitably be obtained from them by another method.

6. It would discriminate against small business and new business.
7. It would impose excessive compliance and administrative cost burdens on both the taxpayer and the Government.
8. It would cripple the growth of a dynamic economy to which the Nation is committed and which is particularly vital to our defense program in present and prospective world conditions.

There is no need to elaborate upon these defects. We quote from a speech of Senator George on August 31, 1950, in the Senate:

"An excess profits tax is not an effective way of doing this job because it is impossible to devise a tax that will isolate a particular part of total profits as being due to the military effort rather than to other factors. Considered as a general source of revenue, the essence of the excess profits tax is that it imposes an extremely high rate of tax on a part of profits rather than collecting the same amount of money through a less extreme rate applied to all profits. The extremely high rates of tax encourage wasteful expenditures by corporations because most of the cost is at the expense of the Treasury. Moreover it is impossible to devise an excess profits tax that does substantial justice as between new firms and old ones, growing firms and declining ones, firms with large capital and firms with small capital. The defects of the tax would be especially serious if it were used to finance a long-continued program of rearmament such as we must now face. * * *"

Certainly, expediency should not be permitted at this time to induce the Congress to enact excess profits tax legislation, particularly as that expediency is masquerading under the wholly fallacious guise that an excess profits tax is calculated to "take the profits out of war." No excess profits tax which has heretofore been enacted has ever done that, and no excess profits tax which could possibly be enacted now, could do it. All that any such tax has done, or ever could do, is to limit the amount of total profits (not just war profits) which corporations may retain from their activities. Such a limitation of profit would hobble the dynamic future growth of our economy.

We have not ignored the directive in the Revenue Act of 1950 that the Ways and Means Committee report a corporate excess profits tax bill, but nothing in that directive constrains this committee to put the stamp of its approval upon such a billl.

We recommend that the Senate Finance Committee report unfavorably a corporate excess profits tax bill. This recommendation is not made to escape taxation, for the paper and pulp industry is prepared to pay its fair share of such taxes as may be necessary to provide funds for the defense program.

We suggest an entirely fresh approach to the question of financing the Federal budget, which approach we firmly believe is necessary if there is to be any real curb upon inflation. Namely, a tax program which will finance our Federal expenditures on an equitable pay-as-you-go basis.

Fortunately we still have the time to overhaul the entire tax structure for this purpose and to produce a well-rounded program which would equitably distribute the taxation burden which all must face and effectively curb further substantial inflation. For the fiscal year 1951 the cash receipts of the Government, according to conservative estimates, will exceed its expenditures, great as they are. The impact of the enormous additional expenditures which the Government has inaugurated will, in large part, have to be paid for in the fiscal year 1952 and succeeding years. By reason of the additional taxes imposed in 1950, the Government is not facing a cash deficit in the fiscal year 1951. But if estimates of the budget for the fiscal year 1952 (which range as high as $77,000,000,000) are realistic, the gap between income and expenditures, even with the addition of a most stringent corporate excess profits tax, would be many billions of dollars.

There is no escape, then, from the question whether our country shall finance from here on its expenditures on a pay-as-you-go basis, or whether it shall continue to indulge in deficit spending as it has in 8 of the last 10 years, with a resulting depreciation of the dollar by over 50 percent. Deficit spending should be reserved as the last resort of our Government to protect its own existence and the freedom of its citizens. It should never be indulged in to lure its citizens into the vain hope that they can have their cake and eat it too. Since a large part of the contemplated expenditures by our Government must be devoted to the production of adequate armament for ourselves and other nations outside the Communist sphere, and for the training and maintenance of men taken from civilian life to use that armament, a pay-as-you-go plan of meeting governmental expenditures involves real self-denial. That self-denial should

apply to our Government and to individuals alike. Self-denial is never pleasant to contemplate, particularly if there is the probability that it may be required for a substantial period of time. But unless accepted and practiced, and unless deficit spending is checked, continued inflation will inexorably lead to the ruin of our free competitive system.

What do we mean by suggesting that Congress should inaugurate a well-rounded program of taxation? First of all, if taxation is to be geared to expenditures, the first step should be, throughout a period such as we are facing, to re-examine all proposed expenditures and to eliminate those not immediately essential. Next the program should encompass all available methods of raising revenue so as equitably to distribute the tax burden and restrict, as little as possible, the continued progress of our free competitive economy. It must be obvious that to bridge the gap between governmental income and proposed governmental expenditures over a substantial number of years, the burden cannot be placed solely upon individual incomes, and corporate incomes.

This burden must be equitably distributed and designed to foster the dynamic character of our system of free competitive enterprise.

The paper and pulp industry is emphatic in stating that its corporate members should and must shoulder an equitable share of any additional burden just as those individuals working in the industry will have to do. We submit, however, that supplementary methods of taxation will have to be devised such as, for example, the imposition of an additional emergency defense tax on the entire taxable net income of all corporations after a reasonable initial exemption. This would equitably distribute the burden on all corporations. No doubt your committee has already considered such an additional form of tax and has recognized that a percentage increase would not have to be great to bring in more income than can be obtained through any excess profits tax. Also, consideration may be warranted of an extension of excise taxes on a substantially uniform basis, including sales by manufacturers and service establishments. But it would be presumptuous for us even to suggest to this committee what taxes should be included in such a program. All we urge is that there be such a program and that it be adequate.

The time has come when there must be in Congress and throughout the country, realization of three things. First, continued inflation can only be disastrous, and disastrous not only to those rapidly increasing millions of people who are dependent for their existence upon a fixed income such as social security pensions, interest, dividends on investments, endowment policies, etc., but for the great mass of people who are currently earning their day-to-day living by their active efforts. Second, if we are to carry on a defense program of the magnitude now envisioned, and are expected to continue that program for any period of years, there must be recognition of common sacrifice by every segment of our economy to produce the revenue to pay for that program. Third, the burden must be so arranged and distributed as to encourage the dynamic increases in production that are essential not only to the maintenance of our defense effort but also to the normal growth of our economy.

It is the high duty of Congress by its action to bring this threefold message home to all the people of the country and the best, if not the only way to do so, is to develop a program of taxation which will convince all that the burden is being equitably distributed and with the least harm to continued expansion of our production of goods and services.

Respectfully submitted.

E. W. TINKER, *Executive Secretary.*

December 8, 1950.

The CHAIRMAN. The committee will now recess until 2 o'clock.

(Whereupon, at 12:35 p. m., a recess was taken until 2 p. m., this same day.)

AFTERNOON SESSION

(The committee reconvened at 2 p. m. upon the expiration of the recess.)

The CHAIRMAN. Mr. W. R. Emery, tax attorney for Armour & Co., submits the following statement on the excess profits tax and its effect upon units in the same industry.

(The statement referred to is as follows:)

STATEMENT OF W. R. EMERY, TAX ATTORNEY FOR ARMOUR & CO.

This statement is submitted on behalf of Armour & Co., Chicago, Ill.

While we are reluctant to see our Federal tax burden increased at a time when we are just beginning to make some small progress in providing for our huge current and funded indebtedness and the dividend arrearages on our preferred stock, we realize that in this hour of grave international tension corporations must assume their share of the necessarily increased tax load. Our only concern, therefore, is that we do not bear more than our fair share—that we are not discriminated against, particularly in relation to our competitors.

In its present form H. R. 9827 would produce the very discrimination we most fear in the meat-packing industry, and unfortunately our company would be one of those discriminated against. The 1946–49 earnings before Federal income taxes of Armour & Co. and some of its principal competitors are set forth below:

Income in thousands of dollars

[Losses indicated by parentheses]

	Armour & Co.	Competitor A	Competitor B	Competitor C	Competitor D	Competitor E
1946	52, 576	21, 875	16, 020	3, 904	3, 476	3, 200
1947	48, 422	53, 592	11, 875	4, 241	4, 530	2, 495
1948	(3, 387)	51, 256	442	4, 099	2, 036	6, 867
1949	(984)	45, 197	(7, 280)	(117)	3, 052	3, 168
3-year average [1]	33, 666	50, 015	9, 446	4, 061	3, 686	4, 309
2-year average	50, 499	52, 424	13, 948	4, 170	4, 003	5, 034

[1] Losses treated as zero.

NOTE.—The incomes set forth in the above table in each instance are for the fiscal years ended Oct. 31 However, since the fiscal years so nearly coincide with the calendar years it is believed that the variation in the calendar-year figures from the above would be slight.

The unfair competitive situation which would result from the application of a 3-year average formula as prescribed in section 435 of H. R. 9827 is quite apparent. We would have 24 months of profits and 24 months of zero (losses are so treated in sec. 435) in our base period with the result that our 3-year tax base would consist of 24 months of profits and 12 months of zero. Competitor A, on the other hand, would have 36 months of good earnings comparable to or even greater than our earnings for the 24 profitable months of our base period. Competitors C, D, and E, though much smaller in size, would also have 36 months of good earnings. The situation of competitor B, on the other hand, would be comparable to ours.

The question naturally presents itself as to why the earnings fluctuated so widely during the base period in the meat-packing industry. The answer is found principally in the CIO strike in 1948. The A. F. of L. and independent union members remained at their posts throughout such strike, with the result that only those companies whose plants were chiefly staffed by CIO union employees were injured—the other companies actually benefited from the strike. A number of years ago the CIO organized the employees in all our large plants and many of our small ones. Consequently, during the strike we were able to operate effectively only a few of our smaller plants, with the result that we were unable to supply our customers with meats or to purchase our ordinary requirements of livestock. When the strike was finally settled many of our former customers had transferred their patronage to our competitors. Furthermore, we had to pay exorbitant prices to obtain a sufficient number of livestock to keep our plants in operation. As a matter of fact we have not yet completely recovered from the effects of the strike—winning back lost customers and livestock supplies is a costly and lengthy process.

The next question which might be asked is: Would not Armour & Co. qualify for relief under section 442 relating to abnormalties during the base period? Theoretically, yes, but practically, no. Only a casual reading of section 442 discloses many of the same ambiguities and pitfalls which enabled the Commissioner to deny relief under section 722 of the old excess profits tax law. There is no reason to assume that the Commissioner will be more liberal in interpreting section 442 than he was in the case of section 722. Then there

is the almost insurmountable burden of proving the aftereffects of a strike in a company as large as ours. Remember too that the 12-month period during which the strike occurred automatically would be eliminated by section 442. No, I fear that if Armour & Co. must rely on section 442 for relief, it will be greatly disappointed.

We submit that the only method for determining the earnings credit on a fair and impartial basis in the meat-packing industry is to permit the taxpayer to select any 2 years, or possibly any two consecutive years, in the base period. The use of such a selective 2-year period would provide each packer with a fair earnings credit and would result in an equitable distribution of the tax burden.

If it be contended that the use of a 2 rather than a 3-year base would result in too great a loss of revenue, our answer would be that an excess profits tax should not provide a primary source of large revenue—otherwise it tends to constitute social, not tax, legislation. If this answer be deemed insufficient and it is decided that the forthcoming excess profits tax bill must yield revenue equal to that of the House bill, then we would suggest the use of the 2-year base but (1) allow a lower percentage of average earnings in computing the earnings credit or (2) increase the tax rate. The important objective in framing an excess profits tax law is to fix a uniformly fair tax base. Unless this is done, the tax burden is improperly and discriminatorily distributed.

I wish to call the committee's attention to one other inequity in H. R. 9827. Undoubtedly all of you have read about Armour's new miracle drug acthar (ACTH) used in the treatment of arthritis and many other diseases. Prior to January 1, 1950, we supplied this new drug free to hospitals and clinics, but since that date we have imposed a reasonable charge therefor. We hope and believe that the marketing of this and other new drugs now in the development stage in our research laboratory will be profitable. Nevertheless, H. R. 9827 contains no relief provision for this type of situation. Section 443 is inapplicable because the earnings of our entire pharmaceutical divison do not constiute anything even approaching 33⅓ percent of our entire net income. Moreover, the base period rate of return in our industry classification, namely, meat packing, is a grossly inadequate measure of reasonable profits in the pharmaceutical field. A formula based on normal profit per unit of sale would provide a much more defensible index for measuring excessive profits derived from the sale of new pharmaceutical preparations.

I know that the committee will be interested in precisely how H. R. 9827 affects the various members of the meat-packing industry, and I trust that it will give favorable consideration to our recommendations for a tax base which does not harshly discriminate within this industry.

The CHAIRMAN. The first witness is Mr. Goldfinger. Will you identify yourself for the record?

STATEMENT OF NATHANIEL GOLDFINGER ON BEHALF OF CONGRESS OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, D. C.

Mr. GOLDFINGER. Yes, sir. My name is Nathaniel Goldfinger. I am secretary of the committee on economic policy of the Congress of Industrial Organizations.

I appreciate the opportunity of presenting the views of the Congress of Industrial Organizations in these hearings on the matter of an excess profits tax. We understand the importance of examining the entire tax structure, but we realize that the special consideration of this committee, under the terms and intent of the Revenue Act of 1950, is with the excess profits tax.

Since Congress passed that act, the international situation has changed considerably. It is now apparent that the total revenue needs of the Federal Government will be much greater than what seemed to be the case last summer. The general consensus of opinion seems to be clearly in support of an excess profits tax. This was reflected by the House vote of 378 to 20.

Yesterday an outstanding publication had the following to say on the excess profits tax:

The Nation's economic prospects have changed drastically since the excess profits tax debate was opened last summer. Then we seemed to face a prolonged period of "light gray" mobilization. We know now that "light gray" mobilization will not do. Our current budget has shot up to more than $70,000,000,000. Industrial mobilization must be vastly accelerated. The tax burden will have to be heavier than anyone imagined. High profits will more and more clearly be associated with arms expansion. With this prospect the case for excess profits tax is strengthened by fiscal and equitable necessity.

That statement comes not from a labor source or from one ordinarily identified with the views of the administration, but from an editorial in the New York Herald Tribune.

A prominent leader in public life, addressing himself to the problem of an excess profits tax, said more than a month ago:

A supertax for the national defense would be better than a further increase in the straight income tax on corporations.

Companies that have abnormally large income in relation to capital or past earnings are better able to bear more taxes than companies that are jogging along without benefit of defense spending and that perhaps are even hurt by curtailment of civilian spending.

These are not the words of the president of the Congress of Industrial Organizations. These remarks were made by Mr. R. C. Leffingwell, at present vice chairman of J. P. Morgan & Co., Inc., and Assistant Secretary of the Treasury in the First World War.

The commitment of Congress before its summer adjournment, the recent action of the House, and the tragic turn of events in Korea leave us, in our judgment, with only one issue: not whether or not an excess profits tax should be enacted, but rather what kind of an excess profits tax should be made into law.

For those who wish, however, to consider further whether or not the application of an excess profits tax is a wise course of action at this time, I refer them to the detailed testimony on the subject presented by Stanley H. Ruttenberg, director of the department of education and research of the Congress of Industrial Organizations, before the House Ways and Means Committee on November 17.

In that testimony, Mr. Ruttenberg outlined and analyzed in great detail four major reasons why our organization considers an excess profits tax appropriate for these times. In our judgment, he thoroughly establishes that:

1. It can produce adequate revenue.
2. It can be a fair and equitable tax designed to capture those profits which are excessive.
3. It can be an effective weapon against inflation.
4. An excess profits tax is basic to an over-all national stabilization program.

In our judgment, the major question today is whether the House bill is adequate from the standpoint of helping to raise the revenue needed by the United States Government in the critical days ahead.

We have held that Secretary Snyder's proposal to raise an additional $4,000,000,000 revenue through an excess profits tax was insufficient. The House bill falls far short even of the administration request. The administration proposals fell far short of what our organization believes an excess profits tax should yield.

The new invasion of Korea by the Chinese Communists and the attendant increases in Government defense needs have bolstered our view that Secretary Snyder's request was not adequate.

In the face of the increased billions of dollars required for the defense of our national security, does it seem reasonable to raise only $4,000,000,000, as proposed by the administration, and leave corporations with a record of about $21,000,000,000 in 1950? We do not think so.

Yet even the inadequate revenue requested by Secretary Snyder is to be cut still further by the terms of the House bill. It is estimated that hardly more than $3,000,000,000 would be raised on the basis of the House bill at the 1950 rate of corporate earnings.

At the time that the House was cutting the anticipated revenue from an excess profits tax below the administration's request, the President of the United States announced that large-scale new military expenditures would be necessary.

The Government will be spending some $50,000,000,000 for national defense and the total Federal budget will be about $70,000,000,000. Revenue must be raised to offset these increased expenditures.

During periods of high levels of production and income it should be the national policy to raise as much revenue as possible. This should be especially true of a period when a large part of the levels of production and income is due to Government expenditures for national defense.

We recommend to this committee that it enact an excess profits tax that will raise at least $6,000,000,000 to $7,000,000,000 over and above the normal and surtax corporate rates. We agree with the House bill that the excess profits tax should be retroactive to July 1, 1950.

But the House bill should be substantially strengthened in other aspects. More revenue must be raised. This can be done, in our judgment, without subjecting American business enterprises to undue hardships or the loss of incentives.

During the third quarter of 1950, corporate profits before taxes were at the annual rate of $42,000,000,000. If we conservatively assume a $42,000,000,000 profit level before taxes in 1951, net income after the 45-percent-tax rate, established under the Revenue Act of 1950, would be an all-time high of $23,000,000,000.

The administration's request to take some $4,000,000,000 through an excess profits tax would leave corporations with about $19,000,000,000. The CIO proposal to take $6,000,000,000 to $7,000,000,000 would leave corporations with a net of $16,000,000,000 to $17,000,000,000, 60 to 70 percent above the average corporate income after taxes, which was earned during the wartime years 1942–45.

It is our proposal that the base period for an excess profits tax be the average for the 4 years 1946–49, during which time profits before taxes were $29,000,000,000. We further suggest that, as an exemption, corporations be permitted to take 75 percent of the 1946–49 base period.

We recommend the retention of the provision in the excess profits tax of the last war which permitted corporations to calculate their taxes either on an income method or on an invested capital method.

We believe that the House bill's normal base of 85 percent of the best 3-year earnings in the 1946–49 period leads to a substantial loss of

much-needed revenue. We urge the committee to give careful consideration to this aspect of the House proposals in view of the importance of enacting an effective excess profits tax.

Corporate profits since the end of World War II have been abnormally high. They soared from $13,900,000,000 after taxes in 1946 to $20,900,000,000 in 1948, declined in 1949 to $17,000,000,000, and have risen to new heights in 1950.

These corporate profits reflected, in large measure, governmental, personal, and corporate expenditures growing out of World War II factors. The Government's defense and foreign-aid expenditures have been an ever-present factor in bolstering corporate profits in the years since VJ-day.

The CIO believes, therefore, that 75 percent of the corporate earnings for the 4-year period 1946–49 provides a reasonable base for an excess profits tax. We also suggest an 85 percent excess profits tax rate, the same rate as in World War II.

These proposals, in our opinion, would go a long way toward substantially increasing the potential revenue from an excess profits tax.

We endorse the objective of the House to improve its legislation over the excess profits tax law of World War II with respect to providing relief for small and new businesses. We recommend, however, that the members of this committee carefully scrutinize all exemptions and special-treatment provisions of the House bill to see that this specific purpose is accomplished without the possibility of unjustified and illegitimate losses of revenue to the Federal Government.

In conclusion, let me emphasize that if an effective excess profits tax is not enacted, the Government's mobilization program, in our judgment, will be weakened, both morally and financially. The enactment now of an adequate and equitable excess profits tax will be a signal to all of the American people, and to those beyond our borders as well, that the United States is moving to meet, with foresight and with strength, the economic necessities which Communist aggression has forced upon us.

The CHAIRMAN. Any questions, Senator Millikin?

Senator MILLIKIN. No questions.

The CHAIRMAN. You of course realize—your organization must realize—that if you took all of the corporate profits you wouldn't really be able to finance this present defense program as it is now projected; do you not?

Mr. GOLDFINGER. Most certainly, sir. We realize that, and we realize the importance of considering the entire tax structure, but in my understanding that wasn't the purpose of this presentation here.

The CHAIRMAN. That is true, but I got the impression from some portions of your statement in the beginning that an adequate excess profits tax might be sufficient to finance this emergency economic program for defense or war, whatever it is.

Mr. GOLDFINGER. I am sorry to have lent such a misunderstanding. We believe merely that an effective excess profits tax would go part of the way toward meeting that condition.

The CHAIRMAN. It would be only one of the sources of revenue that would have to be tapped, of course.

Mr. GOLDFINGER. Yes, sir.

The CHAIRMAN. I think you are quite right about it. Thank you very much for your appearance.

Mr. GOLDFINGER. Thank you, sir.

The CHAIRMAN. Mr. J. T. Sanders?

Mr. Sanders, you may have a seat and identify yourself for the record.

STATEMENT OF J. T. SANDERS, LEGISLATIVE COUNSEL, THE NATIONAL GRANGE

Mr. SANDERS. My name is J. T. Sanders. I am legislative counsel for the National Grange, and I appear in behalf of the National Grange.

The National Grange favors the imposition of an excess profits tax at this time as an emergency measure only. Normally we do not believe that such a tax is necessary as a part of a virile functioning free enterprise economy for America.

If at any time excess profits are realized under a free enterprise economy this is prima facie evidence that competition is not functioning normally: Either monopolistic power is being exercised or demand is abnormal in relation to supply. The latter we believe is the reason for present high profits.

H. R. 9827 proposes 1946–49 as a base, and profits for all industries during the best 3 years of this period were 5.3 times those of the base period from which excess profits were calculated for World War II, 1936–39. Yet these earlier years were not considered low-profit years.

During the third quarter of the current year profits are estimated to be at around an average rate of $42,000,000,000 or over eight times the average profits for the years 1935–39, and these years were at least fair profit years.

By any safe and reasonable definition of profits, therefore, we believe they are now in general excessive and we are in abnormal-profit years as well as years that are abnormal otherwise.

The National Grange believes that the right to do business at a profit is an inseparable and integral part of our liberty and our free enterprise system. We also believe that an excess profits tax can be, indeed would be, in normal times, a grave danger to the American way of life.

Our resolution passed at Minneapolis less than a month ago, therefore, favored the imposition of an excess profits tax only when the three following conditions are carefully guarded in the provisions of the bill: (1) A reasonable return on invested capital and the fairest possible historic base is selected: (2) if volume and efficiency of industry is not penalized in the provisions of the tax measure; (3) if maximum sound expansion of small and large business alike is encouraged to meet the serious emergency confronting us.

We realize that these are extremely difficult conditions of fulfillment, and that they cannot be met in an absolutely conclusive way, but only to a relative extent. They are warning signals calling for the most considered statesmanship possible in the limited time available to the Congress.

Let us examine briefly H. R. 9827 in the light of these three conditions:

First, as to the base selected. In general few would question the base selected from the standpoint of industry. As pointed out, profits

during this base period were at an all-time high, and this holds true even when general price levels are discounted.

Profits in the proposed base period 1946–49 were more than five times what they were in the base period used in the excess profits tax for World War II, and with price level adjustments are around two and one-half times the base period of World War II.

We do not imply by this that every individual company's profits fall in this category. No tax law ever was written that did not do serious inequity to individuals or concerns. We therefore find no objection to the base selected in H. R. 9827, except that we do not believe it allows the collection of the amount necessary for sound fiscal policies under the present crisis. This we believe, however, can be corrected as necessity arises in the next session.

The important consideration now is the early enactment of the best possible measure within the time limit set by Congress.

As to condition No. 2, the impairment of efficiency and volume of output of industry: Aside from the great spiritual and moral values of our ideology and system of government over communism, the superior productivity of free enterprise over communism is beyond question. This superiority must not be impaired by an excess profits tax.

The Grange does not come before you as an expert in these extremely complex problems, but we do believe that safeguarding the bill in this respect calls for the most expert assistance the Congress can muster.

We must be careful not to write provisions in the bill that will impair the incentive to superior productivity that adheres in free enterprise, but must if possible devise provisions that will increase these incentives.

Finally, we trust that the bill as presented by the House can be examined in great detail with the view of writing into it ways and means of not only encouraging maximum efficiency in output, especially defense output, but that it will contain provisions encouraging expanded capacities and volumes of defense industries.

We venture to express our conviction that this could best be done by incorporating provisions that would make it possible for a company to expand in volume its base from which excess profits are calculated, rather than undertake to measure an expanded base in terms of value. We believe that this might be done by using total number of employees and amounts of materials acquired for fabrication as a basis for measuring expanded bases.

We feel that a concern that creates additional profits by cutting down expenses, increasing efficiency, and expanding production is in a different category from one that creates excess profits for itself by charging excess prices.

It is extremely important to the defense effort and to preserving a sound domestic economy that new taxes interfere as little as possible with the incentives to expand production and maximize efficiency. For this reason, we urge consideration of a provision that would broaden the normal profit base of a corporation if it expands production, and possibly a further allowance if it can show increased output per man.

It is often argued that, if we put additional taxes on corporations, they cannot finance needed plant expansion or improvement. We do

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not feel that anyone has a right to expect that he should be able to expand his plant from being in a position to charge the public a higher price and thus enjoy excess profits by soaking up excess purchasing power created through the Government defense program or the prospects of an expanded program.

We believe that the needed plant expansion should come from normal profits, borrowings, and the sale of stocks or some arrangement for Government-expanded defense plants.

We feel that a profit rate of 75 percent of the erratic profit peaks is sufficiently high for a normal profit rate. It is better in our opinion to have a smaller profit base than a higher excess profits tax rate.

In other words, we feel that we should try to keep the excess profits tax rate at 75 percent and that to do so and still raise enough taxes from corporations might require a normal profit base of 75 percent of the three best years in the period 1946–49. We would favor this change from the House bill.

During World War II prices and wages were not adequately controlled and rose considerably, as did profits, despite the excess profits tax. If prices and wages are not to be controlled adequately and are allowed to rise materially, we cannot with fairness and sound economics keep profits at a level which we consider fair under present levels of prices and wages.

In brief, if the crisis continues, prices and wages must be controlled across the board with excess profits. This includes farm prices, and when the time for control comes, if indeed it is not here now, the National Grange favors ceilings of farm prices at not less than parity, with wages controlled simultaneously and food prices set at levels that will not require a subsidy to middlemen to enable them to make their justified normal profits.

While the National Grange favors an excess profits tax in wartime and in times of intense defense preparations, we also favor the elimination of the double tax on corporate income when conditions are such that the tax saving will be passed on to the general public, in the form of lower prices, and under a tax system that does not permit the stockholders to escape taxation on their share of untaxed or lightly taxed corporate earnings.

We hasten to point out, however, that we would like to see a tax measure at an early date providing for greater reliance on individual tax liability rather than hidden taxes derived through the suppliers of goods and services by taxing income in the hands of the individual at a highly graduated personal income tax rate, to increase the revenue of the Treasury and at the same time safeguard purchasing power where purchasing power is needed most.

This objective, in conjunction with a high-level excess profits tax and the elimination of legalized escape from just tax liability, will not only provide increased ability to approach a pay-as-we-go program, but is in accord with the policy of basing tax liability on ability to pay.

In conclusion, we would close with a paragraph passed by our recent annual session as follows:

> Under our capitalistic system business generally, and profits especially, must pay an equitable tax, and in our emergency period a high excess profits tax is completely justifiable. But we must preserve opportunity and incentive to expand and promote efficiency to the end that our very American structure will not be destroyed.

The CHAIRMAN. Any questions of Mr. Sanders?
(No response.)
The CHAIRMAN. Thank you very much, Mr. Sanders.
When this committee last had an important matter before us, your Mr. Goss was with us, your master, and I am very happy to observe that your sane attitude toward public questions is exemplified in your statement as he labored so very hard and over so many years to exemplify and promote.
Mr. SANDERS. Senator, those gracious words are very much appreciated.
The CHAIRMAN. Mr. R. G. Fizer. You may have a seat, if you wish, Mr. Fizer.

STATEMENT OF R. G. FIZER, EXECUTIVE VICE PRESIDENT, AMERICAN PIGMENT CORP., HIWASSEE, VA.

Mr. FIZER. I am here representing our own small company in Virginia, American Pigment Corp., and we feel we are representing small business and business in general. I would like to say that I am pinch-hitting for our president, Mr. E. D. Gregor, who could not be here, and further that I didn't know that fact until very recently so what I have to say here will be very brief. I do not feel too adequate to take his place.
The CHAIRMAN. This committee has already heard and has some previous knowledge, of course, of the general observations that one might offer about this tax. It would be very helpful, really, to present your particular case, with such observations as you wish to make about it.
Mr. FIZER. Thank you very much. We believe that everyone will agree that in this present crisis it behooves both all business and individuals of this country to cooperate in the use of our manpower and resources to try to bring about some settlement of our present international difficulties. It is therefore certainly improper to oppose any necessary revenue-producing legislation that is equitable and does not in itself tend to cripple and hurt our national effort rather than to help.
However, we think there is no question but that there are some bad features about an excess profits tax, as was demonstrated by that, in effect, during the late war. It certainly tends to be an inflationary and wasteful tax and if I understand the records correctly, one that did not produce a large amount of revenue when recently in effect.
It has been my understanding that a few percent added to the regular corporation income tax would produce a like amount of revenue, and it is difficult to write an excess profits tax and make sufficient provisions to eliminate extreme injustices as was attempted in setting up section 722 during the tax of the late war.
I understand that our courts are now filled with thousands of unsettled tax cases coming under the provisions of section 722. These tax cases themselves have and are costing the country a tremendous toll in time and effort and money. We think it is quite plain that businesses which know that they are going to be thrown into the excess profits tax bracket certainly have some tendency to pay out a part of such funds to their employees and to be loose in the general conduct of their businesses, all of which, as above stated, certainly

tends to be both inflationary and wasteful. It therefore seems that in writing an additional revenue-producing measure it is questionable whether part of it should be in the form of an excess profits tax or entirely in a raise of over-all income tax. If there is to be an excess profits tax, it is our feeling that the exemption for small businesses should be at least $50,000 instead of $25,000, and that small business should be allowed a definite exemption of 6, 7, or 8 percent on either their sales or capital investment. Unless this is done, there are certain to be many hardship cases among small businesses and in fact some, I believe, will find it practically impossible to continue to function.

In our particular case, we have had a sum total of no earnings for the years 1946, 1947, 1948, and 1949, and if these years were used as a base period upon which an excess profits tax would be based, we would certainly be penalized except for some definite exemption. We are sure that the reason for these 4 years' experience in our case has been due to the fact that we have been unable to raise prices in the same proportion as inflationary costs have increased our expenses of operation and that you will find many small businesses which have the same experience.

A business with its finances in fair condition and with depreciable facilities can also go along for a certain period living on its depreciation reserves and without profit, but this brings up the point which is uppermost in our minds—the one we would like here to emphasize more than any other, and which we believe is the most serious problem that many small businesses are now facing and will be facing in the near future.

A net profit is absolutely necessary to the existence of any business and much more so in the face of inflation than at any other time. One of the biggest problems of manufacturing is the maintenance and replacement of worn-out and obsolete equipment, and if under the inflation we have had during the past few years, a facility that cost $10,000 15 years ago has to be replaced either because it is worn out or has become obsolete, now costs $30,000 to $35,000, the business must at once either have available for replacement $20,000 to $25,000 in surplus from earnings or must borrow or refinance to obtain the necessary additional funds over and above the $10,000 which the Government has allowed to be set aside in the form of depreciable reserve.

As you know, we are allowed to depreciate facilities on the basis of what they cost at the time they were installed and not on the basis of what they will cost today under our inflationary conditions. From this I think it is very plain that during inflation it is suicidal not to make and retain a net profit, and the fact is that what is being shown is a net profit by either small or large business, is not necessarily a net profit at all under our present inflation, or any further inflation that we might have.

This, we believe, is the most serious implication with which we have to deal, one which hasn't yet had time enough to show its full effect and which is very necessary to be fully recognized in considering any tax legislation. The Government cannot tax beyond a certain limit without eventually throttling and stagnating business in general, and this fact, if not wisely considered, could mean that we would inadvertently in the future thwart our over-all national effort by too high taxes rather than to increase it.

There is one question I would like to pose in regard to making an excess profits tax retroactive to July 1, 1950, and that is the question of accounting. It would cause businesses, as I see it, to take off two entirely different statements for the year, and would cause a tremendous amount of additional work if you are going to consider the 2 years two separate fiscal periods.

Now, if there is some way to get around that, if the law is made retroactive, I think it would be a very fine thing. You have either got to consider those periods as separate periods, or have some definite provisions in the law as to how it is to be handled. Otherwise we are going to be thrown into a tremendous amount of accounting—unnecessary accounting, additional accounting—by making the law retroactive to the last half of 1950.

The CHAIRMAN. We thank you very much.

Mr. Stam, did the committee give any consideration to that problem of throwing whatever part of 1950 was included in the first excess profits tax one year, or one unit. Have you considered those accounting problems?

Mr. STAM. The committee didn't consider that.

Mr. FIZER. What I mean by that: It is going to make business take off two entirely different statements for the year. The fact is you are going to have two entirely different fiscal periods, which will be quite expensive in itself and a lot of additional accounting. I have often wondered how it is going to be handled if it is made retroactive to July 1.

The CHAIRMAN. We did make the corporate rate retroactive to July 1, stepped it up from 38 to 45 percent, maximum, and we did make that retroactive to July 1, 1950, but we did not actually do it in that way, because we prorated it so as to make it a separate rate for 1950—a separate rate for the whole year.

Thank you, sir.

Mr. Eustis?

STATEMENT OF F. A. EUSTIS, TREASURER, VIRGINIA SMELTING CO., BOSTON, MASS.

Mr. EUSTIS. I have asked Mr. Lotze, the comptroller of our corporation, to sit beside me, if you care to ask him any questions.

My name is Frederick A. Eustis, treasurer of the Virginia Smelting Co. I appear on behalf of that company and also I ask permission to appear as a native-born citizen of this country who has been giving careful attention to business matters for more than 40 years.

The CHAIRMAN. You do not have to have any permission to do that, Mr. Eustis, because a citizen always has a right to appear.

Mr. EUSTIS. The matter before you gentlemen, as you know—but I would like to recite it again—is of tremendous importance to this country at this time, because it may affect seriously our rate of production. We are confronted with a terrible menace from the Communists, and one of our greatest pieces of ammunition in opposing that will be the ability of the country to produce. I shall speak only for a small corporation, but I want to interject at the start my conviction that the really enormous number of such corporations can have a very great effect on the total production.

In my remarks, I shall use my company as an example, but hope that you will realize that I believe firmly that it is of importance, because I feel there are so many other corporations that are affected in the same way that we are.

My business associates and myself are not convinced that the excess profits tax is the best way to raise the amount of money needed, but I do not propose to give any time to the discussion of the relative merits of an excess profits tax or other forms of taxation. Rather, I am here to seek to show to you the damage that an excess profits tax can do to the small corporation and to try to outline ways in which I think that damage can be minimized.

My major appeal to you is that if we must have an excess profits tax, which I believe is probably the case, then I do urge you, as eloquently as I can, to guard the wording of that tax as carefully as possible so as to cause it to do as little harm as possible to the type of corporation for which I am speaking.

A small, growing corporation, which is what my corporation is, does not contemplate a horizontal rate of production or of profits. I shall show a little later in my remarks that to live my corporation has had to grow, and I believe firmly that there are a vast number of corporations which are confronted with that same problem. Therefore, any attempt to measure a proper income by using a base period can do a very great harm to such a growing corporation.

A growing corporation plans to increase its rate of output, either by adding one or more new products during each few years or by expanding the volume of one or more of its older products. It needs money to make such growth and it suffers a great hardship if the growing earnings are cut back to the amount it earned at the beginning of or even during the average of a base period.

Again expressing a little the relation of the small corporation to the total industry, the returns of the Internal Revenue Department of this country indicate that there were over 500,000 corporations which filed income-tax returns in 1946, which is the latest year for which I have been able to secure data. A study of the data that they presented indicates that well over 90 percent of those 500,000 corporations are what the ordinary person would think of as small corporations. I think of 2 having less than 500 employees or less than 20,000,000 sales or 10,000,000 sales.

Therefore, I submit to you, sir, that the fate of these small corporations is particularly important, and I also ask you to consider the effect that building up the little corporations or the modest-sized ones will have in the eyes of our Communist opponents as compared with the effort to greatly enlarge our few enormous corporations.

I hope and believe that you will agree with me that it is very much more to the advantage of our country to build up a substantial group of strong, growing corporations than it is to push all the construction into the hands of the few very large corporations. I would now like to turn to my corporation as a type and explain our problems, because as I have indicated I feel they are typical of the type of problem that a vast number of these small corporations face.

Virginia Smelting Corp. is a Maine corporation that was organized in 1909. At that time it took over a small metallurgical business which had been founded by my father in 1899. I have been personally as-

sociated with this business since incorporation in 1909, and to a considerable extent for the period from 1899 to 1909—that is, for over 50 years. We have had our troubles—plenty of them—but we have stuck to our work and we have grown.

We began as a metallurgical company. We shifted to chemistry for interesting reasons which I will not take your time to explain, although I think they might fascinate you if I did, but one thing I will point out: We did find that in the manufacture of chemicals we had a better chance as a small corporation to compete with our many large competitors than we did in the smelting business. When we started, we were very small. We were making and shipping only one product—namely, copper matts—and we had only one customer. Today we are many times larger.

Senator MILLIKIN. What was the source of your copper?

Mr. EUSTIS. From Virginia and from Quebec and from Cuba. Today we are many times larger, producing and shipping seven products and marketing, as middlemen, three more. I would like to give you a visual picture of the change from 1899 on. If I may, I would like to submit these pictures that show the plant as it was 50 years ago, and this shows the plant as it is now.

The CHAIRMAN. We are glad to have them.

Mr. EUSTIS. All our work during the last 30 years, when I have been more actively with it, has emphasized to us that to earn a profit in our competitive markets, where our competitors are mostly much larger than ourselves, we just have to push up the volume of each product handled. Our costs are affected greatly by the volume handled. This means we just have to grow to keep in the race, and that, gentlemen, is the point that I want most to ask you to consider. This small group of companies which are growing bigger and bigger, as a mere condition of life—for their continuance—must be able to expand. The only way we have been able to grow is to reinvest in our business a large part of our earnings.

It has constantly been necessary to add to our plant or to build new units of the plant. To do this we have borrowed money from an insurance company which gives us a longer period in which to repay the loans than can banks. Our present loan calls for repayment in semiannual installments over a period of 12 years. Our contract to make these semiannual repayments of capital was entered into before this excess profits tax law was considered.

It is an old contract. We obligated ourselves, in exchange for receiving this money, to give a portion of our earnings each year to repay this loan that this insurance company made us. We have outstanding two issues of preferred stock. Unless the holders of the preferred stock can receive modest dividends, the standing of our company will suffer seriously.

Our common-stock holders, who represent roughly half of our net worth, have never received any dividends. We have consistently plowed back most of our earnings to make our growth possible. In doing this, we have built up a group of loyal workers for our company, extending from our general manager, who is a Mr. Scribner, I think known to some of you, to the sales forces, to the operating personnel, down to all our employees who are all interested in our accomplishments. We share with them. Our success is entirely dependent on

those who work with us. We are now a happy group because we are growing and all share in the result. If we have to stop growing, every one of these men and women will feel it.

Senator BUTLER. How many employees do you have?

Mr. EUSTIS. Two hundred and seventy-five, about. To grow we have to pay the installments on our capital loans as they become due, which is semiannually, we have to pay our dividend on our preferred stock, and we have to reinvest part of our earnings in our business to grow satisfactorily, and with assurance we ought to have a little leeway between the absolute needs and what is taken away from us by these excess profits taxes.

Therefore, gentlemen, I urge that you frame the excess profits tax law so as to protect as much as possible these small growing companies. To accomplish this, I urge that the base period to be used in computing the normal income tax be placed as close as possible to the period under the contract.

Since I have sat with you here this morning, I have realized that you have got further in your study than I thought when I prepared this paper, and I want now to bring to you—and I can't do it today, but I can send it to you by letter if you will allow me to—a more concrete suggestion of how we think the things that we urgently need and we think others urgently need can best be provided. That is, I ask for permission to add to the paper which I am ready to file with you a copy of this, a letter which will follow in 2 or 3 days, making more specific suggestion as to how we think the relief that is needed could possibly best be given.

The CHAIRMAN. We will be glad to have it.

Senator KERR. Mr. Eustis, do you think that one way in which it could be approached would be the consideration of your borrowed capital with somewhat near the same status as your other invested capital?

Mr. EUSTIS. I don't believe I understand, sir. I am sorry.

Senator KERR. You are familiar with the present law that is before us, that with reference to your company would probably limit the amount of income that would be free from excess profits tax on borrowed capital to 1⅓ times the interest you pay on the borrowed capital, rather than its being considered as invested capital the same as that which came into you from stock.

Mr. EUSTIS. I have been seeking to understand this House bill which I only received 2 days before I came here and it is very complex. I am employing an attorney.

Senator KERR. You and I are the same place in our endeavor.

Mr. EUSTIS. I am sorry. My hearing isn't as good as it used to be.

Senator KERR. A man with the perception that you have can get along without too much hearing. I say I have been trying to do the same thing, but as I understand this bill, if you invest $200,000 of your own capital——

Mr. EUSTIS. We have invested a lot more than that.

Senator KERR. Maybe you are not as small as I thought you were. Then if you borrowed $200,000——

Mr. EUSTIS. We borrowed a lot more than that.

Senator KERR. I don't believe you need any sympathy. Let's just assume the figures I am using. If it does not make you feel too badly. Now, the amount of your own capital that you invest is regarded in

one manner under the House bill. The money that you borrow and invest in your business is regarded in an entirely different manner.

Mr. EUSTIS. I understand.

Senator KERR. I ask you if one of the objectives that you seek—that is, the opportunity to earn on borrowed capital enough to pay the interest and the retirement installments on it—if one way of doing that would be to let the borrowed capital have the same status with reference to your base as the invested capital?

Mr. EUSTIS. That would certainly help. I hadn't quite finished. If I may continue.

Senator MILLIKIN. Mr. Chairman, may I ask Mr. Stam a question?

The CHAIRMAN. Yes.

Senator MILLIKIN. I am somewhat mystified by the distinction between regular invested capital and borrowed capital which is used for the same purposes in the business. What is the theory on which that distinction proceeds?

Mr. STAM. The theory was that some companies have to pay a larger rate to secure capital than other companies, and if you allowed the entire amount of the borrowed capital to go into the invested-capital credit, all the people that suggest that approach would deny the deduction for the interest paid on such capital in computing the excess profits income.

To the smaller company, where they have to pay a very high rate of interest, it would be a little more advantageous to them to get their interest deduction, you see, in computing their income than to just get a flat rate of return on their invested capital. That is the reason some attempt was made to distinguish between the different types of borrowed capital depending upon the amount of interest that was paid.

It may be that the rate is too low the way it is worked out, but that was the idea back of it. The old law made no distinction between whether you paid 6 percent or 4 percent for that money. It allowed it to go into invested capital at one-half its value. Then it denied one-half of the interest deduction on that amount, because that is the amount that went into the invested capital. This approach was intended to try to remove somewhat the discrimination between the small borrower that had to pay a higher rate of return on his money and the large borrower who paid a much less return for the same amount of money. That was the principle back of it. It may not work out well, but that was the idea back of it.

Senator KERR. Let me ask a question right here, if I may, Mr. Chairman. In seeking to remove that which apparently was regarded as evil, is not that which was created here an even worse evil?

Mr. STAM. That may be true.

Senator KERR. I mean, from the standpoint of the group of companies, or the classification of business that Mr. Eustis is addressing himself to where they want to grow and the only way they can grow is through borrowed capital, if they are limited to a return on that not to exceed one-third of the interest rate, and then have that return subject to the normal tax, has not that practically eliminated any consideration of invested capital?

Mr. STAM. You see they get a little more than that, because they get their interest deduction.

Senator KERR. They are just a vehicle through which that flows to the one from whom the invested capital has been borrowed.

Mr. STAM. What I am saying is this: That under the old law, where you included 50 percent of your borrowed capital into your invested capital, you were denied one-half of the interest deduction, because one-half of that borrowed capital was included in invested capital, and the people that want to include 100 percent of the borrowed capital into invested capital all agree that if you do it that way, that you have got to deny the interest deduction that is paid on that capital, because you are getting it through the invested capital allowance, and the question is whether or not it works out more equitably doing it that way or doing it this other way, and it may get into a problem of just whether or not the return allowed under the bill is sufficiently high to provide equity.

You may want to consider it from the standpoint of increasing somewhat the amount of the allowance. I mean that is a matter for the committee to consider, but the principle back if it was to try to tie up the amount of the credit somewhat with the amount paid for the use of the money—the amount on the borrowed money.

The CHAIRMAN. All right, Mr. Eustis, you may proceed.

Mr. EUSTIS. We urge that the law be framed so that a small, growing company may be allowed a credit to be applied in arriving at its adjusted excess profits net income, this credit to be sufficient to allow the company, after it has paid its normal tax, to retain, free from excess profits tax, sufficient income to cover four points, which I now enumerate: One, to repay out of earnings the installments of capital loans that fall due during the accounting period, and please remember that in our case the contract to do that was entered into before an excess profits tax was even considered.

Two, to pay the necessary dividends on its preferred stock to maintain reasonably the standing of the company.

Three, to allow it to continue its planned growth and to pay for the construction that is necessary for its planned growth, that is absolutely necessary for its planned growth, that is actually made during the accounting period.

Senator MILLIKIN. May I ask whether in your company the common-stock holders are roughly the same people as the preferred-stock holders?

Mr. EUSTIS. No; they are not. They were at one time, but they are not now.

Senator MILLIKIN. What interest do you pay on your preferred stock?

Mr. EUSTIS. Five percent.

Fourth, to enjoy a little leeway so that the personnel may be relieved of unnecessary worry. This matter of worry may seem unimportant, but I want to assure you that men and women cannot do good work if they are seriously worried that they may have to either take less pay or seek a new job. It is this happy, loyal group of workers that have made it possible for us to grow in the face of the competition of our big competitors and I want to stress here that most of our competitors are big: du Pont, Cyanamid, Monsanto, Sherwin-Williams, and companies of that type. We urge you to leave us enough of our earnings so that we can continue to grow. That was the end of my printed remarks, but I would like to take a minute, if I may, to explain something that I am afraid is not going to be easy to gather.

A growing company in the chemical industry has to add new products from time to time, and in my experience of 40 years, every time we bring in a new product we have to suffer a period of very poor or no return on that investment until the equipment and the personnel have been trained to work smoothly. That is our growth and I believe firmly the growth of all similar companies has not been a steady line, it has been a line that wavered, but the average has been steadily upward.

It so happens if you take a 4- or 5-year period as a base and you hit one of those depressions caused by bringing in a new product, you do a very serious hardship to our company and I shall try to bring to you in my letter a concrete suggestion of how that hardship might be overcome.

Thank you, sir.

The CHAIRMAN. Thank you, sir. We will be glad to have your letter.

(Mr. Eustis later submitted the following supplemental statement:)

WASHINGTON, D. C., *December 8, 1950.*

To the Finance Committee of the United States Senate.

GENTLEMEN: Supplementing our statement presented at the hearings on excess profits tax legislation today and in particularization of our general presentation, we respectfully offer for your consideration the following proposals which we believe would more adequately protect and encourage small, steadily growing companies:

(1) The abnormal deduction provision should be liberalized to embrace losses attributable to entrance into new fields, including the introduction of new products. This is only fair even though no reconstruction for the earnings level of such new business is granted, either because of the substantiality test of section 443 or because of the limitation of any push-back provision that may be provided. It is compounding abnormality not only to deny reconstruction but to require other income to be offset by such losses. Such abnormal deduction provision should embrace inventory write-offs and should make it plain that the items need not be technical deductions, if they had the effect of reducing income.

(2) Not only must the growth provision in the House bill be liberalized, but continuing growth must be provided for. This should be done by providing for a moving base period, i. e., one which will always consist of the 4 years immediately preceding the taxable year. In order to confine the credit to normal profits, however, the adjustment over the preceding base period should be in proportion to sales rather than profits. Inflationary price increases which raise the profit margin would therefore not be available as a means of materially raising the credit; the same would be true of increased profitability through increased volume, since a rise in profit margin would not be reflected in the credit.

(3) At least 1950, or the portion of 1950 preceding July 1, should be included in the base period, with an adequate growth provision.

(4) For small, growing companies, the proposed borrowed capital provisions are inadequate. Instead of allowing a premium on the interest deduction, the bill should permit borrowed capital to be included in invested capital at 100 percent, thus entitling it to the full differential between the interest rate and the applicable invested capital rate. At the very least the invested capital credit should be increased to cover the amortization of the taxpayer's indebtedness, as was formerly done in the case of the undistributed profits tax.

(5) The first invested capital bracket should be revised to provide for a 15-percent rate on the first $2,500,000 of invested capital, in lieu of the 12-percent rate now proposed on the entire first $5,000,000.

Respectfully,

F. A. EUSTIS,
Treasurer, Virginia Smelting Co.

The CHAIRMAN. Mr. Eric Johnston, you are appearing here on behalf of the Motion Picture Association of America?

Mr. JOHNSTON. Yes, Senator.

The CHAIRMAN. All right, Mr. Johnston.

STATEMENT OF ERIC JOHNSTON, MOTION PICTURE ASSOCIATION OF AMERICA, WASHINGTON, D. C.

Mr. JOHNSTON. My name is Eric Johnston. As president of the Motion Picture Association of America with offices in Washington at 1600 I Street NW., I am here to represent the following nine member companies engaged in the production and distribution of motion pictures: Allied Artists Productions, Columbia Pictures Corp., Loew's, Inc., Paramount Pictures Corp., Republic Pictures Corp., R. K. O. Radio Pictures, Twentieth Century-Fox Film Corp., Universal Pictures Co., and Warner Bros. Pictures.

As I testified before the Ways and Means Committee, I shall try, Mr. Chairman, to conserve your time today by emphasizing only the high lights of matters that are of urgent and vital concern to our companies in your consideration and action on the pending legislation. Members of our association's tax committee have prepared a memorandum on the subject that I would now like to read to you.

Memorandum by MPAA tax committee:

Corporate reorganization: In the motion-picture industry, many companies have been or are being compelled to separate their exhibition business from production and distribution. Supplement A of the World War II excess profits tax law gave companies, which succeeded to substantially all the properties of a predecessor company, the right to use the base period earnings experience of the predecessor. In our situation obviously none of the companies resulting from the reorganizations has or will have acquired substantially all of the properties of its predecessor.

This condition was brought to the attention of the Ways and Means Committee. The report of that committee, in dealing with the recomputation of earnings credit in the case of corporate reorganizations, clearly indicates that the committee intended to provide that in all such reorganizations, including those in which the acquiring company received or will receive less than substantially all of the properties of its predecessor, the acquiring company would have the right to use the base period earnings experience of its predecessor or an equitable allocation or apportionment thereof. At page 30 of that report, the following appears in the third paragraph:

> In the case of an exchange of the general type described in part II which involves a splitting of the assets of one corporation into two corporations, the two corporations are entitled to the growth alternative if the exchange takes place after the base period and the corporation in business during the base period was entitled to it. If the exchange takes place during the base period, the payroll and gross receipts are allocated between the two corporations for the period prior to the exchange for purposes of determining eligibility under the growth alternative.

On the same page, the following appears in the fifth paragraph:

> In the case of the type of exchange described in part II in which the assets of one corporation are split among two corporations the base period earnings experience of the one corporation prior to the exchange is allocated among the corporotions in business after the exchange in proportion to the fair market

value of the assets of the old corporation which are held by each of the corporations after the exchange. However, in lieu of requiring that this determination be made, the earnings experience may be allocated in different proportions if all of the parties to the reorganization agree to the allocation and the Secretary consents to it. If so such agreement is reached or consented to, a final determination of the fair market value of the properties distributed shall be binding on all parties claiming a right to the credit of the old corporation.

The provisions of section 740 (a) (1) of the old law were reenacted in toto in section 461 (a) (1) of H. R. 9827, and subparagraph (E) was evidently added thereto in order to carry out the expressed intention of the committee. Unfortunately, the language of subparagraph (E) is not broad enough to include the types of reorganization which have been or will be effected by members of this industry.

Section 112 (b) (5), mentioned therein, does not refer to a type of exchange in which the assets of one corporation are split among two corporations and the stockholders of the transferor become the stockholders of the new corporations.

A reorganization of this nature is referred to in section 112 (b) (3) and (4) and 112 (d) and is defined in section 112 (g) (1) (D). None of these latter sections is mentioned in subparagraph (E), and it is, therefore, respectfully urged that that subparagraph be enlarged and clarified by the inclusion of the above subsections in order to give effect to the intended and desired result.

Blocked currencies: Motion-picture companies have been prohibited by a number of foreign countries from converting into dollars the foreign currency earned by their pictures. In accordance with the law, those companies have deferred the inclusion of such foreign currency in their gross income until it becomes available in dollars.

It would obviously be unfair to exclude this foreign blocked currency in computing the taxpayers' base period earnings credit and at the same time to include it in excess profits net income in any excess profits tax year when it may fortuitously become available in dollars.

The Ways and Means Committee and the House itself recognized the equity of our position. In the bill as it comes over to the Senate is a provision to deal specifically with this vital problem of blocked currencies. The prime purpose of the amendment was explained by Representative Cooper in offering the amendment to the House on behalf of the Ways and Means Committee. Representative Cooper said:

> Committee amendment No. 1: This amendment deals with the treatment for excess profits tax purposes of blocked foreign income. United States corporations engaged in foreign operations have been unable to return from many foreign countries a substantial part of the income earned in those countries because of monetary, exchange, or other restrictions imposed by the foreign countries. In many cases income so blocked is reported for tax purposes in the taxable year in which the income was actually earned. This amendment provides that the excess profits tax shall not apply to income which, but for monetary restrictions imposed by a foreign country, would have been reportable for tax purposes for a period prior to the excess profits tax years.

We made recommendations to the House Ways and Means Committee, and our suggestion was substantially embodied in the first sentence of section 433 (a) (1) (M), which carries out the primary purpose as so ably expressed by Representative Cooper. However, additional language was added which we feel might well negate the primary purpose of the amendment.

The second sentence, in effect, would give the Treasury the power by regulation to refuse to recognize that foreign currency was not convertible into dollars. We think that this question of convertibility, if it cannot be resolved by agreement between the taxpayer and the Treasury on audit of the return, should be left to the court, which is not one of the parties to the controversy. The courts have had this problem in the past and have dealt with it successfully.

In 1950 the Treasury, in considering the question of convertibility of foreign currency into dollars, issued its mimeograph 6475, which, in substance, says that the taxpayer must report blocked currency as income unless the Commissioner consents to its exclusion in advance of the filing of the return.

We sense the Treasury is apprehensive that the mimeograph is contrary to law in that it purports to give the Treasury the right to tax foreign receipts which are not the equivalent of dollar income, and is seeking to have Congress sanction its position by the inclusion of the second sentence of the House amendment. We ask that this sentence be left out so that an impartial tribunal, and not the Treasury, may determine whether foreign currency receipts should have been included in the taxpayer's gross income.

The last, or fourth, sentence of section 433 (a) (1) (M) is frankly bewildering to us. We do not understand what it means. The sentence is difficult to comprehend or justify because if the foreign currency was earned in an earlier year it is difficult to see how any deductions properly chargeable against it could possibly accrue for the first time in the later year when it became available in dollars.

Senator MILLIKIN. I would like to ask Mr. Stam what is the intended meaning?

Mr. STAM. It was thought that there might be some expenses connected with that and they wanted them to go back to the income for the prior year. The question of allocating the deductions to the income which would be thrown out of the taxable year to some back year.

Mr. HALLIDAY. In answer to that thought, any expenses that were incurred in the earning of income of a prior year would quite normally be charged in that year. As we understand the basic concept of the income tax law, all income and all expenses of any given year, whether it be calendar year or fiscal year, that occurred in that year, have always been claimed as allowable deductions, if such they be, in such a year. Here is a situation where foreign currency income received, received in a year prior to any excess profits tax year, may not be——

Senator KERR. Received or earned.

Mr. HALLIDAY. Earned in foreign currency but not received in the United States in dollars.

Mr. STAM. It does not become income, as I understand it, until it has been received.

Mr. HALLIDAY. It does not become income at least as we have followed the concept of the law by construing such foreign currency income as dollar income until such time as it has been made available to us in dollars.

Mr. STAM. That is right. At that time you may have incurred expenses and if you are going to assume that it should have been thrown back into the prior year when it was earned, then if there are some expenses that are allocable to that particular income, the general thought was that that ought to go back here.

Mr. HALLIDAY. May I inquire whether you are referring to foreign currency expenses or United States dollar expenses.

Mr. STAM. We were referring to any expenses that could be considered to be allocable to the income which goes back.

Mr. HALLIDAY. Surely there would be no such expenses in the year when the foreign currency income of a prior year was brought into account. The expenses of such a year would be the current expenses of that taxable year and not related directly or indirectly to the income earned in prior years.

Senator KERR. I would like to ask the witness a question. Is it your position that if there were any expenses in a previous year they were expenses which you actually paid in dollars and therefore took into account on your return for that year?

Mr. HALLIDAY. That is correct, sir.

Senator KERR. So that if any money now comes in at the year other than the year in which it was earned, there would be no expenses remaining from that previous year that could be charged against it; is that the thought?

Mr. HALLIDAY. That is correct, sir. I might also add that in remitting foreign currencies when and as it is possible to remit them, if there have been any foreign currency expenses they naturally have served to reduce the foreign currencies which then become available for conversion to dollars.

Senator KERR. In other words, if there are any expenses charged against them the dollars you receive for it are reduced by that amount and therefore not received?

Mr. HALLIDAY. That is correct.

The CHAIRMAN. There might be some expenses though in connection with the conversion, might there not, when you converted it into dollars?

Senator KERR. If there are, his position is that that just reduces the number of dollars he gets.

Mr. HALLIDAY. No. Any expenses that might be incurred in connection with conversion itself would be infinitesimal in connection with this problem.

Senator MILLIKIN. But there could be such expenses, could there not?

Mr. HALLIDAY. I cannot bring to mind at the moment, gentlemen, what such expenses might be unless there might be a possibility of converting foreign currency into dollar-income by negotiating with some private individual office, the market which might involve a commission or something of that sort, but it is negligible in any event.

Mr. JOHNSTON. This is important to us because approximately 38 percent of our dollar revenue comes from outside the United States.

Senator KERR. What part of it is impounded?

Mr. JOHNSTON. Approximately 50 percent.

Senator KERR. In other words, while 38 percent of your total revenue is from foreign sources, about half of it has been currently received.

Mr. JOHNSTON. Right.

Senator KERR. Has the other half continued to pile up as a backlog or is there some portion of it which is gradually being——

Mr. JOHNSTON. We are gradually working that out, Senator. My job is to work it out, so I am familiar with any expenses incurred and what Mr. Halliday has told you is correct, that there would probably

be no expenses and if there would be any they would be infinitesimal in working it out. These currencies are blocked in all these lands and it is necessary for us to work them out with all kinds of arrangements with the approval of the governments involved. We build ships with blocked currencies and sell them over here for dollars and we print Bibles in some countries with blocked currency and sell them over here for dollars. We make rayon, we buy wood pulp with frozen currency and make rayon and sell the rayon in dollar areas. Constantly these funds are flowing in in the form of dollars.

Senator KERR. In that process that just increases the number of dollars you get and therefore would be taxable as such when received.

Mr. JOHNSTON. Right, Senator.

Senator MILLIKIN. Is it not also true that if there are no expenses the language presents you with no problem. If there are expenses, it gives you the opportunity to take them back to a time when the money is taken back.

Senator KERR. I understood the witness to say that they had been unable to determine just exactly what the language did do.

Senator MILLIKIN. I will bet you that with this explanation they will find some expenses.

Senator KERR. I will bet you that they find that this explanation is not binding upon the Treasury, too.

The CHAIRMAN. All right, Mr. Johnston.

Mr. JOHNSTON. This whole problem of foreign currencies is very important to us as you well recognize. In our opinion, this bewildering and contradictory sentence has no proper place in the bill and we request your committee to delete it.

Base periods: Because of abnormal postwar conditions, there are industries for which the 1946–49 period does not represent a norm. Many industries suffered serious dislocation, with consequent loss of revenue as an aftermath of the war.

We do not think it is fair to offer such industries the invested capital basis as the only alternative. We favor permitting any taxpayer to elect to use its average base period net income for the period 1936 through 1939, with an adjustment in recognition of the substantially higher level of prices which has since taken place.

In other words, we think the taxpayer should be accorded the right to take, in lieu of average earnings for the best 3 years of the 1946–49 period, 150 percent of its average base period net income for the 1936–39 period. If the taxpayer was accorded a constructive average base period net income under the World War II law, it should be permitted to use 150 percent thereof.

The CHAIRMAN. Going back there, Mr. Johnston: Do you mean to take the average earnings in the old base, World War II, 1936–39, 95 percent of them, or 75 percent, or 100?

Mr. JOHNSTON. One hundred and fifty percent of them, as a base.

The CHAIRMAN. All right. You may proceed.

Mr. JOHNSTON. Excess profits credit. In the present bill, section 435 (a) (1) (A) fixes the excess profits credit at only 85 percent of the average base period net income. If the average base period net income, however computed, is deemed to reflect the normal corporate earnings—and we assume that is the intent—then the entire amount should be treated as the excess profits credit.

During World War II the credit was 95 percent, and at that time the taxpayer was paying a combined normal and surtax of only 40 percent instead of the present 45 percent.

Abnormal expense deductions: Section 433 (b) (9) of the new bill permits the taxpayer to eliminate, in computing its net income in any year of the base period, any class of expense deduction to the extent that the amount of such deduction exceeds 115 percent of the average amount of similar deduction of the four preceding deductible years.

The purpose is to eliminate to some extent in computing base period net income those expenses which are not normal to the taxpayer's business.

But section 433 (b) (1) (B) tends to nullify the effect of section 433 (b) (9), and in many cases will deny the contemplated relief. It says that no portion of the abnormal expense in the base period year shall be eliminated in computing average base period net income unless such portion exceeds 5 percent of the average base period net income computed without the elimination.

Thus, a taxpayer in a base period year may have incurred an abnormal amount of overtime expense to catch up on orders which accumulated during a strike, but if the overtime expense, which is clearly abnormal, does not exceed 5 percent of the average base period net income, no adjustment will be made in recognition of this abnormal expense.

In other words, there might be a series of expenses less than 5 percent which might add up to a considerable total but which might not be allowed back.

Is that right, Mr. Stam?

Mr. STAM. Do you want me to answer that question?

The CHAIRMAN. Yes, if you can answer it.

Mr. STAM. The purpose of this 5 percent provision was to relieve some of the administrative problems of the Bureau where the item didn't affect very much the entire income of the company, and you look at the average year and you are only looking at 1 year. You are taking 5 percent of the average for a year.

Under the old law it developed there were a lot of minor items which were regarded as abnormal, but when you got all through the adjustment it didn't amount to very much with respect to the total income, so that was put in to try to eliminate somewhat the administrative difficulties in fussing around, you might say, with these very small items.

Mr. HALLIDAY. Mr. Stam, may I ask if that 5 percent that is referred to in the bill applies to accumulated abnormal items, or does it apply as we understand it to specific items of abnormal deduction? Because it is quite clear to us that there may be many specific classifications of expense which would border very close to 5 percent.

Cumulatively it could not reasonably be said that the cumulative total of such items were not due for any consideration or should not be given any consideration, and we have made this comment, because as we understand the bill, if any specific item of abnormal expense—there may be a half dozen or more such abnormal items—if any specific item of abnormal expense does not exceed a total of 5 percent of the entire net income, that no benefit would be allowed.

And if that is the case, we think it is a gross injustice.

Mr. STAM. I think it was merely in regard to looking at the whole picture, if you looked at the abnormal items in there and compared that with the 5 percent.

Mr. ROSENTHAL. I would like to point out that subdivision (c) of that same statute coupled with that 5 percent limitation does away with any corporation getting away with the sanction; to get away with an item of 5 percent of the net income it undoubtedly must be the type of expense item which has some effect upon the income of the corporation.

Under subdivision (c) of the section a taxpayer must establish that the excess is not a cause or a consequence of an increase in the gross income of the taxpayer. The two words "a cause" were not in the old statute, and that was inserted in this statute and in effect does nullify any relief that would be granted to a taxpayer under the section.

The CHAIRMAN. We will note those criticisms.

Mr. STAM. We will note that. There is a question on that, though.

Mr. JOHNSTON. Turning now to the invested capital credit, the method of computing this credit is substantially different in the House bill from the method under the World War II law. The new method will frequently result in a lower credit and can never result in a higher credit.

Under the World War II law, the equity invested capital of a taxpayer was deemed to be the entire amount paid in for stock or as a contribution to capital. Under the present bill, this is not so. The equity invested capital under the present bill is the difference between the sum of the tax basis in all the assets and the sum of liabilities, plus only the equity capital which may have been lost in the enterprise since 1939.

Such is the net effect of section 437 (c) and (f). Thus, a corporation which in its initial stages may have lost part of its capital in building up goodwill or a demand for its products will be denied a credit measured by such part of the capital, even though the pioneering may have been the generating cause of its profits in later years.

Borrowed capital: The present bill treats borrowed capital in an anomalous manner.

Senator KERR. I think so myself, but I want to be sure—what does anomalous mean?

Mr. JOHNSTON. In a way in which it has not been treated before.

Senator KERR. It couldn't also include the meaning that it treats it in a nonunderstandable manner?

Mr. JOHNSTON. We are inclined to think that is true, too.

Senator KERR. That is all right. We understand each other.

Mr. JOHNSTON. Instead of providing that borrowed capital, if reasonably necessary for the business, shall receive the same rate of return free from excess profits tax as any other kind of money, it accords a rate of return measured by the interest charge. This rate of return can in no event under the present bill exceed 3 percent on the borrowed capital and may be as low as 1 percent.

Even on this meager return the normal and surtax are assessed so that in effect the maximum return after taxes which a corporation may get on any of its borrowed capital under the bill is 1.65 percent and the minimum can be as low as fifty-five-one-hundredths of 1 percent.

Senator KERR. Don't you think if you lived long enough you could get rid of that by 1 percent amortization a year?

Mr. JOHNSTON. I am afraid we couldn't.

Senator KERR. I am trying to find somebody that thinks he can.

Mr. JOHNSTON. Under section 439 (a) no invested capital credit is given for borrowed capital evidenced by an obligation which matures in less than 5 years.

Senator KERR. Wouldn't that eliminate most of the borrowers?

Mr. JOHNSTON. All small borrowers practically. There are only the larger corporations that can borrow from insurance companies or can borrow on mortgages or bonds.

Senator KERR. In other words, this makes those who need it most the least likely to get it.

Mr. JOHNSTON. In our opinion, yes, Senator.

The CHAIRMAN. Suppose you were allowed 100 percent for your borrowed capital, would you also want to deduct the interest charges on that 100 percent borrowed capital?

Mr. HALLIDAY. May I answer that question, Senator George?

The CHAIRMAN. Yes, sir.

Mr. HALLIDAY. No; we would not. In other words, if a 100-percent credit were allowed on the borrowed capital, we quite naturally concede——

The CHAIRMAN. That you wouldn't also have an interest deduction?

Mr. HALLIDY. That we wouldn't have the interest as a deduction for excess profits tax purposes.

The CHAIRMAN. You would not take that position.

Mr. HALLIDAY. No; we would not, and we do not.

Senator KERR. You don't get that interest, do you?

Mr. HALLIDAY. We pay the interest out.

Senator KERR. Is that not compensation to the man who loans that money?

Mr. HALLIDAY. It is.

Senator KERR. He pays taxes on it, does he not?

Mr. HALLIDAY. Yes; he does pay taxes on it.

Senator KERR. So it is not a tax-free item, even though you charge it off.

Mr. HALLIDAY. It is not tax free, it is true. It may be tax free in one instance, but taxable on the part of the recipient or taxable to the recipient.

We have viewed the problem in this way, gentlemen: You borrow money for the purpose of making money. If you borrow money and you are obliged to pay interest on it, that is just as much working capital as the capital paid in for your stock or for any other purpose, whether it be property in kind or what.

Senator KERR. You take the position that is true whether you borrow it for 2 years or for 20 years?

Mr. HALLIDAY. Yes; we do, and we think that is the only reasonable and fair way to look upon borrowed capital. Certainly no corporation borrows capital for the sake of borrowing, and there has been evident to us at least a fear on the part of Treasury officials that corporations might be moved to borrow capital because it would give them some benefit in this equity capital credit.

To us, it seems very far-fetched, but nonetheless that fear has been evident.

Senator KERR. May I ask you this question: If you fix it on the basis that the corporation can only make—free from the excess profits tax—an amount equal to one-third of its interest rate, wouldn't that have a tendency to increase the interest rate on borrowed capial?

Mr. HALLIDAY. That would be the ultimate effect of it; yes, sir.

Senator KERR. Might not that adversely affect the Treasury's own position in its situation where occasionally it borrows a little money?

Mr. HALLIDAY. We definitely feel that it does, but fortuitously I should say that the Treasury pays no taxes on its borrowings.

Senator KERR. I understand, but they do have to get the money from the Congress with which to pay the interest on the debt.

Mr. HALLIDAY. That is correct.

Senator KERR. And they have done a good job in keeping the interest rate low.

Mr. HALLIDAY. That is correct.

Senator KERR. And if industry which borrows many tens of billions of dollars too is put in the position where the only way they can have anything left out of the earnings on borrowed capital is to borrow at a higher rate of interest, will that not adversely affect the Treasury's own position in trying to keep the interest rate on its borrowings at a low rate of interest?

Mr. HALLIDAY. To say the least, it would be most uneconomic for any corporation to pay high interest rates for capital it did not actually require or employ in its business for the purpose of earning income.

Senator KERR. But if it did have to borrow, there would be no incentive for it to try to get it as cheaply as it could if the extent of its return on it was limited to one-third of the rate of interest that it paid.

Mr. HALLIDAY. I quite agree with that wholeheartedly, sir.

The CHAIRMAN. I wish merely to ascertain your position, that is, if your borrowed capital is taken into consideration in determining credit for equity capital, then you would not expect, of course, to deduct interest paid upon that borrowed capital. That would be treated as if you had taken it out of your pocket, so to speak.

Mr. OWENS. To put it in a specific case, you have various rates depending upon the amount of equity capital, but let us assume you had a flat rate of 8 percent equity capital. Let us assume we had a million dollars of borrowed capital for which we paid 3 percent interest. We would say we should be allowed an 8 percent return on that borrowed capital free of excess profits tax, but in computing the 8 percent return we should not be permitted to deduct the interest charge. In other words, after we paid our interest, we would only be allowed a 5 percent return. That is our position.

The CHAIRMAN. All right, Mr. Johnston.

Mr. JOHNSTON. There are many corporations which are regularly financed by borrowed capital of such lesser maturity. The World War II law recognized that fact and permitted a credit on such borrowed capital.

We see no reason why a corporation which borrowed the money for 5 years should be afforded an excess profits tax free return on the money while one which borrowed it for only 4 years should be denied such a return.

Consolidated returns: Under section 201 of the bill, section 141 of the code is amended so as to provide that if an affiliated group elects to file a consolidated return it must include a member of the group which derives 95 percent or more of its gross income from sources outside the United States if such member of the group was included in a consolidation in any year after 1943.

We feel that there is no logic in this rule. It appears to be an effort to nullify for the most part the excess profits tax exemption which was accorded such corporations under section 727 (g) of the old law and which the Ways and Means Committee thought it was according under section 452 (f) of the new bill.

That completes our testimony, Mr. Chairman.

The CHAIRMAN. Any further questions?

(No response.)

The CHAIRMAN. Thank you very much.

Mr. JOHNSTON. Thank you, gentlemen.

The CHAIRMAN. Mr. Burger you may just have a seat.

STATEMENT OF GEORGE J. BURGER, VICE PRESIDENT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, INC., WASHINGTON, D. C.

Mr. BURGER. I want to thank the committee for giving me this privilege.

I am George J. Burger, vice president of the National Federation of Independent Business, Inc. Our Washington office is at 714 Bond Building, Washington 5, D. C.

The National Federation of Independent Business is an organization composed of, and representing, small, independent business and professional men across the Nation. It is the largest business organization, in point of active individual supporting members, in the United States.

Our members, and they alone, determine our positions on all matters. They put us on record for or against legislative proposals directly by their individual, signed ballots, which are mailed to their Congressmen. Senators present at these hearings are familiar with the true democratic process by which our official positions are established.

The members of the federation have not voted either for or against the excess profits tax as such. Consequently, I am not here to testify either for or against the tax. Our attention has been called to the fact that some people have alleged that we are supporters of the tax. They speak for themselves. They do not speak for the federation.

However, we have questioned our members on one aspect of this proposed tax. In response, they have ordered that we insist if such a tax is enacted, it carry a provision for an excess profits tax minimum credit of $25,000, such as has been proposed by the administration. These members, a majority of whom are unincorporated businessmen and individual income-tax paying professional men, demand this as a protection to the 78 percent of all corporations who, according to the United States Treasury Department, earn under $25,000, and to new small independent corporations which may be formed over coming years while the tax applies.

We believe Senators present are familiar with the very heavy, sometimes discouraging burden which present corporate tax rates impose on small, independent firms. To add to this by way of writing or approving an excess profits tax law without the $25,000 credit would do nothing less than confiscate the earnings of these small and new firms and drive them out of business.

Now, there are a few further points on which we would like to comment. The first has to do with proposed alternatives to the tax which were presented to the House Ways and Means Committee.

Opponents of the excess profits tax proposed, before the House committee, a reduction of taxes on corporations, to be offset by an increase in individual income tax rates and imposition of a new, permanent, and all-inclusive system of manufacturers' excises. These people argued that the proposed excess profits tax law will destroy business incentive and business opportunities for capital formation.

We grant them their right to their opinion and its expression, and respect them for making their stand known. But at the same time we are forced to observe that if their alternative is accepted it can have either one or two results: 1. Imposition of a very heavy tax load on unincorporated businesses which constitute upwards of 85 percent of all the business units in this Nation, and which are predominantly small, independent businesses, and in a vastly higher tax toll among individuals; or No. 2, the foregoing, plus higher taxes on small corporations while leaving total taxes on giant corporations less than they would be under the proposed excess profits tax law.

Thus they are in effect asking Congress to reduce incentive and capital formation opportunity among small, independent business and at the individual wage and salary earning level. Frankly, gentlemen, we of the federation believe that small, independent business incentive and capital formation opportunity are absolutely basic to our continued success as a free nation and to the success of all American free enterprise, corporate and noncorporate, more basic than the incentives and capital formation opportunities to a relatively few giant corporations who have never seemed to have much great difficulty in raising funds for new ventures and expansions of existing ventures, no matter what tax program has been in effect.

Along these lines we remind you that after World War II corporations were the first class of taxpayers to secure tax relief. In 1946 the excess profits tax was dropped. In the same year the surtax rate on giant enterprises was lowered 2 percentage points and the rate on small corporations was lowered up to 4 percentage points.

Tax relief for the 85 percent of all business units that were not corporations had to wait until almost 2 years later. More than this, the Nation's consumers—individual income taxpayers—had to undergo the same tax relief delay, and they were never relieved of the World War II excise taxes. Why, even when the defense tax raise bill was written this year one class of corporations had their taxes reduced by 8 percentage points.

These opponents of the excess profits tax argue that such a tax will be inflationary. We observe that the alternatives proposed will be equally inflationary by promoting further demands for wage increases to shore up purchasing power. We contend, too, that the burden of such wage increases, should they come, will fall heaviest on the small, independent firms—corporate and noncorporate—who are not operat-

ing on gigantic Government defense production contracts, but who will have to depend on income from a vastly curtailed civilian market.

As to the manufacturers' excise tax: We are opposed to this if it means an extension of the present system of manufacturers' excises whereby no tax applies until units are moved from manufacturers' stock to wholesalers' and retailers' stocks, resulting in a need for independent wholesalers and retailers to maintain continuous heavy investments in excises.

This type of tax collection imposes a very heavy financing burden on small independent wholesalers and retailers, which burden becomes but more dangerous to the health of these businessmen when, as, and if, as in the case in the rubber-tire field, these independents have to compete with manufacturers selling direct to consumers or to consumers through branch or company-owned stores.

The second phase of our comment is based upon the fact that our members have voted repeatedly for repeal of the unfairly discriminatory tax exemptions enjoyed by some cooperative organizations. The record will show that their tax exempt status over the years of World War II deprived the Nation of almost $1,000,000,000 in taxes.

The advantages enjoyed by the co-ops during this period especially permitted them a great competitive advantage over their small, independent business competitors who were heavily saddled with taxes to support the war effort.

We believe the Congress will be making a serious mistake—both from the standpoint of securing the greatest possible amount of revenue to support defense expenditures and from the standpoint of killing off artificial competitive inequality promoted by inequitable taxation—if it does not revoke the tax free status of those particular exempt co-op organizations.

Our objective in this testimony is to impress you with the need for spreading the increased tax load required for the defense program mostly fairly and in a way best calculated to promote our national security. You know, of course, that 13 percent of all corporations account for 90 percent of all corporate income, and that in World War II the relatively few or the larger corporations took upward of 75 percent of all Government defense contracts.

In addition, you know that these larger concerns have access to larger volume savings which will permit them to continue their domination over the smaller corporations, whose savings will be relatively small. This is, of course, to say nothing about the fate of the 85 percent of unincorporated businesses who will have their taxes increased. This would continue to discourage our veterans and others from starting a business of their own.

We have faith in your ability to write a fair tax law. The rest we leave up to you.

In other words, they are levied with an excess tax, have millions of dollars invested in stocks and tire manufacturers are relieved of excess taxes until they are ultimately sold to the user.

The CHAIRMAN. Mr. Werntz.

STATEMENT OF ORRIN B. WERNTZ, CLEVELAND, OHIO

Mr. WERNTZ. My name is Orrin B. Werntz, and I come here on behalf of the companies in the screw machine products industry. To

some extent I think perhaps I am an unusual witness among this group today because of 906 producing units in our industry of some 1,200, those 906 average less than $60,000 of sales volume a year. Up to now we have been talking about small business in terms of 275 to 500 employees and I would like to point out some of the inequities of this tax, not referring directly to the written statement, that seem to apply.

For instance, we have also heard some testimony today and in the newspapers that would lead us to believe that everyone today is making more money than they ever did before and the period of 1946 to 1949 for that reason would make a very good base period.

Statistically the screw products interest back in 1926 to 1929, 20 years ago, applying the same credit ratio of 85 percent was making 8.3 percent profit on sales. Ten years later the average company was making 7.3 percent profit. Ten years later the average company, 1946 to 1949 was making 6.1 percent profit.

In other words, 20 years ago in our industry they were making 36 percent more profit before taxes than they are today, using your base period credit.

Now going back to the very best year of the 4 in 1926 to 1929, we had a high of 11.1 percent; 10 years later the best of the 4 years was 10.2 percent; and 10 years later the best of the 4 years was 9.6 percent. The interest feature of that is that 20 years ago the average against the high year, the high year was up 33 percent, 10 years later the high was 40 percent, and 10 years later the high was up 56 percent from the average year.

That has quite a bearing if we take the average company and see what happens to him under this law. We have a $25,000 credit and let's assume we have to use a 6.1-percent allowance on the average for the 1946–49 period. That company comes up with sales on that basis of $410,000.

In our industry the productive employees would only total 35. The total employment in the company would be between 50 and 60. That makes me wonder whether big business, which I had always heard started with 500 employees and up, doesn't actually start under this law with about 50 employees and up.

Actually as far as I know from my business experience and in connection with this industry a company really never gets under way or gets started or is able to expand or produce anything in great quantity and efficiently until they reach that point of 35 to 50 employees. Before that they are too busy trying to earn their own salary out of their smaller sales volume. I believe it was assumed by Congress when they passed—the House that is—when they passed this law, that we would have higher sales volume due to defense orders, due to rearming, and that would lead to higher profits. I was looking back there at the Treasury chart during your recess today, and noticed that a company earning 200 percent of the average base credit would hit a figure of 17.2 percent effectve additional tax.

If we take the 58 percent that I mentioned, the difference between 6.1 and 9.6, if we consider the company doing $410,000 of business, will undoubtedly be doing $600,000 on defense, that company cannot help but come up with a figure of better than a 200-percent increase, therefore this small company with 35 to 50 productive employees, maybe by that time 65 productive employees, will be going into the very high

tax bracket that I thought at least the philosophy back of this taxation was going to be reserved to those with a lot of money and the ability to pay.

Going on a bit further from that, it is noticed that over a period of years, just 10 years, the second page of my submitted report, between 1939 and 1949, despite the inflated dollars, our sales are up 140 percent. The value of equipment that we own is up 127 percent. We aren't getting much more out of the equipment. The number of machines to produce that value numerically is up 26 percent but our profits between those 2 years were off 55 percent.

Applying that still further and going back I found out that we have increased, these reporting companies which are a cross section, the total dollar value of new equipment produced for defense or for peacetime, $4,900,000.

Eighty-five percent of that increase, or about $4,200,000, was put into these plants in the period of 1940, 1941, 1942, and 1943. Only $700,000 more was added in the remaining 6 years. At the same time these same companies reporting on their balance sheet show the somewhat sad situation, as long as they have been in business, that their cost of fixed assets, original acquisition cost, was around $8,700,000, and their net worth today is $200,000 less than the original cost of the equipment.

It would seem to me there would be perhaps two ways of correcting this situation when you begin to think that our industry is not alone in this situation. I know many other small industries face a descending scale of earnings rather than an ascending scale.

One would be to give consideration to only using the best of the 4-year period, the best year, rather than an average of the 3 best and taking 85 percent, or at the worst use the best 2 years. That would give them somewhat of a break there.

The other way would be to take into consideration a moving base or a moving credit rather than a fixed base, because let's assume we come to this same company of $410,000 and he has a $25,000 credit. Well, if you allowed him 6 percent on the acquisition cost of his machinery and 6 percent on his sales volume, then as the dollar became inflated or his sales volume moved up or he had the courage to go out and borrow money to go out and buy more equipment, you would take 6 percent on that and you would find that the credit he would get would move up not as fast as the tax would grab the difference but it would move up.

I gave a definite example in the report on page 2. As an example, if in 1950 a company had sales of $400,000 and the equipment at original cost was $250,000 that 6 percent would be $39,000. In 1952 if sales had expanded to $700,000 but they had purchased equipment up to $400,000 the credit now becomes $66,000. That is only an increase of $27,000, which is quite small but it would help to pay for the $150,000 more machinery needed to the $700,000 sales.

There is only one point for this industry and some others like it, and that is the matter of retroactivity. In the second half of 1948 this industry had a loss. In 1949 throughout the whole year it made less than one-half of 1 percent after taxes. In 1950 in the first half year it broke even. In 1950, second half, it is going to start making a profit again.

In that entire period of time it had no war business and production in the second half of 1950 is still not defense or war business.

Senator MILLIKIN. It is a business which inherently expands its operations because of war; is that not true? In other words, was not a part of your bad base period after World War II due to the fact of the heavy selling during World War II.

Mr. WERNTZ. No, sir. We make component parts only and when the people to whom we sell who also have batteries of automatic screw machines—departments with automatic screw machines which are used to make metal component parts. In other words, our customers compete with us in their own departments making the same product, so when our customers get busy the overflow comes in to us.

If the automotive industry has a very good year, the chances are we will get more business because they have more to let out from their own departments.

Senator MILLIKIN. The overflow would increase with war because the final assembled machines increases with war?

Mr. WERNTZ. Yes, sir; but I might comment to you only that so far we have had no war business in the second half of 1950. So what is happening here on the retroactive situation that the first profit we make in 24 months Congress under this act wants to——

Senator KERR. You mean that they have discovered it.

Mr. WERNTZ. They have discovered it, that is right, Senator. So that completes my statement except for any questions.

I also submitted with this to the committee my report to the House Ways and Means Committee which was more lengthy and gives you greater background of the industry.

The CHAIRMAN. That is already in the House record.

Mr. WERNTZ. And it has also been submitted here, sir, an extra copy.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. Thank you very much.

(Mr. Werntz' prepared statement was submitted for the record at this point, and is as follows:)

TESTIMONY ON EXCESS PROFITS TAX FOR SENATE FINANCE COMMITTEE

My name is Orrin B. Werntz, of Cleveland, Ohio. My occupation is that of trade association management and I am here on behalf of the screw machine products and the stamping industries of this country in the capacity of manager of the National Screw Machine Products Association, and of the Pressed Metal Institute.

First of all to save time I would like to incorporate by reference, my report to the Committee on Ways and Means of the Eighty-first Congress reproduced on pages 932–935 of the recently published hearings on the excess profits tax.

The excess profits tax bill as passed by the House in no way changes any of the opinions set forth in my report, which summed up states that an excess profits tax is wasteful, inefficient, inequitable, undemocratic, and that retroactivity is unfair, as is failure to properly provide for inflationary influences and expansion.

In the time permitted today I would like to be more specific now that a tax bill is available to comment on.

It is true as Secretary Snyder has stated that more than 90 percent of business units will be unaffected for the reason that 90 percent do not exceed $25,000 profit a year; and at least half of the business units are proprietorships or partnerships and are unaffected regardless of their size—and some of these are pretty big. A good example is the screw machine products industry which in 1947 had 906 units of about 1,200 total averaging less than $60,000 a year in sales volume, and 1947 was our best year of the 1946–49 base period.

So this is only giving lip service to small business. When companies are that small they are primarily wage or salary earning media of the owner, who does not wish to work for someone else, and are not individually strong factors in American defense or peacetime productive advancement, although they most certainly are collectively.

So we can forget this 90 percent that will not be touched by any excess profits tax, and specifically examine those who will be.

INEQUITIES OF THE BASE PERIOD

First of all, many industries will be harmed by arbitrary base periods regardless of the House approach that industry cycles are too difficult to completely examine. Fortunately we have figures for screw machine products, dating back to 1926—24 years ago. Using the 85 percent credit figure for the best 3 years we find that companies in this industry in 1926–29 averaged 8.3 percent on sales before taxes; in 1936–39 averaged 7.3 percent; and in 1946–49 only 6.1 percent. A descending scale and entirely contrary to the publicity that makes the public believe earnings were never greater than now for everybody.

But industry profits also include individual losses. An examination of the individual loss years disclosed that in 1926–29 they totaled 6 percent for the three best years; 1936–39 they were 13 percent, and in 1946–49 they were 29 percent of total company-years examined. So both industrywise, and individually I can hardly call an arbitrary base period equitable—at least for us it gets worse each decade.

WHAT IS SMALL BUSINESS?

If you apply a 6.1 percent profit average to a $25,000 credit you have sales of about $410,000, which are produced with approximately 35 productive labor employees. So at that point this tax starts to bite. Are 35 employees big business? Is a sales volume of $400,000 big business? Up to now definitions of big business have meant companies with over 500 employees. So I don't believe Secretary Snyder's statement means too much. A company is just beginning to get under way, expand, advance, and be able to plan for the future when they reach 40 to 50 employees and a half-million-dollar sales volume. In the last war, when money was not so cheap, $500,000 sales was considered small enough to exempt a company from renegotiation.

INEQUITIES OF A MONEY RATHER THAN A PERCENTAGE BASE

Now starting with companies of about 35 productive employees the tax credit is permanently established in terms of money without relation to sales volume or a cheapening dollar.

For example, a $25,000 credit would have been excellent in 1939. In 1950, $25,000 won't buy two completely equipped machine tools used by our industry. In some cases not even one.

In 1939 the acquisition value of 917 automatic screw machines owned by these reporting companies was $3,800,000—in 1949, 1,162 machines had an acquisition value of $8,700,000—235 more machines, 4,900,000 more dollars.

In fact what will an excess profits tax do to this picture? In the 10 years since 1939 and comparing 1949 inflated dollar sales are up 140 percent; number of machines, up 26 percent; value of equipment, up 127 percent; profits off, 55 percent.

It will minimize our chances of further expansion, to be paid for out of earnings.

If Congress is going to insist on an excess profits tax, which by its very name is repugnant because it hints that someone is cheating, would it not be far better to use a percentage credit, such as 6 percent on sales volume, and 6 percent on equipment acquisition cost? Then we would have an easier time financing working capital and keeping equipment up to date.

As an example, if in 1950 a company had sales of $400,000 and equipment at original cost of $250,000 the credit would be $39,000. Then in 1952 if sales had expanded to $700,000 and equipment now was $400,000 the credit would be $66,000. This increase of $27,000 is small enough to help pay for $150,000 more machinery.

In fact in the screw machine products industry in 1949, the tangible net worth of reporting companies was $200,000 less than the acquisition cost of $8,700,000 of fixed assets.

These figures, gentlemen, have been presented to show what can happen to at least one industry if a taxing statute makes a grab bag out of planned expansion

and growth. When the tax hits it will hit indiscriminately, an element of luck will always be present, industry patterns will mean little or nothing, and machinery purchases will grind to a halt. In fact of the $4,900,000 increase in equipment value mentioned, $4,200,000 of it—more than 35 percent—was made in 1940–43 and less than $700,000 value has been added in the 6 years since then.

With businessmen almost 100 percent against excess profits taxation for sound reasons, and 100 percent for increased taxes for equally sound reasons, surely this Congress can raise the money needed without resorting to unpopular and uneconomic methods.

I wish to thank the committee for this opportunity to appear before you, and will be pleased to answer any questions.

The CHAIRMAN. Mr. Dewey, you may identify yourself for the record.

STATEMENT OF BRADLEY DEWEY, PRESIDENT, DEWEY & ALMY CHEMICAL CO., CAMBRIDGE, MASS.

Mr. DEWEY. Bradley Dewey, president, Dewey & Almy Chemical Co., Cambridge, Mass.

I have been president of the American Chemical Society, and, in World War II, I served as United States Rubber Director. In 1945 and 1946 I was chairman of the Joint Chiefs of Staff Guided Missiles Committee and served on the Presidential Evaluation Commission at Bikini.

I appear here as a chemical engineer, who, after serving as a colonel in the Chemical Warfare Service in World War I, started in 1919, with a partner of similar training, a small chemical business with an initial capital of $120,000.

This business has grown from sales of $120,000 in 1920 to approximately $21,000,000 for the current year. In the aggregate its sales have been $175,000,000. It has paid income taxes to the Federal and State governments totaling $7,300,000; it has paid its stockholders dividends totaling $5,900,000; it has reinvested $4,500,000 of its earnings.

It now gives employment to 1,800 men and women who receive almost $5,000,000 per year. They, like the company itself, contribute substantially to tax revenues, local, State, and Federal.

Though I could plead the case for our own company, I cite these figures not because I am going to talk of the effect of an excess profits tax on us but because I know they are incontrovertible facts which show how one growth company is contributing to the national economy, employing men and women and paying out more to tax collectors than to investors.

The years since the last war have accounted for about half its growth, and in this period it has given employment not only to its own veterans but to over 100 veterans of World War II who were not associated with it before the war. Many of these veterans are in responsible positions, just beginning to realize their futures.

Senator MILLIKIN. May I ask you what product or products you make?

Mr. DEWEY. We make a great collection of chemical specialties, including some plastic films for foodstuffs, including sealing compounds for tin cans and glass bottles, glass bottle caps, including products going into shoes, artificial leathers and shoe cements, including products going to portland cement, concrete and asphalt aggregates for

roads—in other words, a great variety of special products, most of which go to other manufacturers for use by them in small quantities.

We spend 5 percent of our sales dollar every year on research. I believe in America and the American way of life. I believe that despite today's clouds we are going forward. We must not let ill-advised taxation smother our future and render us vulnerable to the hordes of police states.

Rather, we must capitalize to the maximum on the inventive genius of our scientists and engineers. Young men, some of whom are now fighting for us, must have their opportunity.

Our industries, especially those based on technological progress, are vital to the maintenance of our standard of living and our economy. One need only travel abroad to see the stagnation and other ills that breed in a country where initiative has been stifled.

As Americans, we have no use for the war profiteer of wars of the past. But he has played a less important part in recent times and is badly hurt by the techniques of renegotiation. Wisely and fairly administered, in harmony with the necessities of procurement agencies, renegotiation can be made to tap secondary as well as primary profits.

What is the purpose of this proposed excess profits tax? In the papers I see it spoken of as a revenue-producing act. This despite the feeling of many that the purpose of an excess profits tax is to limit war profiteers.

If the earnings of all industry were simply dependent upon the amount of capital they employed and the prices they charged, we might have an excess profits tax that could be likened to the surtax on individual income. But this is impossible—no two industries are comparable. Seldom is one company comparable with another, even within an industry.

A dynamic company that has been preparing for growth by spending money on developments during the base years is now to be singled out and penalized. It finds itself with a lower earnings base because of the development expenditures made during the base years. Its reward is to have profits from its new ventures taken as excess profits.

Senator KERR. You spend about 5 percent of your income on research?

Mr. DEWEY. Yes, sir.

Senator KERR. That applies this year in order that it might be reflected on earnings 2, 3, or 4 or 10 years from now?

Mr. DEWEY. Yes, sir.

Senator KERR. Of course you also use considerable portions of your income not only in research work with reference to specific projects, but I would presume in seeking for projects to which you would apply research?

Mr. DEWEY. Both ways.

Senator KERR. The position that you now take, as I understand it, is in view of the fact that it was charged up as expense in the years it happened, it reduced the profit for that year and therefore that year would now have a lesser total profit to be reflected in your base?

Mr. DEWEY. Yes, sir.

Senator KERR. And as the result of that exploration or research, or searching for ways in which to make money, if you now do so, while

in actuality it is a normal return, it would be subjected to an excess tax?

Mr. DEWEY. That is right, sir. As a matter of fact there will be certain things we would be ready to do which we cannot do.

Senator KERR. Which you would be discouraged from doing because you would see yourself faced with the necessity of doing it on a basis that would bring you no return, but rather all of it would be siphoned off in this so-called excess profits tax?

Mr. DEWEY. Most of it would be siphoned off, and in part because the money we have allocated for that just will go to the tax collector.

Senator MARTIN. As I understand, that 5 percent that you use for research is gross sales but not your net.

Mr. DEWEY. That is right. It just happens to figure out that way.

Senator MARTIN. I mean there is quite a difference.

Mr. DEWEY. We spend about a million dollars a year on the sales.

Senator MARTIN. That is what I was getting at.

Mr. DEWEY. An excess profits tax promotes waste and encourages inflation. I do not have to argue these points with you gentlemen. But some may say that the provision that the over-all take of the normal and excess profits taxes shall not exceed 67 percent, will not encourage waste, and that the incentive provided by letting capital keep one-third of its profits, less, of course, the portions taken by the States, will keep industry efficient.

This may be true in some cases. Such a provision is certainly better than nothing. I cannot emphasize that too much. But to benefit by this provision a company's gross profits must be more than 3 times those of the base year; 3.2, as I will show you. This is simple arithmetic.

Companies whose gross profits do not grow by this tremendous factor will still be exposed to the dangers of wasteful expenditures which are bound to creep in in the form of uneconomical advertising, wasteful sales efforts, abnormal wage increases, inefficient checks on operating efficiency, and a lack of the urge to do that little extra which is the foundation of growth and all that is new.

A uniform corporation tax with special relief, if you feel it is needed, for public service corporations, and perhaps with deferment of taxes for those in distress, would, I believe, keep our country stronger.

But if you are determined to pass an excess profits tax, I beseech you to drop the limits of the over-all take from 67 percent to 60 percent. Growing companies need this, otherwise capital will not back them at a time when this excess profits tax will be taking the earnings they had hoped to use for further growth.

The growth provisions of the House bill fit only special cases. A 60-percent ceiling would act to hold down waste and inflationary tendencies because the twilight zone in which the Government would be paying 75 percent of wasteful expenditures would be cut from that represented by a growth above base of 3.2 times profits before taxes to 1.7 times profits before taxes.

I have invited you here to see the accompanying graphs and calculations which accompany my presentation which have set this up for various ceilings. There would be a feeling that the company could hope to surmount the hurdle and increase its growth by this magic factor of 1.7 times. This would stiffen the backbones of a lot of businessmen, cut down a lot of waste, and help to hold down prices and inflation.

A 60-percent ceiling would create more incentive to eliminate the shortages which already beset us and which will become very serious if we have an all-out war. If we ever have an all-out war, then accompany its tax bill with all-out controls on prices, wages, manpower, inventories, and end uses of products, et cetera. But let these controls come simultaneously with any higher tax.

To try to raise all of the costs of war from corporate earnings, while keeping alive expensive and perhaps in some cases luxurious Government peacetime expenditures is to invite killing the goose that lays the golden egg. Do not so cripple our economy.

We still hope to avoid an all-out world war III. If we do, we must stay powerful, so powerful that no one will dare to start trouble. Then, in the future, if we are still faced with the specter of war, we shall go into it with a strong, healthy industrial economy at our backs.

Dr. Vannevar Bush, in his book Modern Arms and Free Men, emphasizes that the strength of a free nation lies in continued technological progress and that with it we can combat the manpower hordes of potential enemies. Have faith in technological progress. Do not stifle it with wasteful inflation and destruction of initiative.

I hope you will not waste this country's greatest asset—the urge to do that little extra which is the foundation of growth and all that is new. Preserve our growth, preserve the incentive to capitalize applied science, technology, and engineering—the skills which work for our standard of living, our farmers, our merchants, our transportation, our communications, and our strength to defend ourselves.

(The calculations of increases in taxable income submitted by Mr. Dewey are as follows:)

CALCULATIONS OF INCREASES IN TAXABLE INCOME OVER BASE PERIOD WHICH ARE NECESSARY BEFORE VARIOUS CEILING RATES CONTROL EXCESS PROFITS TAX

E=total taxable income in excess profits year.
B=base period taxable income.
85 percent of B=base period credit for excess profits tax which bears income tax only.
45 percent= income tax rate (applied to 85 percent of B).
75 percent=rate of excess profits (applied to E—85 percent of B).
Where: 67 percent=ceiling rate on total taxable income

Income tax *Excess profits tax*

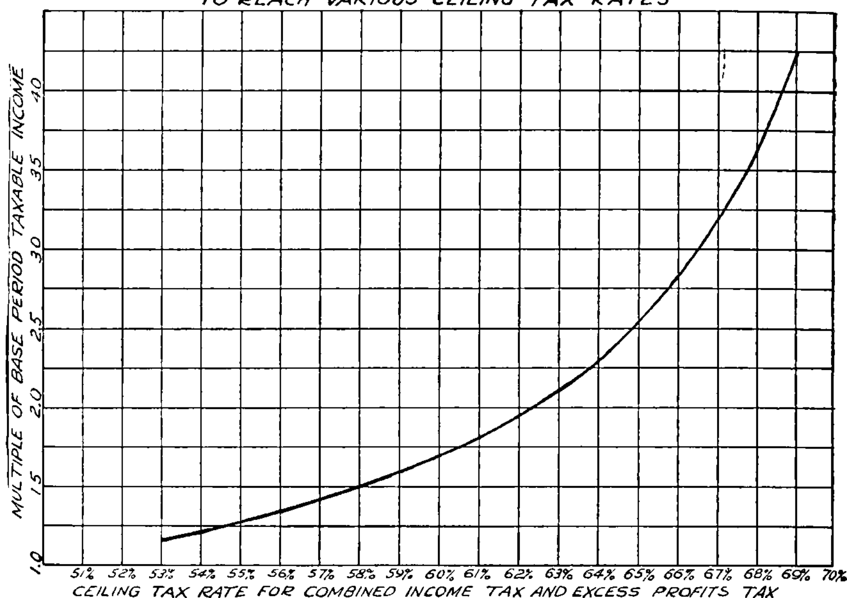
$.67E= .45(.85B)+.75(E-.85B)$
$.67E= .3825B+.75E-.6375B$
$.08E= .255B$
$E=3.19B$

Where: 57 percent=ceiling rate on total taxable income
$.57E= .75E-.255B$
$.18E= .255B$
$E=1.42B$

Where: 60 percent=ceiling rate on total taxable income
$.60E= .75E-.255B$
$.15E= .255B$
$E=1.70B$

Where: 63 percent=ceiling rate on total taxable income
$.63E= .75E-.255B$
$.12E= .255B$
$E=2.13B$

Where: 65 percent=ceiling rate on total taxable income
$.65E= .75E-.255B$
$.10E= .255B$
$E=2.55B$



The CHAIRMAN. Thank you very much. Your suggestion that the over-all ceiling could be dropped from 67 to 60 carries a very strong appeal to me—so strong that I have already conferred with the Secretary of the Treasury, and the Secretary, I think, will come up with an agreement that 65 over-all would not be very hurtful to the revenues, would be slightly helpful, but it would not be as helpful as the 60-percent over-all ceiling.

Mr. DEWEY. I certainly do not come here in the spirit of trade, but I would like to suggest 63.

The CHAIRMAN. When we get past 60 percent, we will have some opportunity to trade with the House people. We will have some trading room, at least, if we can get it below the House.

Mr. DEWEY. I wanted to give you a general argument, because I feel so desperately serious in this, not only for my own business but particularly for growth business and technological progress, for our strength.

The CHAIRMAN. I thought if you had a proper ceiling on the over-all tax takes, then it really would be more helpful than a whole lot of the relief provisions that the House is attempting to write in.

Mr. DEWEY. Much simpler. I have listened to some brilliant men here, but I cannot understand the language. When my accountants, working, not with the law but with the services, telling them what the law means, come around, I may be able to understand. But I will undoubtedly take 10 percent of the time I would like to spend making this country a little stronger conferring as to whether or not to try to argue with the Government and how many more accountants and lawyers to hire. It is a great law for the lawyer.

The CHAIRMAN. Any further questions?

(No response.)

Mr. DEWEY. May I, sir, submit for the record some comments on the relief provisions of the House bill for the growth of new products?

The CHAIRMAN. Yes, sir.

Mr. DEWEY. I do not want to burden you with them. It is a short thing. I know Mr. Stam will take the trouble to read them over.

The CHAIRMAN. If you will put them in the record, we will be glad to have them.

(The comments on the relief provisions of the House bill are as follows:)

SUPPLEMENTARY STATEMENT OF BRADLEY DEWEY—COMMENTS ON RELIEF PROVISIONS IN THE HOUSE BILL FOR GROWTH OR NEW PRODUCTS

I would like to make a few remarks about the growth provisions of the House bill. The section of the bill relating to companies which have grown over-all is limited to companies which show an increase in payroll or gross sales for the last 2 years of the base period over the first 2 years of the base period. This is an automatic provision which should be easy to administer, but there will be many companies which will not qualify. Some provisions should be made for those companies which have experienced large development expenses during the base period which only begin to pay off in the excess profits years.

The House bill attempts to provide some relief for these situations where a company introduces a new product during the 3 years ending December 31, 1949. However, the provision requires that the new product must have represented one-third of total net income in 1 of the 3 years which follow its introduction. That is a tremendous change to look for, from a new product of the average medium-sized company. My company has introduced products which required 10 years before they were out of the "red," and I would say that, for almost any new product line, 3 years is too short even to get it on a break-even basis. This provision also falls short of fair relief because no recognition can be made of modifications or improvements in an existing product. These technological improvements have contributed in large part to the growth of our economy over the past years.

Finally, there is no provision in the House bill for granting relief to a company which introduces a new product during the excess profits years. There will be many cases where a company has devoted considerable expense to developing a new product during part or all of the base period years. Most research requires years of careful development before the results can be offered to the public. I find it difficult to see how the House bill will provide any relief to companies in this situation who bring out the fruits of their research after January 1, 1950.

The CHAIRMAN. Senator Hill, the senior Senator from Alabama, has submitted a statement today on behalf of Mr. Richard S. Reynolds, Jr., president of the Reynolds Metals Co., on the question of the excess profits tax, with certain suggested amendments. That will be entered into the record as of today's hearing.

(The statement is as follows:)

TESTIMONY OF RICHARD S. REYNOLDS, JR., PRESIDENT OF THE REYNOLDS METALS CO.

I am Richard S. Reynolds, Jr., president of the Reynolds Metals Co., of Richmond, Va. This company mines bauxite, extracts alumina from the bauxite ore, and reduces this to aluminum by an electrolytic process. In addition to the production of primary aluminum it has extensive fabricating facilities. It owns ore deposits in Arkansas and Jamaica, and has manufacturing plants in the States of Alabama, Arizona, Arkansas, California, Illinois, Indiana, Kentucky, Michigan, Missouri, New Jersey, New York, Oregon, Virginia, and Washington.

Since commencing the production of primary aluminum 10 years ago it has greatly expanded its productive capacity. During the 5 years since the war, it has explored and developed new ore deposits, has acquired extensive plant facilities, and has proceeded continuously to integrate and improve its facilities and capacity. In total this has been a heavy undertaking for the company. The result is that it has been a low-profit company. Wholly aside from the events in Korea and the defense demands of the country, it had been looking forward to

the latter part of 1950 and the year 1951 as the time when it would begin to realize the profit normally and reasonably to be expected from these extensive undertakings. From its outset, the company has been the apostle of expanded production and low cost. Even in the latter part of 1949, it launched a substantial increase in its capacity for peacetime use of aluminum—an increase in capacity which has just been completed in the second half of 1950.

The result of these circumstances is that the company has been in a solid but expensive state of integration and expansion that would have yielded its increased production and profit in the immediate future, without any of the present critical developments of defense mobilization. The result is also that it is a "growth" company for which no formula of relief has been devised. The excess profits tax bill, in its present form, will inflict a heavy penalty on the company, and at the very time when it is anxious to make its maximum effort for defense.

In order to make the greatest use of its capacity it must increase the consumption of its bauxite ores and undertake heavy financing for still additional facilities. It has already agreed—the first company in the country, and at the request of the Government—to undertake still greater expansion. It is obvious, however, that its ability to obtain sound and sufficient financing, and to do the maximum of which it is capable (and it is extremely anxious to do just this), is affected by its ability to earn a fair profit. Especially is this true since it has already contracted substantial debt in the expansion of its facilities during the past 2 years.

Plain equity and justice call for amendments which will alleviate the general hardship which the House excess profits tax bill would impose.

In these critical times it is clear that the public interest will be served by such amendments.

Two suggestions are urged:

1. An amendment of section 448 which would have the effect of adding primary aluminum to the strategic and critical list therein set forth. Certainly no material is more strategic or critical than aluminum. Since aluminum results from (*a*) the mining of bauxite, (*b*) the extraction of alumina from the ore, and (*c*) the reduction of the alumina to aluminum, it is clear that the simple addition of bauxite to the list of 25 minerals in section 448 (b) (1) is not sufficient. Bauxite is an unprocessed ore; it is not a material of general industrial use such as metallic aluminum. In order to obtain aluminum it is necessary to process bauxite into alumina (which is still an intermediate stage, and not a material of general use) and then into the metallic form: aluminum.

An exemption of the income derived from the mining (whether in or out of the United States) and processing of bauxite into aluminum would make it prudent for an aluminum company to deplete and use its highest-grade ores at maximum efficiency in the effort to produce the volume of aluminum needed for defense. If, however, these earnings are subjected to an excess profits tax an aluminum-producing corporation must either (1) process its lowest-grade ores (and these are its highest-cost ores), and in no greater volume than during the base period, or (2) subject its stockholders to a very considerable penalty.

For example, if a company has produced an annual average of 100,000,000 pounds of aluminum during the base period and then continues the same production under the excess profits tax, the resulting profit would be subject to a tax of 45 percent (assuming similar operating conditions and no discount in the average base period net income). If, however, through utilization of full capacity or through improved techniques of production 200,000,000 pounds of aluminum should be produced, the earnings from the second hundred million pounds would be taxed at the high marginal rate of the excess profits tax, 75 percent. And to produce that second hundred million pounds, four times that quantity of bauxite—400,000,000 pounds—would be required to be consumed. This depleting asset (which is nonreplaceable) would be thus consumed with little or no compensation to the company.

This obvious inequity can be avoided by—

(*a*) Making section 448 (a) apply to the "mining or processing of a strategic mineral or a critical mineral," and by exempting "the portion of the adjusted excess profits net income attributable to such mining and to the processing of such minerals into the metallic state or the form first used predominantly for industrial purposes";

(*b*) By adding bauxite to the list of "strategic minerals" in section 448 (b) (1); and

(*c*) By minor resultant changes.

2. A productivity amendment should also be added. Since a primary purpose of this amendment is to increase production, the amendment is presented in terms of quantity of production, not in terms of dollars. Congress passed the Stockpiling Act in 1946 for the purposes of defense. It is suggested that this amendment, in the public interest and for purposes of defense, should be related to those materials determined to be strategic and critical by the Munitions Board under that law.

The maximum and speediest production of critical materials is the most urgent need during the current crisis.

A producer of these materials should not be penalized for expanding its output. The proposed amendment encourages peak production and the greater utilization of present plant capacity, and thereby broadens the base available for taxation. Consequently this amendment may well increase tax revenues. In addition, the greater production will help offset the inflationary effect of any increase in demand, especially by the military, without corresponding increases in output.

With these ends in view, and in plain justice and fairness to a company anxious to do its maximum for defense, the following amendment is suggested:

"To encourage the maximum production of those materials determined to be strategic and critical pursuant to the authority provided in section 2 (a) of the Stockpiling Act, Public Law 520, Seventy-ninth Congress, any corporation whose production of such materials in a taxable year is greater than its average annual production of such materials in the base period shall be entitled to increase its average base period net income in the ratio that its production of such materials in the taxable year bears to the average annual production in the base period."

Both of these amendments are in the public interest. Both relate to production of primary aluminum in metallic form—one of the most strategic of metals.

The CHAIRMAN. Senator O'Mahoney.

STATEMENT OF HON. JOSEPH C. O'MAHONEY, A UNITED STATES SENATOR FROM THE STATE OF WYOMING

Senatora O'MAHONEY. Mr. Chairman, if you will permit me just a minute I should like to call the attention of the committee to section 448 dealing with corporations engaged in the mining of strategic minerals.

On page 77 there appears subsection (b), the section which defines strategic minerals. An examination of that section makes me feel that it falls short of what should be and is necessary in the national interest. It names some minerals and then has an all-inclusive phrase—

> and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort—

and so forth.

That of course would require a certifying agency to act.

Senator KERR. You did not finish that statement.

Senator O'MAHONEY. No; I did not.

Senator KERR. There is another limiting clause.

Senator O'MAHONEY (continuing):

> and as not having been normally produced in appreciable quantities within the United States.

I thank the Senator for calling my attention to that.

My point is that we should get as many of these strategic minerals named in the body of the law as scientific knowledge indicates should be named. I have asked the director of the Bureau of Mines to examine that. He feels as I have felt, and he is preparing a statement for me.

I do, however, want to say to the committee that there is a special example of trona which is produced in the western part of the United States and which is used in the manufacture of soda ash.

The National Production Authority has already recognized that this is a mineral of great importance and in its Regulation No. 1, issued on September 18 of this year, names soda ash as one of the first materials to be subjected to inventory control.

So I hope that the committee will entertain not only the thought of amending the bill by including trona—and I should say that trona is produced in my own State as well as in other Western States, but also such other minerals as the additional material which will be submitted indicates should be included.

Mr. Chairman, I will file this brief statement.

The CHAIRMAN. We will be glad to have you file it.

The committee has already had its attention called to the limiting factors in this particular definition.

Senator O'MAHONEY. I am happy to know that. I want to call attention to trona because it is used in the manufacture of aluminum, it is used in the manufacture of glass, it is used in oil production and refining, and used in various other production efforts which are very closely associated with defense production.

Senator MILLIKIN. Mr. Chairman, I would like to ask the distinguished Senator, who comes from a great oil-producing State, whether those special features of this bill intended to promote the development of strategic minerals should not also concern themselves with oil.

Senator O'MAHONEY. Of course oil is one of the most important of all the minerals that we produce.

I thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator O'Mahoney.

(The brief statement filed by Senator O'Mahoney to be placed in the record at this point is as follows:)

STATEMENT OF HON. JOSEPH C. O'MAHONEY, A UNITED STATES SENATOR FROM THE STATE OF WYOMING

Section 448 of the excess profits tax bill, H. R. 9827, provides special treatment for corporations engaged in mining strategic minerals. As drafted the section seems to me to be too indefinite. As an example, a mineral highly essential to the war economy has not been included. I refer to the mineral trona, which occurs principally in the western part of the United States.

In my State of Wyoming this material is presently being mined on a relatively small scale. The principal use of the material is in the manufacture of soda ash, a basic chemical commodity in our economy. Large amounts of soda ash are used in the manufacture of aluminum (approximately one-fourth of a pound of the material for each pound of aluminum produced) and in the recovery of uranium. I also understand that it is being used in the West in recovery of other strategic and critical minerals, including manganese, molybdenum, vanadium, and generally in the ferrous and nonferrous metallurgical industries. In fact, I might say that the production of most of these highly essential materials would not be possible without a substantial supply of soda ash. In the West where these metals are recovered there is no production of soda ash other than from trona, and if production of the materials for war purposes is to be increased, it is imperative that soda ash expansion be correlated with such increases.

The National Production Authority has recognized the validity of this contention in its Regulation No. 1, issued September 18, in which soda ash was one of the first materials in the country subjected to inventory control.

I do not wish to take the time of this committee to detail all of the uses of soda ash, but wish to mention that it is necessary in oil production and refining,

manufacture of fiber glass and other glass articles, in sugar refining, soap, chemicals, and a host of other activities more or less connected with the war effort.

I do not hesitate to tell this committee that increased production of trona in the West is as important to our war effort as any of the other minerals specifically enumerated in section 448, and I recommend that the committee give consideration to the inclusion of trona with the other strategic minerals.

The CHAIRMAN. Mr. Stangler. Did you appear before the Ways and Means Committee?

Mr. STANGLER. I did not.

The CHAIRMAN. You may identify yourself for the record.

STATEMENT OF FRANK J. STANGLER ON BEHALF OF THE F. D. KEES MANUFACTURING CO., BEATRICE, NEBR.

Mr. STANGLER. My name is Frank J. Stangler. I am chairman of the board of directors of the F. D. Kees Co., of Beatrice, Nebr.

I am the first one apparently who represents a corporation that we ordinarily refer to as being owned by individuals. There are only my partner and myself in this corporation.

I will read this written statement. Then I would like to make a few remarks afterward if I may.

Senator BUTLER. Does your statement include something about the age of the corporation?

Mr. STANGLER. It does not. I will bring that up later, Senator.

First, I want you to know that I appreciate highly the honor and privilege granted me in permitting me to appear before this committee to testify as to my opinion on a matter that is extremely grave and which is perhaps in its broad sense beyond my understanding.

Please understand, gentlemen, that I am not here because I am against taxation as such. I know that never before in the history of our country has taxation been so necessary—and by that I mean that never in the history of our country was there such a real and thoroughly understood need of money on the part of our Government.

I do not and cannot propose any alternative measure because you gentlemen have been entrusted with the making of our laws.

This matter of the presently proposed excess profits tax, however, is a repetition of the story of the goose that laid the golden egg. I am repeating what somebody said whom I never saw in my life. I just happened to pick this example. You all know that story and you know what happened when the goose was killed.

In the present instance the golden eggs are production and expansion. I know as a businessman that any tax law you pass must take into consideration the present purchasing power of a dollar. Any tax law that is written with this thought paramount will be acceptable and workable.

Base rates must be arrived at not on a theory of average earnings but on a theory of permitting a company to choose any one year between 1946 and 1949—not an average of such earnings. A company could conceivably break even for 3 years and make a good profit for 1 year. Would it be fair to take that company's average earnings?

Many exceptions would have to be made if that were done. If any one year could be chosen very few would have cause for complaint.

To get back to the matter of the purchasing power of a dollar: Supposing for the sake of a starting point that we pass the generally

proposed tax. That will, generally speaking, set as a base profit a certain figure arrived at by various methods. No matter how it is arrived at, the proposal is that only a certain percentage—75 percent as I last understood it—will be the final figure used. Everything over that figure will be considered excess profit.

How can such an arrangement be equitable? Anything a manufacturer buys now costs anywhere from 25 percent to 100 percent or higher more than it did in 1947, 1948, and 1949. If we made a profit of $50,000 a year during those years and were held to a top of that amount now, we would, on a comparative basis, have a purchasing profit of only between $25,000 and $44,000 now. If that $50,000 is reduced to $37,500, our purchasing profit has shrunk to anywhere from $18,750 to $33,000.

Gentlemen, you cannot pass a tax that is based on dollars and cents. It must be based on a dollar's purchasing power. If we needed $50,000 in 1947, 1948, and 1949 in order to carry on the orderly equipment replacements and necessary expansion, and still leave a little for our stockholders, how can we do it now on three-fourths of that amount?

It cannot be done, gentlemen, and as surely as you try to do it you may not kill the goose, but you will surely stop it from laying the golden eggs—the very production that is now and will in the future be so badly needed. Not because we manufacturers and businessmen will not want to expand and produce but for the simple reason that we shall be financially unable to do so.

We are all willing to work harder and longer hours without any additional pay. However, this matter of profit is not a matter of enriching an individual or any number of individuals. It is a matter of putting money into the upkeep and expansion of a business so that production shall continue as great or become greater than it is now. On that principle was the economic and industrial might of this county founded and only on that principle can it continue its growth or, perhaps, even its existence.

I thank you again for the time you have given me and hope that I have planted in your minds some thoughts which will be given full consideration in your deliberations concerning this extremely important matter.

I might say this, if I may: My partner and I bought a company in 1947 that is 75 years old. We have no records. We don't know what was done with that company during the previous years except that we do know that it had not been properly handled from the standpoint of taking advantage of all of its possibilities.

We had in 1947 practically no profit. In 1948 we had a very good year. In 1949 we were disturbed as many metal fabricators are—incidentally this is a metal fabricating business—in 1949 I believe that every metal fabricating business in the country was disturbed by this basing-point situation on steel.

We had to pay immediately 25 percent more for our materials, which were the backbone of our business, and we couldn't pass it on to our customers because there was a considerable amount of controversy regarding the possible rescinding of the order, whether it was going to be changed.

Just what would happen no one knew. Consequently our customers would not stand for any increases in price on the basis of our having to pay that much more for material. The result of that was that in 1949 we made practically no profit. In 1950 we have a good year.

The 2 years that we had a good year in, 1948 and 1950, had nothing to do with the war or the war situation, has had really nothing to do even with general conditions. In our line of business we search out—and I say this not only for ourselves but for other companies in the same line of business—we search out accounts that are what we call big accounts that can be the mainstay of our business for a period of a year or 2 years or however long we can keep them or however long they are making the particular product that we can make parts for.

In 1948 we found such an account. A good deal of our profit came from one account. In 1950—and this happens to be the latter part of 1950—again we found such an account that we had been working on for 6 months in the early part of 1950. True, we have had a good year in the latter part of 1950, but we did it just because we worked like the devil the early part of the year in order to develop an account that started as a small one and kept growing, and we kept getting more business from them because we worked harder and we gave them better service than anyone else could.

I don't believe that the retroactive clause of this proposed bill has any place in the bill. I see no reason, gentlemen, why we should have any retroactive clause that would take us back to June or July or any part of the year. I see no reason why that should be done any more than a criminal law should be passed and made retroactive.

This is a law as much as any other law. We have no right to make laws that are retroactive that change the actions of individual citizens of this country, where today we are following the law and doing what the law requires, and 2 months from now it develops that we did something that was illegal because some law has been passed that has been made retroactive. I do not believe that it should be done, I do not know whether it can legally be done.

I would make this suggestion: I would like to just say that something along this line would perhaps do a job: if we must have an excess profits tax it should be made on the basis of a sliding scale. Let's assume that we are allowed to take the best years of the last 4 years and take 1948. If we earned 5 percent or 10 percent more than we did in 1948, in addition to paying the higher tax on the basis of the tax bracket, we should pay a 10 percent additional tax on that 10 percent additional profit in addition to our regular tax, if it is 50 percent, if it is a hundred percent. That is the way it should go.

So that the tax goes up in proportion to the profit, not on the basis that anything over a certain amount automatically carries 65, or 75, or 85 percent, or whatever you want to put it.

I believe that covers it, gentlemen.

The CHAIRMAN. We thank you very much for your appearance.

Mr. STANGLER. Thank you, sir.

The CHAIRMAN. Mr. Potgeter?

STATEMENT OF GEORGE POTGETER, APPEARING FOR IOWA ASSOCIATED BUSINESSMEN, STEAMBOAT ROCK, IOWA

Mr. POTGETER. I am George Potgeter. I come from the grass roots of Iowa. I have never been here before. I don't know whether I will again. I hope to. It is an education to be here this afternoon and be in the presence of all this ability on both sides of the ring.

My statement is short and I will confine it to a few direct suggestions, not that I haven't agreed with much that has been said and that I could elaborate on but the time is too short.

I am a country elevator operator of Steamboat Rock, Iowa. I am president and a member of Iowa Associated Businessmen, in whose behalf I am appearing before this committee. I have come to Washington at my own expense to present my views as well as the views of my association on a glaring shortcoming of the Excess Profits Tax Act of 1950, as passed by the House of Representatives.

At this time, when no one knows what the cost of war will be in men and dollars, we cannot object to increased taxation even though tax rates become so high that they confiscate everything but the bare essentials of life themselves. We can only ask that you, out of justice, levy those taxes equally on all individuals and businesses and do not let any groups go scot-free as the present Excess Profits Tax Act of 1950, H. R. 9827, proposes to do.

I refer specifically to section 452 on page 96 of the printed bill that lets certain profit-making corporations, including the cooperatives, escape the payment of excess profits tax if they are exempt under section 101 of the Internal Revenue Code.

I submit to you men, members of the Senate, that this is neither right nor decent. The excess profits tax should apply to all alike if their income comes from competitive business.

I was much impressed by a statement made by Congressman Mason, of Illinois, a member of the Ways and Means Committee, on the floor of the House last Monday afternoon. According to Mr. Mason, official figures of the Farm Credit Administration show that tax-dodging cooperatives doubled their business volume during World War II when they were exempt from the 95 percent excess profits tax which the rest of us had to pay. Those figures must be conservative. My own cooperative competition did much better.

Mr. Mason further stated that if we use the Farm Credit Administration's figures of cooperative business, these cooperatives would pay an excess profits tax of more than $63,000,000 a year under House bill 9827.

Senator MILLIKIN. What is your own business?

Mr. POTGETER. I am in the country grain business.

Senator MILLIKIN. Grain?

Mr. POTGETER. Grain and sidelines: coal, feed, lumber.

Now, $63,000,000 may not impress you folks here in Washington, but I am here to tell you that we don't toss that kind of money around in Steamboat Rock. To us that means a lot of tanks, planes, and guns for which we would gladly sacrifice our businesses if we could put them in the hands of our boys in Korea today.

According to my lawyers, the revenue bill of 1950 made a beginning toward tax equality by taxing the business income of colleges, labor unions, and other tax exempts, which compete with taxpaying businessmen, but the present bill excuses these same businesses from paying excess profits tax. This just does not make sense. I have tried to find out why this is done but have met with little success. Can any of you tell me?

Senator MILLIKIN. We do not answer questions.

Mr. POTGETER. I thought so. I guess I am supposed to answer questions, not ask them. I am still going to try to find out.

It is even more ridiculous to let cooperatives and other tax-exempt businesses escape regular income taxes at a time when special taxes are being imposed on excess profits. Surely these people get just as much protection from Government as taxpaying business. Certainly their moral obligations to help pay for the war and equip our boys are just as great as mine.

I insist on the grounds of fair play and decency that the bill before you be changed to remove those provisions which let some businesses escape their fair share of the cost of war.

Most of us have had some experience with the excess profits tax during the last war, and I left my experiences entirely out. If I had time and I thought I was not encroaching upon your time, I would give it, but it is repetitious.

It came mighty close to ruining many of us in the grain business who had to compete with the tax-free cooperatives. It will bring our finish this time. Let me explain. The elevator business has been expanded in the last few years to take care of grain storage under the price-support program. This required many local grain elevators to double their capacity. Naturally, they had to raise capital to pay for this expansion.

Many small operators hesitated before they went along with the support program. Many reasons account for their hesitancy.

First, the present high taxes make it necessary for fellows like myself to take nearly 20 years to pay for our new plants out of earnings. Second, inflation has been raising havoc with our working capital. We need all of our income after taxes to keep up with the increased need for working capital brought on by inflation. Thus, none of our income is available for increasing our plant and equipment.

Third, our tax-free cooperative competitors who can borrow money on any terms from the Government, can pay for their facilities and provide working capital out of money that I and other competing businesses have to pay in taxes. As a result, the cooperatives are taking over the grain business and thereby reducing the number of businesses from which you will be able to collect excess profits tax or regular taxes, for that matter.

Here is what I mean. I have before me the financial statements of the Cooperative Grain & Products Co. of Ringsted, Iowa, whose principal business is the buying of grain, just like mine. By the way, I have extra copies here and I would like to hand them to you [handing to the chairman].

During their 1948 fiscal year, according to this statement, they made more than $80,000 on which they paid no income tax since the majority of their income was classified as deferred patronage dividends.

Gentlemen, if we have a high excess profits tax the small grain elevator operators will have to increase their margin because their income after taxes provides the only means by which they can retire the debt they contracted when they expanded their storage facilities.

Now, if they increase their margin, to increase their income after taxes, you can rest assured that this cooperative will do likewise. Its income instead of being $80,000 will be $120,000 or $160,000 but, unlike the taxpayer, this cooperative will be able to retain the $120,000 or the $160,000.

By the hocus-pocus method of patronage dividend which I hope you will understand.

Now, some co-ops pay a token income tax. You would expect them, therefore, to be subject to the excess profits tax. They are theoretically, but they won't pay any as long as they are permitted to deduct patronage dividends from their income for tax purposes. Even though their income triples and quadruples, they will have nothing to pay because they can call their excess profits patronage dividends. Thus in effect, the excess profits tax not only gave the tax-free business an overwhelming tax advantage, but also increases their tax-free income.

Every individual in the United States is greatly interested in the tax freedom granted in this bill. They realize that for every dollar that escapes taxation they will be called upon to make it up in the form of higher rates.

Make no mistake, the public today is upset. Through television, radio, and the press, they follow the grim developments in Korea. They know that our boys must be supplied and that those supplies have to be paid for. They are willing to tighten their belts, but they expect everybody, including the co-ops, to tighten their belts at the same time. They want no profit-making tax 4-F's on the home front; therefore, you must eliminate the exempts included in this bill. You must levy these heavy taxes on a just and equitable basis.

That is all I have of my written statement. I would like to add one little remark if you will permit me. In the testimony of the gentleman from the Grange, the last line of the fourteenth paragraph on the last page, he said—

> And under a tax system that does not permit the stockholders to escape taxation of their share of untaxed, lightly taxed corporate earnings—

he did not say co-op but he could just as well have said it.

I agree with the statement. They should not be exempt. Also, the last of paragraph 16 on the last page, in which he says:

> But we must preserve opportunity and incentive to expand and promote efficiency to the end that our very American structure will not be destroyed—

and the only boys that can do that are the tax-exempt organizations that can expand and we can't do it.

I thank you, sir.

The CHAIRMAN. Thank you.

The CHAIRMAN. Mr. Ulmer, did you appear before the Ways and Means Committee?

Mr. ULMER. I did, sir.

The CHAIRMAN. We have that record before us.

STATEMENT OF FRED A. ULMER, TREASURER, MONSANTO CHEMICAL CO., ST. LOUIS, MO.

Mr. ULMER. My name is Fred A. Ulmer. I am treasurer of the Monsanto Chemical Co., whose headquarters are located in St. Louis, Mo.

My testimony today is directed to informing the Congress of an excess profits tax credit base more equitable to many taxpayers and less destructive to growth businesses. I shall not discuss whether the Congress should enact an excess profits tax. There is ample testimony before this committee regarding that matter.

I am fully aware of the injustices and harmful effects of the prior excess profits tax and oppose its reenactment. But if there is to be an excess profits tax now or in the future, vast improvements over the 1942 Excess Profits Tax Act can and should be designed.

I have a few remarks at the end concerning the recently passed House version of the excess profits tax. Excess profits taxation methods have heretofore been most unfair, inflexible, and unsuited to most taxpayers, as well as the Government, because an inequitable tax law cannot be equitably administered.

Too much power and responsibility vested in the Commissioner yields the errors of the human element. When the determination of what is normal versus excess profits is rigidly fixed by statutory formula, as in the 1942 law, then a multitude of cases suffering inequity and injustice must be handled through relief provisions in the statute, such as section 722 of the last act, and we have very current knowledge that this does not accomplish its purpose, even after many years' delay.

Who can determine, from cursory independent audit, the normal profits of each of many thousands of business units? No single period is fair or normal for all business. One business is depressed in any selected period, while another is prosperous.

Nevertheless, it is demonstrable and logical that a fairer and more accurate measure of normal profits is presented by the long-term statistics of each business entity, not by use of any universal fixed formula. The 1942 law provides for 8 percent to 5 percent of invested capital as the measurement of normal profit.

The untutored tyro would soon find that many businesses make much profit from little capital—genius and industry serve as well. Whereas in other businesses 8 percent over a long period is good indeed. Knowing this, the 1942 Congress provided the option of an alternative method, the use of 1936–39 average income.

What's erroneous and ineffectual about this? Primarily that the entire base period is abnormal, as industry was recovering from the depression of the ages and preparing for the war of the ages. Normal only on the supposition that a collosal minus and a colossal plus yield a normal average.

It was only by accident that the credit allowed may have been fair in any particular case. For example, my company started two of its largest operations in 1936–39, its phosphorus and plastics divisions, and the birth of both was attended with the usual losses and difficulties. Again in the period 1946–49 we have experienced the worst strike in our history and the worst industrial catastrophe, the Texas City disaster. We do not find normalcy there.

So, in search of a more ideal credit base for taxing excess profits, it is not too difficult to find an improvement over present and past devices.

Although all companies do not make 8 percent on invested capital, all do, over a period of years, cut out for themselves a pattern of conformity with a certain fairly constant percentage of earnings on invested capital before taxes, and a 5- to 15-year average would approach the optimum of fair-average earnings.

For example, Monsanto, through the period 1933 to 1936, earned an average net income before taxes of 18.02 percent on invested capital;

the average of 1946–49 was 18.51 percent on invested capital, very nearly the same; and the over-all average of 1935–49 was 20.66, larger because of the war.

So earlier years do not differ much from later years. Following are the elements of this method:

(1) First, develop normal rate of return on capital of any taxpayer by determining the percent of net income before taxes to invested capital over several recent years, say, several years, from 1935 to 1939, and several of the years 1946–49.

(2) This percentage will be computed over that period fixed by statute as to which years to take.

(3) The average of the percents will be the normal average percent of earnings before tax to the capital invested for that particular corporation.

(4) This percentage of normal earnings will then be multiplied by the invested capital for the taxable year.

(5) The amount so computed under (4) will represent the normal taxable income of the taxable year. The income above the normal will be subject to excess profits tax.

The elements are few and simple. It seems at first that the average of rates of return on capital invested in a base period is little, if any, different than the average of money earnings in that same base period.

In principle and in practice there is a radical variance, and especially is this true in its applicaton to growth businesses in which continuous research and invention is their life and where larger amounts of capital are employed each year.

We recommend the optional use by the taxpayer of several excess profits tax credit bases, not only our rate-of-return basis but the average base-period income credit of 1947 to 1949, as heretofore recommended, and the fixed 8-percent to 5-percent invested-capital base, and preferably one or more others to insure equity and fairness to other types of business. No one is harmed by our plan because it is optional.

The chief advantages conducive to equitable taxation are two:

(1) Opportunity to determine and use a more normal income measure.

(2) Automatic adjustment of the credit base to each succeeding tax year by use of a predetermined normal rate of return on capital applied to each tax year's invested capital.

The Treasury does not seriously suffer as indicated by the example of the 28 large companies shown on the attached schedule, for if option of either average income of 1947–49 or our rate of return of 1935–49 basis is granted, 13 would use the one basis, 2 would be practically identical, and 13 would prefer the other, but estimated excess profits taxable income for 1950 would be reduced by only 5 percent of the credit base on the over-all 28 companies.

For the 28 example companies, the estimated 1950 taxable income is $4,500,000,000, nearly 12 percent of estimated all corporate income, a fair sample, and the large companies pay proportionately more excess profits tax than the small ones.

Their 1947–49 average money income will be about $3,000,000,000, the long-term rate of return times 1950 capital is only about, in this case, $2,750,000, and the election by each company of the best method of the two gives $3,160,000.

The startling fact is that real substantial relief is gained by the growth companies. And it is a fair assumption, and several have testified to the fact, that a taxpayer would much prefer to have a fair choice of several credit bases, and then forego any relief claim privilege, than to have a narrow, catch-as-catch-can basis of fixing normal income and have the questionable privilege of relief claims.

It is said that excess profits tax methods based on invested capital has been impossible of administration and were inequitable because of the vagaries and viscissitude of definition of invested capital. How evaluate good will, patents and processes, trademarks, et cetera? How evaluate large issue of shares given for a new acquisition? What to do about "transferors' basis"?

We do have a definition to recommend, but it is well first to consider that it makes little difference in the excess profits tax credit basis we urge, so long at whatever definition is used is uniformly applied, because if the rate of return on capital in an instant case is calculated on exaggerated capital, the earnings—fixed—will yield a smaller rate of return, and vice versa.

And so the normal calculated in the tax year will not be erroneously affected, for the amount of capital invested and the rate of return will vary inversely—will compensate errors. Consistency alone is mandatory.

But all true capital should be permitted in the base, i. e., long-term debt as well as capital stock and surplus, for all companies do not follow the same financial policy and pattern, some have large proportion of debt, some none, so all must be allowed or the policy of some companies would crucify them in this matter of rate of return on capital.

Also, in order to fairly reflect earnings on capital invested in manufacturing industry, the amount of new capital added in any year should be deferred 1 year in calculating percentage of earnings to investment because of the rather obvious fact that there is a lag of about 1 year before new capital can be converted into plant, and product and profit start to flow.

In other words, the invested capital of the year end of 1948, say, would form the basis for determining rate of return in 1950.

If abuse be feared that capital will be issued merely for the benefit of excess profits tax exemption, it is quite reasonable to provide that invested capital be limited to plant or fixed assets, inventories and accounts receivable, so cash and marketable securities are barred.

If a taxpayer corporation has too short a history to develop its stride, then, as in the 1918 law, it could be provided that the Commissioner of Internal Revenue be empowered to use industry averages.

Charts shown herewith show several interesting sidelights and bring the effect of our plan into high relief:

(*a*) That it will not deprive the Treasury is forcefully evidenced by the showing that the proposed base equals only 92 percent of the 1947–49 average earnings, using 28 of the top big 50 industrial companies.

(*b*) That use of this alternate method or the average earnings 1947–49 method, amounts to about a 5-percent tax loss to the Treasury, and many relief claims would be prevented.

(*c*) That 13 of the 28 would have a more favorable base, two would be practically identical, and 13 would have a less favorable base.

(*d*) That the 13 companies having a more favorable base under the proposed method have increased their capital an average of 196 percent from 1945 to 1949.

Therefore, it becomes evident that the alternate plan we propose is designed for growth companies, those in which research, invention, development, and rapidly increasing investment are most productive.

And these businesses should not be stifled since national prosperity and wartime strength both depend so much on such companies.

It also becomes obvious that any average of several years' earnings, chosen in retrospect as an excess profits tax base, does irreparable damage to a rapidly growing concern. Hence it should be clearly understood that we propose an alternative, not a substitute, so a substantial number of very important companies would thereby gain equal treatment before the law.

If it be objected that this is all too complex and difficult for administration, I say to you a fair and equitable tax is worth a great price. And a relief provision has exacted a high price.

These are my reflections on the House bill presently passed. We sincerely believe the method hereinbefore described produces the only fair and equitable method of determining normal income for growth companies. The method would make expansive venturing possible, insure stability and strength and a profit more commensurate with the risk.

Presently the invested capital method provides an umbrella for those companies who earn low returns on invested capital. Realistically, there is no true invested capital credit base graduated to the historical earning experience of the taxpayer. It is not adapted to those dynamic growing companies whose earnings range upward from 12 percent.

Raising that fixed rate from a minimum of 5 percent to 8 percent as the House bill does, does not help the growth companies. Should the company earning 5 percent on invested capital be allowed an exemption of 8 to 12 percent while one commonly earning 20 percent on investments be penalized because in the arbitrary fixed base period its average earnings fail to reflect the rapid expansion of the company?

Again in one decade America is called upon to defend freedom, our way of life, all we hold dear. And again a large part of our success will be due to our free enterprise and its ability to outproduce the world.

In truth and justice, all should be equitably treated in taxation, and our proposed excess profits tax credit base is the logical and effective way to provide fair treatment to growing companies, both large and small.

I do not suggest that business unjustly and inequitably taxed will fail in its duty to produce gigantically to save this last stronghold of freedom. I do plead with all sense of fair play and justice that this Congress rise above all its predecessors and enact a fair and just excess profits tax law. It can be done.

The CHAIRMAN. Thank you very much for your appearance.

(The sidelights and observations on excess profits taxation are as follows:)

SIDELIGHTS AND OBSERVATIONS ON EXCESS PROFITS TAXATION

(Presented by Monsanto Chemical Co.)

ENUMERATION OF FAULTS AND INJUSTICES OF PREVIOUS EXCESS PROFITS TAX ACTS

1. Determination of excess profits inescapably assumes reasonably accurate knowledge or record of normal profit. As long as excess profits are sought to be taxed, this assumption will be present.

2. Fallacy of presuming that a recent prior period was normal for each and every business entity, or that it could be made a measure of normal.

3. Fallacy of the alternative basis of a fixed return on invested capital, as though all ventures and enterprises do profit equally.

4. Averaging earnings over 3 or 4 years to discover a norm unavoidably fixes an excess profits tax on the peacetime earnings of the one or two higher years of those averaged, so that normal profits, not alone war or windfall profits are excessively taxed.

5. Grievous injuries and injustices of excess profits taxes of past wars were rather short-lived, but the present financial emergency threatens to continue for many years, therefore multiplying the harm that a destructive and unfair tax may cause.

6. A grave and destructive error is involved in the deflationary effect of any confiscatory tax · the wild inflationary effect of collossal government expenditures affects all economic activity, so the deflationary offset of high taxation should likewise be spread as widely as possible, both for just treatment of all persons before the law, and for the salutary effect of deflationary counteraction against the growing inflation ever present in wars and readying for war.

7. As aforesaid, the deflationary effect of a war profits tax should be applied impartially; but in its very nature it is not because it has not been found practicable to apply it to individuals and partnerships, therefore making the stockholder the sole victim.

8. An excess profits tax law always vacillates between two serious evils; i. e., (1) giving too great discretion and powers to the admiinstrative body, the Internal Revenue Bureau, or (2) giving little judgment and scope to IRB by rigidly limiting all taxpayers to inflexible standards, like the two credit bases in the 1942 excess profits law.

9. An arbitrary and rigid base for fixing normal profits, like section 714 in the act of 1942, wreaks its havoc indiscriminately, both against the taxpayer and tax collector. Whether the rate of return be set high or low, someone suffers. Why the rate was set at 8 percent, graduated down to 5 percent, is probably unanswerable at this late date, as it gave no relief to most industries, but was veritable manna from heaven to those companies who had not averaged that rate for years, if ever.

10. Relief provisions in excess profits tax laws like section 722 in 1942 act and sections 327 and 328 of the 1918 act are never found to bring order out of chaos as expected. It was 1940 before claims of the First World War were settled; and it looks as though it may be as long before section 722 claims are settled, as the Council is now in effect threatening to throw in the towel. So an Excess Profits Tax Act should have as little need of adjustments as possible, and that would surely be more true if our third alternative credit basis is granted.

11. Apparently it has been found objectionable to provide more than two alternative credit bases, but if it is desired to tax only war or windfall profits, then there is no valid argument against using any device, formula, or earning record that will best measure normal earning power of the taxpayer in the tax year involved, so only the excess will be classified for excessive taxation.

12. Why do we seek to classify growth companies for special treatment? Largely because of the special injury to them of the inherent error in the average earnings method of the last excess profits tax law, in that no allowance was made for investment of retained earnings, depreciation and depletion reserves, etc., no allowance for investment of debt proceeds, and allowance of only 8 percent of new capital; and this error and injury was progressive in effect, not very serious the first year after retention of profits and reserves, but expanding in equitable taxation as years grow farther from the base years.

HOW OUR EXCESS PROFITS CREDIT BASE IS DETERMINED, AND HOW IT CORRECTS AND REMEDIES MANY OF THE DEFECTS OF THE 1942 ACT

Instead of using money earnings of a recent prior period, there should be an election to use the alternative of an experienced average rate of return on capital, averaged over a reasonably long period to correct for excessive peaks and valleys, although it is quite demonstrable and apparent that even over a short 3- or 4-year period this rate of return method has marked advantages over the straight dollar earnings base.

If the election of more than two alternative credit bases be deemed a serious objection, then our basis could be combined with the 1942 invested capital base so that the taxpayer may use (*a*) either the average earnings of a stipulated period, or (*b*) the average rate of return on capital during specified years with the floor or minimum of 10 percent on first $5,000,000 down to, say 6 percent on top capital.

Discussion of our plan with other tax executives brought the objection that historical capital of the taxpayer should be adjusted to offset or remedy the recent years decline in dollar value. It could be done on the basis of the index of cost of living or the index of the dollar value itself or any one of two or three other tables of Government statistics. For absolute equity and fairness it should be done for the reason that the dollar of plant investment of 1935–40 probably creates twice the dollar profit today as it did pre-1940.

If an excess profits tax is unavoidable, the least remedial improvement that should be worked into the 1942 excess profits tax framework is the following:

(*a*) Whatever credit bases may be provided, long-term debt should be included.

(*b*) Each excess profits taxable year should include instead of 8 percent of all new capital, including debt, the same percentage of that capital as the selected credit basis is of the capital of the base period and undistributed profits should be progressively added to the base.

(*c*) It is our studied opinion that the 1940 method of deducting normal tax before the computation of excess profits tax was a much more fair device than the method used in 1941 to 1945. Its only fault would be that it limits the revenue. Justification for deducting the normal tax is that normal tax is just as much an expense or cost of doing business of the taxpayer as wages, salaries, and rents, and to realistically determine excess profits it is, of course, necessary to deduct normal taxes. Certainly this treatment should be accorded public utilities in order to curtail useless inflation of rates.

Illustrative excess profits tax credit bases, 28 of 50 largest industrial companies

	1950 earnings before tax (estimated)[1]	1950 capital (estimated)	Average percent earnings on capital, 1935–49	1950 capital times average 1935–49 percent earnings on capital	Average earnings, 1947–49	Average earnings, 1946–49	1950 capital times average 1935–49 percent earnings on capital less 1942–45	Average percent earnings on capital 1935–49 less 1942–45 war years	Average percent 6 years (3 best prewar 1935–39 and 3 best postwar 1946–49)	1950 capital times 6 years percent (3 prewar and 3 post war years)
American Can Co	[2] $48,318,059	$221,773,817	[2] 14.91	$33,075,347	$42,959,334	$35,765,977	$34,354,981	15.49	17.22	$38,200,540
Armour & Co	30,509,426	322,059,416	8.76	28,225,287	17,448,221	27,359,635	23,339,645	7.24	9.43	30,389,526
Bethlehem Steel	199,481,146	1,007,760,929	14.19	143,091,974	136,441,491	116,639,109	112,173,869	11.13	11.70	117,978,572
Borden Co	[2] 34,761,241	197,634,155	[2] 15.48	30,599,696	32,206,800	32,562,958	24,293,190	12.29	14.42	28,500,821
Chrysler	[2] 213,170,096	471,220,182	[2] 34.06	160,502,306	158,779,519	127,356,962	172,080,186	36.51	44.75	210,894,592
Continental Can Co	46,342,884	203,985,193	[2] 10.51	21,438,844	21,209,746	18,648,045	22,440,411	11.10	13.03	26,593,550
Deere & Co	73,815,524	190,824,632	[2] 21,98	41,952,795	47,871,429	40,410,928	38,706,868	20.28	23.85	45,526,940
Dow Chemical Co	53,313,105	282,421,290	17.15	48,455,021	31,987,095	26,264,808	41,335,180	14.63	15.23	43,035,356
E. I. du Pont	391,617,976	1,239,889,290	21.36	264,939,543	264,489,216	242,318,751	252,974,612	20.40	21.32	264,431,189
Eastman	81,725,664	348,000,000	[3] 24.81	86,345,760	78,320,351	70,445,457	73,080,000	21.00	21.86	76,079,760
Firestone Tire & Rubber	[2] 35,389,045	236,234,211	[2] 17.95	42,418,215	44,630,922	49,656,456	33,422,416	14.14	17.00	40,181,076
General Electric Co	273,889,984	776,885,778	[2] 33.80	262,618,468	207,296,774	161,520,859	176,213,232	22.68	23.58	183,236,280
General Foods	38,494,120	160,000,000	[3] 26.80	42,888,000	38,263,909	37,404,691	38,350,400	23.96	26.45	42,324,800
General Motors, Inc	1,661,346,778	2,441,343,987	27.21	664,338,526	826,833,803	623,341,602	684,723,721	28.04	38.20	932,739,884
Goodyear Tire & Rubber	54,761,544	236,202,938	21.54	50,894,648	54,688,260	64,574,205	37,206,686	15.75	19.50	46,080,830
International Business Machines	57,075,430	223,292,900	[2] 25.99	58,047,222	46,077,273	42,374,563	45,085,069	20.19	20.86	46,581,130
International Paper Co	114,060,088	300,000,000	[3] 16.90	50,709,000	97,709,484	87,099,452	52,611,000	17.53	22.45	67,371,000
Liggett & Myers Tobacco Co	[2] 49,324,017	413,203,387	[2] 13.16	54,377,553	45,769,444	42,143,708	49,117,475	11.88	13.19	54,522,173
National Dairy Products	[2] 57,088,036	270,435,548	[2] 14.83	40,108,296	46,299,082	46,431,767	36,387,103	13.45	15.61	42,225,806
National Distillers	[2] 40,055,931	205,191,378	[2] 24.18	49,625,535	47,496,454	51,886,037	42,244,801	20.58	27.06	55,526,840
Pittsburgh Plate Glass	[2] 59,435,088	185,697,648	[2] 21.68	40,274,106	56,543,936	50,173,226	42,424,485	22.84	26.91	49,974,951
Procter & Gamble	99,897,084	262,979,989	20.87	54,886,554	78,305,523	67,459,810	56,848,384	21.61	27.61	72,619,295
Radio Corp. of America	70,203,286	200,000,000	[3] 19.88	39,760,000	37,613,294	31,796,604	35,108,000	17.55	18.86	37,726,000
Republic Steel Corp	137,404,151	425,000,000	[3] 10.74	44,716,122	72,133,815	60,378,881	44,153,250	10.38	11.03	46,881,750
R. J. Reynolds Tobacco	[2] 68,925,327	433,056,747	[2] 20.38	88,261,296	62,189,195	58,969,209	88,040,436	20.33	20.44	88,534,121
Swift & Co	[2] 46,342,919	367,861,585	[2] 9.67	35,579,573	51,844,070	44,600,087	27,622,726	7.50	9.53	35,079,280
United States Steel Co	407,158,500	2,100,000,000	[3] 8.43	177,177,000	256,061,906	222,528,407	167,622,000	7.98	9.42	198,009,000
Westinghouse Electric	[2] 110,772,670	553,784,632	[2] 18.85	104,438,244	101,675,365	79,194,113	81,589,089	14.73	17.44	96,596,654
Total	4,554,679,119	14,276,739,532		2,759,744,931	3,003,145,711	2,559,306,307	2,533,549,215			3,017,841,716

[1] 1950 estimated earnings, 6 months on annual basis.
[2] 1950 not available; 1949 figures used.
[3] Estimated on basis of previous years.

Monsanto Chemical Co.

Year	Earnings before taxes	Invested capital	Percent
1935	$4,654,700	$23,710,734	19.631
1936	5,634,322	31,058,371	18.141
1937	6,192,016	37,572,482	16.480
1938	4,144,396	47,312,596	8.760
1939	7,054,524	48,565,611	14.525
1940	10,580,654	46,850,673	22.584
1941	17,917,725	57,097,074	31.381
1942	16,588,738	59,324,577	27.963
1943	16,044,575	61,003,840	26.301
1944	16,341,751	64,423,110	25.366
1945	16,291,601	65,677,346	24.805
1946	16,665,435	109,437,566	15.288
1947	25,940,996	117,269,745	22.120
1948	28,434,771	150,601,470	18.881
1949	28,092,135	157,736,035	17.810
1950, estimated	[1] 44,122,000	[2] 180,000,000	
15-year average return on investment			20.67

1. Average percent of 1935–49	20.67
2. Average percent of 1935–49 less 1942–45 war years	18.69
3. 1950 capital times average percent 1935–49	$37,206,000
4. 1950 capital times average percent 1935–49 less war years	$33,642,000
5. Average earnings 1946–49	$24,783,334
6. Average earnings 1947–49	$27,489,300
7. Average percent 1947–49 earnings on capital	19.603
8. 1950 capital times 1947–49 average percent earnings on capital	$35,285,400

[1] 6 months on annual basis.
[2] Estimated.

International Shoe Co.

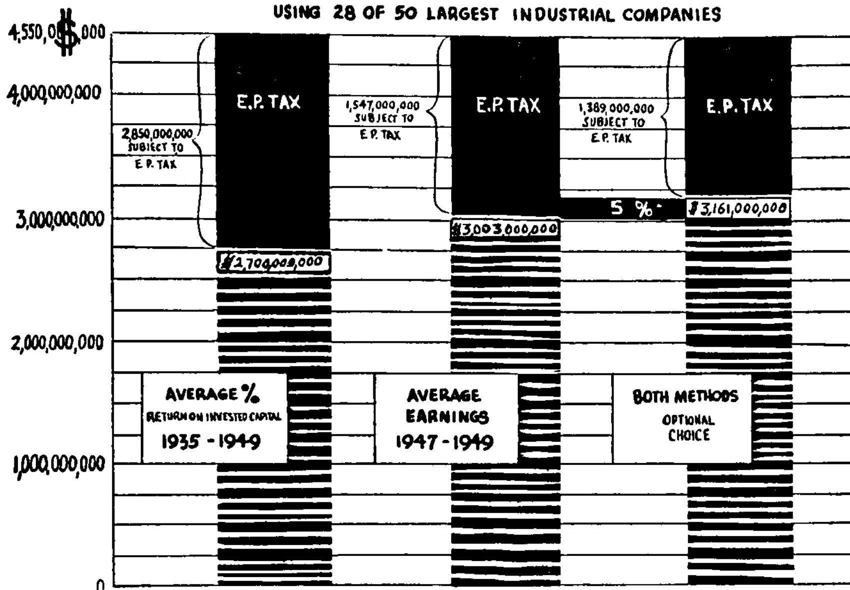
Year	Earnings before taxes	Invested capital	Percent
1935	$10,031,600	$78,283,129	12.814
1936	9,771,445	79,183,655	12.340
1937	7,394,495	78,772,472	9.387
1938	4,890,762	77,195,234	6.335
1939	8,061,897	77,937,168	10.344
1940	8,122,117	78,560,805	10.339
1941	9,691,080	79,082,842	11.711
1942	17,084,161	80,063,635	21.338
1943	19,283,181	80,788,203	23.869
1944	13,219,835	80,738,357	16,375
1945	10,671,210	80,293,997	13.290
1946	2,196,367	79,729,698	2.755
1947	22,533,780	88,212,734	25.545
1948	21,923,601	91,832,931	23.873
1949	12,285,309	89,797,221	13.681
1950 estimate	[1] 14,903,600	[1] 89,762,464	
15-year average return on investment			14.27

1. Average percent of 1935–49	14.27
2. Average percent of 1935–49 less 1942–45 war years	12.65
3. 1950 capital multiplied by average percent 1935–49	$12,809,103
4. 1950 capital multiplied by average percent 1935–49 less war years	$11,354,951
5. Average earnings 1946–49	$14,734,764
6. Average earnings 1947–49	$18,914,230
7. Average percent 1947–49 earnings on capital	21.033
8. 1950 capital multiplied by 1947–49 average percent earnings on capital	$18,879,739

[1] 6 months on annual basis.

1950 INCOME AND PROPOSED E. P. TAX METHODS

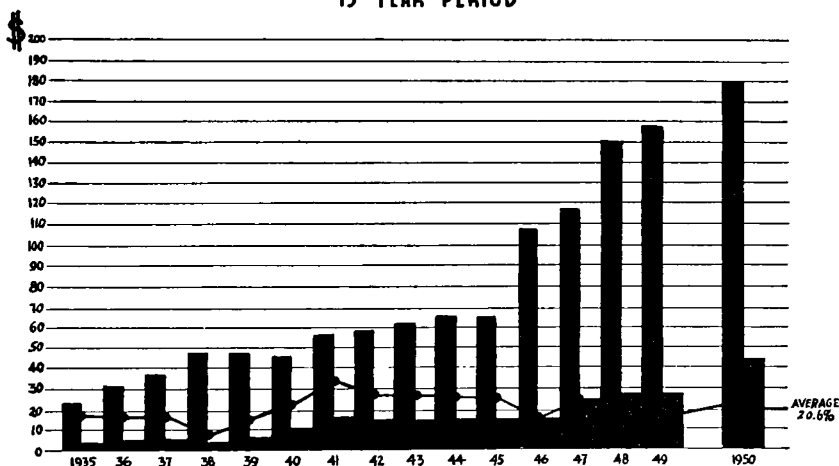
USING 28 OF 50 LARGEST INDUSTRIAL COMPANIES



GROWTH COMPANY *

EARNINGS COMPARED TO CAPITAL INVESTMENT

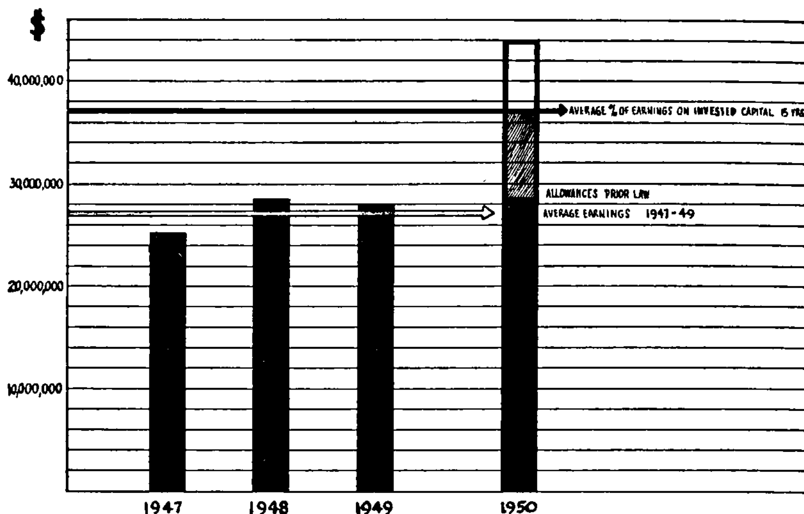
15 YEAR PERIOD



*MONSANTO CHEMICAL COMPANY

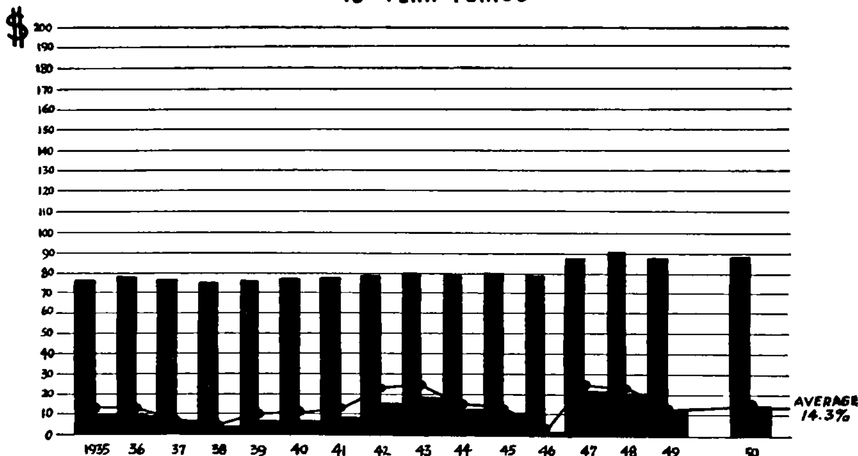
GROWTH COMPANY... EARNINGS

SHOWING VARIOUS INTERPRETATIONS OF EXCESS PROFITS



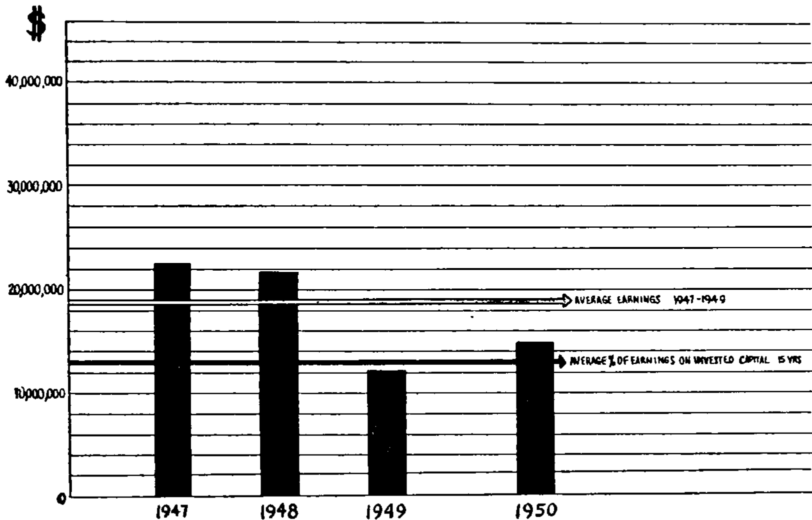
STATIC COMPANY*

EARNINGS COMPARED TO CAPITAL INVESTMENT 15 YEAR PERIOD



* INTERNATIONAL SHOE COMPANY

STATIC COMPANY... EARNINGS
SHOWING VARIOUS INTERPRETATIONS OF EXCESS PROFITS



The CHAIRMAN. Mr. Terborgh, will you kindly identify yourself for the record?

STATEMENT OF GEORGE TERBORGH, RESEARCH DIRECTOR, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. TERBORGH. I am George Terborgh, research director of the Machinery and Allied Products Institute, 1236 Twentieth Street, of this city. Within the 10-minute time limit it is obviously impossible for me to give a complete statement of the views and position of the institute on the excess profits tax, and not even on the pending bill. We did present to the Ways and Means Committee of the House an extended statement and I have taken the liberty of supplying a copy of it to each member of this committee in the pamphlet form in which it was printed under the heading "The defense program and the excess profits tax."

If you think it appropriate to incorporate it in the record of this proceeding, of course we would appreciate it, but I don't know whether that is according to the rules

The CHAIRMAN. It is already in the record.

Mr. TERBORGH. It is in the record of the Ways and Means Committee, that is correct. Let me simply run down the list of recommendations we made without comment and then devote my attention to the provisions of the pending bill.

We propose that whatever the revenue requirements may be on corporations, they be raised by a "defense profits tax" or "defense surtax" imposed at a flat rate and specifically identified as the amount in excess of the preemergency rate of 38 percent. I will advert to that in a moment, but let me go on to give the recommendations we made as to the provisions of an excess profits tax if there was to be such a tax:

1. Compute the excess profits credit after normal tax and surtax.
2. Permit the taxpayer as an average-earnings credit the best 3 of the 4 years 1946–49, with an adjustment for increased earnings during the period.
3. Allow as an alternative credit an income plus after taxes equal to an 8-percent return on invested capital.
4. Graduate the tax rates on excess profits in accordance with the degree of excessiveness.
5. Make adequate provision for growing enterprises.
6. Reenact the relief provisions of the wartime law with some modifications, adding the right of a company to elect its prewar earnings base if higher than its postwar base, and reorganize the review of claims.
7. Provide a 3-year carry-back and a 6-year carry-over of unused excess profits credits.
8. Liberalize depreciation allowances and provide acceleration for intensified use.
9. Apply the tax initially to the taxable year 1951.
10. Set a definite termination date.

These recommendations we still adhere to, but they were, of course, made before we had any specific bill to address ourselves to. I want to talk about H. R. 9827. First, however, let me reaffirm our opposition to any excess profits tax at all at this time.

Mind you, we are not raising a question of revenue. If you gentlemen say that $4,000,000,000 more should be raised from corporations, we accept that verdict. It is entirely a question of the way the burden should be distributed. It is widely considered that an excess profits tax, for some reason or other, yields greater equity under conditions like these than a flat rate tax yielding like revenue.

We dissent from that proposition completely. The only practicable techniques for identifying excess profits are so faulty that they are bound to generate more inequity than they cure and especially if continued in operation for any length of time. What they are supposed to capture is profits during the defense period that would not have been made had the defense emergency not come along. Lacking any criterion of what would have happened in that contingency, we have to fall back on a historical base period which results in tying and chaining each company to its own past, and it multiplies inequities on a huge scale as we go along.

I call the attention of the committee to the fact that you could put in a law comparable to the pending law in time of profound peace and it would begin signaling excess profits on a huge scale and on an increasing scale with the passage of time. If a law will falsely signal excess profits when there are not any, how can such a law be expected to identify and screen out excess profits in a period of a defense emergency.

I want to also point out that all profits from the defense program itself will be subject to renegotiation before the tax law is applied, and that, of course, is the area in which the greatest opportunity for unusual profits will appear. We don't believe that there is any balance of equity in favor of this tax. We think it will breed more inequity than it cures.

As for the economic consequences, you will no doubt listen to testimony on that to which I can add very little except to say that we are

hearing so much these days about the prime necessity of maintaining an expanding economy, building up American productivity, and this is the tax which will bear with differential and discriminatory effect on expanding and growing enterprises.

Now, let me comment a little on H. R. 9827. I want to talk about three provisions only:

1. The limitation of the earnings credit to 85 percent.
2. The use of a flat-rate excess profits tax.
3. The proposed relief provision.

It seems to me it makes no sense to take 85 percent of base period earnings rather than a hundred percent unless it can be shown that base period earnings were for some reason abnormally high. That was the argument used by the Secretary of the Treasury in urging that the cut-back be 25 percent, which appeared as 15 in the House bill.

In taking that position, the Secretary gave currency to one of the great illusions of the postwar era. I would like to call attention to the chart which is on the back of my statement, which shows corporate profits as a percentage of sales for the past 41 years and which clearly shows that the base period average for 1946 to 1949 is substantially lower than the average for the entire 21 years prior to the great depression. It is absurd, therefore, to reduce base period earnings by 25 percent or even 15 percent. Now, a comment on the use of a flat rate.

The bill apparently assumes that there are no degrees of excessiveness and that every dollar ought to be taxed like every other dollar. We see no sense in that view. If the concept of excessiveness has any meaning, it must admit of degrees. Corporate profits before taxes can't be excessive. It is an absurd conception to adjudge the excessiveness of profits before taxes. We propose that the excess profits rate be graduated in accordance with the degree of excessiveness in successive brackets based on the relation of the excess profits net income to the amount of the credit, not, of course, on an absolute graduation such as was incorporated in the excess profits tax of 1940.

We suggest that the first bracket rate apply to excess profits up to 50 percent of the credit; the second to such profits in excess of 50 percent of the credit but not over 100 percent; the third to profits above 100 percent but not over 150 percent; and the fourth to all profits above 150 percent.

A graduated structure of this sort would permit the taxation at a moderate rate of profits that are just over the credit, the excessiveness of which is at best debatable, and a higher rate on profits of less uncertain status.

Senator KERR. Do I understand that you are recommending the principle of a graduated tax on corporations?

Mr. TERBORGH. Not by amounts of income. Not under any circumstances by amounts of income, but rather by degrees of excessiveness as defined by the relation——

Senator KERR. Do you think if you got the graduated principle in on the one hand that it would thereby be easier to keep it out with reference to other types of cases?

Mr. TERBORGH. There may be some risk in that, of which we are aware, but I think there is an absolutely clear distinction between a graduation by size or amount of income, to which we are uncondi-

tionally opposed, and a graduation of an excess profits tax rate in accordance with the degree of excessiveness.

A very small company could have a very highly excessive profit and pay at the top rate. A large company, on the other hand, could pay at the first bracket rate, depending on the relation between the excess profits net income and the amount of the credit.

Senator MILLIKIN. The progressive individual income tax rests in part on the degree of excessiveness.

Mr. TERBORGH. I forgot to look at the clock when I came up here. I suppose I have a minute or two, do I not?

The CHAIRMAN. Yes, sir.

Mr. TERBORGH. That would leave me a little time to comment on the relief provisions in the House bill. Our own approach to this relief headache was to broaden the provisions of section 722 somewhat and take the administration completely out of the Treasury Department and put it in the hands of independent boards more or less comparable to the renegotiation boards.

This bill seizes the other horn of the dilemma and proposes, instead of frankly acknowledging the discretionary character of relief cases and the necessity for informed common-sense judgment on an arbitrary basis, it goes in the other direction to try to set up a formula listing an approach which will obviate the necessity of administrative discretion.

I think that this attempt offers some possibilities, and it is certainly very interesting, but as it is embodied in the pending bill, it serves to restrict the eligibility for relief and the relief given to excessively narrow limits. It eliminates eight separate grounds for relief which were included in section 722 and which are enumerated on pages 6 and 7 of my statement, and with respect to the essential two grounds which are left, it makes very onerous restrictions.

The first of these grounds is that the taxpayer was subject to exceptional physical or economic events during the base period. If you look at the relief given for a taxpayer establishing eligibility under that provision, you will find that if he has got only 1 year of subnormality, he may come out very well, but if he is unfortunate enough to have four depressed years, he can get no relief whatsoever from the provision.

Our recommendation is that a taxpayer who can establish eligibility under that provision be allowed the same kind of relief that is allowed in other cases and for growth companies, namely, that he can take, if he elects, the average earnings rate of his industry during the base period and apply it to his own investment in that period.

The other provision that survives is a change in the products or services furnished. There the relief is fairly adequate if the taxpayer can establish eligibility, but the limitations are so exacting that very few taxpayers will ever become eligible because it requires the introduction of a new product of such tremendous importance in the taxpayer's business that within 3 years from the time of introduction, it accounts for more than one-third of his total net income, and further that his net income in one of those years must exceed 125 percent of such income before the introduction of this new product.

Obviously, that excludes any company that is introducing a multiplicity of new products, no one of which builds up over a 3-year period to a third of its net income. I venture to say that an exceedingly small

proportion of concerns will ever be able to take advantage of that provision because of the difficulty of making the eligibility hurdle.

Finally, our recommendation as to that is that the hurdles be removed and that some definition of the new product and a new produce and service less prohibitive than that be introduced to make the section of some real significance, but more broadly than that, that we reinstate, not necessarily in the same language, but that we reinstate substantially the same grounds for relief that were in section 722 and that have now been stricken, and that we take out of the Treasury and place in the hands of an independent administrative organization the question of determining the taxpayer's eligibility under that expanded gamut of relief provisions.

Thank you.

The CHAIRMAN. Thank you very much. Do you wish to put your brief in in full?

Mr. TERBORGH. Yes, if I may; I will file this for the record.

(The brief is as follows:)

STATEMENT OF GEORGE TERBORGH, RESEARCH DIRECTOR, MACHINERY AND ALLIED PRODUCTS INSTITUTE [1]

Mr. Chairman and gentlemen of the committee, it is obviously impossible in the 10 minutes at my disposal to present an adequate statement of our views on the excess profits tax in general, or even on the provisions of H. R. 9827. Since we have presented to the House Ways and Means Committee a full statement of our position, I have taken the liberty of supplying a copy of that statement to each member of this committee, printed in pamphlet form under the heading "The defense program and the excess profits tax." If you think it appropriate to incorporate it in the record of this proceeding, we shall of course appreciate it.

Under the prescribed time limit, I shall have to be content with a bare recapitulation of our recommendations in that document.

SUMMARY OF RECOMMENDATIONS

1. Increased corporate taxes resulting from the defense emergency should fall on all income alike, without distinction as to "excess" or "normal."
2. Additions to the preemergency rate of 38 percent should be specifically designated as a "defense profits tax" or a "defense surtax."
3. Such additions should be imposed for a limited period only, subject, if necessary, to periodic renewal.

While we oppose an excess profits tax under present conditions, we recommend the following provisions if there is to be one:

1. Compute the excess profits credit after normal tax and surtax.
2. Permit the taxpayer as an average-earnings credit the best 3 of the 4 years 1946–49, with an adjustment for increased earnings during the period.
3. Allow as an alternative credit an income after taxes equal to an 8 percent return on invested capital.
4. Graduate the tax rates on excess profits in accordance with the degree of excessiveness.
5. Make adequate provision for growing enterprises.
6. Reenact the relief provisions of the wartime law with some modifications, adding the right of a company to elect its prewar earnings base if higher than its postwar base, and reorganize the review of claims.
7. Proved a 3-year carry-back and a 6-year carry-over of unused excess profits credits.
8. Liberalize depreciation allowances and provide acceleration for intensified use.
9. Apply the tax initially to the taxable year 1951.
10. Set a definite termination date.

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[1] Subject to amplification in oral testimony.

While these recommendations still represent our best judgment, they were prepared before the excess profits tax bill had been drafted. Since we now have H. R. 9827 to consider, it is appropriate that I address my remarks to the provisions of that bill, of which I shall have time to consider only three. Before I do this, however, I must take a moment to reaffirm the opposition of the Machinery Institute to any excess profits tax at all at this time.

OBJECTIONS TO AN EXCESS PROFITS TAX

Let me make it perfectly clear that we do not undertake to prescribe how much additional revenue should be raised by taxes on corporate incomes. If the Congress decides that it is necessary and desirable to raise $4,000,000,000 more from this source, we accept the verdict. Our representations have to do wholly with the manner in which the burden should be distributed among corporate taxpayers. As the foregoing summary of recommendations indicates, we believe that the added revenue should come from a flat-rate defense profits tax superimposed on the preemergency rate of 38 percent.

The proponents of the excess profits tax appear to believe that it provides a more equitable way of raising additional revenue than a flat-rate increase, hence that we are constrained to adopt this device on moral grounds. This is, in our judgment, an illusion. The only practicable techniques for identifying so-called excess profits are so faulty that they are bound to generate more inequity than they cure, especially if continued in operation for any length of time.

The basic concept of "excess" profits relates to profits made during the defense emergency that would not have been made in the same taxable years in the absence of the emergency, hence that are attributable to the defense program itself. Since there is no way to measure the profits that would have been made had the emergency not appeared, it is necessary to fall back on the earnings of some prior period as a substitute for the correct, but unavailable, measure. This substitute is a sorry one indeed, for it not only chains each company to its own past; it creates and multiplies inequities on a gigantic scale.

To show the failure of this base period test of normal profits to identify profits generated by, and attributable to, the defense emergency, I invite the committee to consider what would happen if H. R. 9827 or its equivalent were imposed in a period of profound peace. In the first year of its application it would stigmatize a large volume of profits as "excess" and the volume would increase from year to year as the base period receded into the background and as growth and economic change shifted the pattern of profit distribution. It is pertinent to ask how a device that would falsely stigmatize profits as "excess" if applied in time of peace can be expected correctly to identify such profits in a defense emergency. The answer is, of course, that it cannot. We sincerely believe that an excess profits tax imposed now would work more inequity than equity.

This conviction is fortified by the knowledge that profits arising from defense production itself will be reviewed and adjusted by the renegotiation boards before corporate taxes take effect. It is, of course, in defense production that the greatest opportunities for exceptional profits will occur, and their subjection to renegotiation narrows very drastically the area for which an excess profits tax could even theoretically be desirable.

If the excess profits tax is so doubtful as an instrument of equity it is even more doubtful from the standpoint of economic policy. For it not only encourages wastefulness and laxity in the use of productive resources; it falls with special gravity and with discriminatory effect on the more efficient and rapidly growing enterprises whose expansion is the mainspring of economic progress. As it impairs the incentive to further growth by such enterprises, it cuts down drastically the retained earnings from which such growth must be largely financed. Thus, the tax lessens the intensity and effectiveness of competition and holds an umbrella over the incompetent who would otherwise be eliminated.

COMMENTS ON H. R. 9827

As I indicated earlier, time does not permit me even to touch on all the features of the pending bill which deserve comment and discussion. I shall limit myself therefore to three provisions, the limitation of the average earnings credit to 85 percent, the use of a flat excess profits tax rate, and the proposed relief provisions.

The 85 percent credit

Since the whole purpose of this tax is to identify abnormal or "excess" profits, the limitation of the base period earnings credit to 85 percent makes no sense unless such earnings were themselves abnormally high. In requesting a 75-percent limitation, the Secretary of the Treasury indicated that this was in fact the case. Here he was grievously in error in giving currency to one of the great popular illusions of the postwar era. I invite your attention to the attached chart which presents corporate profits as a percentage of sales since 1909. You will notice that the average profits-to-sales ratio for the proposed base period 1946–49 was substantially below the average for the predepression period 1909–29, and that in none of the base years did the ratio reach that average. By any reasonable historical test, base period profits were, if anything, subnormal. It is absurd, therefore, to reduce them by 25, or even by 15, percent, to obtain a measure of normal.

The flat rate

The flat-rate tax imposed by H. R. 9827 apparently assumes that there are no degrees of excessiveness, hence that every dollar above the credit should be taxed the same as every other. To this view we are unable to subscribe. If the concept of excessiveness has any meaning, it must admit of degrees and these should be considered for tax purposes. An appropriate graduation of rates, ascending with increasing excessiveness, seems to us not only sound in principle but desirable in practice.

The basis for graduation, I hasten to add, should not be the absolute size or amount of excess profit. As the Machinery Institute has repeatedly stressed before this committee, tax progression on the basis of size has no place in the corporate area. What we are asking for is a progression based on the relation between the excess profits and the excess profits credit. We suggest that the first bracket rate apply to excess profits up to 50 percent of the credit; the second to such profits in excess of 50 percent of the credit but not over 100 percent; the third to profits above 100 percent but not over 150 percent; and the fourth to all profits above 150 percent.

Such a graduated structure would permit a relatively low rate on profits only moderately over the credit, the excessiveness of which is at best debatable, and higher rates on profits of less uncertain status. In this way it would minimize the importance of the precise dividing line between normal and excess profits, and would reduce substantially the hardships and controversies inseparable from this type of taxation.

Relief provisions

In its statement to the House Ways and Means Committee, the institute advocated the retention of substantially the provisions of section 722 of the wartime law, with a complete overhaul of the administration of relief. It suggested placing the responsibility in a special agency independent of the Treasury and modeled generally on the set-up for contract renegotiation. By this approach it sought to substitute informed judgment, applied in a bold, nontechnical manner, for the legalistic morass into which the administration of general relief has sunk under the Treasury. The pending bill takes an opposite course. Instead of giving wider discretion to a responsible authority, it proposes a drastic narrowing of the area of administration by substituting precise formulas both as to eligibility for relief and as to the amount of relief to be granted.

This approach is an interesting one and might conceivably offer a way out of a difficult problem. As embodied in H. R. 9827, however, it is too narrowly restricted to be at all adequate.

The proposed relief provisions exclude not less than eight important grounds for relief which were available to the taxpayer under section 722 of the wartime statute. These grounds are as follows:

1. That the industry of which the taxpayer was a member was depressed by reason of temporary economic events unusual in the case of the industry (sec. 722 (b) (2));
2. That the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in the industry, subjecting the taxpayer to a profit cycle differing materially in length and amplitude from the general business cycle (sec. 722 (b) (3) (A));
3. That the business of the taxpayer was depressed by reason of conditions generally prevailing in the industry, subjecting the taxpayer to sporadic and

intermittent high production and profits, such periods being inadequately represented in the base period (sec. 722 (b) (5) (B));

4. That there was a change in the operation or management of the business in the base period (sec. 722 (b) (4));

5. That there was a change in the base period in the capacity for production or operation (sec. 722 (b) (4));

6. That there was a change in the ratio of nonborrowed capital to total capital (sec. 722 (b) (4));

7. That the taxpayer acquired during the base period all or part of the assets of a competitor, with a diminution or elimination of the competition of such competitor (sec. 722 (b) (4)); and

8. That there was "any other factor affecting the taxpayer's business which reasonably may be considered as resulting in an inadequate standard of earnings during a base period" (sec. 722 (b) (5)).

As it now reads, H. R. 9827 limits general relief (1) to abnormalities arising from interruptions or curtailments of normal production because of temporary occurrences, either physical or economic, unusual in the experience of the taxpayer, and (2) to changes in products or services. Not only are the grounds for relief drastically limited in the second case, as I shall point out in a moment; the income adjustment in the first case is determined by a formula which can result in a complete denial of relief.

The formula for deriving the constructive base period net income when the relief claim arises from temporary and abnormal physical or economic events may work passably well for a company having one or more normal years in the base period, but it is utterly valueless to concerns that were the victims of abnormalities affecting the entire period, and which lack even one normal year on which to base the formula adjustment. As the committee well knows, there are whole industries, such as machine tools and aircraft manufacture, for example, for which all 4 years 1946–49 have been subnormal, and of which many member companies would be deprived of general relief under the scheme proposed.

When we turn to the second surviving ground for relief, a change in the products or services furnished, we find limitations on eligibility to relief which are exceedingly restrictive. To claim eligibility under this provsion, a taxpayer must show that a new product or service introduced during the base period produced more than one-third of its entire net income by the end of the third year following the introduction, and further that its total net income in one of these years was more than 125 percent of its income prior to the change in product or service. These restrictions exclude all but the small minority of cases where changes have been so concentrated in one product that earnings therefrom climb rapidly to the required level. Comparatively few taxpayers with new products can hope to establish eligibility for relief under this provision.

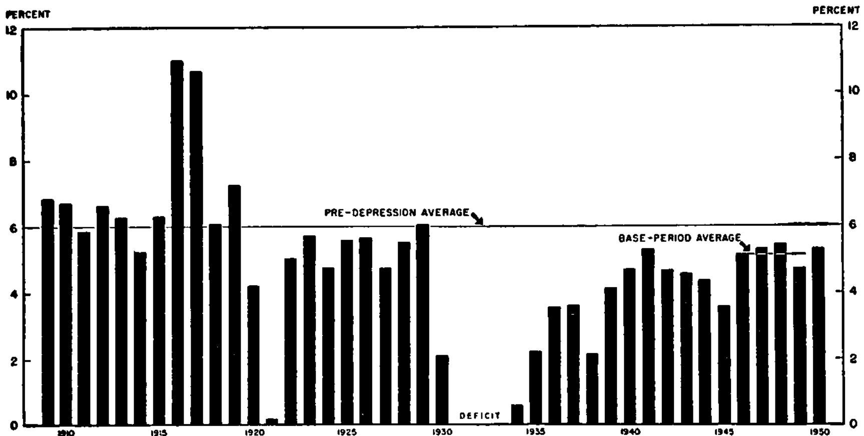
If the constructive base period net income is to be derived by formula, rather than by the judgment of administrative authorities, we must broaden the grounds for relief beyond those in the bill and improve the character of the relief where eligibility can be established. We propose specifically that the statement of grounds be liberalized in line with section 722 of the wartime law, and that all claimants establishing eligibility for relief on these grounds be allowed, as a constructive base period income, a return on total assets equal to the average base period return of their own industries as determined and promulgated by the Treasury. This would give all relief cases the same alternative now prescribed by the bill for companies eligible on the ground of changed product or service (sec. 443) and for new and growth companies (sec. 444).

As a further measure of relief for companies in industries with depressed base-period earnings, which companies would of course fail of relief under the foregoing proposal, we suggest the right to elect their own earnings of 1936–39 (best 3 of the 4 years) if higher than other excess profits credits available to them. This alternative would provide a modest but much-needed relief in a few cases not otherwise adequately covered.

I may add as a final observation on the subject of general relief that while it may be practicable to determine the constructive base period net income by formula, once the eligibility of the taxpayer for relief has been established, the establishment of such eligibility can completely bog down the administrative process if it is handled by the conventional legalistic approach of the regular tax authorities. We can still have a repetition of the horrors of section 722. We suggest, therefore, that the committee give serious consideration to our

proposal that an administrative organization be set up independent of the Treasury, after the model of the contract renegotiation boards.

While these suggestions by no means exhaust our recommendations on the excess profits tax, they are all that time permits on this occasion. Let me remind the committee again of the more complete discussion in our statement before the Ways and Means Committee. Thank you.



Prepared by Machinery and Allied Products Institute.

The CHAIRMAN. Mr. S. H. Davis.

STATEMENT OF S. H. DAVIS, OZARK MAHONING CO., TULSA, OKLA.

Mr. DAVIS. I am S. H. Davis, of Tulsa, Okla., and this is Mr. C. L. Anderson.

Senator KERR. This is one of the men who has a great interest in the State of Oklahoma. He has an interest in Illinois and Kentucky, also. We are glad that he represents interests in the great State of Oklahoma.

Mr. DAVIS. Thank you. It so happens that the thing I want to talk about is fluorspar, a strategic mineral, and we do not have anything to do with that in Oklahoma. We have a chemical-manufacturing business which is based in Oklahoma, but our mining business is based in these other States. I will read just the forepart of this statement and then fill it in to save time.

I represent the Ozark-Mahoning Co., of Tulsa, Okla., producers and processors of fluorspar. This company produces the bulk of the acid grade of fluorspar consumed in this country in the chemical and aluminum industries.

The Ways and Means Committee, in drafting H. R. 9827, preserved the old section 731 as section 448 in the new bill, these sections relating to the exemption of strategic minerals from excess profits tax, and fluorspar is included in the House bill.

Fluorspar is a strategic mineral. It was so designated in World War II and now the Munitions Board, by Order 15-18, issued Sep-

tember 26, 1950, designated fluorspar as both a critical and a strategic mineral. I would like to place the Munitions Board Order in my statement in the record.

The CHAIRMAN. You may do so.

(The order referred to is as follows:)

DEPARTMENT OF DEFENSE,
MUNITIONS BOARD,
Washington 25, D. C. September 26, 1950.

MB Order No. 51-18

Subject: Current List of Strategic and Critical Materials for Stockpiling.

1. Pursuant to section 2 (a) of Public Law 520, Seventy-ninth Congress, the following materials have been determined to be strategic and critical under the provisions of the act.

2. The following materials will be acquired through purchases pursuant to section 3 (a) and by transfer of Government-owned surpluses pursuant to section 6 (a) of Public Law 520, Seventy-ninth Congress, and constitute group I:

Agar
Aluminum
Antimony
Asbestos
  Amosite
  Chrysotile
  Crocidolite
Bauxite
  Metal grade
  Abrasive grade
Beryl
Bismuth
Cadmium
Castor oil
Celestite
Chromite
  Chemical grade
  Metallurgical grade
  Refractory grade
Cobalt
Coconut oil
Columbite
Copper
Cordage fibers
  Manila
  Sisal
Corundum
Diamonds, industrial
Emetine
Feathers and down
Graphite
  Amorphous lump
  Crystalline flake
    Crucible grade
    Lubricant and packing grade
Hyoscine
Iodine
Jewel bearings
  Instrument jewels, except V jewels
  Sapphire and Ruby V jewels
  Watch and time-keeping device jewels
Kyanite
Lead
Manganese ore
  Battery grade
  Chemical grade
  Metalugrical grade
Molybdenum
Mercury
Mica
  Muscovite block, good stained and better
  Muscovite film
  Muscovite splittings
  Phlogopite splittings
Monazite
Nickel
Opium
Palm oil
Platinum group metals
  Iridium
  Platinum
Pyrethrum
Quartz crystals
Quebracho
Quinidine
Quinine
Rubber, crude natural
Sapphire, and ruby
Shellac
Silk
Sperm oil
Talc, steatite, block
Tantalite
Tin
Tungsten
Vanadium
Zinc

3. The following materials will be acquired only through transfer of Government-owned surpluses pursuant to section 6 (a) of Public Law 520, Seventy-ninth Congress, and constitute group II:

Cryolite, natural
Diamond dies
Fluorspar
  Acid grade
  Metalurgical grade
Graphite
  Crystalline fines
Magnesium
Mica
  Muscovite block, stained and lower
  Phlogopite block
Optical glass
Pepper
Platinum-group metals
  Osmium
  Palladium
  Rhodium
  Ruthenium
Rutile
Selenium
Talc, steatite, ground
Zirconium ores
  Baddeleyite
  Zircon

4. This order supersedes MB Order No. 51–6 dated July 26, 1950.

PATRICK W. TIMBERLAKE,
Major General, United States Air Force,
Director of the Staff.

Mr. DAVIS. Fluorspar is used in the open-hearth steel furnaces where it increases the capacity of the furnace. If steel ingot capacity is to be increased, we must have an adequate supply of fluorspar. It takes 6 pounds of fluorspar for every ton of steel produced. That is the principal use of fluorspar in industry. We also produce the metallurgical grade, but our principal produce is the acid grade, and that is the one that we are vitally concerned with, because those people who are our customers and are using it are looking to us for their supply.

The increased output of aluminum called for in the preparedness program will necessitate 40,000 to 80,000 tons additional acid-grade fluorspar annually. There is no substitute for fluorspar in the production of aluminum.

We operate mines in Illinois, Kentucky, Colorado, and New Mexico, and buy crude ore and partially prepared ore from many small producers in this country, and we buy foreign ores. We are the largest producers of acid grade in this country and are operating at capacity.

In addition to its use in steel and aluminum manufacture, it has other uses. It is used in the atomic bomb according to the official Government report.

If the preparedness program is carried out—particularly the expansion of the aluminum capacity—hundreds of millions will be spent. To fall short of a supply of fluorspar would be a tragic mistake, as there are no substitutes.

Importations are growing. We import—that is, our company—1,500 tons per month from Spain. Before World War II importations were negligible. Last year on the order of 31 to 32 percent of the domestic consumption came from imports, and the imports are growing all the time.

Senator MILLIKIN. What percentage?

Mr. DAVIS. Last year it was about 31 to 32 percent. Before World War II it was practically nothing.

Senator MILLIKIN. If we got into World War III, those imports would be seriously curtailed?

Mr. DAVIS. The situation in fluorspar is very critical. I am worried about it, because these companies look to us for their supply.

Senator MILLIKIN. Therefore you want to build up your domestic supplies?

Mr. DAVIS. We have got to. We have got to do everything we can. We have got to get importations, too, insofar as we can. For instance, Reynolds Metals, which is, I guess, the second largest aluminum producer, we furnish them all of their fluorspar, and with this expansion we have got to get more fluorspar, and just how we are going to get it I do not know. We have already combed the West and Mexico and other foreign countries. There are many deposits of fluorspar in the Western States—Colorado, for instance—there are a number of producing areas out there, and we are operating one mill and several mines, and there are other places where we can get it, but it is always a small tonnage. Those are not big deposits. There are 10,000, 20,000, or 30,000 tons in each individual ore body, and you have got to get it from a lot of different sources.

Senator KERR. Do those usually occur in ignious rock?

Mr. DAVIS. In Colorado it occurs in granite. In the Illinois district and Kentucky it is in sedimental rock. Ordinarily it is associated ignious emanation because fluorin is one of those elements which come from depth, they say. I would say it is about 50–50. Generally in the West it is in granite and in the East it is in sedimentary rocks.

We in the fluorspar industry wish to do all we can to further preparedness program irrespective of profits. We, however, obtain much of our ore from many small operators and must obtain more. To impose a tax which will retard production of this mineral will leave particularly the many small operators without funds to search for and develop further supplies.

We believe the public interest would be served by the inclusion of fluorspar in the list of strategic minerals to be exempted from excess profits tax, for the following reason:

1. The supply situation is already acute. Ozark-Mahoning Co. has supplemented its domestic supply of fluorspar by imports of 1,500 tons per month from Spain, an uncertain market, and is combing world markets for additional material because it is unable to supply the demand.

2. Fluorspar increases the capacity of the open-hearth steel furnace by making the slag more liquid and allowing the furnace to operate at higher capacity and at a lower temperature, thus prolonging the life of the furnace. Steel requires 6 pounds of fluorspar per ton of ingot steel. Steel used 58 percent of the total supply of fluorspar in 1947, 61 percent in 1948, and 58 percent in 1949.

3. The increased use of fluorspar in the last war outran, percentagewise, all nonferrous metals or steel, by manyfold. The War Production Board, in the last war, first made fluorspar a critical mineral, then recommended it to the Congress as a strategic mineral.

4. In aluminum production, about 160 pounds of fluorspar are required for each ton of aluminum manufactured. As we understand it, the defense program calls for an expansion in the aluminum industry of about one-half million tons of aluminum per year. This increased aluminum capacity would require in the neighborhood of 40,000 tons additional acid-grade fluorspar. Hydrofluoric acid, chiefly used in aluminum production, consumed 26 percent of the total supply in 1947, 24 percent in 1948, and 27 percent in 1949.

5. Fluorspar, by way of hydrofluoric acid manufactured therefrom, was extensively used in World War II in the processing of 100-octane gasoline. Many of the gasoline plants using hydrofluoric acid for this purpose were shut down immediately after the end of World War II, and the rehabilitation in 1950 has been to date very slow. If they are put back into use on anything like that basis observed during the last war, consumption of acid-grade fluorspar will exceed 20,000 tons annually for this use.

6. Fluorspar enters into freon, which constitutes 90 percent of the contents of the aersol and DDT bombs which, due to their use in insect control, contributed to the effectiveness of the Armed Forces in the Mediterranean and Pacific theaters.

7. It was learned, after the Second World War, that fluorspar was used in connection with the atom-bomb development. Dr. H. D. Smyth, in the official report on atomic energy for military purposes, said:

> The two most promising methods of separating large quantities of U-235 from U-238 were the use of centrifuges and by use of diffusing through porous barriers. Each method required the uranium to be in gaseous form, which was an immediate and serious limitation since the only suitable gaseous compound of uranium then known was uranium hexafluoride (p. 691).

And on page 159:

> Since uranium itself is not a gas, some gaseous compound or uranium must be used. The only one obviously suitable is uranium hexafluoride.

A ready source of fluorine is as essential as the uranium itself.

Fluorspar is produced and used in three grades designated as (*a*) metallurgical, 85 percent CaF_2, (*b*) ceramic, 95 percent CaF_2, (*c*) acid or chemical, 97 percent CaF_2. The metallurgical grade is used principally in making steel; the lesser amounts of this grade are used by foundries and in electric steel furnaces. Open-hearth furnaces steel capacity is accelerated by the use of fluorspar.

The ceramic grade is used in opaque glass and in dense enamels, some of which are used as facings and coatings on sanitary bathrooms, hospitals, and plumbing fixtures, tablet tops, stoves, refrigerators, facilities on ships, and so forth.

The chemical or acid grade is the only acceptable economic raw material for the preparation of hydrofluoric acid. In turn, as stated, hydrofluoric acid is used freely in the manufacture of aluminum, high-octane gasoline, in insecticides, refrigerants, pickling stainless steels, and in many processes in the chemical industry.

Fluorspar is mined by many small companies and individuals without adequate funds for expansion. With the imperative demand for more steel, more aluminum, and greatly increased demand for chemicals used in the mobilization effort, which demand has already reached a critical state, it will be disastrous to place an excess profits tax on fluorspar draining off 85 to 95 percent of any revenue so badly needed to augment the supply. That is, funds needed to sink new shafts and increase facilities for production. Such action will lead to months of delay and then it likely will be found necessary to amend the law as was done in World War II.

Ozark-Mahoning owns contracted mines and deals with these small operators and that is the source of procurement of its supply. The impact of the excess profits tax on Ozark-Mahoning Co. is not so

important from the standpoint of increased production as on the small producing and contracting companies who, in event a tax takes too heavy from their profits, find less incentive interest in production. If the profit range is too narrow, it will slow down or discontinue production operations which would be the natural result, whereas if their production is exempted, the incentive on the part of these companies to produce would be accelerated, especially when, as now, the supply is short and the demand is great. If fluorspar is not exempted, as it was during the Second World War, it is likely that these small operators will slow down their operations, having no incentive of profit to operate, and that the supply of fluorspar will grow less instead of being augmented.

In the other World War they passed an excess profits tax and fluorspar was not included. We just had got into production, but we were an important supplier. At that time we were even supplying the Aluminum Co. of America with part of their fluorspar. We would get a telegram or telephone call from the War Industries Board several times a week wanting to know how much more we could get out, and every car, "When can you ship it?"

I came down here, and Mr. Disney at that time was on the House Ways and Means Committee, and I went to him and I showed him that we owed the Government more money than we had. We owed the Government in accrued taxes, largely excess profits taxes, between $400,000 and $500,000. We only had about $100,000. And still they wanted us to expand.

That same thing is coming up right now, with our company and with these smaller producers, if there is a high tax on it they simply don't have the funds to go ahead and do the exploration work and the development. For instance, during the last war the consumption of fluorspar was increased 400 percent.

Senator MILLIKIN. What do you want to do about fluorspar?

Mr. DAVIS. We are already as busy as we can be. We just want it included in the revenue bill, just like it was in the House.

Senator MILLIKIN. You want to keep it in?

Mr. DAVIS. Just the way it is in the House. It is all right with us. We produce many other ores, zinc and lead and acids and things, and we will be taxed on all of those, but this is a critical situation with us and we think it must be retained.

The CHAIRMAN. I do not think you will find any strong disposition here to throw it out, if it is in the House bill.

Mr. DAVIS. I just wanted to be sure. I will not take any more of your time.

Senator MILLIKIN. Keep your mind on Colorado as a source of fluorspar.

Mr. DAVIS. We are sinking a shaft and diamond drilling right now and operating three mines.

Senator MILLIKIN. Get more of it from Colorado.

Mr. DAVIS. We will get all we can.

The CHAIRMAN. Thank you very much.

Mr. Mitchell?

STATEMENT OF GEORGE A. MITCHELL, VICE PRESIDENT, NATIONAL BISCUIT CO., NEW YORK CITY

Mr. MITCHELL. My name is George A. Mitchell. I am a vice president of National Biscuit Co. and my address is 449 West Fourteenth Street, New York City, the home office of the company.

I appreciate the opportunity to contribute whatever I may to the subject of your inquiry. As an individual and as a representative of a corporation, I realize that we are all going to pay more taxes—individuals and corporations alike. The cost of the present emergency should be financed insofar as possible on a pay-as-you-go basis. Therefore, the question is not whether we should pay more tax but rather how the additional tax is to be assessed.

In drafting an excess profits tax bill I respectfully suggest that we should be careful not to confuse our objectives. If we must have an excess profits tax law its sole purpose should be to recapture excessive profits realized by profiteers. Its primary purpose should not be to raise revenue.

An excess profits tax should not be used for the purpose of raising revenue because it is not an equitable tax. It is not equitable for the reason that it is impossible to devise a formula for developing a normal earnings base that will be fair to all taxpayers. This is true whether the base be established on the past earnings record of corporations or as a percentage return on their invested capital.

The excess profits tax law in effect during World War II fully recognized the impossibility of developing a just and equitable normal earnings formula for the purpose of determining excess profits. Many relief provisions were incorporated in that law in an endeavor to take care of hardship cases as it was obvious the tax would otherwise be discriminatory.

These relief provisions, as we now know, were monstrosities. They have created an enormous administrative problem. They have not served the purpose for which they were intended in any respect.

As an example, due to peculiar conditions in the industry, the base period earnings—1936 to 1939—of National Biscuit Co. and, for that matter, of the entire baking industry were actually lower than in the years 1931 to 1934, the period of the great depression.

National Biscuit Co. has obtained no relief despite 5 years of effort, numerous conferences, and the submission of a staggering mass of statistics. Our only recourse is expensive and long-drawn-out litigation. We know of no other member of our industry who has obtained relief because of depressed earnings during the base period years. We do not believe our company or our industry is exceptional in this respect.

An excess profits tax law primarily designed to produce large sums of revenue must, of necessity, be drawn so as to affect all corporations. That is the reason the inequities in a law designed for such a purpose are so widespread. Corporation taxpayers vigorously object to this kind of taxation because it cannot be levied equitably among them due to the impossibility of accurately defining normal profits.

However, a law designed to recapture excess profits realized by profiteers would not affect very many taxpayers and its impact would not have the severe consequences of the last excess profits tax law or one patterned after it.

A World War II type excess profits tax has other and possibly more serious consequences. The length of time of the present emergency is uncertain. It may last for many years. During those years it will be necessary that we produce efficiently and at high levels. A tax on excess profits tends to discourage rather than encourage maximum, efficient production. It destroys incentive and it is inflationary.

It results in a waste of materials and manpower at a time when there should be no such waste. This was demonstrated in many ways during the last war. In fact, because of the lack of incentive for good management such a tax may in the long run produce less over-all revenue than would be realized by the imposition of other types of taxation.

An excess profits tax law designed to produce revenue must of necessity divide normal corporation income into two classes: First, income subject to normal and surtax rates of tax; second, so-called excess profits subject to very high rates of tax.

The second class of income becomes, to the taxpayer, relatively unimportant. There is no incentive to produce more, to economize, to promote technological improvements, to risk capital. The end product is inflation.

This result is not due to unpatriotic motives on the part of corporation management, as was suggested during the Ways and Means Commitee hearings. It is a natural reaction to an unrealistic approach to securing tax revenue when there are other and better ways of accomplishing the desired result.

Profits of corporations are already subject to certain controls: (*a*) by the probability of price controls on goods in scarce supply, and (*b*) by renegotiation of profits on sales of goods to the Government. Furthermore, the profits of corporations, now heavily taxed, and likely to be subjected to higher rates as the emergency continues, are taxed again when they are distributed to stockholders as dividends.

Any additional taxes levied on corporations should be equitable and not discriminatory as between corporation taxpayers. Any control of corporation excess profits should be on a very broad basis to the extent that only those corporations obviously profiting from the emergency are affected.

Should it be deemed necessary to enact an excess profits tax law to control profiteering, the base income to be used should be most carefully determined. Rather should some taxpayers benefit from too high a base than others suffer from one that is too low.

Dependence should not be placed on the filing of claims for relief. It has been, and is being, demonstrated that such claims are impossible to adjudicate on a fair basis.

I believe corporations should be permitted to choose any one of several selected years for determination of normal profits. I am saying that on the assumption that the normal rates of tax would increase. There is no reason why they should not have a choice of any one of the 4 years, 1946 to 1949, inclusive, with 100 percent of the profits of the year selected as representing normal profits and the base for determining excess profits. This will be especially important if there are to be no relief provisions in the law.

As an alternative, and to provide a fair base for growth companies or those whose earnings for any reason may have been depressed, I

believe the Treasury Department should compute an average rate of return on invested capital by industries for a representative period, and that representative period may not necessarily be the same for all industries.

Such rates should be published and corporations within an industry should have the alternative of using such rates of return on their invested capital or the privilege outlined in the preceding paragraph, whichever proves to be more favorable.

In effect, each corporation would determine its own normal earnings base before filing its first excess profits tax return and not rely on claims for refund. This would eliminate the collection by the Treasury of millions of dollars in taxes which might later have to be refunded, and also avoid all the administrative problems inherent in the type of tax legislation enacted in World War II.

Some corporations may have an advantage under this plan, but if we keep in mind that we are trying to siphon off true excess profits from so-called profiteers or from companies in a very fortuitous position, rather than provide revenue, there is logic in this approach.

I respectfully suggest that we are too conscious of the fact that someone may unduly profit from the emergency.

Our efforts should be directed more to achieve maximum, efficient production. Every incentive should be toward that goal if we are to restrain the inflationary aspects of a wartime economy. Inflation will do far more harm to our country than a few profiteers could ever do.

I do not believe that capital gains or dividends received from foreign subsidiaries should be subjected to a United States excess profits tax.

I appreciate your having accorded me this opportunity to express the viewpoint of the management of our corporation.

The CHAIRMAN. Thank you very much.

Mr. MITCHELL. Thank you, gentlemen.

STATEMENT OF THOMAS GREEN, CHAIRMAN, FEDERAL TAX COMMITTEE, AMERICAN INSTITUTE OF ACCOUNTANTS

Mr. GREEN. Thomas J. Green, chairman of the Federal taxation committee, and the American Institute of Accountants.

Mr. Jenson, chairman of the legislative committee, and Mr. Sigety, our administrative assistant: I am Thomas J. Green, chairman of the Federal taxation committee of the American Institute of Accountants. Our organization represents the National Organization of Certified Public Accountants, having a membership in excess of 16,000. Many of our members are engaged from day to day in active tax-accounting practice and we, therefore, feel well qualified to come before your committee today to make our observations.

We come before your committee as technicians reporting on what we see as technical aspects of the bill before you, and we will not deal with any of the physical or political or policy implications of the bill.

As a matter of fact, we have, a short while ago, at the request of the Joint Committee on Taxation, rendered a private report in which some of our observations on excess profits tax matters are written. We are happy to see that a number of our recommendations were adopted.

With respect to the rate of tax and with respect to the over-all rate limitation in accordance with our previous observations we make no comment. As to the choice of the dual method of credit, the use of the invested capital as well as the earnings method, we think that a proper method has been set up in the bill as to the choice of two methods.

You will recall that in the 1940–41 scheme the taxpayer had to disclaim one method in favor of the other, and we are happy to see here that the taxpayer has the choice of either method. We approve, as a measure in itself, the choice of the 1946 to 1949 base period, but we feel that our recommendation, as contained in the previous report of the Joint Committee on Taxation, wherein we stated that, with respect to the choice of the best 3 years out of 4, a 90-percent rate should be applied is a better one than that contained in the present bill.

We further stated in our previous recommendations that corporations should have the privilege of using a 1-year method at a 75-percent rate, the purpose of the use of the 1-year method being to give corporations who had a spotty period—the whole base period is spotty, in other words.

Some companies made money in 1946 and 1947. When competition came to the fore there was a down trend. Others because of priorities and other reasons did not make money in 1946 and 1947 and therefore did not show any real earning power in 1948 and 1949. Because of that spottiness we recommended the 1-year period at a 75 percent rate. We think those two suggestions—the 3 out of 4-year method at 90 percent or the 1-year method at 75 percent—is superior to that contained in the bill.

With respect to the invested capital credit we have no comments as to the rates contained therein, but we do approve as a sound basis the use of the tax basis of assets. We feel this will be additionally helpful with respect to computing retained earnings under the income method, and therefore will be some simplification.

We have one comment with respect to borrowed capital. With respect to the floor of 1 percent, specified in the bill, on borrowed capital, we are at a loss to know why that 1 percent floor was only attributed to obligations having maturity of 5 years or more.

We feel that there are a number of legitimate borrowings which should have that application in a period under 5 years, and we are simply asking the question: We are at a loss to know why the 5-year period was stipulated.

Senator MILLIKIN. Mr. Chairman, may we ask Mr. Stam?

The CHAIRMAN. Mr. Stam.

Mr. STAM. I think that when the committee ruled over there that was their own decision, on that matter of the 5 years there was this question of the open accounts and they thought some limit ought to be set, because they didn't want a corporation just to accumulate money and not use it in its business.

Mr. GREEN. How about legitimate notes payable to banks? It may be perfectly in order to borrow on a 1-year period from the bank at a rate which would come under this floor but that company would be discriminated against by not having it.

It seems to me anything from 6 months to 4 years and 11 months should come within that category.

Mr. STAM. It might be that 5 years was too long but that was the committee's action. They were thinking about long-term securities and they were a little afraid about these short-term accounts.

Mr. GREEN. Well, we call that to your attention for possible further consideration.

With respect to the earnings credit we think that the use of retained earnings and additions to equity capital for the entire year 1949 and one-half of the year 1948 is a good method. We think that is a good method both with respect to earnings in the base period as well as the retained earnings after the base period, which latter recommendation was contained in our previous report to the joint committee.

As to growth corporations we again are at somewhat of a loss to understand why corporations which were organized before the base period must have this particular $20,000,000 limitation apply to it at the beginning of the base period. I think some previous commentators have spoken with relation to this particular item but it seems to us that this favors one large corporation as against another large corporation, and in addition favors set-ups where a parent has a number of subsidiaries as against where one corporation has divisions within itself rather than in subsidiary form.

We think that $20,000,000 limitation ought to be reviewed by the committee.

Senator KERR. What would be your suggestion?

Mr. GREEN. That would be my suggestion; yes, sir.

Senator KERR. What would be your suggestion? Let us say that we have now reviewed it.

Mr. GREEN. I would say it should be eliminated. I think the entire limitation ought not to appear so I don't think it is fair to set a figure.

The CHAIRMAN. You think it ought to be eliminated?

Mr. GREEN. Yes.

Senator KERR. You think the principle of growth ought to be recognized as distinguished from the extent of growth?

Mr. GREEN. Exactly. With respect to the disallowance of certain deductions in the excess profits year, we have two comments there. We think that the elimination of the deduction with respect to loss on bond redemptions, as well as the loss on disposal of business assets under 117 (j)—we feel that that elimination is a rank discrimination and that those natural deductions should be allowed in the excess profits year. We are happy to see that the present bill provides for an integration of the income tax and excess profits tax as one tax.

There was such a great amount of difficulty with respect to interest on assessments and refund claims, 90-day letters, and all other types of administrative difficulties, that we think that a forward step has been taken in integrating these taxes into one.

With respect to abnormalities in the base period comparable to old section 11, we make the same comment and the same observation as Mr. Johnston made previously: that we feel that the 5 percent limitation ought to be delected from the bill. If there is any one particular criticism we have against the bill it is with respect to the general relief provisions—those which are analogous to the previous provisions contained in old section 72 (b) (1), (2), (3), and (4).

We have no quarrel with the elimination of the 722 (b) (3) concept because in general we agree with the committee report which stated that since a company can establish depression itself it is not necessary to have the industry prove it as well, so we agree to that relief provision.

However, with regard to the other (b) (1), (2), (3), and (4) concepts, first of all it is very difficult to understand this whole average base period concept translated to indexes and getting yearly rates of return and average rates of return for the entire period.

As a matter of fact, we note that the committee report states that these are tentative. We feel that that is using a mild word. They are not understandable as well as tentative.

Senator KERR. Do you mean that you as a representative of the certified public accountants—is that who you represent?

Mr. GREEN. American Institute of Accountants. In the limited time at my disposal——

Senator KERR. Let me ask the question before you answer it. You men are specialists in tax law and tax phraseology and tax matters?

Mr. GREEN. Yes, sir.

Senator KERR. And you say the whole bill is confusing to you?

Mr. GREEN. Not the entire bill; those sections taking the place of section 722 (b) (1), (2), (3), and (4) the general relief provisions. We think first of all that the committee has realized the fact that administration of relief under the old bill has had so much administrative discretion in it that no one got relief because there was not a sympathetic and wise and just administration of that relief within the Bureau.

Now, apparently the pendulum has swung to the other side and the bill endeavors to set up with some mathematical exactitude exactly what shall take place with respect to relief. We think the pendulum has swung too far in the other direction, and that this entire relief situation perhaps ought to be reviewed more carefully, that it has possibly been hastily drawn, putting the Treasury Department as the prosecutor, judge, and jury, to draw up these particular indexes.

We think that the 50 classifications outlined in the bill are not nearly enough. Companies may not be able to fit one pattern or the other of a given classification. So that our recommendation with respect to this segment of general relief is to reconsider the entire idea and perhaps it might be handled in the same way as the exact directive to put forward this excess profits tax.

In other words, there might be a directive put in that the joint committee on taxation shall report back, let us say, by March 1, 1951, which is the date, as a matter of fact, contained in these provisions, to come forward with some more realistic and more understandable and more equitable relief provisions.

We will be glad to assist the joint committee in that respect if called upon to do so.

The CHAIRMAN. Are there any questions?

(No response.)

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

Mr. GREEN. Thank you, sir.

The CHAIRMAN. Mr. Kellen. Identify yourself, please.

STATEMENT OF STEVEN KELLEN, VICE PRESIDENT, GENERAL CERAMICS & STEATITE CORP., KEASBEY, N. J.

Mr. KELLEN. My name is Steven Kellen, vice president of the General Ceramics & Steatite Corp., Keasbey, N. J.

We are a small manufacturer. It being very late I want to be really very brief, but the excess profits tax bill up under the House has created a problem for us which I am sure is shared by many other small companies and some of them have mentioned it already this afternoon.

This problem is caused by the 67-percent maximum ceiling which in our case and probably also many other cases does not permit a sufficient accumulation of capital for financing of expansion, which is so badly needed in an expanding economy. To illustrate our point, we should like to present the case of our company.

For years we have manufactured steatite insulation and similar materials, used in the radio and electrical appliance industry, and chemical stoneware for the chemical industry.

Senator MILLIKIN. What is steatite?

Mr. KELLEN. Steatite is a talc which is mined in California and in Manchuria, but we buy it mainly in California. It is mined.

Senator KERR. What is it?

Mr. KELLEN. A talc, t-a-l-c.

Senator KERR. That is what you make face powder out of?

Mr. KELLEN. Well, it is a powder, but we fire it in a kiln and it is used as an insulation material.

We are an old established company. Our net worth amounts to about $1,000,000. Due to overexpansion in our industry during the last war and replacement of some of our products by new materials, our sales and profits were unfavorably affected in the years since 1945.

We therefore concentrated all our efforts to develop new products. After many unsuccessful and expensive attempts, we succeeded in developing a new revolutionary material called ferrite, which has been used, so far, only in the television industry but which we hope will also have other valuable applications.

Research and development expenses were extremely high but very worth while, as will be seen from the following sales and earnings figures:

Year	Sales	Earnings before taxes	Year	Sales	Earnings before taxes
1947	$2,309,000	$21,000	1950—May	$282,000	$37,000
1948	2,001,000	[1] 70,000	June	338,000	36,000
1940	1,697,000	[1] 35,000	July	333,000	52,000
1950—January	141,000	[1] 19,000	August	454,000	82,000
February	149,000	[1] 6,000	September	450,000	90,000
March	198,000	14,000	October	499,000	73,000
April	228,000	15,000			

[1] Loss.

We should like to stress that none of the new ferrite materials has so far been used in the defense industries.

Senator KERR. If I understand the figures, it indicates that in January of this year you sold $141,000 and had a net loss of $19,000.

Mr. KELLEN. That is right.

Senator KERR. I do not know what that means—a loss before taxes.

Mr. KELLEN. Just a loss.

Senator KERR. In October your sales were $499,000 on which there was a profit of $73,000 before taxes?

Mr. KELLEN. That is right.

Senator KERR. I understand.

Mr. KELLEN. You see our ferrite material only started to take effect in March. Before that there were sales for our other materials.

Senator KERR. I noticed there that in August, on $454,000 you made $82,000; in September on $450,000 you made $90,000; in October the sales went up to $499,000 and it went down to $73,000.

Mr. KELLEN. Of course monthly statements are very difficult to keep in a company, so one must take an over-all figure. But as an illustration I wanted to give our figures as we have them.

In order to achieve the above results, we expended during 1950 alone, $200,000 and have ordered equipment for an additional $90,000. Under the new tax proposals we would have to pay 67 percent; the balance will be less than the cost of our expansion program.

We cannot qualify as a growth company as our sales increased only in 1950. We cannot qualify as a new company, despite the fact that our success is entirely due to a new product.

We feel that it is not the intention of Congress to penalize a company of our type to such extent. We gather from the proposal that it is intended to establish simple and clear regulations for growth companies in order to avoid lengthy discussions such as were produced by section 722 of the last excess profits tax bill.

In order to accomplish this aim and at the same time protect small companies, we would suggest a lower ceiling than 67 percent for small companies. The following scale would, in our opinion, be fair and we believe would not excessively reduce the receipts of the United States Treasury: companies with a capital under $1,000,000, 50 percent over-all ceiling; companies with a capital under $2,000,000, 55 percent over-all ceiling; companies with a capital under $3,000,000, 60 percent over-all ceiling; companies with a capital over $3,000,000, 67 percent over-all ceiling.

As you will have seen from the earnings schedule, our earnings and sales began to increase before Korea, and our success has absolutely nothing to do with the war economy. Sales and earnings only increased slowly at the beginning because it took some time until we could finish our expansion, and we also didn't have the money at the time but used monthly earnings for the expansion.

Senator MILLIKIN. To whom do you sell your product?

Mr. KELLEN. To the television industry. You must realize that small companies have a great problem in finding the necessary capital, because they have no access, like some of the big companies, to insurance loans or to long-term financing or to the capital markets.

The only source which small companies really have as capital is retained earnings. As I said before, in our case under the proposed law, 67 percent would be taken away, which in this year leaves us little more than half what we really have spent for expansion.

No dividends were paid since 1945, which is 5 years, and the 1950 earnings are really the profit for our work during the last 5 years.

As I said, we are not a growth company under the new bill. What complicates matters further for small companies, in my opinion, is that under the present law we only have a 1-year carry-back, which means that if we may have at a later date two or three bad years, we may in one or two bad years lose more money than we could have retained out of the balance of prior good years.

We do have a carry-forward, but the carry-forward is always of course a dangerous gamble.

Senator MILLIKIN. Your suggestion is limited to lowering the maximum?

Mr. KELLEN. Yes, for small companies, and I would only emphasize once more, without making a long story, the difficulties which small companies face in obtaining capital for their business, because the only thing which they can obtain are the retained earnings. And my only suggestion is to have a lower over-all ceiling for small companies.

That is all.

The CHAIRMAN. Thank you very much for your appearance.

Dr. Drysdale?

STATEMENT OF ROBERT M. DRYSDALE, JR., EXECUTIVE VICE PRESIDENT OF THE FEDERATION FOR RAILWAY PROGRESS, WASHINGTON, D. C.

Mr. DRYSDALE. My name is R. M. Drysdale, Jr. I am executive vice president of the Federation for Railway Progress with headquarters in this city. This federation is a nonprofit, unincorporated association, established to give the millions of people who own and work for the American railway industry and hold its securities, as well as shippers, manufacturers of railway equipment and the general public who use and depend on our railroads, a chance to present to you as one body the requirements of a sound rail transport system.

I want to thank the committee and you Senators personally for your courtesy and patience in waiting here until this late hour to give me an opportunity to speak here briefly today and I will try to show my appreciation by making my presentation short and to the point.

At the outset I feel I must remind you for the record although I am sure you are all well aware of the fact that our rail transport system is as much a weapon in the arsenal of our defense as the ships and planes and other military equipment in the hands of our Armed Forces.

The distinguished Chairman of the Interstate Commerce Commission, the Honorable J. Monroe Johnson, who was Director of the Office of Defense Transportation during World War II stated the matter very clearly. In 1943 Colonel Johnson said, "We might suffer military reverses and still win the war, but we cannot avoid defeat should our railroads fail."

Yesterday in Charleston, W. Va., I had to call the attention of a group of businessmen and civic leaders to the fact that the physical capacity of our railway plant today is not much greater in comparison with industry as a whole than at the time of Pearl Harbor; that in terms of production and contribution to the national income it had lost ground to the rest of our economy since the fateful day of Decem-

ber 7, 1941. I repeat these somber facts to you gentlemen here today, since they must be faced. The railway industry needs freight cars badly, more than a quarter of a million of them, just to bring itself up to the minimum requirements of an all-out war emergency. The impact of our Korean effort has already created acute shortages in the car supply even before the rest of industry begins to produce for war.

Senator KERR. How many do they manufacture in a year?

Mr. DRYSDALE. It depends on the year.

Senator KERR. The last 10 years?

Mr. DRYSDALE. Manufactured cars?

Senator KERR. Yes.

Mr. DRYSDALE. Right now the average they are turning out is five or six thousand a month. They hope to get out 10,000 a month.

Senator KERR. What has it been over the past 5 years since World War II? Fifty thousand dollars a year?

Mr. DRYSDALE. I would say not over that.

Senator KERR. What is it averaging right now?

Mr. DRYSDALE. Seventy-five thousand cars a year.

Senator KERR. In other words, the current rate of replacement is not quite keeping up with the abandonment?

Mr. DRYSDALE. Not quite at the present time. Since 1946 I think the railroads have increased their unit number of cars net 38,000 cars in 5 years up till today. They have planned to do a little bit more in the next 2 or 3 years.

Senator KERR. Thank you.

Mr. DRYSDALE. It needs passenger cars, at least 2,000 of them, just to get back on a par with the Pearl Harbor capacity for moving persons—and who knows how many more in order to handle military plus civilian requirements in an atomic war.

It still needs more motive power in spite of the great improvements and additions made since the last war. And although more than 1½ billion dollars have been spent on improvements to roadway and terminal properties since 1946, more will be required to bring these properties fully up to the condition required by the struggle we face today.

By the end of this year, the railway industry will have spent the impressive sum of $5,000,000,000 on additions and betterments since 1946. This represents a tremendous effort. Taking the industry as a whole, this money came largely out of earnings and depreciation. I believe it would be fair to say that at least an equal amount will be needed in the next 5 years to meet the requirements of our growing defense effort.

Gentlemen, I think you should ask yourselves very soberly where this money is to come from. Remember, unless all our most trusted military advisers are wrong, we will need strong and flexible railroads and money will be needed for this just as for planes, ships, and other weapons. I am sure you will want to consider very carefully before you do anything which would further impair what has been the principal source of this money in the past.

It was with such thoughts in mind that we presented our recommendations with regard to an excess profits tax to your joint committee staff and to the Ways and Means Committee of the House.

Quite frankly, those recommendations, if followed, would largely have relieved the railway industry from the burdens of such a tax.

For who, by even the widest stretch of the imagination, could define as excessive, profits which in the railroads' best year in the suggested base period were only 4½ percent on railway investment?

Profits which have averaged only 3.6 percent for the past 30 years and which reached the level of 6 percent only once in the last 20 years? And yet under the Treasury formula for an excess profits tax, those 1948 profits of 4½ percent would have been reduced to about 3.65 percent.

Our recommendations, as embodied in our statement to the House committee, a statement which I should like permission to submit for the record as an appendix to these remarks, were in substance as follows:

1. Railroads subject to the Interstate Commerce Act should be allowed an excess profits tax credit which would include their normal taxes and surtaxes, plus 6 percent on their invested capital as reflected in the capitalization carried on their corporate books of accounts, which have been under Interstate Commerce Commission supervision since 1907, or 6 percent of the adjusted basis for determining gain of all their assets, including money and current assets less current liabilities.

The House bill recognizes the equity of allowing a regulated industry to include its regular taxes in any excess profits credit, since these taxes are given weight in regulating the rates of the industry, but it limits the railroads to a return of only 5 percent on their capital, while other utilities are allowed 6 percent.

The railway industry needs the protection of a 6 percent net return on its present investment if it is to meet the requirements which will permit it to make its full contribution to the Nation's defense effort. An additional 1 percent is, if anything, too small an amount to ask to supply the earnings with the aid of which these tremendous requirements must be financed.

2. Under the average earnings basis, it should be recognized that the railway industry suffered two unusual years in the base period 1946–49, when industry earnings dropped below 3 percent, in contrast to the very high earnings of business generally. Thus railroad companies should be allowed to select 2 years out of the 4-year period 1946–49 as their base, or two out of the 3-year period 1947–49.

The House bill makes no provision for these special circumstances in the railway industry, and consequently those railroads using the average earnings basis will have the generally modest level of their earnings for 1947 and 1948 averaged much lower by the much lower year 1946 or 1949.

3. Under the average earnings basis railroad companies should be allowed a credit of 100 percent of their average earnings in the base period, since even in the best postwar year for railroads, 1948, the general level of earnings could not in any way be considered excessive. On the contrary, the level of even the best earners was still not high enough to attract the equity capital the industry needs so badly.

The House bill, as you know, recognizes only 85 percent of average base period earnings as below the level of excessive.

4. Railroad companies should be relieved of the penalty of 2 percent for filing consolidated returns.

The House bill retained this penalty against the filing of consolidated returns.

I have followed with interest and great respect the considered and deeply attentive hearing you gentlemen have given this important matter of an excess profits tax law, and I am confident that you will be guided by equity and fairness in formulating such a tax.

I hope that you also will keep in your minds that this tax can and will have profound effects on our defense effort. Our railroad transport system is the backbone of that effort.

Everyone knows, and the record shows, that its earnings have for years—and especially in recent years—been the very opposite of excessive. And I hope you will agree with me that this vital industry needs more than the level of recent low earnings to strengthen and enlarge its plant for war. For this reason such a higher level should be protected in the bill you are here considering.

I believe the proposals we have submitted, if recognized, will fairly assure this desired result.

Thank you very much, Senator.

The CHAIRMAN. Thank you, sir. Will you furnish the data to the reporter?

(The data are as follows:)

STATEMENT OF JOSEPH C. KAUFFMAN ON BEHALF OF FEDERATION FOR RAILWAY PROGRESS

My name is Joseph C. Kauffman. I am general counsel for the Chesapeake & Ohio Railway Co. at Cleveland, Ohio, with 30 years of experience in handling the tax problems of that property. I appear here today as a member and representative of the Federation for Railway Progress, an unincorporated association with headquarters in this city. The federation was established over 3 years ago to give to the millions of people who own the American railway industry and hold its securities, as well as shippers, railroad employees, the makers of railway equipment, and the general public who use and depend on our railway transport system, the chance to present to you as one body the requirements of a sound railway industry.

Let me emphasize, therefore, that it is not only for the carriers themselves but principally in the interest of the taxpaying citizens who own their securities, the shippers who look to them for service, and the public for whom they represent a vital weapon in our national defense, that I appear here today to discuss with you the problem of an excess profits tax for the railway industry.

I. INTRODUCTION

The Federation for Railway Progress welcomes this opportunity to make suggestions as to the form the proposed excess profits tax should take in its application to the railroad industry.

It should first be stated that the term "excess profits" is one almost completely foreign to the railroad industry and that any excess profits tax will have a most restricted application to this industry if a suitable standard can be devised to measure true excess profits. As proof of these statements, we need only set forth the rate of return realized by the class I railroads on net property investment (including cash and materials and supplies but deducting accrued depreciation) during the 30-year period 1921–49, inclusive. The showing is as follows:

Year	Percent	Year	Percent	Year	Percent
1921	2.99	1931	2.20	1941	4.28
1922	3.75	1932	1.38	1942	6.30
1923	4.57	1933	2.03	1943	5.71
1924	4.49	1934	1.98	1944	4.71
1925	5.07	1935	2.15	1945	3.77
1926	5.35	1936	2.87	1946	2.75
1927	4.64	1937	2.54	1947	3.41
1928	5.01	1938	1.61	1948	4.24
1929	5.24	1939	2.55	1949	2.85
1930	3.59	1940	2.93		

For the entire period of 30 years, the average rate of return was in the neighborhood of 3.6 percent. In only one year, 1942, were the railroads able to earn as much as 6 percent on their net property investment. Moreover, it will be noted that in the four postwar years 1946–49, the average rate of return was only 3.31 percent. This is the record of earnings for the railroad industry at a time when other public utilities, the most nearly comparable industry, were earning between 6 and 8 percent on net investment and unregulated industries were earning as much as 15 percent or even more on their net worth.

In this situation it might be thought that the railroads should be completely exempted from the imposition of an excess profits tax, and the figures given above certainly lend strong support for such a contention. But we are mindful that, notwithstanding the paucity of earnings realized by the railroads as a group, there are a few of the more affluent companies within the industry that might under emergency conditions realize sufficient revenues to render them subject to an excess profits tax properly admeasured and applied. Traditionally the railroads have not sought subsidy or preference, and if any railroad companies derive excess profits out of a war emergency, we feel certain that they will be altogether willing to pay a tax on such profits commensurate with that imposed on other forms of industry. Accordingly, we do not advocate complete exemption of the railroad industry from an excess profits tax.

But if the railroads are to be treated like all other taxpayers in this regard, it is of the utmost importance, in view of the niggardly return they have been able to realize from their operations, that proper safeguards be provided to insure that an excess profits tax will be applied only to any excess earnings they may receive and that they shall not be subjected to such a tax on income which cannot in any proper sense be deemed as anything other than normal income. The margin of profit in the railroad business is so small as to provide no cushion of safety, and any additional taxation imposed on normal earnings might well prove disastrous. No greater disservice could be rendered the national economy than the imposition of a tax which would create further inroads on the meager income of the railroads, particularly at a time when they are called upon to devote every dollar that they can raise from earnings or borrowings to improve their plant and expand their facilities.

We suppose no argument is required to demonstrate the national interest in a sound and efficient railroad transportation system. Suffice it to say that during World War II, the railroads moved more than 90 percent of war freight, carried more than 97 percent of the organized troop movements, and performed more than 70 percent of all transportation services. The contribution of the railroads in time of national emergency can be classed as second only to that of the military personnel itself.

It should be remembered, too, that aside from money that can be raised from the sale of prime obligations secured by a first lien on new equipment, practically the only source of funds that the railroads have today is earnings. The railroads have been unable to raise any funds through equity financing for many, many years, and there have been only a few cases since 1930 in which a railroad has been able to raise new money through the issuance of mortgage bonds. Under these circumstances, the record of the railroad industry in making capital expenditures in excess of a billion dollars a year since 1947 is truly remarkable. It is of the utmost importance that the railroads be permitted to carry on this program of improvement and expansion out of earnings. It would be no less than a tragedy for the Nation if any part of these earnings were to be siphoned off as taxes on excess profits.

II. SUMMARY STATEMENT OF PROPOSALS

The proposals that we are about to make for the railroad industry are only such as will offer suitable insurance that an excess profits tax will be applied only to true excess profits. We urge consideration of these proposals in the light of all of the circumstances hereinbefore mentioned. We urge that the standards to be applied in measuring any excess profits of the railroads be practicable ones comporting to the realities of the situation.

Our proposals are as follows:

1. That in addition to any other methods prescribed by law for computation of the excess profits credit, a railroad company be permitted at its election to compute is credit as an amount equal to the aggregate of its normal tax and surtax, plus a sum equal to 6 percent of the total of its capital stock, outstanding borrowed capital, and surplus, as reflected in its corporate books of accounts,

with a corresponding adjustment to excess profits net income for interest on borrowed capital.

2. That as an alternative to the proposal made in (1) above and likewise in addition to any other methods prescribed by law for the computation of the credit, a railroad company, at its election, be permitted to compute its credit as an amount equal to the aggregate of its normal tax and surtax, plus 6 percent of the adjusted basis for determining gain of all its assets, including money and current assets, less current liabilities.

3. Under any computation of invested capital, there should be included 100 percent of borrowed capital, and indebtedness represented by conditional sales contracts should be specifically included in borrowed capital.

4. In the case of a railroad company, the credit based upon earnings should be determined by permitting the taxpayer to choose as its base the earnings for any 1 or 2 years within a given period, or if that does not appear practicable, such credit should be based on an average for a number of years without arbitrary diminution (such as to a 95 percent basis). If the credit is to be based on the average for a number of years, taxpayer should be given the right to make adjustments similar to those provided for in the World War II statute, particularly the adjustments allowed under sections 711 and 713 of the code. There should also be added to the credit otherwise determined not less than 6 percent of all net capital additions whether represented by equity or borrowed capital, or retained earnings, added during the last 2 years of the base period and all subsequent years prior to the first excess profits tax year.

5. The 2 percent penalty for filing consolidated returns should be eliminated.

6. The excess profits tax, normal and surtax, should be treated as one tax for limitation, credit and refund purposes, and for the sending of 90-day letters.

III. REASONS UNDERLYING PROPOSALS

1. Railroad company should be permitted, at its election, to compute its credit as an amount equal to the aggregate of its normal tax and surtax, plus a sum equal to 6 percent of the total of its capital stock, outstanding borrowed capital, and surplus, as reflected in its corporate books of accounts

Under a statute giving the taxpayer the option to compute its excess profits credit either on the basis of invested capital or of average earnings, most of the railroads are inevitably relegated to the invested capital method. As hereinbefore demonstrated, the railroads have not in recent years earned revenues sufficient to serve as a reasonable basis under the average earnings method. On the other hand, no other industry has such a large capital investment in relation to earnings. The nature of the railroad business requires huge expenditures of capital before there can be any operation. A railroad must provide right-of-way and tracks from terminus to terminus, and individual railroad systems comprise thousands of miles of tracks together with necessary roadway structures such as bridges, tunnels, signal systems, etc., incidental stations and office buildings, and equipment such as locomotives, cars, and vessels. In the main, the railroads are perforce committed to a method based on property costs or values.

Invested capital, as defined in section 718 of the Internal Revenue Code was the sum of the equity invested capital, represented by the amount of money or property paid in for stock, or as paid-in surplus, or as a contribution to capital, plus the accumulated earnings and profits as of the beginning of the taxable year, less capital distributions theretofore made, and the borrowed invested capital, as defined in section 719, which was one-half of the outstanding indebtedness evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust. It would appear that invested capital as thus constituted might be susceptible of exact determination and ready calculation, but quite the contrary is true; for the amounts of the constituent elements enumerated above are not necessarily the respective amounts appearing in the taxpayer's balance sheet, but are rather to be determined in accordance with methods and rules prescribed in the law and regulations. The determination of invested capital, as thus defined, presented a complex problem even in the ordinary case, and the difficulty was immeasurably increased in the case of taxpayers having an extended corporate existence, such as the railroads, particularly if one or more "reorganizations" as defined in section 112 (g) of the Internal Revenue Code or certain other types of corporate readjustments had occurred in the history of the company.

"Property paid in," which in respect of many taxpayers is the most important constitutent factor in the computation of invested capital, was includible "in an

amount equal to its basis (unadjusted) for determining loss upon sale or exchange." While the unadjusted basis for determining loss is generally cost, it can be seen that where property has been paid in for stock, resort must be had to valuation to determine this tax basis. In this situation, the regulations provided that the cost of the property was the fair market value of the stock issued in exchange therefor at the time of issuance. If the stock had no established market value at the time of the exchange, the regulations further provided that the fair market value of the assets of the company at that time should be determined and the liabilities deducted, and that the resulting ne worth would be deemed to represent the total value of the outstanding stock. In respect of property acquired by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, after December 31, 1920, the regulations provided that the basis should be the same as it would be in the hands of the transferor, with suitable adjustment for depreciation allowed to the transferor while the property was in his hands; while if the property was so acquired by a corporation prior to January 1, 1921, the basis was the fair market value of the property at the time it was paid in (Reg. 112, sec. 35.718–1).

Thus, although theoretically the tax basis of the property was cost, it is apparent that values rather than cost were the determining factors where property had been paid in for stock, and in many instances where it had been paid in as surplus or as a contribution to capital. Furthermore, in cases where corporate reorganizations or readjustments had occurred, the tax basis of the property in the hands of the taxpayer was generally a substituted basis, carried over from some predecessor company, and the date of valuation, either of stock or of property, might be forced back to a remote point in the chain of ownership where values were extremely difficult to prove.

Accordingly, under the method prescribed in the statute, the portion of invested capital consisting of property paid in for stock was often a hodgepodge of values as of various dates. In the typical railroad case, the Bureau of Internal Revenue, in accordance with the law and regulations, used as a starting point for the determination of invested capital a reorganization that occurred somewhere in the distant past. Usually such a reorganization occurred in a period of depression such as 1873, 1884, 1893, etc. The chief element in the computation of invested capital in such a case was the item of property paid in for stock. In order to arrive at this figure, the Bureau would make a valuation of the securities issued by the reorganized company on the basis of market prices as of the reorganization date. Since, as previously stated, these reorganizations occurred in depression periods, market prices were likewise depressed, and the method used was not calculated to arrive at the fair market value of the securities even on the basis of fragmentary market quotations. Moreover, in many, if not most, cases equity securities were not issued at the time of the reorganization, and the market prices were those of voting trust certificates or of securities on a when-issued basis, so that so far as equity securities are concerned the market prices did not represent the prices of the stock which was eventually issued, say, some 5 years later. Even in the case of bonds, market prices were applied notwithstanding that the reorganized company actually incurred an obligation in the face amount of the securities issued and agreed to discharge these obligations at 100 cents on the dollar. The inevitable result of this fantastic procedure was to wipe out tens and hundreds of millions of dollars of actual bona fide investment in railroad property in the computation of invested capital.

In the administration of an excess profits tax at a high rate there should be certainty that the tax is applied only to true excess profits and not to reasonable normal profits. There can be no such certainty when the tax basis excludes any consideration of present investment or present net worth of the taxpayer. The method set forth in the statute for the determination of invested capital appears to have been based upon considerations of expediency. In many cases it would have been merely accidental if true excess profits could be determined under that method. The railroads were most seriously affected and prejudiced by the failure of the statute to give adequate consideration to present investment or present worth.

It is in the light of these considerations that we advance our first proposal that a railroad company be permitted at its election to compute its excess profits credit as an amount equal to the aggregate of its normal tax and surtax, plus a sum equal to 6 percent of the total of its capital stock, outstanding borrowed capital, and surplus, as reflected in its corporate books of accounts. The railroads were the first industry in this country to be subjected to regulation insuring the integrity of their accounts. Since 1907 the railroads have been required

to keep their books in conformity with the system of accounts prescribed by the Interstate Commerce Commission, and that Commission has for many years had full powers of investigation and supervision. The accounting classifications of the Interstate Commerce Commission have been the prototype for similar prescriptions of accounting methods for other types of regulated industries. Practically every form of utility today must keep its accounts in accordance with a classification furnished it by a regulatory agency. In the case of the railroads, the governing provisions are found in section 20, part I, of the Interstate Commerce Act and in the accounting classifications promulgated by the Interstate Commerce Commission.

The proposal advanced under this heading presents a common-sense realistic approach to the problem of developing the true invested capital of most railroad companies. As stated by the Supreme Court of the United States, taxation is an intensely practical matter. It is wholly inconsistent with sound administration to base the tax on a formula leading to so much dispute and litigation as attended the invested capital provisions in effect during World Wars I and II. It will be recalled that litigation arising out of the 1918 act was still in the courts in 1940 at the time the second excess profits tax was under consideration. Experience of the railroads with the more recent act indicates that in many cases it will take at least 10 years more to settle all of the disputes arising out of that act. Certainly a more workable method must be devised, and we submit that the proposal we are here expounding adequately meets the requirements of the situation. Instead of relying on nebulous calculations of property paid in for stock in connection with railroad reorganizations occurring as far back as 1850, it substitutes the standard of present worth as reflected in the taxpayer's books of account kept under the full supervision and policing of the governing regulatory body. We submit that no proposal offers so much promise of simplifying the tax structure with so little conceivable detriment to the Government's revenues.

We have intimated that while this method would fulfill the requirements of most railroads, there are nevertheless certain exceptional cases requiring some different form of treatment. The exceptional cases are chiefly those of railroads which have undergone reorganization in recent years with a consequent substantial reduction in their capital structures. Since these reorganizations, occurring chiefly since 1935, have constituted tax-free reorganizations within the definition of section 112 (g) of the Internal Revenue Code, the continuing or successor corporations are entitled to retain their predecessors' cost basis of property and assets. In such cases, a determination of invested capital on the basis of book figures would be wholly inequitable, and it is reasonable to assume that no railroad within this class could avail itself of this alternative method of computing invested capital. It is chiefly to take care of railroads within this class that we are offerng alternative proposal (2) which would base invested capital on asset value.

We do not think it necessary to summit any extended argument in support of our proposal that the excess profits credit should include the normal tax and surtax. It is well recognized in rate regulation that income taxes are expenses which must be deducted before there can be a determination of fair return. There cannot be a proper determination of what constitutes excess profits as distinguished from normal profits without including in expenses ordinary income taxes. To the extent that revenue must be used to meet such taxes, it cannot conceivably constitute excess profits.

Neither do we think it necessary to submit any extended argument in support of the proposal that the credit should be computed at 6 percent of capitalization rather than some lower percentage figure. We know of no case in which it has been held that a return of 6 percent is more than a fair return upon the value of utility property, and there are many cases where a return in excess of 6 percent has been deemed to be entirely reasonable for a regulated industry. It will be recalled that in connection with the recapture provisions of the Transportation Act of 1920 a return of 6 percent upon the value of property devoted to transportation service was postulated. A return of not less than 6 percent is required to enable the railroads to attract new capital sufficient to permit them to make the necessary improvement and expansion of their facilities.

We recognize that our proposal involves still another departure from the World War II statute in that it contemplates the inclusion of 100 percent rather than 50 percent of outstanding borrowed capital in the computation of the credit. The capital structure of the railroads is approximately 50 percent stock and 50 percent debt. No other industry except the utilities has nearly so high a percentage

of debt to total capitalization. This situation is not a matter of choice with the railroads. For many years investors have been wholly unwilling to invest new money in railroad equities, and in recent years they have been reluctant to invest new money even in mortgage bonds. This situation is in sharp contrast with the experience of unregulated industries whose earnings, in many instances, have been so great as to permit them to extinguish all of their indebtedness. There are hundreds of leading industries in the manufacturing and mercantile fields that have no outstanding indebtedness at all, and many of them have nothing but common stock outstanding.

Accordingly, of all the taxpayers in the country, the railroads are most seriously discriminated against by any restriction on the eligibility of borrowed capital as a component of invested capital. This discriminaton should be removed, as borrowed capital is just as permanently devoted to railroad operations and is just as much responsible for the production of earnings as equity capital. We recognize, of course, that under this treatment interest should not be permitted as a deduction in the computation of excess profits net income, because otherwise the taxpayer would be accorded what would, in effect, be a double benefit.

We have previously noted that the definition of borrowed invested capital contained in section 719 of the code limited the computation of borrowed capital to the amount of the outstanding indebtedness of the taxpayer evidenced "by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust." Under this provision, indebtedness of a railroad evidenced by outstanding equipment trust certificates has been uniformly included in borrowed capital. But there has been considerable reluctance in some districts, if not downright refusal, to permit the inclusion in borrowed capital of indebtedness represented by conditional sales agreements. Within recent years, railroads in financing the purchase of new equipment, have resorted more and more to the conditional sales device in view of its comparative simplicity and economy as compared with the equipment trust. Under either method, the railroad usuallly makes an initial down payment of approximately 20 percent of the purchase price of the equipment and obligates itself to pay the remainder over a period of from 8 to 15 years, the maturities under conditional sales agreements tending to be somewhat shorter than in the case of an equipment trust. Since the obligation and indebtedness of a railroad evidence by a conditional sale agreement is just as real and just as binding as that existing under an equipment trust and both methods have for their sole purpose enabling the railroad to acquire needed equipment without the necessity of paying the entire purchase price in the year of acquisition, any distinction between these two methods for tax purposes is purely artificial and without justification. Accordingly, the definition of borrowed invested capital in any new excess profits tax law should be enlarged so as specifically to include a "conditional sale agreement."

2. *As an alternative to proposal (1) above, a railroad company, at its election, should be permitted to compute its credit as an amount equal to the aggregate of its normal tax and surtax plus 6 percent of the adjusted basis for determining gain of all its assets, including money and current assets, less current liabilities*

Having in mind that, as previously indicated, there are some railroad companies which could not afford to base their excess profits tax credit on the total capitalization as shown in their books of accounts, we propose that, as an alternative to that method, a railroad company be permitted to compute its credit as an amount equal to the aggregate of its normal tax and surtax, plus 6 percent of the adjusted basis for determining gain of all its assets, but deducting current liabilities. This proposal is suggested by section 723 of the code, which provided a computation of equity invested capital on a similar basis in the event that the Commissioner should determine that the equity invested capital could not be determined in accordance with section 718. That provision dealt only with equity invested capital and thus provided for reduction of the resulting total figure by the amount of indebtedness outstanding at such time. We have modified that limitation to the extent of indebtedness qualifying as borrowed capial in view of our recommendation that a railroad company should be permitted to include in its credit 100 percent of the amount of its borrowed capital with a consequent adjustment of the interest deduction. We must also mention that our proposal differs from former section 723 in that we have provided that the assets should be included at their adjusted

basis for determining gain. The reason for this modification will be hereinafter explained.

Of course this proposal, like proposal (1), is intended to relieve the Government and the railroad taxpayer from the well-nigh impossible and completely artificial method of computing the invested capital of a railroad company that was used in connection with the World War II statute which, as previously pointed out, required a computation based on a reorganization occurring at some early stage in the taxpayer's history extending, in some cases, as far back as nearly a century ago. If there be agreement that this situation must not be perpetuated and that there should be an end to dispute and litigation, then some other method must be devised for the computation of the excess profits credit of those railroads for which, by reason of circumstances previously related, it would be wholly unfair to use capitalization as reflected in the books of account.

The method herein proposed, while lacking some of the simplicity of proposal (1), nevertheless sets forth a workable rule permitting an accurate and definite basis of calculating the invested capital of a railroad company. The provision permitting inclusion of the assets at their adjusted basis for determining gain would allow a railroad to bottom its calculation on the March 1, 1913, value of that portion of its property then in existence. Proof of such March 1, 1913, value in respect of the operating properties of every railroad company in existence at that time is already available through the basic valuations of the properties of each company made by the Interstate Commerce Commission under section 19a of the Interstate Commerce Act. While these valuations were generally made as of some date in 1915 or 1916, the Commission in evaluating such properties as of such date, uniformly used prices reflecting the average prices of the 1910–14 period. It is to be noted that the critical date, March 1, 1913, falls well within the pricing period used by the Commission. Moreover, the Commission has found and reported that the average prices for the 1910–14 period used by it fairly reflected the level of construction costs of railroad property for many years prior thereto. *Texas Midland RR* (75 I. C. C. 140); *Telephone and Railroad Depreciation Charges* (118 I. C. C. 295, 346). Certainly no other class of taxpayer is so fortunately situated in the matter of proof of the March 1, 1913, value of the greater portion of its property in existence at that time, because this valuation was made by a Federal commission under compulsion of statute and all the railroad properties were evaluated on a uniform basis with no thought of income-tax consequences. Such valuations are worthy of complete credence as fixing the value and cost of railroad operating property in existence on March 1, 1913.

Moreover, we wish to point out that the basic valuations of the Interstate Commerce Commission have generally been used by the Bureau of Internal Revenue as a starting point for the determination of the cost of railroad operating property for purposes of computing losses on retirement or sale and as a base for depreciation calculations. Under section 718 of the code, the basis of property for inclusion in equity invested capital was "equal to its basis (unadjusted) for determining loss upon sale or exchange." Accordingly, the basis recognized by the Bureau as proper for determining loss upon sale or exchange must necessarily be proper for determining the basis of property for inclusion in equity invested capital.

But the Treasury Department, in the audit of returns for the 1940–45 period, has refused to recognize the valuations of the Interstate Commerce Commission as proper evidence of the cost of railroad operating property acquired and installed prior to the basic valuation dates for this purpose and would undoubtedly maintain this position in the future under similar statutory provisions. For this reason, we are proposing that the assets of the taxpayer be includable at their adjusted basis for determining gain, the difference being that this proposal indicates a congressional intent that March 1, 1913, values should be considered. With such a direction from Congress, we feel certain that the Treasury Department would be willing to accept the ICC valuations constituting as they do the best possible evidence of the value of the operating assets as of March 1, 1913.

Of course the basic valuations of the Interstate Commerce Commission were limited to operating property and did not include any property therein classified as noncarrier. For most railroads, the amount of noncarrier property is relatively small, and no paticular problem would be involved in valuing the portion of such property in existence on March 1, 1913, as of that date.

The railroads uniformly have complete records of the actual cost of all additions and betterments made since their basic valuation dates and complete records

of all retirements which, so far as they relate to property in existence as of the basic valuation date, have been written out of the accounts on the basis of valuation figures and, so far as they relate to retirements of property acquired after that date, have been written out at cost. Thus the aggregate cost of all assets on hand as of the beginning of the taxable year could readily be determined. Our proposal contemplates that the "adjusted" rather than the "unadjusted" basis should be used in respect of all depreciable assets so that there should be deducted from the aggregate unadjusted basis of such assets all depreciation allowed or allowable in previous tax years.

3. Under any computation of invested capital, there should be included 100 percent of borrowed capital, and indebtedness represented by conditional sales contracts should be specifically included in borrowed capital

The reasons supporting these proposals have been fully set forth under the preceding headings. We recommend that these proposals be incorporated in any new excess profits tax law regardless of the action taken on other proposals.

4. Proposals regarding computation of credit based on average earnings

As previously stated, the earnings of the railroad industry in recent years have been so meager that most railroad companies must rely on the invested capital method rather than the average earnings method for computing their excess profits tax credit. There are, however, a few railroads that might conceivable be able to avail themselves of the average earnings method provided they were permitted to choose as the earnings base any one or two postwar years or, if the credit be based upon an average for a number of years, were given relief similar to that provided in section 713 (e) and (f) of the former law.

For most industries, earnings during the period 1946 to 1949 were uniformly good, and it might be deemed fair to use the entire 4-year period as the base period for determination of the average earnings credit. But the use of such a base period in the case of the railroad industry would result in substantial injustice and hardship owing to the fact that 2 of the 4 years within that period were conspicuously bad years, even as compared with the generally depressed level of railroad earnings which prevailed throughout the postwar period. In 1946, the class I railroads of the United States, excluding terminal and switching lines, earned only 2.75 percent on their recorded net investment. The corresponding figure in 1947 was 3.41 percent, and in 1948 was 4.24 percent, while in 1949 it was only 2.85 percent. Clearly, the years 1946 and 1949 ought to be excluded in the determination of an average earnings credit for the railroad industry.

In order to place the railroads on a comparable basis with other kinds of industries, a railroad should be permitted to pick out 1 year within the period 1946–49 as the basis for its credit on the income method, or it should be permitted to use the average of the 2 years 1947 and 1948. If it be thought that a longer period should be used, it is suggested that the base period should consist of the 3 years 1947, 1948, and 1949. But if such a period is used the railroads should be accorded relief similar to that provided in section 713 (e) (1) of the Internal Revenue Code which would permit them to substitute for the low earnings of 1949 at least 75 percent of the average earnings for 1947 and 1948.

It is essential also that adjustments be made in arriving at excess profits net income, such as were included in the former law. Reference is specifically made to the exclusion from excess profits net income of dividends and of capital gains and gains from the retirement of bonds. The figures which have been given as to the rate of return upon net investment of the railroads emphasize that any earnings base applicable to the railroad industry must in justice be computed upon 100 percent of the average earnings after appropriate adjustment.

Certain bills introduced in the present Congress have provided that the measure of normal profit should be as low as 75 percent upon average earnings during the base period. This proposal undoubtedly follows the thought that for many industries the period of the postwar years was one of great prosperity and resulted in earnings beyond those which should be considered as normal. But railroad earnings were low throughout the period and an arbitratry deduction from average earnings on a percentage basis would as to them plainly be unjust.

The final recommendation under this heading is that there should be added to the credit otherwise determined an amount equal to 6 percent of all net capital additions whether represented by equity or borrowed capital or retained earnings, made during the last 2 years of the base period and all subsequent years prior

to the first excess profits tax year. In explanation of this proposal, we wish to point out that the capital expenditures of the class I railroads for the year 1948 aggregated approximately $1,275,000,000 and for 1949, $1,310,000,000. While the figures for 1950 are, of course, not yet available, this high level of expenditures has continued during the present year. If the earnings credit were based on the average earnings for, say, the 4-year period 1946–49, it is apparent that such average earnings would not reflect, except to a minor extent, the earnings attributable to the new facilities installed after December 31, 1947, or the economies resulting from these expenditures. For instance, hundreds of millions of dollars have been devoted in the last 3 years to the purchase of Diesel locomotives, and in many instances the savings resulting from the substitution of such power are in the neighborhood of 30 percent per annum of the amount of the investment. If such locomotives were acquired in 1949, the resulting economies would be reflected in base period earnings only for a portion of 1 year. But those economies will be reflected throughout the excess profits tax years and will serve to increase the net income subject to tax. In this situation, earnings resulting from these capital expenditures would be reflected as excess earnings subject to an excess profits tax.

The proposal to add to the amount of the credit otherwise determined 6 percent of the net capital additions made after December 31, 1947, will substantially remove this inequity and permit the reflection in the base period income of earnings attributable to the facilities which will be available during the excess profits tax years. It is no answer to this problem to suggest that the railroads might be entitled to procure relief in respect of such a situation under section 722 or its equivalent, because the railroads have been completely unable to persuade the Bureau of Internal Revenue that relief should be accorded under similar circumstances during the 1936–39 period.

5. The 2 percent penalty for filing consolidated returns should be eliminated

There is no economic justification for imposing a penalty for the privilege of filing consolidated returns. Accounting authorities are in agreement that the published reports of affiliated companies should be made on a consolidated basis, and regulatory agencies, including the Interstate Commerce Commission, advocate consolidated balance sheets, income accounts, and profit and loss statements. Consolidated returns simplify administrative problems and produce savings for the Treasury as well as the taxpayer. Accordingly, there is not the slightest justification for the imposition of a penalty on the filing of consolidated income and excess profits tax returns.

6. The excess profits tax, normal and surtax, should be treated as one tax for limitation, credit, and refund purposes and for the sending of 90-day letters

This recommendation is made to eliminate the confusion and correct the manifest injustice attending the administration of the World War II statute. The Treasury Department has felt compelled by reason of statutory provisions to make separate computations of interest on deficiencies and refunds of normal tax and excess profits tax even though occasioned by the same basic adjustments.

The problem may be illustrated by assuming a reduction of excess profits credit for 1944. The excess profits tax is increased accordingly, but the income tax liability for the same year is automatically reduced. The Commissioner charges interest on the excess profits tax deficiency from the due date of the 1944 return, March 15, 1945, but allows interest on the related income tax refund only from the date of the payment which produced the overpayment, which in most instances would be December 15, 1945.

The practice of the Commissioner in such a case is to offset one tax against the other. However, before the offset is made, he computes interest on the deficiency from the due date of the tax and adds this to the deficiency and applies the overassessment to the aggregate of the deficiency plus interest.

Later a separate check is sent for the interest on the overassessment, this interest being computed from the date upon which the tax was overpaid.

It is manifest that this obvious inequity should be corrected in any new excess profits tax law. In view of the interrelationship of the excess profits tax and the normal and surtax, they should be treated as one for all administrative purposes.

The CHAIRMAN. I am handing the reporter two letters from the CIT Financial Corp. to be incorporated in the record at this point.

(The letters referred to are as follows:)

CIT FINANCIAL CORP.,
New York 16, N. Y., December 8, 1950.

Re H. R. 9827.

Senator WALTER F. GEORGE,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: Following our conversation of yesterday, I am giving you herewith the statement for the record which you requested. This is signed by Arthur O. Dietz, president of CIT Financial Corp.

In our talk I called your attention to an omission in draftsmanship of section 433, subsection (b), paragraph 7, and section 453, subsection (a), dealing with income from installment sales. The provision in question, while affording needed relief to the seller of merchandise on the installment method (House committee report, pp. 13, 15), fails to provide correspondnig relief to the bank or other financial institution which succeeds to the rights of the seller.

We also desire to call your attention to a highly discriminatory phase of section 435, subsection (e), paragraph (1) (B) of the House bill which defines "growth companies." This section denies the relief of the "growth company formula" to all corporations whose total assets, at the beginning of the base period, exceeded $20,000,000. If any test based on the size of the corporate taxpayer is justified, certainly this test of total assets should not be the one selected.

I will be very grateful if you will introduce this statement into the record and give it your personal consideration and support.

Thank you for the time which you were good enough to give me.

Sincerely,

ERNEST KANZLER.

C. I. T. FINANCIAL CORP.,
New York 16, N. Y. December 8, 1950.

Re H. R. 9827.

Senator WALTER F. GEORGE,
Chairman, Finance Committee, United States Senate,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: This statement is submitted to you in the form of a letter because of the congested calendar of the Finance Committee. Out of consideration for the time of the committee, we are forwarding it with the request that you place it in the record of the hearings on H. R. 9827.

The report of the House Committee on Ways and Means on this legislation states on page 13:

"As a result of testimony received at the recent hearings of the Committee on Ways and Means, provisions have been included in the bill designed to correct the income of taxpayers using the installment basis of accounting * * * Under the installment basis method of accounting income arises when the payments made under the contracts are received. In the absence of a relief measure, many taxpayers now using this method would probably be required to pay unusually large taxes during the first years of the excess profits tax period because the receipt of payments arising out of sales made in earlier years will exceed substantially the volume of new business. This is expected to occur because the volume of installment purchases was very heavy in 1948, 1949, and 1950 and will probably diminish sharply in 1951 and subsequent years as a result of the application of controls to installment purchases and the development of scarcities among the commodities ordinarily sold by the installment method. To prevent this result, the bill permits a taxpayer who is on the installment basis for income tax purposes to elect to report its income on an accrual basis for the excess profits tax. This has the effect of excluding from the excess profits net income of the taxable years the payments arising out of sales made during the years in which the tax did not apply. Such an election when made is irrevocable."

This excerpt points out the necessity for relief for taxpayers engaged in selling on the installment basis. However, as a matter of fact, the majority of sellers of goods on the installment method find it necessary to sell the receivables arising out of such sales. These receivables are sold to banks and other financing institutions, who succeed thereby to all the rights of the original sellers of the merchandise, and who therefore should be entitled to the same tax treatment.

Everything that is said in the House committee report concerning sellers of commodities on the installment method applies with equal force to those who buy the receivables from these sellers. The earnings on the receivables so purchased in 1948, 1949, and 1950 also have been deferred. In the absence of relief, these buyers of receivables will be required to pay unusually large taxes during the first years of the excess profits tax period. This is true because the receipt of payments arising out of business transacted in earlier years will exceed substantially the volume of new business. The volume of installment purchases of commodities and, correspondingly, the volume of installment receivables purchased was very heavy in 1948, 1949, and 1950. As a result of the controls referred to in the House committee report and the development of scarcities in the commodities ordinarily sold by the installment method, the business of installment financing also undoubtedly will diminish sharply in 1951 and subsequent years. As a result, banks and other financing institutions which engage primarily in this type of business would be required to pay unjustifiably large excess profits taxes from which the original seller of the goods and owner of the related receivables would have been exempt if he had continued to carry these receivables himself.

To prevent this result, the same kind of relief should be afforded to the buyers of installment receivables as the House bill affords to those who sell commodities on the installment method.

In submitting this amendment to your committee, may we state that no such proposal was made to the House committee when it considered H. R. 9827. In the few days which were available before H. R. 9827 was reported by the Ways and Means Committee, the foregoing was not presented and it seems apparent to us that the committee did not have an opportunity to consider the subject matter.

Thank you most sincerely for this opportunity to present our views to you and the other members of the Finance Committee.

Sincerely,

A. O. DIETZ, *President.*

GERBER PRODUCTS CO.,
Fremont, Mich., December 4, 1950.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MR. GEORGE: Confirming my telegram today I'm again writing you to express my objections and our company's objections to enactment of an excess profits tax at this time along the lines proposed by the administration.

It occurred to me that you might be interested in knowing more specifically how the excess profits tax of World War II affected us and how some of the proposals might affect us in the future.

As an example of the inequities and unjust penalties imposed on growth companies by the excess profits tax of World War II, we present the following statement of facts with respect to Gerber Products Co.

Year ended March 31	Sales	Taxable income	Federal income and excess profits tax	
			Amount	Percent to taxable income
1940	$3,144,121	$71,182	$13,611	19.1
1941	3,989,285	284,950	86,831	30.5
1942	6,680,249	744,789	395,784	53.1
1943	10,731,347	1,560,597	1,129,779	72.4
1944	12,627,164	1,406,842	1,008,499	71.7
1945	17,479,942	2,261,970	1,640,512	72.5
1946	21,094,061	1,546,925	971,823	62.8

Before passing judgment regarding the equity of such a tax set-up as shown above, please keep in mind that Gerber Products Co. is a producer of baby foods and that baby foods is a new industry which has been developing and growing since 1928, and it is not a war product.

Please also note that the sales dollars in the foregoing table represent actual growth in unit sales because during these years there was no increase in the

unit selling price to our customers even though costs of agricultural and other materials, labor and other costs, increased substantially and in some cases phenomenally.

The Gerber Products Co. is still a growing company, with sales for the year ended March 31, 1950, having reached $42,235,693, and increase since then indicates that sales of $48,000,000 or $49,000,000 may be expected for the year ending March 31, 1951.

Please do not draw any conclusion from this letter that Gerber Products Co. is objecting to the payment of its proper share of taxes, but it is not in favor of a method of taxation which unjustly imposes higher rates on growing companies compared to older and well-established businesses.

Growth companies and the development of new industries has been one of the most important reasons why the economy of this country has reached its present status, and this opportunity should be preserved and encouraged rather than checked and retarded by any inequitable basis of taxation.

Companies which radically improve their methods, products, or services and/or reduce costs and prices contribute equally well toward our national economy and should be encouraged.

The administration proposal includes establishing as normal profits (by using an arbitrary formula and period) 75 percent of the average earnings before taxes for the years 1946–49, and to tax any excess at 75 percent.

On this basis our normal profits would be established at approximately $2,400,000 and would be used to compute our taxes for future years. This is obviously entirely unrealistic when reviewing our actual growth and earnings over the last 10 years and considering the many adverse circumstances we encountered during that time. It is equally obvious that our actual normal profits are really closer to $6,000,000, as shown below:

Year ended Mar. 31	Sales	Taxable income
1946	$21,094,000	[1] $1,547,000
1947	20,735,000	[1] 468,000
1948	29,559,000	3,406,000
1949	39,036,000	4,500,000
1950	42,236,000	5,384,000
1951 (estimate)	49,000,000	6,300,000

[1] Adversely affected by being held to 1940 prices by OPA ceilings while prices of materials and labor increased substantially.

With further growth from natural and regular development, sales and income (before taxes) should continue to increase substantially over the present basis during the period any such proposed tax would be applicable.

Nevertheless, our tax in 1951, and subsequently, would be computed as follows:

	Tax
"Normal profits," $2,400,000, at 45 percent	$1,080,000
"Excess profits," $3,900,000, at 75 percent	2,925,000
Total and average, $6,300,000, at 64 percent	4,005,000

Naturally, with continued added sales and income in later years, a greater portion would be subject to the 75 percent "excess profits" tax rate whereas it is our contention that regular normal and surtax rates should apply.

The Honorable Mr. Wilbur D. Mills, Representative from Arkansas, has addressed an inquiry to us on this subject and we are taking the liberty of sending copy of our answers to his questionnaire along with this letter which we hope will be helpful to you in your consideration of the matter.

As previously stated, we believe that careful consideration is necessary to avoid action which might contribute to extravagance and inflation (resulting from tendency to spend "20- or 25-cent dollars" too freely) and at the same time create inequities greater than such action may be intended to prevent.

We strongly urge a program of rigid economy in both civilian, defense, and foreign-aid spending and imposition of a separate defense tax for a limited period of time using the same base as used for normal and surtaxes for all companies and that provisions be made for efficient procurement policies and practices in

connection with defense and war materials and all contracts be subject to bid, negotiation, and renegotiation.

Very sincerely,

DAN GERBER.

[Telegram sent December 4, 1950]

Congress should pass a tax bill to raise the money essential for national defense. There certainly is basis for serious criticism if the House passes the buck to the Senate on an inflationary measure like this so-called excess profits tax at a time of national crisis. The plan should be branded with its proper name, a bonus plan for inefficiency and extravagance and a drastic deterrent to initiative and productivity.

A brief review, on your part, of the effect of the excess profits tax of World War II cannot help but convince you of its extreme inequities, particularly with respect to growth companies. Arbitrary base periods are unrealistic and fundamentally unsound. Hope you can vigorously protest this petty political expedient and face the issue squarely with a defense tax on all income with renegotiation of war contracts continuing.

DAN GERBER,
President, Gerber Products Co.

EXCESS PROFITS TAX QUESTIONNAIRE

Congress is preparing to enact an excess profits tax for the purpose of largely taxing away corporation profits in excess of normal profits. Several formulas are under consideration to measure normal profits in order to exempt them from the tax. Please indicate how the following measures compare with what you consider normal profits before Federal income tax.

RETURN ON INVESTED CAPITAL

1. What percent profit before tax to invested capital do you consider normal? 5 percent, 8 percent, ——— percent.
2. If you believe 8 percent is below normal, explain why: __________________.
3. What rate of return do you have to pay to procure additional borrowed capital? ——— percent. Equity capital? ______ percent (dividend yield).
4. If your assets were revalued at reproduction cost less depreciation, your invested capital would be increased approximately ______ percent.
5. If research patents and other development expenses had been capitalized, your invested capital would be increased approximately?

AVERAGE PROFITS

Please check in one of the three columns on the right how well each formula below measures your normal profits before taxes?

	Too high	Too low	Normal
1. 140 percent of 1936–39 average profit			
2. 100 percent of 1946–49 average profit			
3. 95 percent of 1947–49 average profit			
4. 95 percent of 1948–49 average profit			
5. 90 percent of 1947–48 average profit			
6. 85 percent of best year in 1946–49			

State reasons why certain of the above formulas are too low.

What other formula would you suggest as a more reliable measure of normal profit?

Which method did your company use to determine its excess profits credit during most or all of the years 1940–45?

1. Invested capital method ( )
2. Straight average of profits, 1936–39 ( )
3. Average after substituting 75 percent of average of three highest years for poorest year ( )
4. Growth formula section 713 (f) which was applicable to corporations with higher average earnings in second half of base period ( )

GROWTH FORMULA

1. Would it, if applied to 1946–49, provide a relatively reliable measure of your normal profits now?
2. What formula would you suggest to measure more reliably your normal growth?

CREDITS AGAINST TAX

1. Did you use section 783 (credit for debt reduction)?
2. Would you need such credit to prevent financial hardship now? Why?
3. Would a similar credit for capital expenditures prevent financial hardship? Why?

GENERAL RELIEF

1. Did your company claim relief under any of the following sections of the Internal Revenue Code?

	Granted	Denied	Pending
Sec. 711(b)(1)(H), (I), (J), (K)			
Sec. 721			
Sec. 722			

2. What suggestions do you have for changes in these sections to assure the granting of appropriate relief in hardship cases and to improve or simplify their administration?
3. Would you need to seek relief under section 722 if the years 1946–49 are the base period for the new excess profits tax? Years 1947–48? Best year in the period 1946–49?
4. Would you prefer that 722 be administered by the Bureau of Internal Revenue or by a board outside of the Treasury whose sole functions would be to determine what corrections in base period earnings, invested capital, or rate of return are needed to produce a correct statement of your excess profits? Why?

WAR PROFITS TAX

Assuming that each of these methods would produce about 3 billions additional revenue, which would your company prefer?

1. Retention of the combined normal tax and surtax at 45 percent and the imposition of an excess profits tax of 75 percent on profits in excess of a reasonable normal?
2. A war profits tax which would be 25 percent of the combined normal and surtax?
3. A further increase in the combined normal tax and surtax from 45 percent to 55 percent?

FACTUAL INFORMATION

1. Name of your company.
2. The largest part of your business is in what industry?
3. Your approximate net worth is?
4. Your approximate invested capital is?

5.	Sales	Profits before taxes	Payroll
Estimated 1950			
Actual 1949			
Actual 1948			
Actual 1947			
Actual 1946			
Average (1936–39)			

ALTERNATIVES

1. In your opinion which, if any, of the aforementioned formulas is better than any other for businesses as a whole?
2. Would the choice of several alternative formulas result in a closer approximation of normal profits for all businesses as a whole?
3. What alternatives would you suggest that would not result in exempting above-normal profits of many businesses from the tax?

Answers to Excess Profits Tax Questionnaire

RETURN ON INVESTED CAPITAL

1. With tax rates as high as they are the return on invested capital can only be expressed as a percentage after taxes and not before. For companies in a business such as ours a return of from 10 to 15 percent on invested capital should be the minimum. It must be remembered that while successful companies will show good rates of return on invested capital, there are at the same time companies operating at no profit and even losses. To provide risk capital there must be a chance to provide more than a nominal return, some chance takers lose and some win, but there must be a chance to win.

2. An 8 percent limitation of return on invested capital is too low to attract new venture capital so vital to the growth and continued development of our economy. It must be remembered that even 8 percent return to corporation may only permit from 3 to 6 percent payment to shareholders because of prudent financial policies necessary to protect the business because of—
   (*a*) Increasing capital needs accompanying—
      (1) A healthy expending economy generally.
      (2) Growth companies.
      (3) Some years of low returns or losses.
      (4) Inflationary influences which require more funds for even replacement of same quantity of inventory, machinery and equipment, and to larger dollar amounts of accounts receivable.
   (*b*) Returns to investors should be higher on venture or risk capital otherwise funds will flow to channels providing relatively more safety and return of from 4 to 6 percent.
   (*c*) Invested capital as reflected by corporations' books are frequently not proper basis for establishing equitable return to investor. Shareholders' investment may be greatly in excess of book values because equity has been purchased at the economic value of shares based on current or recent conditions, prices, etc., whereas books indicate values (particularly of fixed assets) of many years previously.
   (*d*) Earnings are frequently not directly related to capital in companies where ideas, products, services, etc., are much more important than actual capital required.
   (*e*) Invested capital should be interpreted to include proper provision for borrowed capital; the holders of equity capital are assuming risk on it.

3. 3¼ percent, plus financing cost, equals 3½ percent. 7 percent plus.
4. 20 percent.

AVERAGE PROFITS

1–6. All too low.

All too low because we are a growing business. No lower than 100 percent of average of years 1948 and 1949 with consideration given to inclusion of first half of 1950 and extending base period to end of fiscal year for companies whose fiscal year ends in 1950 to at least June 30.

Any formula should provide for additional growth in each year subsequent to any established base period. Use actual for each year with some formula to discount for influence by the defense economy.

Growth of our business

[In thousands]

Year ended March 31—	Sales	Taxable income	Federal income and excess-profits taxes	
			Amount	Percent
1940	$3,144	$71	$14	19.1
1941	3,989	285	87	30.5
1942	6,680	745	396	53.1
1943	10,731	1,561	1,130	72.4
1944	12,627	1,407	1,008	71.7
1945	17,480	2,262	1,641	72.5
1946	21,094	1,547	972	62.8
1947	20,735	468	195	51.7
1948	29,559	3,406	1,310	38.5
1949	39,036	4,500	1,750	38.9
1950	42,236	5,384	2,075	38.5
1951 (estimated)	49,000	6,300	(?)	(?)

Sales prices remained at 1939 and 1940 levels or lower until late 1946 in spite of substantial (and in some cases phenomenal) increases in costs of materials and labor during that period. Since then, increases in selling prices have been at much lower rates than increases in material costs and labor rates. During most of 1946 and the first half of 1947 many abnormal conditions prevailed in our industry as well as in industry generally, seriously and adversely affecting our operating results.

During 1937, 1938, and 1939 we began several major changes in the character of our business. Our "base period" earnings (1936–39) were therefore not representative of normal earnings of the business after giving effect to the change. Although section 722 of the Internal Revenue Code was enacted to provide relief for such cases as ours and claims were made, the relief obtained was grossly inadequate because of unsympathetic consideration and attitude of the Bureau of Internal Revenue. Constructive average base period net income of $271,158 was allowed by the Bureau with net tax abatement of $81,379. Most of our earnings were accordingly taxed as excess profits at the 81- and 85½-percent-net rates. Such earnings, we contend, were not excessive and should not have been treated as war profits but taxed at regular rates.

METHOD USED TO DETERMINE EXCESS PROFITS CREDIT DURING YEARS 1940–45

1. Invested capital method. A small amount of relief was granted for the first 2 years under section 722.

GROWTH FORMULA

1. No; because of its limitation to highest year in the base period, and because of its static nature as applicable to all subsequent years. Growth is a continuing thing and not static.

2. A formula recognizing actual sales, payrolls, and profits, discounted by a factor measuring the influence of the defense economy, which could not be determined until some time after the taxable year.

CREDITS AGAINST TAX

1. Yes.

2. Yes; in order to meet debt-retirement requirements.

3. Yes; to allow retention of earnings to assist in the financing of capital additions.

GENERAL RELIEF

1. Yes, under section 722, but only an insignificant amount was granted, and then only for the first 2 years. (It is estimated that time and costs involved were about equal to amount of relief obtained.)

2. (*a*) A congressional mandate for reasonable and sympathetic administration.

(*b*) No limitation, such as 2 years, for projection beyond the base period.

(*c*) The allowance of actual performance, discounted by influence of the defense economy, as proof of the reasonableness of the credit claimed for each tax year of its own.

(*d*) It is exceedingly important that personnel of any group similar to the Excess Profits Tax Council,. conferees, and staff include significant ratio of practical, experienced businessmen, attorneys, accountants, and economists even if only available on part-time basis. Thorough knowledge of business operations is necessary also to understand and appreciate the practical aspects of problem codes.

3. Yes; because ours is a growing business.

4. Section 722 should be administered by a board outside the Treasury in order to provide for more reasonable and sympathetic administration. It is the job of the Bureau of Internal Revenue to collect taxes, not to make refunds, and therefore difficult for such Bureau to function with an unbiased opinion.

WAR PROFITS TAX

2. To provide additional revenues, to the extent necessary, a war profits tax as a percentage of the combined normal and surtax is far more equitable and economical of administration than any devisable excess profits tax, and particularly if combined with price controls and war contract renegotiations.

It appears advisable for several reasons to impose separate defense or war taxes for definite short periods of time, not to exeed 2 or 3 years to require review of results, needs, and administration.

FACTUAL INFORMATION

1. Gerber Products Co.
2. Baby foods industry.
3. $17,000,000.
4. $20,000,000.

5. Year ended—	Sales	Profits before taxes	Payroll
Mar. 31, 1951 (estimated)	$49,000,000	$6,300,000	$7,200,000
Mar. 31, 1950	42,236,000	5,384,423	6,604,107
Mar. 31, 1949	39,036,000	4,500,381	6,783,347
Mar. 31, 1948	29,559,000	3,405,668	5,167,003
Mar. 31, 1947	20,735,000	467,656	5,153,119
1936-39 average [1]	2,851,000	90,000	501,000

[1] During this period business was on different basis than subsequent to 1939. Over ½ of business was in staple canned foods with low margins and baby-foods business was just developing. Earnings were distorted because of changes occurring during the period. Earnings in excess of $200,000 were made in some years prior to 1936.

ALTERNATIVES

1. A war profits tax which would be a percent of the combined normal and surtax.

2. No.

3. Without renegotiation of war contracts and price and materials controls, any method may result in above-normal profits to those businesses taking advantage of the situation in a scarce economy.

The CHAIRMAN. That concludes the hearings and the committee will be in recess until Monday when the bill will be considered in executive session.

(The following material was submitted for the record:)

NATIONAL ASSOCIATION OF PHOTOGRAPHIC MANUFACTURERS, INC.,
New York 20, N. Y., December 7, 1950.

In the Matter of the Proposed Excess Profits Tax Law.

COMMITTEE ON FINANCE,
Senate Office Building, Washington, D. C.

GENTLEMEN: This association, whose member companies, according to best available information, produce more than 90 percent of the total volume of photographic products of all kinds manufactured in the United States, respectfully presents in behalf of the photographic-manufacturing industry the following

statement with regard to the proposal before your committee that an excess profits tax be imposed:

We are undertaking to present only those aspects which are of major and particular importance to this industry. In doing so, we will not burden your committee with any discussion of the merit or lack of merit of an excess profits tax.

We will, therefore, merely state that we believe an excess profits tax law, despite the great care which might be exercised in draftsmanship, would be too vague, too uncertain, too hard to administer with any degree of fairness, and productive of such widespread inequities and discriminations that it should not be enacted.

We believe, therefore, that to the extent that additional reevnues to the Government are essential they should be obtained by some more equitable, broadly based form of taxation.

SPECIAL CONSIDERATIONS AS TO THE PHOTOGRAPHIC MANUFACTURING INDUSTRY

As the committee is aware, the Amrican photographic manufacturing industry is engaged about two-thirds in making photographic products for use in industry, science, education, and government, including vital uses by the armed services, and about one-third in the manufacture of products for amateur use. You are also aware that this is a relatively small industry, that it is principally comprised of small companies, that a large proportion of its product areas are classified by the Munitions Board as comprising "basic and potential bottleneck items," the "production of which is vital in time of war." It has also been called to your attention that most photographic products can be made during wartime only by the photographic manufacturing industry because of the very highly specialized skills and specialized facilities required for their manufacture.

While it is our hope that the Congress will decide not to enact excess profits tax legislation, in the event that such legislation is nevertheless enacted, we respectfully submit that it is important to the continuance of this industry on a healthy basis that the following points be suitably recognized in any such law:

(1) Despite the serious drag on this industry occasioned especially by the 25-percent manufacturers' excise tax on photographic apparatus, machinery, and equipment, this is nevertheless a growing industry. It becomes essential, therefore, to provide for a suitable growth factor in any excess profits tax law in order that such growth, including vital scientific development associated therewith, may not be unduly discouraged.

(2) Data obtained from a representative group of photographic equipment and sensitized paper manufacturers, of all sizes, indicate that the average profit on sales (after Federal taxes on company income) for the years 1946–47 is 6.01 percent; for the years 1948–49 is 3.34 percent.

Further, a number of companies whose output is largely or wholly subject to the 25-percent excise tax as a group actually experienced a loss in 1949. (See p. 275, Hearings Before the Committee on Finance, Revenue Revision of 1950.)

To avoid the highly undesirable result of subjecting many photographic manufacturers, especially smaller companies engaged in the manufacture of equipment and apparatus, to additional hardships and inequities, we believe it to be of the utmost importance that should an excess profits tax law be enacted, it provide several alternatives at the option of the taxpayer for determining the excess profits tax base. Such options should include the provisions carried in the House bill, namely:

> (*a*) To allow a more realistically stated exemption of not less than $25,000—a matter of especial importance to new enterprises and other small and growing companies.
>
> (*b*) As in the case of previous laws, to permit the use of the invested-capital method, but in doing so to allow a more liberal return on invested capital.

also additional options such as permitting the taxpayer—

> (*c*) To select the best 2 years out of a period of 4 years.
>
> (*d*) To utilize as the base the highest year in the base period.

In connection with the matter of an allowance for growth, we understand that one possibility that has received consideration is that of using the comparison between 1948–49 average profits and 1946–47 average profits as a method of determining a growth factor. Whereas this might prove to be a very equitable method as to some companies, and should be used where appropriate, we wish to emphasize that it would prove highly inequitable, particularly in the product

areas where this industry has been deprived of its normal sales and profits levels by reason of the regressive effects of the high rates of manufacturers excise taxes to which they are subject. This is clearly shown by profit data presented herein. Moreover, suitable provision for recognition of continuing growth should be provided.

TREMENDOUS DRAIN ON CASH

The committee is aware of the necessity for a company to maintain a cash position which is adequate to finance its current operations, and that making profits does not necessarily mean an improvement in cash position. It was our experience after the last war when cash was drained off by high taxes, including the excess profits and excise taxes, and when the country entered the period of inflation, it became very difficult even for the strongest companies to maintain an adequate cash position. Some companies were unable to do so and as a result got into financial difficulties.

Your attention is directed to the extremely high demands upon the cash resources of the photographic manufacturing industry which taxes already make. In addition to the corporate rates which are already somewhat dangerously high, the necessity for the regular monthly payment of what for this industry are vast sums of money in manufacturers' excise taxes, whether or not these taxes have actually been collected from customers, is a serious problem. Additional drain on their cash position as a result of an excess profits tax, we believe, would prove to be more than some photographic manufacturers could bear. No doubt typical information by no means confined to this industry is available to the committee showing the dangers inherent in this phase of the problem.

PROFITS A MAJOR SOURCE OF CAPITAL

Attention is also directed to the fact that it has been the practice in this industry to reinvest a substantial proportion of earnings in plant expansion or other capital improvement. Our data indicates that over the past 4 or 5 years, typically 65 to 75 percent of earnings have been plowed back into the business and that this is historically the major source of additional capital required by this industry.

It would seem particularly important therefore that any excess profits tax law which may be enacted—

(a) Shall not serve to eliminate this important source of new capital.

(b) Shall provide appropriate optional methods by which a taxpayer having poor profits experience can nevertheless obtain an equitable base. The provisions of the House bill as to this are not adequate.

(c) Shall make provision whereby all increases in invested capital after the base period will be permitted to enjoy the same return as that on the invested capital during the base period.

CONCLUSION

In conclusion, we appeal to your committee to provide appropriate safeguards against the possible inequities and hardships pointed out herein in any proposed legislation which it may report.

Respectfully,

WILLIAM C. BABBITT,
Managing Director.

LOS ANGELES CHAMBER OF COMMERCE,
December 7, 1950.

Senator WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR GEORGE: In connection with the excess profits tax question, we would like to present a brief summary of our views. The following six-point statement was approved by our board of directors today after careful study by our Federal affairs committee. We would appreciate your including this statement in the hearing record:

1. There is no immediate revenue problem of such importance as to require precipitate action by Congress.

2. Events of the past few days indicate that long-range defense outlays may have to be much greater than seemed likely when the current excess profits tax legislation was being considered. It is perfectly obvious that the whole revenue and expenditures picture will have to be reexamined by the Eighty-second Congress as one of its first and most important items of business.

3. Because heavy additional defense taxes probably will be needed into the indefinite future, the form of such levies will play an important part in maintaining the internal strength of the United States.

4. As has been pointed out to the House Ways and Means and the Senate Finance Committees, there are serious objections to an excess profits levy at any time. Every possible means of avoiding such a levy should be explored; and if suitable alternatives cannot be developed, most deliberate thought should be given to the ways in which its uneconomic effects may be minimized.

5. It would be unwise to adopt any tax measure at this session. Rather, the tax committees and their experts should continue the careful, thoughtful exploration of the problem already begun by the Eighty-first Congress with a view to expediting action by the Eighty-second Congress.

6. Renewed study should be given to the matter of curtailing nonessential expenditures at home and abroad. Vigorous action in this field by Congress and the administration could alone serve to bring the budget into approximate balance for the remainder of fiscal 1951 whether taxes are increased now or not, and would reduce the tax load immeasurably over the years to come.

Sincerely,

HAROLD W. WRIGHT,
General Manager.

EVERETT & JOHNSON,
New York 5, N. Y., December 8, 1950.

Hon. WALTER F. GEORGE,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

MY DEAR SENATOR: In the interests of a sound, fair, and workable excess profits tax law, I would like to request that you and your committee give serious consideration to eliminating the $20,000,000 prerequisite to the application of section 435 (e) (1) (B) and to other amendments of this section. The requirement of $20,000,000 in gross assets bears no relation whatsoever to the need for a fair base period income where the taxpayer is patently a growth corporation. The benefit of the current war effort is neither more nor less by reason of the size of the taxpayer and the existence of inequities in the base period as a result of growth conditions is neither more nor less because of the size of the taxpayer. Furthermore, the definition as it stands would play into the hands of the less conservative taxpayers since the condition is predicated upon gross assets, and, therefore, would favor the corporation which whether wisely or not had overexpanded its borrowings. Most important of all, however, it seems unsound and unfair to make a differentiation between two taxpayers with precisely the same factors of growth merely because one taxpayer happens to have gross assets which exceed those of another. You can readily imagine that taxpayer A with gross assets of $19,999,999.99 at the beginning of the base period might pay only half the tax of taxpayer B with gross assets of 1 cent over $20,000,000 even though identical proportionate factors of growth, as elsewhere defined in the subsection, might exist for both A and B. It is extremely difficult to comprehend the equitable basis for such a distinction. I trust that the above will commend itself to your sense of fairness and that it will receive full consideration.

I would also like to urge that the section be extended. Gross income and payroll are only the means to an end and not the end in itself. A corporation may and often does expand either its volume or its employees without necessarily expanding its real earning capacity or its productivity related to the economy as a whole. These factors are only part and parcel of the ultimate earning capacity of the corporation which is generally and presumably reflected in the net earnings of the corporation for the year. Therefore, would it not be more sensible to predicate the growth factor upon the result of the various economic factors, namely, the net income for the year in somewhat the same manner as was done under section 713 (f) of the Internal Revenue Code.

Section 439 is, according to the Secretary's statement, designed as an improvement or mollification of the borrowed invested capital of the previous bill. I

would like to call to your attention, however, that subsection (b) thereof operates as a very considerable penalty upon insurance companies as compared with the World War II profits tax. Under the World War II law an insurance company was entitled to include 50 percent of the average unearned premium reserve at the beginning and end of the year and, therefore, if its invested capital was less than $5,000,000 it received a credit of 4 percent (50 percent of 8 percent). Under section 439 (b) of H. R. 9827, however, an insurance company receives a credit of only 1 percent. It should be remembered that the insurance industry operates largely upon the working capital provided by premiums and that under other sections of the bill the companies are required to treat as liabilities all reserves, including unearned premium reserves in the computation of equity invested capital. In view of the fact that the premiums constitute the lifeblood of these companies and provide the funds which are invested in equities and fixed obligations of the general economy, it is respectfully submitted that such companies should procure at least as favorable a treatment as under the World War II law.

Very truly yours,

MALCOLM JOHNSON.

Chicago 9, Ill., December 6, 1950.

Senator WALTER GEORGE,
Senate Office Building, Washington, D. C.

DEAR SENATOR GEORGE: As there is such limited time to appear before your committee regarding the proposed excess profits tax, we are writing to ask your consideration of our case.

In the 1930's, Spiegel, Inc., was a very prosperous company, doing a sizable mail-order business on the installment plan.

Regulation W, passed in 1941, made this company a definite war casualty. Our company suffered operating losses during many years of the war period, while others enjoyed record-breaking profits.

To maintain its position, this company, in 1944, embarked upon a program of acquiring retail stores, and in the years 1944 to 1946 some 165 units were acquired.

Many problems were encountered in connection with these acquisitions and, while the company has improved its position in recent years, it is still unable to earn a rate of return at all comparable to that of its leading competitors.

Of course, we never paid an excess profits tax because our earnings were always insufficient. We would now like to use all, or a substantial part, of our unused excess profit credit from the previous war period in order to mitigate the impact of the new excess profits tax on our company, which has not yet fully recovered from the last war.

Knowing of your reputation for fairness, we are sure you will agree that our request is equitable, and warrants inclusion as an amendment to the excess profits tax bill.

Respectfully yours,

ROBERT D. STECKER.

RECOMMENDATIONS OF THE CONTROLLERS INSTITUTE OF AMERICA, REGARDING THE TAX BILL FOR THE YEAR 1950–1951

The tax committee of the Controllers Institute believes that it is impossible to design and write an equitable excess profits tax bill. Inevitably a certain amount of normal profits will be taxed at excessive rates in a bill of general application. With the repricing and renegotiation policies of the armed services now in effect it is the belief of the Controllers Institute that very little, if any, excess profits will be earned during the emergency priod and that any excess profits tax bill will, if it is to secure a substantial amount of revenue, have to tax ordinary corporate profits. The excess profits tax approach, then, will tax some corporation normal profits at excessive rates and will tax other corporation profits at normal and surtaxe rates.

The recommendation of the Controllers Institute, therefore, is that the Government should first make every economy possible in the operation of the Government so that the emergency and military expenditures will require a minimum addition to corporate taxation. Whatever amount is required to be raised in addition to the amount already being raised from corporations should be procured through the application of a percentage to the corporate rates in effect at the end of the year 1949, that is, the percentage should be applied to the 38 percent corporate rate. This should be called a war emergency tax.

Should it be decided not to write a tax bill in accordance with the above recommendations the Controllers Institute has the following recommendations with respect to an excess profits tax bill:

Base period.—We recommend that the base period be the years 1946, 1949, inclusive, with the taxpayer entitled to use the three best years. Also, we would include the growth formula and the 75 percent rule of the last excess profits tax.

Specific exemption.—A specific exemption of $25,000 should be provided for all corporations.

Normal and surtax deducted in the ascertainment of excess profits tax net income.—The normal and surtax of the corporation should first be deducted similar to the pattern used in 1940.

Alternative basis of taxation.—We have above recommended that the method of taxation be that of applying a percentage to the normal and surtax of 38 percent. Should an excess profits tax also be written, we recommend that the taxpayer be allowed to pay either the excess profits tax or such percentage applied to the normal and surtax, whichever is smaller. This alternative will eliminate many of the inequities latent in an excess profits tax bill. In addition, adequate relief provisions should be provided, with administration by a neutral body.

Effective date.—The excess profits tax should not be effective before January 1, 1951, and a specific duration period of 2 years should be enacted.

Borrowed capital.—We recommend that borrowed capital be included in invested capital at 100 percent and that no interest deduction be allowed if invested capital credit is used.

Additions to excess profits tax credit.—We recommend that accumulated earnings after the effective date of the excess profits tax have the effect of increasing both the invested capital base and the average earnings base.

In addition, we recommend that an incentive rate be allowed for new equity capital after the beginning of the excess profits tax period for both the average earnings credit and the invested capital credit.

Rates of return for invested capital.—The Controllers Institute submits no specific recommendations as to the rates of return which should be allowed on invested capital. Such rates would necessarily be materially affected by technical factors, such as whether excess profits net income is determined before or after the deduction of Federal income tax and surtax. Furthermore, this Institute has historically refrained from embarking on contentious budgetary controversies and has restricted its recommendations to matters of clarification, equity, and sound administration.

We are sure that in establishing the rates to be allowed on invested capital your committee will not be unmindful of the fact that without an adequate return to the stockholders of our corporations, the supply of equity capital, which is already seriously curtailed, may vanish. Nor can the stockholders' claims be met until the prior demands of debt service, plant replacement (at enormously increased prices), and actual expansion have been met. There is little doubt that the invested capital credit provided by the tax law of World War II is no longer adequate. Secretary Snyder in his statement to the Ways and Means Committee on November 15, 1950, said: "To meet present requirements, the invested capital credit requires substantial revision."

SPECIFIC RECOMMENDATIONS

Consolidated returns.—The Controllers Institute recommends that consolidated returns be allowed for either the normal and surtax or the excess profits tax at the option of the taxpayer and that such election shall be binding only for 1 year. There should be no requirement that election for one tax requires the same election for the other tax.

Foreign subsidiaries' income and dividends.—It should be the privilege of the taxpayer to exclude the earnings of a foreign subsidiary or a Western Hemisphere trade corporation from either tax or both taxes, and whether consolidated returns are filed or not.

Dividends from foreign subsidiaries or from foreign stock holdings should be excludable.

Deferred foreign income earned in a year prior to that in which the excess profits tax becomes effective and which becomes unblocked in an excess profits tax year should be exempt from excess profits taxes.

Elimination of consolidated return penalty.—As tax rates become higher the consolidated return penalty becomes more onerous and more of a penalty. Only true earnings of the enterprise should be taxed, and corporations should not pay a penalty because the tax is limited to true earnings. The Controllers Institute, therefore, recommends the elimination for all purposes of the consolidated return penalty.

Deficiencies and refunds.—We recommend that for the purposes of calculating deficiencies, refunds, and interest thereon, both taxes be considered as one with deficiencies in one offsetting refunds in the other, so that only a net deficiency or net refund for both taxes carries interest.

Carry-back and carry-forward.—The taxpayer should be permitted to carry-back and carry-forward the excess profits tax credit for the duration of the excess profits tax law.

Further, we recommend that carry-over and carry-back continue to be available to the surviving taxpayers or the carry-back to predecessors through nontaxable reorganizations for the purposes of both the income and the excess profits taxes.

Capital gains.—Capital gains should be excluded from excess profits net income.

"Lifo."—The privilege of involuntary liquidation replacement should be extended to taxpayers using the Lifo method. Because of the possibility of great bidding up of prices in replacing inventory at the end of 1950, this privilege should be retroactive for the year 1950. The privilege of replacing inventory involuntarily liquidated before 1947 should be extended beyond 1950.

Respectfully submitted.

WARREN M. MAULE,
Chairman, National Committee on Federal Taxation.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION ON EXCESS PROFITS TAX TO THE SENATE COMMITTEE ON FINANCE, DECEMBER 11, 1950

The American Bankers Association, which numbers among its membership over 97 percent of the commercial banks, savings banks, and trust companies of this country, welcomes this opportunity to present its views regarding excess profits tax legislation to the Senate Committee on Finance.

The association strongly supports the proposition that additional revenue should be raised to put the defense program on a pay-as-you-go basis to the extent that can be done without injuring the national economy.

Before discussing particular matters relating to an excess profits tax, certain general observations would seem to be appropriate.

Since our economy is based on the private enterprise system, it is essential that this system should not be unduly dislocated and injured. An excess profits tax is not compatible with the private enterprise system which ordinarily receives its drive from the profit motive. Experience has demonstrated that an excess profits tax inevitably causes inequities, encourages extravagant wasteful practices, discourages growth and retards productivity. Too drastic taxation can endanger our economic strength. For these reasons great care must be exercised in making an excess profits tax as fair as possible.

Any consideration of an excess profits tax must, in the public interest, recognize the necessities of a strong banking system. From the standpoint of the national economy, it is necessary that we have a sound banking system with a strong capital position. It is therefore essential that there be sufficient net income after taxes to provide for additions to bank capital funds and reserves, and a fair return to the stockholders.

Bank earnings today are not, by any proper standard, excessive. Banks have had no postwar profits comparable to business in general.

In considering H. R. 9827, the following problems require particular attention:

EARNINGS BASE

1. Adjustment for abnormalities arising from statutory provisions

(*a*) *FDIC assessment credit.*—In 1950 Congress recognized that the assessments which practically all banks had to pay to the Federal Deposit Insurance Corporation in prior years had been made at a high rate in order to build up an adequate insurance reserve as rapidly as possible. A sufficient reserve having

been accumulated, the statute was amended in 1950 to provide for the allowance of credits against future assessments. Each credit is computed by reference to the operating experience of the FDIC in the preceding year. The result is that the FDIC assessments payable in excess profit years will be much less than those which were paid in the base period years. This abnormality should be adjusted by reducing the deduction for FDIC assessments in each base year in the same percentage by which the credits reduce the gross assessments in the excess profits tax year.

(*b*) *Partially tax-exempt bonds.*—Certain United States bonds, under the statute authorizing their issuance, are exempt from normal tax. H. R. 9827 excludes from income for the base years and for excess profits tax years, the interest on such partially tax-exempt bonds. As a result of a statutory change no such bonds have been issued since March 1, 1941. Accordingly, the amount of these bonds outstanding during the base years greatly exceeds the amount now outstanding and in the near future there will be further major declines. Amounts previously invested in these bonds usually have been reinvested so as to produce fully taxable income, although in some cases such amounts may have been reinvested so as to produce partially or fully exempt income. Under those circumstances taxpayers should be given an option to include such partially exempt and completely exempt interest in income for the base years upon the condition that any such interest received in an excess profits year is reported as taxable.

(*c*) *Deferred deduction of funded past service costs under a pension plan.*—Under the Internal Revenue Code the deduction for a payment to fund past service costs of a qualified pension plan is limited to 10 percent annually of the basic cash cost of such funding; the balance being deductible in installments in later years. In many cases the deduction allowed in a base year has no relation whatsoever to that year, except that it was required to be deferred to that year by the code. To the extent that such deferred installments have been deducted in the base period years, but smaller installments or none at all are deductible in an excess profits tax year, the deduction in a base period year should be adjusted by reducing it to an amount not in excess of the allowable deduction in the excess profits tax year.

2. Amount of credit

As a matter of principle 100 percent of the earnings for the base period should be allowed as a credit.

INVESTED CAPITAL BASE

1. Net reserve for bad debts

Section 437 (c) defines equity capital as the excess of the basis of the assets over the liabilities, including any reserve for bad debts. Section 433 (a) (1) (L) disallows additions to a reserve for bad debts in computing the excess profits tax net income of a bank and in lieu thereof allows a deduction for specific bad debts charged to the reserve during the year. Consistency requires that the net reserve for bad debts (the balance remaining in the reserve after deducting such specific charge-offs) should not be treated as a liability for the purpose of computing a bank's equity invested capital.

2. Allowable return

The allowable rate of return should be 12 percent on the entire invested capital. This equals a net return of only 6.6 percent after taking into account the 45 percent normal tax and surtax. Irrespective of the amount of capital involved, such a net return cannot be deemed excessive, particularly since under the proposed method of computation, invested capital will more closely approximate the capital actually used in the business than it did under prior law.

GENERAL COMMENT

1. Recoveries of bad debts

Section 433 (a) (1) (G) is wrong in principle in requiring recoveries on bad debts allowable as deductions in a year for which the World War II excess profits tax was imposed to be reported as income for excess profits tax purposes. The proposed excess profits tax is an entirely new and different tax and is not a continuation of the World War II excess profits tax. A recovery on a debt deducted as worthless prior to the imposition of the proposed excess profits tax is capital insofar as that tax is concerned. In no event should such a recovery be treated as income unless an excess profits tax benefit resulted from the allowable deduction.

2. Effective date of excess profits tax

H. R. 9827 in effect proposes the imposition of an excess profits tax as of July 1, 1950. When a tax bill is not passed until late December it should not be given so much retroactive effect. If the tax is made effective as of October 1, 1950, then such period of retroactivity will be approximately the same as that applicable to the tax increases made by the Revenue Act of 1950. Furthermore, the financial strain of meeting accelerated income tax installments in 1951 should not be aggravated by the imposition of a tax as retroactive as that proposed.

Respectfully submitted.

Mr. LEE P. MILLER,
Chairman, Committee on Taxation, American Bankers Association and President, Citizens Fidelity Bank and Trust Co., Louisville, Ky.

STATEMENT OF THE NATIONAL LUMBER MANUFACTURERS ASSOCIATION WITH RESPECT TO H. R. 9827 BEFORE THE SENATE FINANCE COMMITTEE, UNITED STATES SENATE, DECEMBER 11, 1950

The Board of Directors of the National Lumber Manufacturers Association, at its annual meeting held in Houston, Tex., November 13–16, 1950, discussed extensively the matter of Federal taxation and adopted unanimously the following resolutions:

"*Be it resolved by the National Lumber Manufacturers Association*, That instead of the proposed Federal excess profits tax to be imposed upon corporate income, it favors a tax at a uniform rate superimposed upon the normal and surtax corporate rates to be known as a special defense or war profits tax."

We would like to present the underlying reasons that motivated the passage of this resolution—

There are many sound reasons why the Congress should not enact an excess profits tax, either at this time or at any other time:

1. The excess profits tax laws that were enacted to finance World Wars I and II were unsatisfactory, as demonstrated by experience. Many of the objections to the enactment of such a tax at this time are based on that experience. These laws were intricate and complicated in their nature and were productive of inequalities, discriminations, and hardships. Section 722 of the World War II law was designed to, but in most cases did not, remedy these inequities.

H. R. 9827, the present bill, consists of 146 pages directed to one specific objective in taxation. That it takes a bill that long should be enough to convince anyone that the law will prove to be unsatisfactory and will not attain the objectives the Congress appears to have in mind.

2. No practical nor workable distinction can be made between normal profits and excess profits.

3. The selection of the period 1946–49 as a base is unrealistic in that profits during that period were inflated profits as compared to the profits of prewar years due to the build-up of the war and the ensuing postwar inflation.

4. The pending bill will create many inequalities and discrimination and much unfairness in its operation unless so many exemptions and exceptions and special provisions are embodied therein that it will be exceedingly difficult to administer.

It is seriously doubted whether using the period 1946–49 as a base period will not produce inequalities which cannot possibly be remedied by special provisions, even though the salient features of section 722 are embodied in the bill. Even if they are, it will take years of controversy and litigation to determine just how these special provisions will apply. It seems quite likely that by reason of large earnings during the base period many corporations will escape paying the taxes that they should pay to finance the national defense, while other corporations which did not have such earnings during the base period will pay more than their proportionate share of the total tax burden.

5. The pending bill will not retard inflation but will stimulate it and carry it to further heights. This bill if enacted will remove the incentive of many employers to keep down costs, including wages, and there will be a strong tendency to permit increases in costs on the theory that the Government will be paying the greater proportion of those costs.

6. It goes without saying that to the extent the revenue raised under the proposed act is inadequate to meet defense expenditures now facing us, other sources of revenue will have to be found. At the present time that primary source would appear to be incomes of individuals. This resort to individuals

for revenue purposes is apt to cast upon them an inordinate burden and great danger will be done to individual initiate and incentive.

It would seem that the foregoing difficulties could be avoided by the passage of a corporation tax in the form of a uniform rate special defense or war profits tax recommended in the resolution of the board of directors of the National Lumber Manufacturers Association. After all, how can it be said that profits made by taxpayers not directly or indirectly connected with production and aid of the defense effort are excess profits? Logically, it would seem that what a corporation made or did not make in a period before the war emergency is immaterial from the standpoint of taxes that it should justly pay in order to contribute its fair share to the expenditures which are to be made in the future. After all, the burden is a current one and should be discharged currently according to the ability of all taxpayers to contribute, having in mind a just and fair distribution of the total burden.

Statement of Smaller Business of America, Inc., on Excess Profits Defense Tax Program

The board of trustees of Smaller Business of America, Inc., on November 30, 1950, approved the following three-point Federal tax program for financing the defense preparations (assuming that normal tax and surtax on corporation net income remain as established by the Revenue Act of 1950; namely, 25-percent tax on the first $25,000 of corporation net income and 45 percent tax on all corporation net income in excess of $25,000).

RESOLUTION AS DRAWN BY OUR LEGISLATIVE AND TAX COMMITTEE

Chairman, S. S. Parsons; Secretary, G. William Jedlicka; Committee—Jules Eshner, William J. Franz, Max Gustin, Harry Jackman, and Clyde Williams

I. No immediate new excise taxes should be enacted.

II. A corporation excess profits defense tax should be enacted with the following provisions:

(*a*) The first $25,000 of corporation net income should be exempt from the tax.

(*b*) In addition to the $25,000 exemption noted in II (*a*) above, corporation net income should be further exempted for the tax to the extent of either—

1. A percentage of invested capital to be determined thus:

   12 percent of invested capital in excess of zero, but not in excess of $100,000.

   10 percent of invested capital in excess of $100,000 but not in excess of $500,000.

   9 percent of invested capital in excess of $500,000 but not in excess of $1,000,000.

   8 percent of invested capital in excess of $1,000,000 but not in excess of $5,000,000.

   6 percent of invested capital in excess of $5,000,000 but not in excess of $10,000,000.

   5 percent of invested capital in excess of $10,000,000.

   Invested capital should include average borrowed capital for the year.

2. Or, a percentage of average base period 1946–49 net income to be determined thus—

   100 percent of the average in excess of zero, but not in excess of $100,000.

   95 percent of the average in excess of $100,000 but not in excess of $200,000.

   75 percent of the average in excess of $200,000.

Each taxpayer should have the option of using either the "invested capital" method or the "average base period earnings" method in determining the exemption to which it is entitled (in addition to the flat $25,000 exemption).

(*c*) The excess profits tax rate should not be in excess of—

Total rate	*Normal tax and surtax rate*	*Excess profits tax rate*
65 percent, i. e.	45 percent plus	20 percent of excess profits tax taxable net income in excess of zero but not in excess of $100,000.
70 percent, i. e.	45 percent plus	25 percent of excess profits tax taxable net income in excess of $100,000 but not in excess of $250,000.
75 percent, i. e.	45 percent plus	30 percent of excess profits tax taxable net income in excess of $250,000.

Net income subject to the above excess profits tax rates should also be subject to the normal tax and surtax rates noted in the introductory paragraph of this resolution.

(*d*) The excess profits tax should become effective with regard to net income earned on and after January 1, 1951.

III. There should be repealed the section of the Revenue Act of 1950 which makes it mandatory by the year 1955, for corporations to pay their federal income taxes in full within 5½ months after the close of the taxable year.

(*a*) Instead there should be reenacted the pre-1950 provision that Federal income taxes be paid in four equal quarterly installments during the 11½ months period following the close of the taxable year.

STATEMENT SUBMITTED TO SENATE FINANCE COMMITTEE ON BEHALF OF COMMITTEE FOR ECONOMIC DEVELOPMENT BY MEYER KESTNBAUM, CHAIRMAN, RESEARCH AND POLICY COMMITTEE, DECEMBER 8, 1950

The events of the past month have made it clearer than ever that it would be unwise to adopt an excess profits tax. The freedom, the security, the lives of all of us depend upon the strength of America. Today we are basically the strongest nation in the world—in large part and probably decisively because of our unmatched industrial power. We are strong because we use our economic resources efficiently and increase our resources rapidly. How strong we shall be next year or 5 years from now will depend in large measure upon the kind of taxes we now adopt.

More taxes are certainly needed now in order to help prevent further inflation. On August 28 the CED issued a statement pointing out that a step-up in taxes beyond the interim tax bill would be needed soon. On November 15 we proposed a program of $6,000,000,000 of taxes to be enacted in the present (special) session of Congress and additional taxes to be enacted in 1951. We need taxes that will have a strong anti-inflationary effect and that will interfere as little as possible with the efficiency and expansion of the economy.

It will be difficult to add more taxes to the present structure without some adverse effects on production. But different taxes differ greatly in the magnitude of this effect. The problem of tax policy is to find or devise kinds of taxes that give the most anti-inflationary effect with the least antiproduction effect. The excess profits tax is not merely a bad tax from this standpoint. It is exactly the reverse of what we need. It gives the least anti-inflationary effect with the most antiproduction effect.

In all the pages and hours of argument about the excess profits tax one fact emerges beyond dispute. More than almost any other conceivable tax, the excess profits tax hampers efficiency and retards expansion. There are differences of opinion about the size of this effect. We in CED believe that the effect upon production would be very great. There are others who claim that the evil is exaggerated. Suppose we are wrong and that the testimony of all others who have had the opportunity to watch how our economic system operates is also wrong. Suppose that the effect is not as great as we believe; suppose that the damage to production is not a certainty but only a risk. Is there any reason to take this risk when all the proper purposes of taxation can be served better by other taxes? This is not a case in which we must take a calculated risk in the hope of achieving some important goal. This is a case in which the risk is reckless because unnecessary.

It would be hard to think of a tax better calculated than the excess profits tax to penalize the enterprising firm relative to the sluggish, the efficient relative to the inefficient, the new and growing firm relative to the old-fashioned one. The big established firm pays a standard rate so long as it does not exceed its base period earnings. But the firm that has a better product or more efficient method must pay the Treasury 75 percent on its additional earnings if it starts to grow up to challenge the established firm. The corporation that uses its capital wisely and earns a high return pays much more tax than one that has a higher invested capital base. The yardstick by which management makes decisions depreciates. Efficiency is worth only 25 cents on the dollar; waste costs only 25 cents on the dollar.

In discussing the rate of profits taxation before the Ways and Means Committee, Secretary Snyder said, "Excessively high rates tend to increase inflationary pressures because they induce waste and inefficiency." Again he said, "If under present conditions, and in the absence of wartime production motivation,

corporations were allowed to retain only a small part of any additional income they earn, they may not be left with sufficient incentive to maximize production." We believe that 25 percent is a very small part of additional earnings to allow corporations to retain. We believe that a 75 percent tax rate is an excessively high rate. The rate is excessive because the purposes of taxation could be achieved by a lower rate applied to total corporate profits.

There has been a great deal of misunderstanding about the reasons why the excess profits tax retards production. It is sometimes considered a reflection on the patriotism of American business to say that the excess profits tax will cause inefficiency. This is a superficial viewpoint. There is no basis on which to question the patriotism of the American business man or the strength of his natural drive for efficiency. But this does not justify needlessly setting up a system of rewards and penalties that work in complete opposition to the national interest.

However, the fundamental consideration is not a matter of the behavior of individual businessmen at all. It is a matter of the process by which the more efficient firms grow and the less efficient are held back. Suppose that all businesses are trying to be as efficient as they can. Some are going to be more efficient and enterprising than others in appraising the Nation's demands, in devising products, in production. The economy as a whole becomes more efficient by the relative expansion of these more efficient firms, causing the others to improve or contract. How are these more efficient firms selected out for growth? They are not selected by a Government agency. They are selected by the profit system. The more efficient firms earn more profits which they can use for expansion and which attract outside funds for expansion. The excess profits tax blots out the distinction between efficient and inefficient firms so far as profits after tax, reinvestment, and investment are concerned.

The so-called growth formula in the House bill reflects recognition of this problem. But it also shows that the problem of growth cannot be handled within the framework of an excess profits tax. The growth formula recognizes and makes allowance for growth in the past. But what we should be concerned about is stimulating growth in the future. Any excess profits tax must retard growth because the basic and fallacious premise of the tax is that all increases of profits are windfalls due to the military program and therefore subject to confiscatory taxation.

CED wants to make it perfectly clear that its opposition to an excess profits tax of the ordinary type is not opposition to large additional taxes now. We have advanced a program for immediate action to raise $6,000,000,000 of taxes, half from corporations and half from individuals directly. We recognize that it will be necessary in the emergency to strain the limits of sound taxation and to impose more taxes on corporations even though the corporation tax is a basically bad tax. But we believe that this particular form of taxation—the kind of excess profits tax that has been adopted by the House—needlessly and recklessly exceeds the limits consistent with a strong America.

The term "excess profits" by itself does not define the proper base for an excess profits tax. No one knows what excess profits are or how to measure them. As Secretary Snyder told the Ways and Means Committee, "Except in the case of individual defense contracts, it is impossible to determine the specific factors contributing to the changes in profits of a particular corporation or even of an industry." The profits resulting from the defense program are mixed with the profits resulting from all other factors. They are mixed beyond all possibility of isolation except in the direct military contracts. In the case of direct military contracts, profits should be limited by strict pricing and by renegotiation.

Surely the standards of base period earnings and return on invested capital are arbitrary standards by which to measure the excessiveness of profits. For example, it is clear that a credit equal to 85 percent of base period earnings is recommended because that is the way to reach some revenue goal, not because 85 percent is a better measure of "normal" than 100 or 125 percent. The 85-percent credit is inconsistent with the basic idea of taxing profits attributable to the defense program, which is supposed to be the justification for an excess profits tax.

A clear distinction should be made between a tax directed at "war" or "defense" profits on the one hand and a tax directed at "excess" profits on the other. Whatever form of emergency taxation is adopted, it would be unwise to accept the idea that a part of the profits earned in peacetime can be identified as "excess."

We believe that additional taxes should be enacted at the special session to take effect January 1. We believe this can be done if a simple tax plan is followed. The tax proposal should not require the determination of a wholly new tax base, as the ordinary kind of excess profits tax does.

How much additional tax should be imposed on corporate profits depends upon the total amount of revenue needed and upon the added revenue that should be obtained from other sources. We have found it exceedingly difficult to get reliable estimates of expenditures in 1951. However, we have seen no evidence to suggest that as much as $4,000,000,000 of additional taxes from 1951 corporate profits will be needed. On the basis of an estimate that 1951 military expenditures might be $35,000,000,000, we concluded that $3,000,000,000 of additional taxes on 1951 profits might be needed. It does not now appear that actual expenditures in 1951—as distinguished from appropriations—will exceed that amount. We believe that it would be extremely undesirable to impose further retroactive taxation on 1950 profits at this time and that the budget situation does not justify such retroactivity.

In our opinion, the requirements that should be met by a corporate profits tax plan are as follows:

1. It should avoid as far as possible very high marginal rates that will retard economic progress and weaken America.
2. I should comply as well as possible with your instructions to draft a tax on profits attributable to the defense effort, while recognizing that such profits are spread through the economy and cannot be isolated by statutory formulas.
3. It should be simple, so it can be agreed upon and enacted quickly.
4. It should raise the added revenue needed from 1951 profits, which may be about $3,000,000,000.

After considering many possibilities we came to the following proposal as best meeting these tests: Establish the basic rate of corporate profits tax at 38 percent on profits in excess of $25,000 and 18 percent on the first $25,000. This 38 percent was the basic rate in effect in 1946–49. Add to that a defense profits tax at an equal, flat rate on all corporations.

We believe that progression does not belong in the corporation profits tax. It is an impediment to growth and has no basis in the principle of "ability to pay," since the "ability to pay" of the ultimate taxpayer—the stockholder—is not measured by the size of the corporation in which he holds stock.

If $3,000,000,000 additional revenue is needed from corporations the rate of defense profits tax should be 15 percent, giving a combined rate of 53 percent. It should be noted at this point that six members of our committee dissented from this recommendation and said that the combined rates should not exceed 50 percent except in all-out war.

We wish to call to your attention two facts about the rate we suggest. First, the combined tax rate our committee suggests would take as a high a share of corporate income as was taken even during the war years. In the war years 1942 and 1945, inclusive, total corporate taxes—normal, surtax, and excess profits taxes—were 52.5 percent of corporate income. Our suggestion would give a combined tax rate of 53 percent.

Second, if we control inflation as we can and should, total profits after tax in 1951, under our proposal, would be almost exactly equal to profits after tax in 1947–49. Thus there would be no increase in total profits after tax either because of or during the 1951 defense program.

We believe that Congress should and can enact in the present session not only a defense profits tax but also a defense income tax at a flat rate on income above the present exemption and tax. A description of the defense income tax is contained in our November 15 policy statement, Paying for Defense, copy of which is attached to this statement.

Both the defense profits tax and defense income tax should be enacted now for 1 year only to assure further study and improvement. Also we recommend further study of excises looking to an increase in their yield later in 1951.

It is clear that main reliance in taxation for the defense program will have to be placed upon individual income taxes and excises. The primary function of taxes in the present situation is to help combat inflation by restraining private expenditure. This restraint must be chiefly directed to consumers' expenditures. Consumers' expenditures are about 6 times as large as business gross investment expenditure. Moreover, holding back investment expenditure now means less production later, which will aggravate the problems both of inflation and of defense. And in order to restrain consumers' expenditures higher individual income taxes and excises are needed. If consumer's expenditures are not

curved by income taxes and excises they will have to be checked by rationing or inflation.

We believe that Congress can act quickly and decisively if it will do two things:

First, make use of simple and well-established methods of taxation.

Second, base its action on the urgent objectives about which there is common agreement—to strengthen America and to fight inflation.

PAYING FOR DEFENSE

A Statement on National Policy

by

The Research and Policy Committee

of the

Committee for Economic Development

PAYING FOR DEFENSE

What began with Korea will not end with Korea. The attack upon South Korea was shocking evidence of the menace of Communist aggression. But the menace existed before Korea and military victory of the United Nations in Korea will not by itself end the menace. As long as the foreign policy of the United States and other free nations must be underwritten with military strength, the economic problem of defense will remain with us.

The Nature of the Economic Problem

The problem has three parts:

(a) To build up our military strength rapidly to a high level and be prepared to maintain it for a long time if necessary.

(b) To promote the continued growth of our productive capacity and its ability to meet greatly increased military requirements.

(c) To avoid inflation and preserve the stability of our economy.

The necesseary condition for a solution of this problem is that the total demand for goods and services—government, business, and consumers' demands—must be held in balance with the available supply of goods and services. Put another way, the nonmilitary demands must be held in balance with the supply of goods and services available for nonmilitary purchase. If this balance is achieved, the necessary resources will be released for the military programs, the demands for the remaining nonmilitary supplies will not be so excessive as to cause general increases of prices, and the pressures of organized groups for higher prices or wage rates will be restrained. If this balance is not achieved, the military programs will have to compete with nonmilitary demand, and prices of both military and civilian supplies will increase.

Experience shows that the necessary balance between total demand and total supply, or between civilian demand and civilian supply, will not come about automatically. It must be achieved by positive measures. One basic reason is that individuals and businesses earn incomes from production, whether the production is for military purposes or for nonmilitary purposes. But the goods and services available for them to buy come only from the nonmilitary production. As military expenditures rise the gap between total production and nonmilitary production rises, and so does the gap between incomes and the supplies available to be bought with those incomes.

Another reason why a rising military program generates inflationary pressure is that individuals and businesses expect a rising military program to result in inflation. Our past history, and the history of other countries, provides a reason for this expectation. And expecting this, buyers rush to buy, even before there has been any increase in military expenditures or incomes.

It is possible that in the next few months we may enter a period in which inflationary pressure subsides, as a result of the control measures already taken, the abatement of scare buying and the slowness with which military expenditures rise. This possibility should be taken into account in timing the application of policy to prevent inflation. But neither the possibility nor the fact, if it should develop, would in itself mean that the inflation problem had been solved.

The Size of the Military Program

Since the attack upon South Korea and the increase of the United States military program there has been only one official indication of the level of expenditures to be expected under the new program. This was the statement in the President's speech of September 9 that "By next June, under our present plans, we expect to be spending at the rate of at least $30,000,000,000 a year. In the year after that, we shall probably have to spend much more than $30,000,000." This statement itself is vague as to amount and time. Moreover, since the President's speech there has been a continuous flow of reports, more or less official, of changes in the program—in terms of appropriations, men under arms, air groups and other measures. Whether or not these reports are true, whether or not they represent changes from the program reflected in the President's September speech, whether they are changes agreed upon, under discussion or hoped for, what they imply in terms of the rate of expenditure—all these things are uncertain.

The size and rate of growth of military expenditures are dominant factors in the economic picture. There cannot be intelligent, informed public consideration of economic policy unless the public has a better basis than rumor and guess for appraising the magnitude of the program. Even during World War II the public was given more authoritative, more usable, more current information about the military program than it is now getting. We recommend that the Government establish responsibility in some agency, possibly the National Security Resources Board, for a new system of regular reporting to the public on the military program. This reporting might follow the pattern of the quarterly reports of the Office of War Mobilization and Reconversion.

For the present we must analyze the inflation problem in terms of the best information now available to the public, recognizing that it is subject to a considerable margin of error. On this basis a figure of $35,000,000,000 of military expenditure for calendar 1951 seems reasonable. This would be an increase of about $20,000,000,000 above the rate in the third quarter of 1950. Military expenditures would be rising throughout 1951 and might reach an annual rate around $40,000,000,000 by the end of the year.

Leaving aside any particular figures, the program may be characterized as large enough to create serious difficulties and call for real sacrifice, but not too large to be solved with intelligence and determination.

TWO APPROACHES

Given the prospect of an excess of nonmilitary demand over the supplies available for nonmilitary purchase, how can we stop inflation? Two basic approaches are possible:

(*a*) We can try to suppress inflation, by a system of general price controls, wage controls, and rationing.

(*b*) We can remove the inflationary pressure by monetary and fiscal policy.

Under the first approach an attempt would be made to prevent the inflationary pressure from affecting prices immediately and openly. The results of the inflationary pressure would at most only be postponed; the pressure itself would still be present in the form of a demand for more goods and services than are available, a demand backed up by high incomes, large money supplies, and abundant credit. Prices could not legally rise above ceilings set by the Government, and purchases would be limited either by formal rationing or by "bare shelves" rationing (the goods would not be available to be bought). If the excess demand were substantial the ceilings would have to be quite general; otherwise excess demand diverted from one commodity by controls would spill over to raise prices elsewhere. As recognized in the Defense Production Act of 1950, wage controls would be necessary to prevent wage increases from forcing increases of price ceilings.

Experience in the United States and in other countries has demonstrated that this is not an effective solution to the inflation problem, especially if the problem lasts for a long time. Even while the controls are nominally in effect, price increases break through in black markets, in deterioration of quality, and in the disappearance of low-priced goods from the market. Price ceilings and wage rates come to be determined in a political bargaining process which pushes up the prices and incomes of the groups most powerful politically at the expense of those less powerful. And when the controls finally come to an end, either by formal decision or by erosion in fact, the dammed-up inflationary pressure breaks out in open inflation. During the period when the inflation is

suppressed the excess demand still has its damaging consequences. It reduces efficiency because business managers know they can sell whatever they can produce and workers have no fear of losing a job. The pattern of materials allocation becomes frozen so that new businesses cannot start and grow. Prices are prevented from performing their economic function of directing production and distribution and economizing the use of scarce resources.

The second approach would check inflation by eliminating the excess of demand over supply rather than by trying to dam up the excess of demand behind a wall of price and rationing regulations. The approach is two-sided—to restrain demand and increase supply. On the one hand, it calls for the use of taxation to reduce the incomes individuals and business have available to spend, credit controls to restrict expenditures financed by borrowed money, a program to promote savings, and maximum economy in Government expenditure. On the other hand, it calls for vigorous measures to stimulate production, to help restrain inflation, and to provide more goods for military and civilian use. This means, among other things, that the monetary-fiscal program should encourage a flow of individual and business savings adequate to finance a high level of productive investment. Also the program should preserve incentive that makes for increased efficiency.

Despite the achievement of an over-all balance of demand and supply there would still be shortages of certain products. In these cases, the problem is to assure that the most essential uses are met and that supplies are increased rapidly. Monetary-fiscal policy can help meet this problem; selective credit controls can divert less essential demand from the scarce materials, and accelerated amortization can be used to induce more investment in the critical areas. These measures may need to be supplemented in some instances by limitation orders and allocations to restrain less essential demand and to direct short materials to essential uses, including expansion of productive capacity.

The great advantage of this monetary-fiscal approach to the problem of inflation is that it can be effective in controlling inflation. It can remove inflationary pressure, not merely postpone its effects, not merely push it around from one commodity to another, not merely drive it from legal markets into black markets. And it can work while leaving the economy free to adapt itself to changing conditions and to grow. It thus preserves the vitality of the free economy to make the best possible correction of shortages—namely, an increase of supplies.

It may seem paradoxical to say the inflation can be controlled while the economy is left free, for this implies that businessmen and labor unions are left free to raise prices and wage rates. But in the absence of direct controls, businessmen and labor unions are always legally free to raise prices and wage rates, yet prices and wage rates in general are not always rising. In 1949 prices in general were declining; in the first half of 1950 prices were rising moderately; in the third quarter of 1950 prices were rising sharply. The difference among these three situations was not in the legal freedom of business and labor but in the state of the market. In the third quarter of 1950 we entered a sellers' market, where more goods could be sold at higher prices, where higher wage rates could be passed along in higher prices without affecting sales or employment. In 1949 we did not have a sellers' market. It is not the legal freedom to raise prices and wage rates that results in inflation—it is the combination of legal freedom and the sellers' market which results from an excess of demand. The approach to the inflation problem via price and wage ceilings is the approach via limitation of the legal freedom; the approach via fiscal-monetary policy is the approach via restraint of the sellers' market.

We believe that business management and labor unions should be left as free as possible to determine prices and wage rates without Government control, but subject to the overriding discipline of the market. This freedom carries with it a responsibility. Even if an over-all balance of demand and supply is achieved, so that there is no general shortage of goods or labor, management and unions in particular industries will be in a position to raise their prices and wage rates. Some adjustments, including some increases, of particular prices and wage rates there should be, reflecting changes in costs, productivity, and demand-supply conditions. That is one reason for seeking to avoid the rigidity of Government wage-price controls. But businesses and labor organizations must not use the power their freedom and strategic position may give them to exploit the rest of the community. And they must not force the rest of the community to choose between direct wage-price controls and a low level of business and employment in the community's attempt to protect itself against exploitation.

THE BUILDING BLOCKS OF POLICY

As the program committee of CED pointed out in a statement issued in August,[1] a policy to achieve a balance between total demand and total supply while military expenditures are rising would include five main lines of action:

1. Economy in Government expenditures, Federal, State, and local, military as well as nonmilitary;
2. Higher taxes;
3. Restrictions on consumers' credit and housing credit;
4. Monetary and debt-management policy to restrain the growth of the money supply and bank credit;
5. A program to promote savings.[2]

Some steps have been taken along these lines in the past few months.

(*a*) Tax rates were increased by the Revenue Act of 1950, which became law on August 28, 1950. This act raised rates on individual and corporate incomes for calendar 1950 and subsequently. Withholding from individual incomes for tax purposes was increased on October 1 under this act. Excise taxes were imposed on television sets and deep freezers. This act will raise tax revenues by about $5,000,000,000 in a full year.

(*b*) Regulation W, prescribing minimum down payments and maximum maturities on loans for the purchase of consumers' durable goods, was issued effective September 18, and substantially tightened effective October 16.

(*c*) Regulation X, prescribing minimum down payments and maximum repayment periods for loans on new construction, was issued on October 10.

(*d*) The Federal Reserve System has raised rediscount rates, and by lowering its buying price has raised the yield of short-term Government securities, both moves to tighten up the money market.

The steps that have been taken are grounds for confidence in the ability of America to stop inflation. They are a reply to the cynical argument that America cannot stop inflation because no group in the Nation will accept the restraints and burdens that are necessary to stop inflation. The housing credit regulation and the revised consumers' credit regulation particularly display the vigor and willingness to accept responsibility and risk criticism, without which effective action will be impossible.

But while the steps taken so far encourage the belief that an adequate antiinflation program can be developed and executed, they do not themselves constitute such a program. Six positive steps will be necessary before we have a program adapted to the needs of a defense economy:

1. *A clear location of responsibility within government for formulating a program that is adequate in total and balanced in its parts*

Division of responsibility for various parts of the antiinflation program among numerous agencies of the Government militates against the development of an adequate total program. There is a tendency for each agency to justify the mildness of its own action by the observation that the whole program would succeed if the other agencies would act with sufficient vigor. No one has had the responsibility for assuring that the several parts of the program add up to an adequate total.

The function to be performed is more than clearance, coordination, and refereeing disputes. The function is an affirmative one, to develop plans looking as far ahead as possible, to see that the plans make balanced use of all instruments, and to see that action is taken at the proper time and in the amounts called for by the military program. Responsibility for this function must be located at a central and high position in the administration, for it involves nothing less than the total economic policy of the Government.

2. *Policies with respect to nonmilitary expenditures of Government—Federal, State, and local—that are realistic in view of the expanded military requirements*

To emphasize the need for maximum economy in Government expenditure is today more than the necessary repetition of an obvious truth. The Federal Gov-

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[1] Economic Policy for Rearmament, a statement by the program committee of CED, August 1950.

[2] Footnote by Philip D. Reed: I believe a sixth item should be added (6) A program to promote increased production, particularly of those raw materials which are already the bottleneck to maintaining a high output of consumer goods. The struggle against inflation would be greatly aided by the prospect of an increased supply of things people want to buy.

ernment is going to call for economy by the public; it is going to use higher taxes, credit restrictions, and the savings program to make individuals and businesses do without things they would like to buy. Such a program can succeed only if the Government gives evidence that economy is being vigorously and impartially enforced upon its own expenditures. The Government cannot justify restraints upon private expenditure if it does not impose equal restraints upon its own expenditure.

The change in economic conditions at home and abroad since a year ago creates the opportunity for a substantial reduction in Federal nonmilitary expenditure. It is almost inconceivable that nonmilitary expenditures should fail to decline. The important and difficult thing is to assure that the decline is as rapid and large as the new conditions warrant. In the case of the European recovery program, for example, this means that expenditures must be geared to the improvement in the European balance-of-payments position, largely unforeseen when the current appropriations were enacted. It means that the opportunity must be taken to sell Government-held stocks of farm commodities, both to raise revenue for the Government and to stabilize prices for consumers. It means that efforts to prevent abuses and waste in the provision of readjustment benefits for veterans of World War II should not be relaxed merely because total expenditures under the program are declining.

The problem of economy has other important aspects. The work of the Budget Bureau in reducing or deferring public-works projects that are not urgent in the present situation should be intensified and should have the support of the citizens and the Congress. Progress in carrying out the recommendations of the Hoover Commission to improve the operations of the Government must continue even while many agencies are adapting themselves to new or enlarged responsibilities under the military program.

Many expenditures of the Federal Government that are classified as nonmilitary are essential to the national security; they cannot be reduced and may even have to be expanded. The situation does not call for indiscriminate slashes, in Government or elsewhere. But it does call for measurement of all Government expenditures against the standard of necessity in a defense economy and reduction of all expenditures that do not meet that test.

The total expenditures of State and local governments are now about as large as the nonmilitary expenditures of the Federal Government (excluding interest on debt in both cases). Economy in the operation of State and local governments is not merely a matter of concern to the citizens of the particular States or localities—it is a matter of national concern. The national concern with State and local economy can be brought to bear effectively only through the assistance of the local citizens. This is one of the most important points at which the voluntary cooperation of the public must be enlisted in an economic stabilization program.

One step which should be taken by the Federal Government, which would tend to restrain State and local government expenditures, would be to eliminate, with respect to future issues, the exemption of State and local debt interest from Federal income taxation. This committee has urged this tax reform previously on grounds of equity and productivity. It would now have the additional advantage of holding back debt-financed State and local expenditures.

3. A workable plan for achieving more economy in military expenditures

It is especially necessary now to focus attention on the need for economy in military expenditures, which will soon be more than half of the total budget. This Committee believes firmly that a rapid and large increase of America's military strength is necessary. We are not raising a question here about the military program or the expenditures needed to carry it out. But we wish to emphasize that waste in military expenditures not only places unnecessary burdens upon the citizens but also endangers the military effort. Military procurement is in many cases its own worst competitor. Nonessential military demands interfere with meeting essential military requirements. Wasteful expenditures that impose unnecessary tax burdens weaken the ability of the economy to support an enlarged military program. And waste and inefficiency reduces the willingness of the public to support the program.

Conspicuous examples of waste on military programing, requirements, specifications, and operations in the last war are common knowledge. Reports of similar cases in the current program are beginning to appear. In our opinion, the situation urgently requires, as the first step to greater efficiency, more intensive, independent civilian review at many levels—in Congress, in the National

Security Council, in the National Security Resources Board, in the Army-Navy Munitions Board, and in the military departments and branches.

4. A program to promote savings

Private saving has an essential part to play in America's defense. Sufficient savings must be available to carry through the investment in productive facilities that is needed alongside the military program. Moreover, if the military program should rise to a level at which deficits are unavoidable, it will be imperative to stimulate savings and to tap them for financing the Government. The problem of stimulating savings is complicated by the impending maturity of large amounts of savings bonds—1.6 billion dollars in 1951, 3.9 billion dollars in 1952, 6.7 billion dollars in 1953. The cashing of these matured bonds will tend to reduce savings unless steps are taken to offset or prevent it.

The savings-bond program has been the instrument used by the Government to encourage saving. There is now a common view that this instrument can no longer be used because of the prospect of inflation. In our opinion, this reflects a mistaken appraisal of the problem and the program.

In the first place, inflation is not inevitable. Government cannot act, and private individuals should not act, as if inflation were inevitable. There is a risk of inflation. The American people cannot evade the risk of inflation by not saving. The Government has the duty to call upon the voluntary support of the American people in reducing the risk of inflation by saving more. The savers have the right to expect in return, not a promise that there will be no inflation, but assurance that every effort will be made to check inflation. This assurance can only be given by Government action—to cut nonessential Government expenditures, to balance the budget, to manage the public debt without recourse to monetary expansion.

It is of course true that persons who bought savings bonds during the war would have been better off if there had been no inflation. But this does not mean that they would have been better off to have saved less or, given the choices and needs of most individuals, to have saved less in the form of savings bonds. And if we look ahead to a period in which inflation is a risk, rather than back to a period in which inflation is a historical fact, the advantages of saving for the individual are even clearer.

The purpose of the savings-bond program is not primarily to sell savings bonds. The primary purpose is to promote savings. As one means of promoting savings the program makes available for those who prefer it an investment combining complete liquidity and safety from default, attractive interest earnings, and the opportunity for self-discipline through systematic savings, with main reliance on payroll deductions. There are many other ways in which savings can be invested; the important thing is that the total amount of savings should be adequate.

No effort should be spared to improve the savings-bond program as an instrument to stimulate saving, including the voluntary new purchase of bonds and voluntary exchange of maturing bonds. At the same time the Government should not hesitate to use vigorously the instrument that now exists.

5. *A policy to limit the expansion of the money supply and bank credit.*

No program to stabilize the economy and control inflation can be effective unless it includes measures for limiting the expansion in the money supply and bank credit. The purchasing power which has been reduced by heavier taxation must not be replaced through borrowing from banks. This would mean undoing with one hand what is being done by the other.

Certainly one of the most effective available methods of limiting the expansion in the money supply and bank credit is action to make the money market, including the market for short-term Government securities, self-supporting. Such action requires flexibility in money rates, for no satisfactory way has as yet been found to restrict the availability of credit without affecting interest rates charged all borrowers, including the Government. Even small increases in money rates dissuade some banks from selling bank-eligible Government securities and induce some yield-conscious investors to buy them. Without flexibility in short-term interest rates, the Federal Reserve System is unable to follow consistent anti-inflation objectives as it is obliged to do by law.

Relying on a self-supporting money market and permitting Federal Reserve actions to affect money rates is entirely consistent with a Government debt-management policy that is in the national interest even though it results in some temporary increase during the present defense emergency in the cost of carrying

the public debt. This increase in carrying cost is but a small fraction of the possible cost to the Treasury and to the people of this country of a substantial and a sustained rise in prices.

To say more on this subject would be beyond the scope of the present statement. This committee has discussed the question in an earlier statement[3] and is planning to issue another statement on the subject soon. Moreover, the issues have been analyzed with great clarity in a report of a congressional committee.[4]

6. A tax policy appropriate to the needs of a defense economy.

The problem here is not only to raise greatly increased amounts of revenue, although that itself is difficult. The problem is to raise more revenue in ways that will interfere least with the growth and efficiency of the productive system. This problem had not been satisfactorily solved even for the smaller pre-Korean budgets. Its solution becomes much more difficult for the budgets we now face. And its solution becomes much more imperative when we recognize that not only the welfare but also the national security of the American people are at stake in the economic strength of America.

The remainder of this policy statement will be addressed to this problem.

TAXATION FOR A DEFENSE ECONOMY

The committee recommends a tax program designed to do three things:

1. Produce a substantial surplus in the Federal cash-consolidated budget in the first half of the calendar 1951 (in addition to the effect of seasonally high tax receipts every spring).[5] It will be important to do more than just balance the budget in the January-June period, for several reasons. When the rearmament program is in a rapidly rising stage, expenditures lag behind orders and production; thus the military demands on the economy are not fully revealed in the expenditure figures. In this situation, an even balance of revenues and expenditures would not fully balance the impact of the military program. Moreover, in this early, accelerating state of the program it is especially desirable to relieve the economy from inflationary pressure so that shortages and bottlenecks do not unduly impede the changeover to military production. We should take advantage of the opportunity that will exist in the first half of 1951 to put a definite stop to the inflation and thereby to weaken the general expectation of more inflation. If the inflation is not stopped by mid-1951 it will be much more difficult to stop it later.

2. Balance the Federal cash-consolidated budget in the second half of calendar 1951. To run a surplus in the second half would be more difficult than in the first half, since expenditures will be larger in the second half. And if the inflationary trend has been arrested in the first half a surplus in the second half will be less necessary. But balancing the budget in the second half of 1951 would be the minimum contribution to be required of tax policy for economic stability.[6]

3. Provide for revision and reform of the Federal tax structure so that the large revenues that may be needed for a long time to come may be raised equitably and with least impairment to enterprise and productivity.

To achieve these objectives we recommend:

1. Revise the corporate profits tax so that it consists of a basic rate of 38 percent (18 percent on profits under $25,000) plus a defense profits tax at a flat rate on all corporate profits. This revision should be enacted before December 31, 1950, to take effect January 1, 1951, and should automatically expire December 31, 1951. We recommend that no excess profits tax be imposed and that an additional tax at a flat rate be used to raise needed revenue from corporate profits.

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[3] Monetary and Fiscal Policy for Greater Economic Stability, a statement on national policy, Committee for Economic Development, December 1948.

[4] Report of Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, 81st Cong., 2d sess., January 1950.

[5] See appendix note.

[6] Footnote by Fred Lazarus, Jr.: I disagree with the proposal that a substantial surplus, possibly at a 3-to-4-billion-dollar annual rate, be raised in the first half of 1951, and that taxes then be raised sufficiently to keep the second half of calendar 1951 in balance on a cash basis. The tax program for calendar 1951 should raise an amount sufficient to meet governmental cash expenditures for calendar 1951. Under such a revised policy, the corporate tax could be held to 38 percent plus a 12-percent defense profits tax, or a total of 50 percent. The amount needed to be raised from excises could also be reduced, even if expenditures for the year 1951 are as high as the $62 billions estimated on p. 22. The pay-as-you-go principle does not call for achieving a large surplus by dangerously high tax rates. A balanced budget would, in my opinion, be the best contribution that tax policy could make to a stabilization program for 1951.

2. Levy a defense addition to the individual income tax at a fla percentage rate on net income in excess of exemption and the present tax. As in the case of the corporate tax, this addition should be enacted before December 31, 1950, to take effect January 1, 1951, and should automatically expire on December 31, 1951.

3. Revise the Federal excises to rationalize the structure of rates and coverage and to increase the yield. This should go into effect sometime in 1951, perhaps July 1, 1951.

The increased yield of excises added to the yield of present taxes plus the temporary increases proposed for immediate enactment should be sufficient to balance the budget in the second half of calendar 1951.

4. During 1951 give the full consideration that is required to a revision of the individual and corporate income taxes to take effect January 1, 1952, replacing the temporary increases which would expire at the end of 1951. This revision should, in general, be addressed to the problem of raising the revenue required from these two sources fairly and in such ways that will support the maintenance of high economic productivity.

We suggest that the additions to the corporate and individual income tax be enacted immediately in order to assure a substantial surplus in the first half of 1951, and also to avoid retroactivity in imposing taxes on 1951 incomes. We suggest that these additions be made temporary, expiring at the end of 1951, in order to avoid freezing into the tax system any changes made now in haste to meet the revenue needs of 1951. A tax program must be developed to meet the needs of a budget that may continue to be very large for a long time. There is not now any national agreement on even the general character, let alone the detailed specifications, of such a tax program. A conscientious attempt to arrive at such an agreement will take months of study and discussion.

We recommend that study of the complex issues involved in excise tax revision be started now so that revision may be enacted during 1951 to bring in more revenue in the second half of 1951, when more revenue will be needed.

The specific tax rates needed to yield a surplus in the first half of 1951 and balance the budget in the second half depend, of course, upon the expenditure program. This program, in which the largest element is the military program, is of uncertain size. Presumably before Congress acts on taxes it will obtain more and better information about the expenditure plans than is now available to the public.

In the absence of more reliable information on the expenditure outlook we can only indicate the rates that would be necessary on certain assumptions. As already indicated, $35,000,000,000 seems a reasonable figure for military expenditures in calendar 1951, on the basis of the President's statement that the rate of expenditures in mid-1951 would be at least $30,000,000,000. Nonmilitary expenditures should not exceed $27,000,000,000. This is about $5,000,000,000 below the amount included for nonmilitary programs in the fiscal 1951 budget last January. Part of this reduction should be achieved automatically, or nearly so, as a result of the improvement of economic conditions since last January, which will cut outlays for unemployment compensation, farm price supports and mortgage purchases, and as a result of the planned decline in ECA expenditures. The remaining reduction is attainable with reasonable effort; some part has already been achieved by action taken in the last Congress. In fact, we believe that nonmilitary expenditures can and should be held below the $27,000,000,000 figure. However, for the present illustrative purposes we shall assume total expenditures of $62,000,000,000—$35,000,000,000 military and $27,000,000,000 nonmilitary.

If the gross national product in 1951 is $300,000,000,000, tax liabilities under the present tax rates will be about $55,000,000,000.[7] This is $14,000,000,000 more than the actual revenue collections in fiscal 1950—and results from the nearly $5,000,000,000 tax increase enacted in September, the increase in social-security coverage, and the increase of $45,000,000,000 in the gross national product between 1949 and the 1951 estimate.

If expenditures for 1951 are as much as $62,000,000,000 and rising through the year, the committee would recommend:

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[7] See appendix note.

(a) That the temporary defense profits tax be set at 15 percent of total profits. This would yield about $3,000,000,000 more than the present profits tax.[8]

(b) That the temporary addition to the individual income tax be set at 5 percent of income in excess of exemptions and the present tax. This would yield about $3,000,000,000 net.

The amount of additional revenue to be obtained from excises could be determined in the spring after Congress had seen and considered the January budget.

We wish to emphasize that the rates suggested here are based upon very uncertain expenditure estimates. The rates should be lower if expenditures can be held to lower figures. If less revenue is required, the rate of defense profits tax especially should be lower than the suggested 15 percent, because of the special danger that high rates of corporate taxes hold for the strength of the economy.

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[8] *Footnote by Messrs. Folsom, Kanzler, Patterson, Reed and Scherman.*—The undersigned fully agree with the opposition to an excess profits tax but dissent from the recommendation that a defense profits tax of 15 percent be added to a basic corporate rate of 38 percent, making a combined tax of 53 percent. We consider this proposal bad in principle and inconsistent with the fundamental tax philosophy previously presented by the CED, and also inherent in the present statement.

The case made for the 53-percent corporate rate is not that it is a good way to raise the needed revenue, or even the least harmful of all possible ways, but only that it is less harmful than an excess profits tax, "for which it may be considered a substitute." This seems to us a poor reason to advance in support of any tax proposal. The excess profits tax should be opposed on its clear demerits. These are well set forth in the statement, and there is no doubt that they represent the views of practically all persons informed on tax matters.

It is precisely when the tax burden becomes dangerously high that the soundest possible tax policies are most called for. This committee in previous statements has emphasized the evils of a high corporate profits tax—the impediment to the starting of new businesses and the growth of small businesses, the deterrent to productive investment, the discrimination against equity financing, the unfair double taxation of dividends. Also—and this is too little understood—part of the corporate tax burden is passed on to labor in lower-than-possible wages and to consumers in higher prices. One additional factor is especially important today, when a major objective of tax policy is to help stop inflation. The corporate profits tax is much less anti-inflationary than other kinds of taxation, because it reduces savings, retards production and encourages waste and higher costs. The net effect of raising the corporate tax, though less damaging than the excess profits tax, may be to promote rather than restrain inflation.

For these reasons we believe that there is a limit beyond which it would be unwise to raise the burden of corporate taxation. We believe that the opportunities for eliminating nonessential expenditures are even greater than this statement suggests. If, despite all efforts to achieve greater economy in govrnmnt, additional revenue is needed beyond that provided by other recommendations of the committee it should and can be raised in ways less damaging to the Nation, including higher excise taxes.

The CED in the past has looked with disfavor upon excise taxes, except on tobacco, gasoline, and alcoholic beverages, and we have set forth in previous statements their inequities and disadvantages. However, a temporary increase of excise taxes would be much less damaging, in our opinion, in the present state of affairs than a 53 percent rate of corporate taxes. Higher excises would greatly assist in preventing inflation, because they would not retard production and because they would reduce private expenditure rather than private savings.

If it is decided that there should be some addition to the corporation tax, we believe that in no circumstances, except under conditions of all-out war, should the increase go beyond a total of 50-percent corporation tax. We take this position because we believe that a clear firm limit should be set in the public mind, beyond which taxes on business profits must not be allowed to go except under conditions of all-out war.

Every thoughtful person now recognizes that the closely interrelated welfare of all of us rests solidly upon the encouragement of individual enterprise. Every form of tax, of course, has some effect upon employment; but some do more damage than others, and through discouraging and hampering business enterprise) the corporation profits tax is outstandingly bad in this respect. Consequently, pending the time when our whole tax system is thoroughly and wisely reformed, we believe that a purely arbitrary limit—of 50 percent on a corporation tax, may at least be useful in putting a halt to the pernicious sapping of our national strength that opportunistic and uninformed taxation represents.

Added comment by Mr. Kanzler.—I agree with the above footnote and would like to add the following: The CED policy statement says that inflation is not inevitable. Of course it is not inevitable, but only if the Government will take the necessary steps to prevent it, which it definitely has not done and is not now doing. It will take great statesmanship and courage in the face of political pressures for the various agencies of the Government to put into effect promptly a unified program which on the one hand will prevent inflation, but which at the same time will permit the free enterprise, profit, and capital system to flourish in the manner which has developed for our country the leading economy in the history of the world.

Our tax receipts and jobs depend upon a profit progress and when corporations which carry the torch of this progress (not only through their own earnings but in the wages and salaries of individuals and the dividends they pay) are taxed more than 50 percent, incentives begin to fade, venture begins to disappear, the spirit of management is undermined, and our whole system begins to lose its driving force, which deterioration is just what Russia is hoping for. Therefore, before this essential segment of our producing system is squeezed too tightly and thus strangled, and I believe any tax over 50 percent does this, many other available means of spreading the tax burden should be employed (see

Taxation of corporate profits

The committee recommends the division of the corporate tax into a basic rate and a defense profits tax for two reasons. First, it is desirable to give statutory recognition to the fact that a corporate tax rate higher than the 1946–49 rate is justifiable only in emergency conditions. Second, with a combined rate as high as is now proposed a number of statutory relief provisions may be needed to prevent great hardship; in some cases these provisions might apply only to the defense profits tax.

The committee believes that the flat additional rate recommended here represents the form that any increase in corporate profits taxation should take. However, we do not believe that it would be satisfactory merely to make a flat addition to the corporate rate for the duration of the defense program. An increase in corporate taxes makes it especially urgent that full consideration be given to possible ways of reducing the adverse effects of high rates on productivity. Therefore we suggest that the addition be made temporary, to expire automatically on December 31, 1951. This will give time for the development of an improved corporate tax to take effect January 1, 1952.

Among the questions which should be examined in the construction of a corporate profits tax are the following:

(*a*) *Current asset position.*—Corporation taxes must be paid in cash, but the earning of profits does not automatically yield the cash with which the tax can be paid. The earning of profits may be reflected in an increase of assets, such as goods in process of production, that can be converted into cash only with great difficulty, if at all. This problem becomes acute when taxes rise to half or more of total profits. Consideration should be given to abatement or postponement of tax for corporations with low current assets (assets readily convertible into cash).

(*b*) *Contractual amortization.*—Many corporations have contractual obligations to make annual repayments of debt out of their profits. An increase of

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my footnote to the CED policy statement, A Postwar Federal Tax Plan for High Employment, August 1944).

I agree that we should pay an additional 12 percent of corporate profits as a special-defense tax to bring the total up to 50 percent. However, what additional is needed we should secure by excise taxes, sales taxes, manufacturers' sales taxes, or best by a substantial broadening of the base on individual income taxes, where it is evident to all the greatest source of revenue exists.

The following table shows the distribution of total income by tax status (based on 1950 income levels):

Total personal income	$220,000,000,000
Income not subject to tax (legally excluded, not reported, deductions, personal exemptions)	138,000,000,000
Income subject to tax (surtax net income)	82,000,000,000
Tax at present (1951) rates	19,000,000,000
Taxable income after present tax, total	63,000,000,000
$0 to $2,000	48,400,000,000
$2,000 to $4,000	6,500,000,000
$4,000 to $6,000	2,700,000,000
$6,000 to $10,000	2,600,000,000
$10,000 to $20,000	1,900,000,000
Over $20,000	830,000,000

Every citizen should be made to feel and to carry his share of the burden. This will awaken in him the demand for economy in nonessential Government expenditures, especially those of a nonmilitary nature.

Such a public pressure for economy will never arise if overly high corporation tax rates—that is, over 50 percent—provide easy (but gradually self-exterminating) excess Government receipts.

Most importantly, the Government must take some immediate steps to breathe public confidence into its fiscal policy—to let its people believe and understand that the Government honestly and fearlessly, without playing politics, will take all the means at its command really to stop serious inflation.

The Government cannot merely single out for taxation those segments of the economy which carry with them no political disadvantage. It cannot merely limit its actions to credit curbs, limitation orders, higher taxes and savings and bond sales promotions. It must do more. It must do enough to succeed. It cannot repeat its performance carried on since World War II, resulting in excessive depreciation of savings and insurance and simple preferred stock and Government bonds, etc., which have been allowed to depreciate to fractions of their V-day values by policies which have become unsound.

There can be only one end to such a program in a country whose strength has been born of the free enterprise, capitalistic and profit system. We have come a long way up the road of inflation and some flight from the dollar is evidencing itself even now, and a frank and honest facing of the problem dictates that since we cannot have "business as usual," we cannot have "politics as usual."

The public is rapidly alerting itself to inflationary effects of present policies on its Government bond purchases and savings. It would be the end of our freedom if the Government would have to invoke dictatorial measures to keep itself financed by forcing the purchase of Government securities on our people.

profits tax to 50 percent or more would make it impossible in some cases to conform to these contracts. The possible desirability of reducing or postponing tax in these cases should be examined.

(*c*) *Flexibility in depreciation.*—The committee has pointed out on earlier occasions the desirability of giving the taxpayer more flexibility in determining the timing of depreciation charges so that the tax will come closer to the intent of taxing net income after full allowance for the reduction in the value of assets. The possibility of taking some steps in this direction should be studied now that higher tax rates make the problem even more urgent than previously.[9]

(*d*) *The depreciation basis.*—Consideration should be given to possible ways of providing statutory recognition to the fact that depreciation charges based on the original cost of assets are inadequate to replace the assets at current prices, which are generally much higher than the prices at which the assets were acquired.[9]

(*e*) *Loss carry-back.*—The committee has previously recommended that taxpayers be permitted to carry over an operating loss of 1 year to apply against the income of the preceding year or the 5 succeeding years. This system has now been adopted in the Revenue Act of 1950. However, in view of the prospects for higher tax rates, especially the possibility of a combination of temporary high rates and temporary high profits, there is a question whether the carry-back should not be lengthened to 2 years.

(*f*) *Regulated public utilities.*—Consideration should be given to possible special treatment for regulated public utilities, where rates are limited to yield rather low earnings and where the financing of expansion requires steady dividend payments.

Excess-profits taxation

Since there is so much current discussion of alternative forms of corporate taxation, and especially of excess profits taxation, we wish to explain why we recommend a flat-rate addition as the best way to impose additional taxation on corporate profits.

First, we should point out that there is no "good" way to tax corporate profits as such. The incidence of the corporate profits tax is indirect, distributed in unknown proportions among stockholders, customers, and employees. There is no possible way to relate the burden of the tax to the income status of the persons who bear it. The corporate tax imposes the same rate of tax on a dollar of income earned for a $1,000 stockholder as for a $1,000,000 stockholder. Corporate profits are taxed twice, once when earned by the corporation and again when received by the stockholder. There is no good reason, in equity or economic policy, why earnings from investment in a corporation should be taxed more heavily than income earned by the same person from investment in a partnership, or in a municipal bond, or from wages and salaries. Moreover, when the corporate rate gets high adverse effects upon productivity are inevitable.

Given the need to raise additional revenue from corporate profits the problem is to find the "least bad" way, since there is no "good" way.

The essential difference between the additional flat rate proposed here and an excess-profits tax is that the first imposes an additional tax on all profits whereas the second imposes a necessarily higher additional tax on a part of profits. This may be seen in the case of a corporation that earns $100,000 (abstracting from the complications of specific credit, lower rates on the first $25,000, etc., which do not affect the basic principle). Under the system proposed here, and assuming a 15 percent defense profits tax, the Treasury would say to the corporation, "Your basic tax is 38 percent of your total profits, and your defense profits tax is 15 percent, making a combined total of $53,000." Under the excess-profits system the Treasury would say, "Your tax is 45 percent of your first $80,000 which the law defines as normal, plus 85 percent of $20,000 which the law defines as excess. The total is $53,000." The tax paid is the same, but the effects are quite different. The reasons for preferring the flat-rate system may be summarized as follows:

1. The flat rate increase keeps the marginal rate of corporate tax to the lowest figure consistent with placing any desired total burden on corporate profits.

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[9] *Footnote by Philip D. Reed.*—Secs. (*c*) and (*d*) are excellent examples of what can be done, as suggested in the footnote on p. —, to provide stimulants to projects which will increase both production and productivity. The same is true of the 5-year amortization section of the Revenue Act of 1950. That section should be speedily and generously administered.

Under this system the Government says to the corporation, "If by keeping costs down and increasing efficiency you can increase your profits $100,000, you can keep 47 percent of it." This is little enough. But it is incomparably better than the excess profits tax which allows the corporation to keep only, say, 15 percent of any additional profits. The extremely high marginal rate is, of course, the reason why excess profits taxation is such a source of waste and obstacle to efficiency. The fact that excess profits taxation was an incentive to extravagant expenditure for travel and advertising was a national joke and national scandal during the last war. But there were much more serious costs resulting from the tax, and these would be even more serious costs now if the tax has to remain in effect for a long time. Excess profits taxation is in direct conflict with the Nation's need for maximum efficiency in production at all times, and especially now.

2. The problem of waste and inefficiency resulting from an excess profits tax cannot be met by having the Bureau of Internal Revenue exercise stricter control over allowable expenses. If this is attempted, either the Bureau of Internal Revenue would have to issue a series of arbitrary regulations which would hamstring management or the Bureau would get bogged down in trying to second-guess management in a mass of case-by-case decisions. At best the influence of this kind of control can be only negative. It may catch some conspicuous example of waste but it cannot provide a positive inducement to efficiency.

3. A flat-rate increase, by avoiding the extremely high marginal rates of the excess profits tax, will avoid the most seriously inflationary features of the excess profits tax. Corporations subject to an 85 percent excess profits tax would often rather spend their potential profits for various nonproductive and nonessential purposes than pay them to the Treasury. But the money they pay the Treasury does serve an anti-inflationary purpose, whereas the money they spend for such purposes serves to bid up the prices of goods and services. Also, such action by excess profits tax corporations may force higher costs upon other companies that would have to raise prices.

4. Given the total tax burden to be carried by corporations, the flat-rate increase is less burdensome in the crucial field of new and growing business than an excess profits tax. A growing business is especially dependent upon its ability to retain earnings and at the same time is likely to be subject to especially heavy burdens under an excess profits tax. A new business, because it is subject to exceptional risk of loss, must often have some prospect of exceptional profit if it is to get started. But an excess profits tax almost eliminates the chance of an exceptional profit while leaving the chance of exceptional loss.

5. The flat-rate increase is relatively simple to administer. It does not involve interminable argument about the "normality" of some historical base period. There are still about 15,000 unsettled claims for relief under the wartime excess profits tax, involving about 4.5 billion dollars of refund claims in dispute.

6. The most effective way to prevent excessive profits on military production is by strict pricing on military contracts in the first instance and by full use of the renegotiation power. The Renegotiation Act now in force provides for the recapture by the Government of excessive profits earned by prime contractors and subcontractors on military contracts. Therefore, an excess profits tax, primarily intended to accomplish the same result, is unnecessary. The force of this act may be judged by the fact that over $6,000,000,000 was recovered by the Government in renegotiation of World War II contracts.

The act provides that "In determining excessive profits there shall be taken into consideration the following factors:

"(i) Efficiency of contractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower;

"(ii) Reasonableness of costs and profits, with particular regard to volume of production, normal prewar earnings, and comparison of war and peace time products;

"(iii) Amount and source of public and private capital employed and net worth;

"(iv) Extent of risk assumed, including the risk incident to reasonable pricing policies;

"(v) Nature and extent of contribution to the war effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

"(vi) Character of business, including complexity of manufacturing technique, character and extent of subcontracting, and rate of turn-over;

"(vii) Such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time as adopted."

This list of factors to be considered is significant as an indication of the complexity of the problem of defining "excessive profits" when a real attempt is made to take into account the different circumstances of different companies and to preserve some flexibility, efficiency, and vitality in the economy.

7. If, as seems a reasonable estimate in the absence of further inflation, corporate profits in calendar 1951 are $40,000,000,000, a basic tax rate of 38 percent, plus a defense profits tax of 15 percent, would leave profits after tax of $19,000,000,000, almost exactly the average profits after tax of 1947–49. Thus with taxes at that level there would be no increase in total corporate profits after tax either because of or during the 1951 defense effort.

8. With a flat-rate increase set to yield as much revenue as an excess-profits tax, some corporations would pay less tax than under an excess profits tax and some corporations would pay more. That is, with the total burden the same, the distribution of the burden among corporations would be different. A corporation with a high invested capital basis, as valued for tax purposes, would pay less under an excess profits tax, even though its profits have increased as a result of the rearmament program. But a growing corporation may pay more under an excess profits tax even though rearmament may actually have slowed down its growth. There is no reason to think that the distribution of the burden under the excess profits tax would be better from the standpoint of "taking the profits out of war," while there is every reason to think that the distribution of the burden would be much worse from the standpoint of national efficiency.

9. A basic rate of 38 percent plus a defense profits tax of 15 percent would yield as much revenue and place as heavy a tax burden on corporations as the present rate for 1951 (45 percent) plus a severe excess profits tax. Under the wartime corporate profits tax plus excess profits tax, in 1942 to 1945, corporate taxes were 52.5 percent of corporate net incomes.

10. The combined effect of the corporate profits tax plus the individual income tax in recapturing any additional profits earned by higher income stockholders is not generally appreciated. This may be illustrated by the case of a married stockholder with $100,000 of surtax net income. He pays 75 percent tax (1951 rates) on any additional dividends he receives. Suppose the basic corporate tax rate is 38 percent and the defense profits tax is 15 percent. Then the combined corporate and individual tax is 88.25 percent if the corporation distributed all its profits after tax. If the corporation distributes only half of its profits after tax, the combined tax is 70.625 percent even before allowing for any future tax when the retained earnings are distributed or realized as capital gains.

Individual income taxation

The individual income tax permits the closest approach to the basic principle of equity in taxation, that persons similarly situated should be similarly taxed. Moreover, with a proper selection of rates and exemptions, the individual income tax still offers the greatest room for raising revenue without excessive burdens on lowest incomes and without excessive additional impairment of incentives. In fact, a system of personal exemption permits complete insulation of lower income families from the burden of the tax, which cannot be done under any system of indirect taxation. The individual income tax is the most equitable and effective means of reaching the large aggregate incomes of the middle-income groups, whose incomes are large enough to bear additional burdens without privation and who do not now pay tax rates so high as to weaken incentive seriously.

No method for raising additional revenue from the income tax will be fair and realistic unless it takes into account the income tax paid under present rates. What is now available to be taxed is the income left after the present tax is paid. A flat increase in tax on net income after exemptions, such as might be effected by an equal increase in tax rates in all brackets, would be a tax on the amount already paid in tax as well as on the income now left to the tax-

payer. This would have very unequal effects, as may be seen in the following table:

Effect of a 5-point flat increase in tax rates (married person, 2 dependents)

Net income	Tax under present 1951 rates	Income after tax	Additional tax 5-point rate increase	Percent cut in income after tax
$3,000	$120	$2,880	$30	1.00
$10,000	1,592	8,408	380	4.52
$50,000	18,884	31,116	2,380	7.65
$100,000	51,912	48,088	4,880	10.15
$500,000	402,456	97,544	24,880	25.50

This kind of increase would not only, in our opinion, be unfair, it would be an additional long step toward eliminating the significance of income as an incentive to effort and risk taking. This may best be seen by looking at the effects of a flat rate increase on marginal income after tax, that is, on the amount of an additional dollar of income left to the taxpayer after paying income tax. At the rates now in effect (for 1951) a taxpayer with $50,000 of net income after exemptions (surtax net income) pays a marginal tax of 75 percent and has a marginal income after tax of 25 percent. If he earns an additional $1,000 he pays $750 tax and has $250 additional income left. A five-point increase in tax rates would cut his marginal income after tax by 20 percent. What it would do in other brackets is shown below:

Surtax net income	Present law (1951)		5-point rate increase	
	Marginal tax	Marginal income after tax	Marginal income after tax	Percent cut in marginal income after tax
	Percent	*Percent*	*Percent*	*Percent*
$1,000	20	80	75	6.25
$6,000	30	70	65	7.14
$16,000	50	50	45	10.00
$26,000	62	38	33	13.16
$50,000	75	25	20	20.00
$100,000	89	11	6	45.45
$200,000	91	9	4	55.55

In our opinion the fairest and least damaging way to obtain an emergency increase in income-tax revenue, if exemptions are not to be changed, is to impose an additional tax at an equal percentage rate on net income in excess of present exemptions and present (1951) tax. The effect of a 5-percent additional tax at various income levels is shown in the table below:

Effect of a 5-percent tax on income above exemptions and present tax (married person, 2 dependents)

Net income	Income after tax, present law	Additional tax	Percent cut in income after tax
$3,000	$2,880	$24	0.83
$10,000	4,408	300	3.57
$50,000	31,116	1,436	4.61
$100,000	48,088	2,284	4.75
$500,000	97,544	4,757	4.88

This method results in a larger percentage cut in total income after tax at higher income levels than at lower, but the disparity is not so extreme as under the 5 percent flat increase on income before tax. The cut in marginal income after tax is held to 5 percent at all income levels, and this is the most important feature of the proposal so far as the efficiency of the economy is concerned.

The committee recommends that this increase in the individual income tax be temporary, to expire on December 31, 1951. It would be unwise to make a final determination of the income tax structure without having a clearer picture of

the revenue requirements and without further consideration of the system of exemptions and of the division of tax burden between the corporate tax and the individual tax.

Excise taxes

The Research and Policy Committee recommended in 1944 and in 1947 that the normal Federal tax system should contain no excises except those on alcoholic beverages, tobacco, and gasoline. In 1948 and in early 1950 we recommended immediate reduction of excises so far as seemed consistent with the revenue requirements at the time.

We remain of the opinion that in the normal Federal tax system excises should be confined to alcoholic beverages, tobacco, and gasoline. However, it is clear that the budget requirements of the defense program do not permit the $4,000,000,000 of revenue now obtained from other excises to be abandoned without replacement. In fact, more revenue will be required from excise taxes to avoid greatly overburdening the income tax system.

A choice must be made between (*a*) adding new excises or higher rates to the existing structure and (*b*) replacing the existing structure with a new one that is more rational and will yield more revenue. We believe strongly that the effort should be made to rationalize the system. The present structure is a tangle of separate taxes on different items at different rates, imposed at different points in the economic process, with some taxes hidden and some open. It discriminates among products, producers, regions, consumers without, for the most part, any reason except historical accident. If excise taxes are necessary, as for the time being they are, certainly a better system than this can be devised.

The committee is not prepared now to recommend what the structure of a defense excise tax should be. We recommend that the question be studied during the next few months with a view to enacting a program later in 1951.

There seem to be three main possibilities, a general retail excise tax, a general manufacturers' excise tax and a system of selective excises, either at the retail or at the manufacturers' level. A tax at the retail level has the advantage that it is visible, the public knows what it is paying. If the tax is imposed at retail rather than at the manufacturing level, there is less danger also that the tax will be pyramided and result in a price increase greater than the amount of the tax. On the other hand, a tax imposed at the manufacturers' level would be easier to collect and would interfere less with the State retail taxes. Under either system, food and rent could be excluded from the tax in order to avoid excessive burden on low-income consumers.

In some circumstances selective excises to divert scarce resources from nonessential uses may be helpful in an economic mobilization program. This certainly does not justify the present excises, most of which are not adapted to the current defense program. Moreover, in order to use selective excises as an instrument for mobilization, it is necessary to know the location and extent of future shortages fairly precisely and to be quite sure that the excises themselves will not interfere with expansion of supplies to correct the shortages. It is not clear whether conditions for the effective use of selective excises are present now. In any case, the selective excises that might be justified as an aid to mobilization could provide only part of the additional revenue that will be required from excise taxes.

Tax privileges

The need for additional revenue and higher rates of tax makes it more important than ever to subject each special tax exemption or concession to scrutiny and to require its justification if it is to be continued. With every increase in general rates of tax, special privileges become more valuable to those who receive them; if they are unjustified the injustice to those who pay full rates of tax becomes greater. One exemption which in the opinion of this committee is unjustified is the exemption of interest on State and local government bonds from Federal income taxation. This inequity should be corrected as soon as possible. The Revenue Act of 1950 made changes in the tax law to close certain loopholes which were found to exist. There are a number of other cases, such as the tax treatment of cooperatives, where unjustified privileges are alleged. This committee has not studied these cases and is offering no judgment as to their merits. However, there has been sufficient dispute over their merits to warrant further congressional study to determine whether in these cases the present law does conform to the principle of fair and equal treatment of all sources of income and all forms of business operated for a profit.

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No one likes higher taxes, tighter credit, or curtailment of Government services. But we are determined that America shall be strong. This means that we are prepared to pay the cost of defense. We can pay the price by open inflation, we can pay the price by suppressed inflation and total controls, we can pay in high taxes, tight credit, and Government economy.

This third way, the monetary-fiscal approach recommended in this statement, is in some respects the most difficult. It makes the costs of the program clear and open. Therefore it depends for its success upon the support of the public; it cannot be imposed or "slipped over." This approach requires that the Government take the responsibility for developing a program that distributes the costs of military strength fairly. It requires that the Government set a standard for the behavior of the private citizen by practicing economy in its own expenditure. It requires that the public accept the costs, not only as they are meted out by tax laws and credit regulations, but also by voluntary individual and group action. Success will be the result not of a handful of decisions made in Washington but of millions of private decisions to save, to work, to exercise restraint in pressing for higher prices and higher wage rates.

This is, nevertheless, the only acceptable course of action. It is fair and efficient. It would permit our growing military strength to be erected upon a solid base of growing economic strength. Beyond this, it is best for the very reason that makes it difficult, because it calls upon the responsible action of free citizens.[10]

APPENDIX NOTES

"Balancing the cash-consolidated budget" or "producing a surplus in the cash-consolidated budget" means that tax rates are sufficiently high that revenues would equal or exceed expenditures in the cash-consolidated budget under conditions of high employment without inflation.

This Committee recommends use of the cash-consolidated budget rather than the administrative-control budget as a guide to over-all budget policy because the cash-consolidated budget gives a more complete statement of Federal financial transactions with the public and a more accurate reflection of the economic effects of Federal finance. The main difference between the two budgets is that the cash-consolidated budget includes the operations of social security and other trust accounts, whereas the administrative-control budget does not. A detailed explanation of the cash-consolidated budget may be found in an earlier statement of the Committee, Tax and Expenditure Policy for 1950, page 35.

Further inflation would increase Federal receipts more than Federal expenditures and so would contribute to a balanced budget or to a surplus. However, the goal of policy should be to prevent further inflation. Budget policy should not rely upon further inflation to balance the budget. Tax rates should be high enough so that without further inflation they would yield revenue equal to or in excess of expenditures.

The adequacy of tax rates in effect during any period should be measured by the revenue they would yield in a year of full operation rather than by the collections actually received by the Treasury during the period. Collections of taxes lag behind the period to which the tax rates apply. This is notably true of the corporate profits tax. The tax applied to 1951 incomes will be collected in 1952. An additional tax on 1951 corporate incomes will yield no additional collections in 1951. In considering whether taxes in 1951 are adequate to balance the 1951 expenditures we should consider how much the taxes levied on 1951 incomes will yield, even though collection lags in part into 1952.

The figures used in this statement for the yield of existing or suggested taxes in calendar 1951 are based on an estimated gross national product of $300,000,000,000 in that year. This $300,000,000,000 is an approximate estimate of the total value of production that is reasonably attainable in 1951 without further inflation of prices in general beyond the average level prevailing in the third quarter of 1950. The estimate implies an increase of about 6 percent in real output from the third quarter of 1950 to the average of 1951. Such an increase assumes, in addition to the "normal" growth of productivity and the labor force, moderate reduction in unemployment, increase of hours of work, and additional entrants into the labor force.

(Whereupon, at 6 p. m., the committee adjourned.)

[10] Footnote by John M. Hancock.—Although there is much in this statement which I heartily approve, I have reservations with regard to some of the recommendations made as stated in the report, therefore I do not wish to be recorded as approving the statement in its entirety.

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