

# TO PREVENT PROFITEERING IN WAR

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## HEARINGS

BEFORE A

### SUBCOMMITTEE OF THE COMMITTEE ON FINANCE UNITED STATES SENATE

SEVENTY-FOURTH CONGRESS

SECOND SESSION

ON

## H. R. 5529

AN ACT TO PREVENT PROFITEERING IN TIME OF WAR  
AND TO EQUALIZE THE BURDENS OF WAR AND  
THUS PROVIDE FOR THE NATIONAL  
DEFENSE, AND PROMOTE  
PEACE

CONSOLIDATED

February 13 and 18, March 6, April 2, 8,  
6, 7, 9, 10, 13, 14, 24, 28 and 29, 1936

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# TO PREVENT PROFITEERING IN WAR

THURSDAY, FEBRUARY 13, 1936

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

The subcommittee met in executive session, pursuant to call, at 10:30 a. m., in room 312, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Guffey, and La Follette. Also present: Ralph W. Brown, special assistant to the General Counsel, Treasury Department; P. J. Mitchell, of the General Counsel's office of the Treasury; S. G. Winsted, of the General Counsel's office of the Treasury; and L. H. Parker, chief of staff, Joint Committee on Internal Revenue Taxation and members of his staff.

Senator CONNALLY. The subcommittee will come to order.

It will be remembered, gentlemen, that when we met last, on the 13th of August 1935, the committee determined that we would lay aside for the time being the bill before us with regard to war profiteering and request the Treasury experts and Mr. Parker during the recess of Congress to make a study of the bill and its provisions and report back to us at this session. I have here a letter from the Secretary of the Treasury, which I would like to have incorporated in the record, without objection, without reading it.

Senator LA FOLLETTE. That is agreeable.

(The letter referred to is as follows:)

OFFICE OF THE SECRETARY OF THE TREASURY,  
*Washington, February 12, 1936.*

HON. TOM CONNALLY,

*Chairman, Special Subcommittee of the Committee on Finance  
to Consider the Bill to Prevent Profiteering in Time of War,  
United States Senate.*

MY DEAR MR. CHAIRMAN: At the hearing held before your subcommittee on August 13, 1935, to consider the provisions of title I of H. R. 5529, known as the Emergency War Time Tax Act, Mr. Oliphant, on behalf of the Treasury, undertook that during the recess the Treasury would make a study of the tax provisions of the bill and would furnish to Mr. Parker and the staff of the Joint Committee on Internal Revenue Taxation such suggestions and assistance as it might be able to contribute to the consideration of this bill.

This work was commenced immediately thereafter and continued over a period of several months. Conferences were had from time to time with Mr. Parker and his staff and assistance and data on special subjects furnished. By arrangement with Mr. Parker, the Treasury's contributions were confined chiefly to the administrative problems which appeared to be raised by the various provisions of title I. The suggestions of the Treasury have been embodied in one principal study, covering the provisions of this title generally; in several special studies on particular subjects which seemed to require some detailed treatment; and in a revised draft of certain provisions of the bill. These have been turned over to Mr. Parker, together with several earlier studies dealing with the Treasury's experience with the war-profits and excess-

profits taxes in effect during and immediately after the World War, and are, of course, available to your subcommittee.

Sincerely yours,

H. L. MORGENTHAU, JR.,  
*Secretary of the Treasury.*

Senator CONNALLY. We have present this morning Mr. Ralph W. Brown, special assistant to the General Counsel of the Treasury, Mr. P. J. Mitchell, of the General Counsel's office of the Treasury, Mr. S. G. Winsted, of the office of the General Counsel, and Mr. Parker of the Joint Committee on Internal Revenue Taxation, and his staff.

I suppose the proper procedure first will be to hear a brief statement from Mr. Brown.

I will say for the benefit of the members of the committee and those present that it will be impracticable this morning to hear all these gentlemen in full, and this meeting is largely called for the purpose of allowing the committee to determine just how we would proceed, and in order to get a picture of the matter I would like to have a brief statement from Mr. Brown.

Mr. BROWN. Mr. Chairman and gentlemen of the subcommittee, I am just going to speak for a minute, because I think in view of the nature of the Treasury's work and the division of labor between Mr. Parker's staff and our staff, that perhaps, if you have no objection, it might be more appropriate for Mr. Parker to precede me in any remarks, because my remarks relate primarily to the administrative features of the bill, and to a much lesser extent to any questions of policy.

Senator CONNALLY. We can do that. Because of your rank I gave you precedence.

Mr. BROWN. I appreciate it very much. But I do think that perhaps it would facilitate the work of the committee if Mr. Parker would say what he has to say before I proceed with any further remarks.

Senator CONNALLY. If that is agreeable to the committee, then that is all right.

Mr. Parker, Mr. Brown preferred that you go first.

#### STATEMENT OF L. H. PARKER, CHIEF OF STAFF, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Mr. PARKER. I thought that I would just give this morning a very brief description of the bill. Probably the Senators have read the bill, but it has been some time ago, and unless they have read it recently, I do not think it will be out of place to review it at this time.

Senator CONNALLY. I think that is a very good idea, because you have made a more intensive study of it than we have.

Mr. PARKER. I will, then, first briefly describe the bill without making any substantial suggestions for changes.

Senator CONNALLY. This is the House bill you are discussing?

Mr. PARKER. No; I am discussing H. R. 5529, which is the bill which was first prepared by the Special Committee on Munitions, and then was referred to the Military Affairs Committee, and reported out by them with a report. It is practically an entirely new bill from the House bill, the House bill being a mere skeleton of the present bill.

Senator CONNALLY. The bill, though, which the House passed is the one before us, is it not?

Mr. PARKER. You might call it so.

Senator LA FOLLETTE. It is in the nature of a substitute.

Mr. PARKER. But practically everything has been stricken out of the House bill. It is before you; yes.

Senator LA FOLLETTE. It is really in the nature of a substitute.

Senator CONNALLY. Who struck it out? It is still before this committee.

Mr. PARKER. Oh, yes, Senator.

Senator LA FOLLETTE. You see the bill first went to the Munitions Committee.

Senator CONNALLY. Yes.

Senator LA FOLLETTE. Then they reported it back to the Senate with the provisions of the House bill stricken out and another bill substituted for it, and then it went to the Military Affairs Committee, where they suggested, as I remember, a few amendments, and they are incorporated here, and then it came back to the Senate and was referred to this committee, and that is the bill we have under consideration.

Senator CONNALLY. Of course, we have the entire bill before us.

Senator LA FOLLETTE. That is right.

Senator CONNALLY. We have the bill as it passed the House, and then these proposed substitutes.

Mr. PARKER. The description that I was prepared to give is of the bill in its present form, that is, the House language stricken out, with the amendments, and so forth, made by the different committees before which the bill has already been.

Senator GUFFEY. And that has been referred to us?

Senator LA FOLLETTE. Yes.

Mr. PARKER. The bill is voluminous.

Senator CONNALLY. Yes; we have it here. Voluminous is a good word.

Mr. PARKER. The stated objectives of the bill, as stated in the hearings and reports of the Special Committee on Investigation of the Munitions Industry, are as follows:

(a) To take the profits out of war.

(b) To protect the economic society from the maladjustments resulting from war inflation.

(c) To pay for the war while we are engaged in it.

(d) To avoid, as far as possible, the post-war calamities of deflation.

The principles are contained more in detail in the preamble to the bill itself.

The proposed bill is not predominantly a military measure, but rather a fiscal and economic measure. To accomplish its objects, the bill utilizes several devices, viz, (1) the levying of drastic income and war-profits taxes; (2) a draft of industrial management; (3) the granting of power to the President to close the exchange, fix prices, profits, wages, to establish priorities for the purchase of essential products, to license industry, to commandeer any product or industry necessary for the carrying on of a war, and to allocate commodities to essential war industries; (4) creation of a finance control committee with power to limit and regulate new financing and to admin-

ister a revolving fund to aid in the financing by the Government of war industries.

The bill is divided into six titles as follows:

Title I, income tax; title II, industrial management provisions; title III, war resources control; title IV, securities exchange provisions; title V, war finance control; title VI, general provisions.

For the purpose of designation, title I may be referred to as the tax bill and titles II to V, inclusive, as the economic and industrial management bill. Title I comprises a complete revenue act for war-time purposes. In point of construction, it represents a superstructure imposed upon the framework of the 1934 Revenue Act. Severe war-time rates have been proposed, many changes have been made with a view to preventing evasion and in addition many new provisions have been included, constituting limitations in determining taxable net income. Title II and subsequent titles represent an adoption of the major features embodied in the industrial mobilization on plan of the War Department as concurred in by the Navy Department. Objections to some of the provisions have been noted by the War Department as indicated in a statement prepared by Col. Charles T. Harris, Jr., director, planning branch. Copy attached and marked appendix II.

#### APPENDIX II

WAR DEPARTMENT,  
OFFICE OF THE ASSISTANT SECRETARY,  
Washington, D. C., January 27, 1936.

MEMORANDUM FOR MR. GASTON D. CHESTEEN, ROOM 3041, INTERNAL REVENUE BUILDING

1. Referring to your telephone conversation of Saturday, January 25, the following remarks are submitted on H. R. 5529, Report No. 889:

The War Department has recorded its support of the industrial titles of H. R. 5529, as amended in report 889. With reference to title I, covering tax measures, the War Department refrained from discussing the provisions contained therein, believing that other agencies of the Government were better qualified and had a more direct responsibility in connection with taxation measures. The War Department did, however, set forth that an excess-profits tax would be necessary to assist in preventing profiteering in war and further stated that tax measures should not be made so drastic as to hamper production activities required in war.

With reference to Title II, Industrial Management Provisions, the War Department has stated that it does not believe this title is necessary, but will interpose no objections to its passage.

Although the War Department is supporting the industrial provisions of titles III to VI, inclusive, a careful study has suggested several minor changes therein. These changes will be discussed below.

Page 217, line 10: After the word "use" insert the words "import, export." This change is to broaden the activities referred to, including those relating to importing and exporting of materials.

Page 219: Strike out line 25, page 219, to line 9, page 220. The War Department is in sympathy with what was intended in the lines recommended for deletion, but believes that the proposed wording makes the measure too drastic and that this proposed wording would deprive the Government of the services of practically every experienced person who knew anything about the problem with which he had to deal. The danger contemplated in this clause is less serious than the danger resulting from leaving the direction of the great procurement activities to the individuals necessarily selected by the standard proposed to be set up. The great bulk of business men are, after all, honest and patriotic.

Page 222, lines 16 and 17: The meaning of the words used in these two lines is not clear. These lines should be clarified.



Page 228: Section 509 should be deleted. The payment of a brokerage fee can easily, on occasion, save a buyer large sums of money and a great deal of time. In actual practice, what happens when a buyer utilizes a broker is that the purchaser asks the broker to locate certain specific merchandise for him. This the broker does. The broker's fee is paid by the seller (who thus is put in touch with a customer at less cost than he could locate such buyer himself) and the purchaser pays the going market price. Procurement agencies in time of war would not commonly deal through brokers, but they should not be prohibited from doing so.

Page 231, line 11, states that no member so appointed shall refuse to serve. It is not believed that this is a wise provision, as a man who served against his will in a position of the character set forth would not normally give good service.

Page 231, lines 18 to 23: This prohibition seems unnecessarily drastic, although naturally a man should not benefit by decisions he assists in making.

Page 233, line 20: Strike out the words "capital plant", and insert the words "plant, capital."

C. T. HARRIS, JR.,

Colonel, Ordnance Department, Director, Planning Branch.

Major features of Title I, Emergency War Time Tax Act: Section 11 increases the normal tax on individuals from 1 to 6 percent. Section 25 decreases the personal exemption for a single man from \$1,000 to \$500 and for a married couple from \$2,500 to \$1,000. A credit of only \$100 for each dependent, as against \$400 in the existing law, is proposed. The bill also eliminates the hitherto allowable 10-percent earned income credit. Under section 51, the filing of a joint return by husband and wife is made compulsory; also the respective husband or wife is made jointly liable for the full amount of tax due on the return, but in an amount not to exceed the income reported by such spouse. Section 12 (b) sets forth new drastic surtax rates, beginning at a surtax net income of \$3,000, with a 10-percent rate, and reaching to a surtax of 93 percent, applicable against surtax net income in excess of \$20,000. The tax effect of the proposed rate structure on individuals contrasted with the tax effect as imposed by the 1935 Revenue Act is shown in detail in appendix III in the attached chart.

I think I might give you some of these charts.

Senator CONNALLY. And give one for the record there.

Mr. PARKER. And I will give one for the record also; yes.

(Appendix 3 referred to is as follows:)

#### APPENDIX III

##### Maximum earned-income credit of married men, no dependents

Personal exemption	\$1,000 (H. R. 5529)	\$2,500 (1935 act)	Increase in tax	Percent of increase
Net income:				
\$2,000 .....	\$60	0	\$60	.....
\$3,000 .....	120	88	112	1,400
\$5,000 .....	340	80	260	325
\$6,000 .....	500	116	384	331
\$10,000 .....	2,640	415	2,225	513
\$20,000 .....	10,240	1,589	8,651	544
\$50,000 .....	39,790	8,869	30,921	348
\$100,000 .....	89,290	32,469	56,721	174
\$200,000 .....	188,290	95,344	92,946	97
\$500,000 .....	485,290	304,144	181,046	60
\$1,000,000 .....	980,290	679,044	301,246	44
\$2,000,000 .....	1,970,290	1,449,019	521,271	36
\$5,000,000 .....	4,940,290	3,788,994	1,151,296	30

*Maximum earned income credit of single persons, no dependents*

Personal exemption	\$500 (H. R. 5529)	\$1,000 (1935 act)	Increase in tax	Percent of increase
Net income:				
\$2,000.....	\$90	\$32	\$58	181
\$4,000.....	150	68	82	120
\$5,000.....	420	110	280	209
\$6,000.....	680	256	424	163
\$10,000.....	3,030	560	2,460	459
\$20,000.....	10,720	1,834	8,786	479
\$50,000.....	40,285	9,334	30,951	331
\$100,000.....	89,785	33,354	56,431	160
\$200,000.....	188,785	96,304	92,481	96
\$500,000.....	485,785	305,224	180,561	59
\$1,000,000.....	980,785	680,184	300,601	44
\$2,000,000.....	1,970,785	1,450,174	520,611	35
\$5,000,000.....	4,940,785	3,790,164	1,150,611	30

MR. PARKER. The net effect of the proposed rates in the case of a married man is to limit the retention of income to \$9,920 on a net income of \$21,000 and to take in normal and surtaxes, 99 percent of any excess.

Senator CONNALLY. Let me ask you a question just right there.

MR. PARKER. Yes, sir.

Senator CONNALLY. I see in this chart you have got a net income of \$3,000; and you have out here percent of increase, 1,400 percent; is that right?

MR. PARKER. Yes. Of course, that does not mean much, that percentage of increase. That is not a very large tax. On the \$3,000 the proposed tax is \$120, and the present tax is \$8.

Senator CONNALLY. I see.

MR. PARKER. The percentage increase is large, and still the percentage of tax to the net income is not large.

Senator CONNALLY. All right.

MR. PARKER. You will note, going down the line, that a man with \$10,000 income pays a tax of \$2,000, as compared with \$415 at present; and that a man with \$100,000 income will pay a tax of \$89,290, as compared with \$32,469.

Senator CONNALLY. A man with \$100,000 income will pay \$89,000?

MR. PARKER. Yes, sir; he will have \$10,710 left after paying his tax.

Senator CONNALLY. It is pretty hard on some of us.

MR. PARKER. When the bill was first constructed it had a 100-percent instead of a 99-percent rate. It took everything a man had over \$10,000. But they have now reduced that 1 percent, so that if a man, for instance, makes a million, he will have nearly \$20,000 left.

Senator CONNALLY. Nearly \$20,000?

MR. PARKER. Yes, sir; now, section 13 (a) imposes a graduated income tax on corporations, as follows: 15 percent on net incomes not in excess of 2 percent of adjusted declared value; 25 percent on net incomes not in excess of 6 percent of adjusted declared value; 100 percent on net incomes in excess of 6 percent of adjusted declared value.

That, of course, means that if corporations make as much as 6 percent on the adjusted declared value, everything over that will be taken away.

Briefly stated, this graduated scheme of excess-profit-tax levy will allow corporations to retain net income only to the extent of 4.7 percent of their adjusted declared value.

Senator CONNALLY. In other words, though, would not that be a substantial discrimination against individuals in favor of corporations? An individual would not get that much allowance. You allow the corporations 4 and what percent?

Mr. PARKER. They can make 4.7 percent. But there are other provisions in the bill which provide a corporation has to distribute nearly all that it earns, so that when they make the distribution, of course, we get it from the individual. I would hardly call it discrimination.

Senator CONNALLY. What I mean is, suppose an individual just had his own private business, he would be taxed at a much more heavy rate than a corporation would, would he not? Here is a man who makes a million dollars, and he only gets \$20,000. That is about 2 percent. He only gets 2 percent and the corporation gets  $4\frac{1}{4}$ , or whatever it is.

Mr. PARKER. That is true in a way, but still the corporations are of all sizes, and we have never penalized a corporation merely on account of the large size of its income. If we did, of course, American Telephone & Telegraph would always pay a big tax; and, therefore, its 400,000 stockholders would be discriminated against. We rather look through the corporation so as not to do an injustice to individuals that happen to have their money in a big corporation instead of those who happen to have it in a small corporation. But there are other provisions here in the bill which I do not think give the corporation any advantage, because when they make this money and all they can make is 4.7 percent on declared value, after they make that, they can only keep 2 percent of their adjusted declared value. The rest of it they will either have to distribute out to the stockholders, where it will come again under these severe rates, or else they will have to pay 75 percent tax on it. That is another provision that we come to in the bill later.

This is not to be confused with a 4.7 percent return on sales.

In addition to these taxes, section 102 (a) imposes a tax of 98 percent of the amount of the net income not in excess of \$100,000 plus 100 percent of the amount of the net income in excess of \$100,000 in the case of corporations other than personal holding companies adjudicated to have accumulated surplus improperly. A similar section but with rates of 25 percent and 35 percent in lieu of 98 percent and 100 percent, respectively, is contained in the 1934 Revenue Act with the notable exception: however, that the levy under the 1934 act is based upon an "adjusted" net income instead of statutory net income. In the case of personal holding companies the rates as imposed by the 1934 act have been changed from 30 percent of the amount of income not in excess of \$100,000 to 98 percent, and from 40 percent of the amount of income in excess of \$100,000 to 100 percent. In addition to any other corporate taxes imposed by the proposed bill, section 102 (b) attempts to legislate an innovation in taxes by imposing a tax of 75 percent on so-called undistributed surplus determined by taxing that portion of the net income in excess of 2 percent of the adjusted declared value and after provision for taxes under title I and dividends paid during the year.

By the provisions of section 141 (c) an additional tax of 2 percent is added to the rates imposed by section 13 (a), on railroad companies electing to file consolidated returns. Since section 13 (a) imposes a 100 percent tax on that portion of the income which is in excess of 6 percent of the adjusted declared value, the effect of the 2 percent provision is to impose a tax of 102 percent.

Senator CONNALLY. Now, if we can get that, why could we not make it 200 percent.

Mr. PARKER. Of course that is 102 percent of the excess over a certain amount. I do not think, personally, that it is advisable ever to go over 100 percent, or even to 100 percent.

The tax on both domestic and foreign life insurance companies is made 95 percent instead of 13¾ percent of the net income, except that if foreign life insurance companies shall waive military and war risk liability restrictions and in addition will provide that, with respect to policies upon which the annual aggregate premiums are in excess of \$1,000, they will not permit them to lapse even though the premium is not paid during the war time, the tax rate is to be 10 percent.

Section 143 provides for a 95 percent withholding tax on tax-free covenant bonds in lieu of a 2 percent withholding tax as contained in the present law.

Senator CONNALLY. Wait a minute right there. What is that withholding tax—

Mr. PARKER (interposing). We have a provision—

Senator CONNALLY (continuing). On tax-free bonds, are they public bonds?

Mr. PARKER. These bonds were issued with a covenant that the corporation will pay the income tax, the normal income tax up to 2 percent.

Senator CONNALLY. What kind of bonds, Government bonds?

Mr. PARKER. No; corporate bonds.

Senator CONNALLY. Oh, yes.

Mr. PARKER. The corporation issues those tax-free covenant bonds. They withhold the 2 percent at the source and pay it to the Government. Then the taxpayer reports that in his income, but credits against his tax the tax the corporation has paid on his account.

Senator CONNALLY. But not Government bonds or State bonds?

Mr. PARKER. No. They are mostly railroad and other corporate bonds.

Senator CONNALLY. You said tax-free bonds.

Mr. PARKER. That is what they call them, tax-free covenant bonds. They are not tax-free, except as to the 2 percent tax paid at the source.

Senator GUFFEY. The tax is credited at the source?

Mr. PARKER. Yes.

Senator GUFFEY. Like a lot of Pennsylvania corporations who sell off securities?

Mr. PARKER. That is right.

The rate of withholding on nonresident aliens has been changed from 4 percent to only 2½ percent, while on foreign corporations from 13¾ percent to 95 percent.

A penalty is imposed upon corporations equal to 10 percent of the amount by which the tax due for the fourth quarter exceeds one-

quarter of the total amount of tax for the entire year, unless the Commissioner is satisfied that the excess is not due to retention of amounts properly apportionable to the first three-quarters of the taxable year. This feature is injected as a corollary to the provisions contained in section 52, covering the filing of quarterly returns by corporations, based on estimated figures for the first three-quarters and an actual determination of net income on an annual basis for the last quarter. This is in the bill in order to get in money to run the war and requires in the case of corporations quarterly returns.

The tax on corporations is predicated on a self-valuation of the corporate capital structure in lieu of invested capital, utilized in the war-revenue acts of 1917 and 1918. The basic plan adopted is the mandatory use of the adjusted declared value as reported for 1934 for capital stock tax purposes. The bill provides for reductions in valuations to be made by the Commissioner only, but has no provision for upward revisions.

Under the provisions of 22 (b) (3), gifts may have to be included in gross income. This, in many instances, will constitute double taxation, besides raising a constitutional question. We never have taxed gifts as income in our income-tax laws, and there is grave doubt whether or not that can be done.

Senator CONNALLY. We tax it when a man makes a gift.

Mr. PARKER. We tax the gift with a transfer tax or excise tax on the privilege of making a gift, but we do not tax it as income.

Senator CONNALLY. Under this act there would not be much use of giving anybody anything, if you took it all away.

Mr. PARKER. Not any large gift. There would not be many gifts under the bill, and, therefore, you would not get much revenue from that provision.

Senator LA FOLLETTE. I suppose the theory back of it is that an individual making large profits might escape the general provisions of this act by making gifts to beneficiaries, or anticipated beneficiaries? Is not that the theory back of this provision?

Mr. PARKER. I do not think that he would escape the income tax on current profits.

He might desire of course to give some of his capital to his son and perhaps split up his income so that the income would go in two places. This provision might prevent that if it is constitutional.

Senator CONNALLY. The ordinary gift tax would catch him, would it not?

Mr. PARKER. The ordinary gift tax would catch him, except not at such severe rates. This bill does not revise gift tax rates.

Section 23. Deductions from gross income: In this section there are imposed many severe limitations and prohibitions with the purpose, as stated by the sponsors of the bill, to "iron out wrinkles in the present tax laws which are most conducive to tax evasion." On this supposition legal and accounting concepts of what business deductions are have been ignored, and there is proposed a series of arbitrary deductions as well as limitations which are based on allowances predicated on prior years' averages.

What I mean is, that restrictions are placed on what we ordinarily term "sound accounting deductions" in arriving at net in-

comes, which will result in the rates being applied to something greater than net income.

Salaries to officers, directors, and to stockholders owning in excess of 1 percent of stock are limited to \$5,000, or to the salaries during any one of the 5 immediately preceding peacetime years, whichever is larger. The same section limits the deductions to be made for interests, repairs, promotional public relation, and selling expenses to a sum not larger than the average annual outlay for such purposes in the preceding 3 peacetime years. In the case of banks, interest paid on deposits is not allowable as a deduction if the deposits are invested in obligations, the interest from which is exempt from tax. This section also attempts to prevent taxpayers from avoiding tax by rearranging their capital structure, converting stocks into bonds and thus increasing their fixed charges. It further is designed to disallow interest on income bonds on which the interest is paid only in the event it is earned.

The right to a foreign tax credit, such as is provided in section 131, Revenue Act of 1934, had been eliminated.

Severe statutory restrictions have been placed in the bill with respect to allowances for depreciation, depletion, and amortization, as follows: In the case of depreciation, the provision limits the allowable deduction to not more than 2 percent of the gross income or of the adjusted basis of the property, whichever is lower. Depletion deductions are not allowable if the aggregate of prior deductions equals 100 percent of the basis of the property. In cases where the basis has not been fully recovered in prior years, further deductions are allowable, as follows: Oil and gas, 9 percent of the gross income from the property in lieu of 27½ percent, as in the present law; metal mines, 7½ percent in lieu of 15 percent; coal and sulphur, 2½ percent and 5 percent in lieu of 5 percent and 23 percent, respectively. No provision whatsoever is made in title I for amortization allowances or for special depreciation in the case of war facilities.

The 1935 Revenue Act permits a deduction for dividends received by domestic corporations to the extent of 90 percent thereof. The proposed bill eliminates the privilege of this deduction. A new deduction is made permissible for insurance premiums on life-insurance policies not to exceed \$4,000 in any taxable year.

The proposed bill carries the same provisions with respect to publicity of tax returns (pink slip) as were incorporated in the Revenue Act of 1934, though these were subsequently repealed. In addition, section 55 (c) authorizes the President to make public the returns of all taxpayers for the year prior to the effective date of the War Revenue Act.

Tax payments by corporations fall due on the day upon which the return is due. In the case of noncorporate taxpayers, voluntary advance tax payments may be made and, as an incentive for so doing, the bill provides for interest, payable by the Government at the rate of 1 percent per month, with the limitation that in no event shall there be allowed interest in excess of \$10,000 in any taxable year (sec. 56).

That provision was to allow people to pay their tax in advance on an estimate, so that the Treasury would get money in sooner for war purposes. That is why the Government pays the interest, although

as we interpret the bill the interest would again go into income and be taxed.

Section 63 is a complete innovation. It provides for the appointment by the Speaker of the House of Representatives of a general auditor, whose functions shall be to have access to all records in the Treasury Department, or any other department or agency, relating to the tax imposed by this title, and who shall have power to subpoena witnesses, administer oaths, and, upon request by any Member of Congress, produce for the official use of such Member all details of any record relating to any tax imposed by this title.

Section 112, the reorganization section, has been revised so as to make taxable all gains from reorganizations and exchanges but to disallow all losses therefrom. In the rewriting of the section, the policy adopted has not been consistently carried out. In addition, Section 133, covering bases, has not been properly revised to conform with the suggested revision of section 112.

Section 115—Distributions by Corporations. This section has been rewritten so as to make taxable, distributions out of earnings or profits or increase in value of property accrued before March 1, 1913. This change is identical with changes proposed by the House of Representatives in the writing of prior revenue acts, which suggested changes were disagreed to by the Senate.

The provisions with respect to capital gains in the present law have been eliminated, with the result that the entire gains are recognized for tax purposes no matter how long a period the capital assets were held. Capital losses, however, are recognized only to the extent of \$2,000. This completely throws out of balance the capital gains and loss section as previously administered and constitutes a drastic change of policy.

The penalties for evasion have been made more severe. The maximum fine has been increased from \$10,000 to \$100,000. There is an added liability for three times the amount of tax to be paid in cases of evasion in connection with "withholding" cases (sec. 145). Interest charges, in the case of jeopardy assessments and in the case of extensions of time for filing returns, have been doubled.

Finally, the proposed draft includes a tax in the nature of an excise tax on the issuance of stock dividends. The bill requires that corporations must pay \$100 for each share or fraction of a share which they may issue as a stock dividend.

That is a very brief discussion of title I. That is the war revenue part of the bill.

Coming now to Title II, Industrial Management Act:

By the provisions of this title, the President is authorized at his discretion to require the registration of persons engaged in the management or control of business concerns. The President is further empowered to proclaim certain establishments or industries to be essential to the effective operation of the military forces and to assign to the management of such plants, the registrants as provided above. These industrial managers are to be subject to the jurisdiction of the War Department. The amount of compensation payable shall be only such an amount as is fixed by the President with the restriction that from no other sources is the registrant to receive any other income or gifts. If found to have received other income,

the proposed bill provides that he shall be dishonorably discharged from the service of the War Department and shall be guilty of a felony punishable by fine not exceeding \$10,000 or by imprisonment for not more than 10 years or by both.

#### Title III, War Resource Control:

The President is given authority to establish maximum, minimum, or absolute prices for commodities and for real property in connection with any transaction declared by him to be essential for national security. The President is also empowered to close any commodity exchange and to issue regulations governing the establishment of priorities and rationing in favor of purchases most vitally linked with the prosecution of the war. Under the provision of section 502 (e), the President is empowered to requisition plants and stores and supplies for war purposes. Under subsection (f) he may limit the sale of any commodity to the Government and to establish quotas. Under the terms of subsection (j), the President may license the production, manufacture, sale, storage, distribution, or transportation of any product, foodstuff, material, commodity, or real property, in the interest of the successful prosecution of the war. By subsection (o) the President is empowered in the event of emergency or inefficiency, or labor dispute, to requisition the physical establishment of any plant and to operate it with such personnel as he may deem suitable to serve the interests of the nation.

By the terms of section 503, it is provided that the powers granted to the President under title III may be exercised in whole or in part under his direction by such agencies or officers as he may designate with the limitation that such administrators as he may chose shall receive a salary of \$10,000 per annum.

Section 506 provides for the creation of a revolving fund of \$500,000,000 to enable the President to make purchases of commodities.

An important provision is contained in section 512 in connection with the effective date of title III. It provides that notwithstanding the provisions of any other section of this act, the effective date of the War Resources Control Title shall be upon the declaration by Congress that a state of war exists between the United States and any foreign power or that a grave national emergency has arisen owing to the imminence of declaration of war, or owing to the existence of a state of war between two foreign powers.

That particular point there would probably be open to considerable constitutional objection; that is, you would not be limiting the President's powers to fix prices, to close exchanges, and do all these things which might be proper under the war power, to the war period, because here you give him this power when a national emergency is declared by Congress, or if there is war between two other nations; for instance, the war between Italy and Ethiopia, under this bill would give the President power to fix prices.

Senator CONNALLY. To do what?

Senator LA FOLLETTE. To fix prices.

Senator CONNALLY. Does that mean fix prices in private transactions as well as prices for Government purchases?

Mr. PARKER. Oh, yes; all prices.

Senator CONNALLY. It might well give him power to fix them all of the time, because there is a war all of the time somewhere.



Senator GUFFEY. They usually keep one going in South America.

Senator CONNALLY. Yes.

Mr. PARKER. Title IV—Securities Exchange Provisions:

The President is given authority for the duration of the war to close any or all exchanges where securities are bought, sold, or offered for sale and by rules or regulations to prevent any public or private sale of securities.

Title V—War Finance Control:

A War Finance Control Commission is authorized to consist of five members appointed by the President. This commission is to pass upon any securities registered with the Securities Exchange Commission and is to approve all issues offered for sale if in excess of \$100,000. By the terms of section 701 the commission is empowered to advance necessary funds to any corporation or agency engaged in production essential to the prosecution of the war. A revolving fund of \$500,000,000 is provided for this purpose.

In section 705, a provision is included which prohibits the borrowing corporations from taking depreciation or amortization or obsolescence on any of the assets purchased with money loaned or advanced by the commission.

Title VI contains merely a few general provisions.

I have here in appendix I a statement of intention as expressed in the bill:

"It is hereby declared to be the intention of Congress that no person subject to the protection of the United States shall profit in any manner whatsoever from the conduct of any war to which the United States is or may be a party.

"It is the intention of Congress to protect the economic organization of the Nation from the disturbance due to war in order that such economic organization may be accomplished to function at the highest efficiency in support of the armed forces and other agencies engaged in the prosecution of war.

"It is the intention of Congress to protect the economic organization from the inflation of prices, wages, earnings, profits, and the consequent destructive deflationary collapse which follows the actual ending of military and naval operations.

"It is the intention of Congress that the expenditures for the successful conduct of the war and the protection of the economic organization in the emergency shall be made out of current revenues and that any private interest conflicting with the Government's war objectives and operations shall be for the duration of the war subjected to the supervising necessities of the public interest in successful prosecution of war.

"It is further declared to be the intention of Congress that in the event of war all technical and industrial resources shall be mobilized for the successful prosecution of the war, and that industrial management shall be subject to enlistment and conscription for the successful prosecution of war in the same general manner as combat manpower has been and is subject to enlistment and conscription for the same purposes."

That concludes the very brief statement that I have prepared in order to describe the bill in general.

Senator CONNALLY. Have you a copy of your statement, another copy?

Mr. PARKER. Yes, Senator.

Senator CONNALLY. I would like to have it for my own use.

Mr. PARKER. We will have one for you, Senator.

Senator CONNALLY. All right.

Mr. PARKER. Now, as far as the work of the staff has gone, we have investigated this matter carefully and written up a considerable amount of data, but we have not yet written a final report.

With the cooperation of the Treasury Department, we have got a redraft of the bill correcting minor administrative defects, and then we have another report on administration.

Senator CONNALLY. Of course, you have not gone into the policy of the matter.

Mr. PARKER. I thought, Senator, to minimize the work, we would not at this time. We can write a report on it, but it seemed to me there are 15 or 20 major questions which the committee ought to decide and ought to discuss first.

Senator CONNALLY. That is what I meant by "you had not gone into the matter of policy."

Mr. PARKER. We are ready to bring those up in order, if that is the desire of the committee, to bring these big issues up, and then when the committee decides on those propositions, of course, that would greatly minimize our work.

Senator LA FOLLETTE. May I suggest, Mr. Chairman, would it not be very helpful to an orderly consideration of this measure, which raises so many important questions, if we could arrange for a series of meetings of this subcommittee, where we would have the experts from both the Treasury and the joint committee present and take those issues in their regular order and discuss them and get the benefit of the opinions and factual material that the various experts can furnish us, and have the committee attempt to pass upon those policies, so that we could get some effective statements from the experts when we have finished that preliminary survey of those important questions?

Senator CONNALLY. I think that is a very good suggestion, indeed, and I think it would be well for you to list those.

Senator GUFFEY. And give us a chance to look at them in a glance, and then we can list them.

Mr. PARKER. I can do that. I can just state four of the most important ones now to the committee, if you desire, so you will see some of the things we would have to discuss.

One of the first, and perhaps the biggest of the issues, would be this question, Does the subcommittee wish to take the profit motive away from both the corporations and individuals?

That question really has to be determined before you can go into the rates. You would, of course, hardly go to 100 percent or 99 percent rates, if you would want to leave much profit motive. If you think you can get along without the profit motive, and that you simply can do it by force on the part of the Government by making these people work in certain places, or perhaps patriotism, and what not, why, that is different. But that is one of the big issues here—whether or not you should take the profit motive away. Upon that

question will depend your maximum rates, and upon those rates in turn will depend what you should do in connection with other things such as preventing tax evasion.

Another issue that might be raised here would be this, Does the subcommittee wish to close all possible loopholes in existing law which are proposed in the bill, but which are not directly connected with war conditions?

What I mean by that is, we have been closing loopholes, trying to close them for years, as each revenue bill comes along. As the Senators know, that takes a lot of discussion, takes a lot of time. If you are going to go into this bill and try to correct defects which are really present in the existing law, that broadens the scope of this very greatly. For instance, if you think depreciation deductions are too liberal, that ought to be fixed now, it seems to me, because with high rates, and certainly you will have high rates if you have a war revenue bill, it seems to me increasingly necessary to have the true net income taxed and not to tax something that is not net income.

Then another question, which is not as difficult as the others, but it should be answered: Does the subcommittee think it wise to keep the bill in its present form, or to separate it into two parts, one dealing with taxes and one with industrial and economic provisions?

There might be some constitutional question, as I have pointed out a moment ago, about certain provisions in industrial management in the bill. At least, it would be worth considering.

Another question might be: Does the subcommittee wish the bill to produce the maximum revenue possible, or does it deem the social effects most important?

What I mean is, Are the rates in this bill so severe that we will get less revenue than we would with somewhat lower rates? I think when you take all a man makes over \$10,000 he just won't make it in a great many instances, and therefore I am very much afraid you won't get the revenue you expect in this bill. In the hearings which were held it was stated the estimate would range from eight to fifteen billion dollars. That was based on putting these rates on actual war incomes of the other years. Of course, those estimates would be very erroneous if those incomes were not there. Now, under one provision here corporations will reduce officers' salaries. There is one provision in here where a corporation cannot deduct more than \$5,000 for any officer who owns more than 1 percent of the stock. Of course, they won't pay more than \$5,000.

Senator CONNALLY. Right there, of course, during the last war the expansion of plants, and that requiring the investment of a lot of new capital, where people did that with the prospect, of course, of reaping a sufficient return of profit to offset that—then when the war ended they had a lot of contracts and the Government canceled them and made adjustments, and all that sort of thing. Now, if there is no profit motive at all, would they do that? Would they expand their plants? Would they take the hazard of putting in new money when they knew they would get no return at all on it? Does not that enter into the question?

Mr. PARKER. I don't think they would, especially if you keep these provisions about limiting depreciation, where they are not even allowed to get the money back at the usual rates. Of course, that

opens up another thing. It always seemed to me, and I think even in the hearings on the bill the sponsors of the bill meant, that should we get into war one of the primary things is to win it. I think that is the prime thing. In any war-revenue bill or war-control bill the primary purpose ought to be to win the war. That is just my belief. And that ought to be more important than the social purposes, because we just cannot afford to lose.

And in the last war, of course, as soon as we got into the war everybody rushed down to Washington and wanted contracts; the doorsteps of the War Department were full of people ready to go to work. Now, I am somewhat in fear under this bill if we went in to war people would not rush down to Washington to get contracts, because there would be no money in them; so the War Department would have to go and search out these people, and either urge them to go in for patriotic reasons or it would have to commandeer the plant. There are plenty of teeth in this bill. They could do it. But can the War Department go out and run all these plants successfully?

The last question is: Does the subcommittee wish to adopt the general principle that the most important thing in connection with war legislation is "to win the war"?

All those things are, of course, very serious questions, and have to be discussed.

Senator CONNALLY. I think you ought to go ahead and pick out all these other questions, as you say there are about 15, and give us a brief memorandum of them, and the subcommittee can take them up.

Senator GUFFEY. I agree that if you want to take the profit motive out of war the rest of the bill would depend on that.

Senator LA FOLLETTE. That is the big question.

Senator GUFFEY. That is the only question.

Senator CONNALLY. My own view is we want to take all the profit out of war that is profitable to the Government to take out, yet leave the industrial structure alive, if you can do that. There is somewhere in there a boundary line at which you can kill the goose that lays the golden egg.

Mr. PARKER. I think you have got to have the revenue. I feel this bill won't bring in the revenue. It is not to my mind heavy enough on the small man. Here is a man with an income of \$5,000. The tax proposed is only to be \$340 against \$80 at present. A man with \$5,000 income in these times in England pays almost \$630. That tax is not high enough in this bill to bring in the revenue. Everybody, it seems to me, ought to make a sacrifice. The question then comes up as to whether you want the bill designed to bring in a lot of money. There would be a lot of money in those smaller incomes down there.

Senator CONNALLY. Is there anything further, Mr. Parker?

Mr. PARKER. Not unless you want to start the discussion of this profit motive.

Senator CONNALLY. I do not think we better do that until we get the other members here. I thought possibly we would hear from Mr. Brown briefly and then the Committee can determine on its course of policy.

Thank you, Mr. Parker. That was a very good and clear statement.

We will now hear from Mr. Brown.

**STATEMENT OF RALPH W. BROWN, SPECIAL ASSISTANT TO THE  
GENERAL COUNSEL OF THE TREASURY DEPARTMENT**

Mr. Brown. I should like to say in the beginning that the Treasury, by arrangement with Mr. Parker, has confined itself more particularly to the administrative provisions of the bill; that is, we have tried to clear up any ambiguities or inconsistencies, and we have in addition considered the practical administration of the bill. In other words, assuming it be passed can we administer it? That was the primary concern of the Treasury in the division of labor that was agreed upon.

I should say also that we approach this problem under rather different conditions from those that existed when we had to administer the wartime acts in the World War. At that time, as you are aware, our experience with income taxes was slight, and the personnel was not developed. We had a changing personnel and many problems were entirely novel. Of course, we have behind us today a long experience. That does not mean we have solved all of the problems, or that existing revenue laws are perfect. But many of the provisions of this bill and some of the changes that have been introduced by the drafters seem to us to have been influenced very largely by some of the things that occurred during the administration of wartime acts, and which today probably could not happen, or would not be necessarily as serious.

The work of the Treasury has been embodied in a rather lengthy report, which I understand you would not wish us to start on today. It is a document of some 141 pages. And in addition we have prepared a tentative, revised draft of the bill. However, I think I can summarize some of the essential points without repeating too much of the ground covered by Mr. Parker.

It may be helpful to the committee, from the point of view of reference, to have a more or less brief outline of the mechanical structure of the bill as distinguished from the substance.

Title I of this bill in its main outline follows the set-up of title I of the Revenue Act of 1934, except as follows:

Under subtitle B, part III, section 31, relating to credits against the tax for taxes paid to foreign countries and possessions of the United States, has been omitted.

Under Part IV of subtitle B, section 46, relating to change of accounting period, has been omitted.

Under part VI of subtitle B, five new sections, sections 63, 64, 65, 66, and 67, have been added and section 63, relating to taxes in lieu of taxes under the 1932 act, has been omitted.

Under subtitle C, supplement C, relating to credits against tax for taxes paid to foreign countries and possessions of the United States, has been omitted, and the subsequent supplements relettered accordingly.

Under Supplement D, Estates and Trusts. Section 168, relating to taxes paid to foreign countries and possessions of the United States, has been eliminated.

Under Supplement E, Partnerships. Section 185, relating to earned income, and section 186, relating to taxes paid to foreign countries and possessions of the United States, have been eliminated.

Senator CONNALLY. You mean of course they did not relate them in the general act. They just eliminate them during the time of the war?

Mr. BROWN. That is correct.

Senator CONNALLY. Would they repeal them or just not reenact them?

Mr. BROWN. This is a complete income tax bill by itself, which is substituted for the—

Senator CONNALLY (interposing). I did not understand Mr. Parker to have that view. His view was it was superimposed on the existing law.

Mr. PARKER. No; I may have stated that, but that is incorrect, Senator.

At the advent of war your old bill stops operating and a new bill comes into effect. That is what happens. And they even split up that portion of the year which before the war is declared is taxed at certain rates, and the new bill taxes the rest of the income under the bill at new rates.

Senator CONNALLY. All right.

Mr. BROWN. In other words, this bill is complete in itself, and during the war it is substituted for other provisions now existing.

Senator CONNALLY. Why were those portions eliminated? Any reason given?

Mr. BROWN. Yes; I intended to go into that.

Senator CONNALLY. Very well.

Mr. BROWN. But I do not think I would want to take up the time of the committee now.

Senator CONNALLY. All right.

Mr. BROWN. I was reading this into the record because I thought it would be very convenient as a matter of reference, so that in comparing it with existing law you would have in effect this outline, which would make it very easy for you to pick up the changes.

Senator CONNALLY. Very well.

Mr. BROWN. Under supplement F—Insurance companies: Section 205, relating to taxes paid to foreign countries and possessions of the United States, has been eliminated.

Under supplement C—Nonresident alien individuals: Section 213, relating to credits against tax, has been eliminated.

Under supplement H—Foreign corporations: Section 234, relating to credits against tax, section 235, relating to returns, and section 236, relating to payment of tax, have been eliminated.

Under supplement J—China Trade Act corporations: Section 262, relating to credits against the tax, has been eliminated.

Under supplement L—Interest and additions to the tax: Section 295, relating to time extended for payment of tax shown on the return, and section 296, relating to time extended for payment of deficiency, have been eliminated. Under this supplement a new section (sec. 295) relating to interest on deferred payments, has been added.

In addition to the changes indicated above, there have been many omissions, additions, and changes made in the various subsections under title I too numerous to catalog at this point, but which will be referred to hereafter in commenting upon the text of the bill.

In lieu of title I-A of the Revenue Act of 1934, a new subtitle D has been added. Section 351 of this subtitle imposes a surtax on personal holding companies similar to that imposed by the same section of the Revenue Act of 1934, except at much harsher rates and with restricted deductions.

A new subtitle E has been added, and section 381 thereof imposes a very heavy tax upon stock dividends.

It should be emphasized at the outset that the Department has taken as its broad field the technical and administrative aspects of the bill, believing that the economic and policy questions are primarily outside its scope of study. Therefore, the presentation of the subject will be confined to those aspects of the bill which the Treasury believes should be changed to render the bill susceptible of satisfactory administration, to remove ambiguities and inconsistencies of language, and to reduce to clearer terms what the Treasury conceives to be the intent of the committee.

The bill is based on the framework of the Revenue Act of 1934 and thus constitutes a complete income-tax revenue act. With the exception of a tax on stock dividends, it is confined solely to the field of income taxes.

While the bill keeps the framework and sequence and sections of the Revenue Act of 1934, it departs from that measure in the following vital respects:

1. It imposes on corporations so-called "excess-profits tax" instead of a flat-income tax.
2. It develops a concept of net income materially different from that defined in the Revenue Act of 1934.
3. It disturbs seriously the provisions of existing law dealing with the manner of making returns and payment of the tax, reorganizations, credits for foreign taxes, and in other administrative respects.
4. It imposes severely increased rates of tax.

A discussion of the first point of divergence brings up at once the subject of adjusted declared value which is the yardstick employed by the bill in determining the excess profits upon which the tax is levied. Such adjusted declared value has as a starting point, in the case of corporations making declarations under Section 701, Revenue Act of 1934, the value of the capital stock of such corporations as thus declared.

The committee will recall that in the 1935 act a new declaration was provided for, which will be made during the current year. And one of the questions of policy, if the committee retains the basis of adjusted declared value, would of course be whether, as this bill does, it should be tied up to the 1934 Act and the declarations made thereunder, or whether it should be tied up to the new declaration authorized under the 1935 Act. Of course if it is not tied up to the latter act, it will be necessary to carry along in the Bureau the returns under the peacetime Act, that is the 1935 Act, and the returns under the 1934 Act, to which this bill is geared. In order to facilitate handling in time of war it would seem advisable to us that all adjustments should be made annually so far as the wartime bill is concerned, so that when we arrive at war we won't have to go back over a long period of years and make all the adjustments in declared

value necessary to arrive at a proper base for the application of this tax.

The bill also makes provision for adjusting the initial value thus declared, as well as for determination of adjusted declared value in the case of corporations not making declarations of value under section 701. It also makes specific provision for valuation of additions to adjusted declared value within 1 year prior to the effective date of the act. In all cases the Commissioner is given the power to reduce downwards the adjusted declared value initially declared by the taxpayer, but makes no provision for scaling such adjusted declared value upwards.

The Treasury Department, in its approach to the problem, accepts the principle of adjusted declared value as the measure of excess profits and hence its task has been directed toward trying to improve the provisions of section 13 as found in the bill.

When I say "accept" I mean that in the work which we have done we have not attempted to suggest a different basis for the tax, but for the purposes of our work we have accepted the basis found in the bill.

The Treasury Department as a result of its studies has changed the section in many material respects, both as to form and substance. While there have been changes of substance they really have not changed the basis, but merely the means of arriving at the basis.

As to form, the section as it stands in the bill imposes a tax and lays down the yardstick for measuring excess profits. It is believed that the tax should be laid in a separate section from that setting forth the manner of determining what portion of the income is excess. In other words, we have separated the imposing section from the manner of determining adjusted declared value. That was the scheme followed in the war-revenue acts during the World War, and it would seem to be clear.

Senator CONNALLY. Is it working out satisfactorily?

Mr. BROWN. As a matter of form and set-up, yes, it was very satisfactory.

This is in keeping with the structure of the Revenue Acts of 1917, 1918, and 1921. In accordance with this view section 13 has been redrafted and split up into two sections.

With respect to substance, it was believed to be necessary to redraft practically all of the remainder of section 13. Where the bill provides, as in subsection (c), for the redetermination by the Commissioner of adjusted declared value, its language does not identify clearly the element, which it is intended to revalue, nor is the time at which such value should be redetermined set forth either in subsection (c) or subsection (d).

In the interests of good administration it is believed to be inadvisable to prescribe in the bill the method of valuation. Section 13 provides, for example, if the Commissioner decides that the adjusted declared value should be adjusted downward that he may make an appraisal. Of course, that is only one way of solving the question of valuation. Appraisal is one of many ways. It seems to us the Commissioner should not be so restricted, and that he should have an opportunity to apply any of the accepted methods which will permit him to arrive at a fair estimate of the value, and in our



suggested redraft of this provision we have given the Commissioner that authority.

Senator CONNALLY. AS I understand it, those suggested amendments are in this compilation that you have there, are they not?

Mr. BROWN. That is correct. Of course, that is only tentative.

Senator CONNALLY. I understand.

Mr. BROWN. No definite plan of revaluation is uniformly applicable in all cases. Hence the Department's experience suggests that the Commissioner's hands be left unhampered as to the method of valuation. It should be remembered in this connection that a large number of corporations will be found which have not made declarations of value under section 701, as to all of which corporations the Commissioner is required under the terms of the bill to make an original determination of value. Holding companies are an example of that, that is, they are not subject now to the provisions of the present capital-stock tax, which is confined to those concerns which are engaged in business as distinguished from the mere holding of property.

Similarly, the subsections dealing with reorganization, consolidation, and merger, with revaluation of capital stock issued for property within 1 year prior to the effective date of the act, and with regard to the exclusion from adjusted declared values of so-called inadmissible assets the income from which is not taxable, require reframing. Such changes, it should be emphasized, were made, not to disturb the fundamental principles of section 13 but to clarify its terms, remove ambiguities and uncertainties of language, and make the section more easily administered.

The second major respect in which the bill differs from the Revenue Act of 1934 may be summarized under two captions: (a) Inclusions in gross income, and (b) deductions from gross income.

As to (a), the bill, by omitting from exclusions from gross income gifts, impliedly includes gifts in gross income.

That has already been commented on by Mr. Parker, and it raises a constitutional question. I do not think perhaps the drafters really intended that gifts should be treated as income. If they did that raises a question which the committee will undoubtedly wish to consider.

Again, in section 24 the bill seeks to include in gross income loans by corporations to stockholders and officers, as well as distributions from depletion and depreciation reserves and incomplete or partial liquidation. The inclusion of such elements in gross income, it is believed, would be invalid in the light of the sixteenth amendment, and the decisions dealing with what constitutes income within the meaning of that amendment. Besides, the provisions with respect to distributions by corporations are not in keeping with section 115 of the bill. These considerations persuaded the Treasury to suggest redrafts of the provisions referred to so as to give effect to the intent of the committee and at the same time mold the provisions in such language as to remove the possible danger of unconstitutionality.

With respect to (b), the bill severely restricts deductions from gross income allowed under prior revenue acts. Such restrictions affect salaries and other payments to officers, directors, and certain stockholders of corporations; also such items as promotional, public-

relation, and all selling costs, repairs, interest, depreciation, and depletion. These limitations, most of which are found in subsections (a) and (b) of section 23, are novel in a revenue measure.

The administrative problems raised by the limitation provisions of section 23 (a) appear to deserve special consideration by reason of the fact that they are based upon taxpayers' experience for pre-war years. The application of this principle necessarily involves examination of taxpayers' returns for such pre-war period, a procedure which places a heavy burden upon the administrative machinery of the Bureau. The problem is related to section 67 of the bill with respect to the use of prior averages of comparable trades or businesses where taxpayers themselves do not have pre-war experience. The past experience of the Department with respect to employment of comparatives suggests the necessity of refraining section 67. This has been done.

As to the third general aspect of the proposed bill—section 51 seeks to tax as that of a single individual, the income of husband and wife and the income of a parent and minor child. The Department has studied these provisions and has reached the conclusion that the section as found in the bill is of doubtful validity. However, it presents for consideration three alternative plans. The bill also provides for quarterly returns in the case of corporations, such returns to be filed for the current year in which the profits taxed are being accrued or earned. In the interests of good administration and to avoid inconvenience to taxpayers without corresponding benefit to the Government, this provision has been reframed.

Again, the bill seeks to radically change existing reorganization provisions, taxing gains, and disallowing losses arising therefrom.

It is not the purpose to discuss here the technical aspects of this problem, it being a subject which appears more properly to be taken up in detail with the staff. It is suggested, however, that the reorganization provisions have found expression in revenue acts beginning with that of 1921, and that such provisions have been from time to time examined with a view to closing avenues of tax avoidance therein. The attention of the committee in this connection is invited to the report of the Senate Finance Committee, dealing with its study of the reorganization provisions incident to consideration of the revenue bill of 1934. Such report sets forth the reasons which induced that committee to leave substantially intact existing reorganization provisions. These considerations have persuaded the Treasury to recommend that these provisions of the Revenue Act of 1934 be permitted to remain in the proposed bill.

Another problem with respect to corporate returns is that attaching to affiliated returns, which, under existing law, are permitted only in the case of common carriers (sec. 141). The triflingly small number of corporations filing consolidated returns and the fact that adjusted declared value is geared to a single corporation and not adopted for affiliated groups of corporations have induced the Treasury to recommend that section 141 be stricken from the bill. This would carry with it elimination of those other sections of the bill referring to affiliation.

Again, as to the time and manner of payment of the tax, the proposed bill introduces an innovation in that those sections of existing law providing for installment payment, for extension of the time for payment of the tax, and for filing bond in appropriate

cases for securing ultimate collection of the tax, have been stricken from the bill. While this matter may be said to be a question of policy, it concerns seriously the administrative set-up, since the collection of the tax is an administrative problem. It has been the experience of the Bureau that cases of great hardship will arise if the tax is summarily collected in every instance. The business of taxpayers will be seriously embarrassed or perhaps forced to liquidate. Thus prior revenue acts have anticipated such hard cases and have provided for a certain degree of flexibility by giving the Commissioner discretion to extend time for payment of the tax in appropriate cases.

The subject of payment of the tax comes up in connection with the procedure incident to appeals before the Board of Tax Appeals. Under existing law the deficiencies involved (except in cases of jeopardy) cannot be collected until after the decision of the Board becomes final. Under the proposed bill the deficiencies may be collected after issuance by the Commissioner of a notice of deficiency. For administrative reasons the Treasury recommends that the power to collect such deficiencies be made mandatory upon the Commissioner, and the provision has been redrafted accordingly.

Again the bill eliminates credits for taxes paid to foreign countries and possessions of the United States. This is recognized as a question of policy, but it may be pointed out that hardship may result in many cases by reason of the fact that the combined United States and foreign taxes may exceed the income upon which such taxes are imposed.

With respect to the fourth aspect, the severely increased rates of tax, it is recognized by the Treasury that the rate of taxation is a question of policy.

However, the attention of the committee is invited to section 102, laying a surtax on corporations improperly accumulating surplus. The effect of this section, when combined with that of section 13, results in levying a tax materially in excess of the income upon which it is imposed. For these reasons the restoration of section 102 as it appears in the Revenue Act of 1934 is suggested.

In addition to the above major fields of departure from existing law, the proposed bill contains numerous minor technical, typographical, and other errors, the correction of which was essential. An illustration of this is section 206, dealing with mutual insurance companies other than life. Though it was the obvious intent of the drafters to tax such companies, the language of the bill rendered them not subject to the tax.

Senator CONNALLY. Mr. Brown, I do not want to interrupt you at this time, but I am going to have to leave, and I will turn the hearing over to the other Senators.

It has been suggested that we adjourn at this time, and I do not suppose it is necessary at our next meeting for all of you gentlemen to come here at one time; the clerk will arrange for a meeting next week, on Tuesday, at 10 o'clock, and notify everyone; and, Mr. Brown, you can be here and finish your statement at that time.

Mr. BROWN. Yes, Senator.

Senator CONNALLY. Then we will adjourn at this time.

(Whereupon, at 12 noon, an adjournment was taken until Tuesday, Feb. 18, 1936, at 10 a. m.)



# TO PREVENT PROFITEERING IN WAR

TUESDAY, FEBRUARY 18, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 312, Senate Office Building, Senator Joseph F. Guffey presiding.

Present: Senators Guffey (acting chairman) and La Follette.

Also present: Ralph W. Brown, special assistant to the general counsel of the Treasury, and members of his staff; and L. H. Parker, chief of staff, Joint Committee on Internal Revenue Taxation, and members of his staff.

Senator GUFFEY. Mr. Brown, you were on the stand when we adjourned. You may proceed.

## STATEMENT OF RALPH W. BROWN, SPECIAL ASSISTANT TO THE GENERAL COUNSEL OF THE TREASURY—Continued

Mr. BROWN. Upon adjournment last week I had nearly completed a summary of the work carried on by the Treasury during the recess. I have only a few additional observations to make before concluding.

There are contained in the bill, as there are in existing law, several provisions dealing with the problem of undistributed current earnings or surpluses. This problem has had the attention of the Congress ever since the adoption of the first income tax following the taking effect of the sixteenth amendment, and grows out of the fact that corporation earnings have been taxed at a low flat rate, whereas those of individuals have been subject to the normal tax and surtaxes.

Section 102 of the Revenue Act of 1934 imposes a surtax at rates of 25 and 35 percent on corporations accumulating gains or profits beyond the reasonable needs of the business. In section 102 of the bill these rates are raised to 98 and 100 percent, respectively. Moreover, so far as appears, this tax is in addition to the taxes imposed by section 13. In addition section 102 (a) (B) imposes a tax of 75 percent upon the undistributed surplus of a corporate taxpayer without regard to intention to improperly accumulate surplus. The undistributed surplus of a corporation is defined for the purposes of this subsection as 4.7 percent of the adjusted declared value, minus certain deductions, which reduce the undistributed surplus to 2.7 percent of adjusted declared value, or less.

These are very drastic provisions, and under certain circumstances may result in a corporation paying taxes substantially in excess of the income upon which they are levied. In the redrafting of the bill

we have restored the provisions of section 102 as they appear in the Revenue Act of 1934 on the theory that in a revenue act imposing taxes at rates as severe as those found in section 13, the question of undistributed current earnings is scarcely a problem. Moreover, it was felt that your committee would wish to consider these provisions in connection with the provisions of those titles of the act which have to do with the operation and financing of industry in wartime. While it is recognized that this action invades the field of policy, it was believed to be justified in the absence of a clearer statement of the necessity for the provisions of section 102 as found in the bill.

Another section bearing on the problem of undistributed current earnings is found in subtitle D, section 351 of which imposes a surtax upon the undistributed net income of personal holding companies at rates of 98 percent on the amount of such net income not in excess of \$100,000, and 100 percent on the amount in excess of \$100,000. In computing the undistributed adjusted net income subject to this tax, losses from sales or exchanges of capital assets, which are disallowed as a deduction by section 117 (d), are not allowed. This section is modeled upon section 351 of title I-A of the Revenue Act of 1934, except for the higher rates and greatly restricted deductions.

Again in this connection, section 381 of subtitle E imposes an excise tax on the issuance of stock dividends at the rate of \$100 a share or fraction thereof. The severity of this tax, it is feared, raises a question whether an attempt is not being made to regulate the internal affairs of corporations, which regulation is reserved by the Constitution to the States. Probably the drafters made the rate high to take care of stock with a high par value or selling price. It is believed that this difficulty could be met by providing a somewhat higher rate on high-priced stocks than on low. A precedent for this exists in the present tax on the issuance of stock. Subdivision (2) of schedule A of title VIII of the Revenue Act of 1926, as amended, particularly section 722 of the Revenue Act of 1932. Probably a fairly high rate of tax could be supported, but it is a question whether the present rate is not too severe.

Apart from the foregoing considerations, it is a question whether the tax imposed by section 381 of the bill is necessary, in view of the fact that stock dividends scarcely present a serious question so far as affects the problem of distribution of current earnings, especially under a tax bill which in the first instance takes so large a share of the corporation taxpayer's income. The declaration of stock dividends presents a problem in the case of surpluses accumulated in the past and not yet distributed, inasmuch as it permits the taxpayer to enjoy such surpluses without immediate tax liability. However, the decision as to the imposition of this tax is clearly a question of policy for the committee.

This concludes the Treasury's summation of the field covered by its administrative studies.

Senator GUFFEY. Thank you very much, Mr. Brown.

Senator LA FOLLETTE. I now suggest that we have the questions that were worked out by Mr. Parker as pertaining to the policy that must be determined prior to action upon any specific provisions of the bill incorporated in the record at this point.

**STATEMENT OF L. H. PARKER, CHIEF OF STAFF, JOINT COMMITTEE  
ON INTERNAL REVENUE TAXATION—Continued**

Mr. PARKER. I, unfortunately, do not have a copy of the letter here.

Senator LA FOLLETTE. The letter is not important.

Senator GUFFEY. I have the whole thing here for you. It may be incorporated in the record.

(The foregoing letter referred to is as follows:)

FEBRUARY 15, 1936.

Hon. JOSEPH F. GUFFEY,  
*United States Senate, Washington, D. C.*

MY DEAR SENATOR: As requested by the subcommittee considering the war revenue and industrial management bill, I am enclosing a table containing the principal issues which in my judgment should be discussed by the subcommittee. I believe that the next meeting of the subcommittee is tentatively set at 10 a. m. on Tuesday, February 18.

Very respectfully,

L. H. PARKER, *Chief of Staff.*

The questions referred to in the above letter are as follows:)

**PRINCIPAL ISSUES IN THE WAR REVENUE AND INDUSTRIAL MANAGEMENT BILL—  
SUBMITTED FOR THE CONSIDERATION OF THE MEMBERS OF THE SUBCOMMITTEE**

**TITLE I. INCOME TAXES**

1. Should the bill be designed so as to take the profit motive away from both corporation and individual?
2. If the answer to issue 1 is in the negative, what maximum rates can be used without destroying the profit motive?
3. Should the bill be designed to produce the maximum revenue possible, or should the social and economic effects of the bill be deemed more important?
4. Is it sound to adopt the general principle that the most important thing in connection with war legislation is "to win the war"?
5. Should the bill be designed to tax net income only, or should limitations be imposed on the deduction of necessary business expenses with the result that the tax rates may apply to a figure greater than true net income?
6. Should the bill attempt to correct possible defects and to close possible loopholes in existing law when such defects or loopholes are a present problem not directly connected with war revenue legislation?
7. Should the rather low taxes proposed in the bill on the individual with a moderate net income be increased so as to secure more revenue?
8. Is it constitutional to tax gifts as income, as indicated by the bill?
9. Is it constitutional to require the filing of joint returns by husband and wife as proposed in the bill, such a provision affecting the present community property system?
10. The bill taxes all gains from the sale of capital assets, but disallows all losses from such sales, except to the extent of \$2,000—that is, if a man has \$50,000 of gain from the sale of capital assets and in the same year has \$80,000 of losses from such sales, the bill proposes to tax the man on \$48,000 regardless of the fact that he had a net loss of \$30,000. Is this a sound policy?

**TITLES II TO VI. INDUSTRIAL MANAGEMENT**

11. Should the bill be kept in its present form or should it be divided into two separate bills—one dealing with revenue and the other with industrial management and control?
12. Title III of the bill gives the President power to fix prices, close exchanges, requisition plant, etc., not only after war has been declared but whenever Congress declares a grave national emergency exists, or whether there exists a war between two foreign powers. Is it constitutional to grant this power to the President at a time we are not actually at war?

13. As a practical matter, will the War Department be able to organize quickly enough to handle the exceptional duties placed on it in titles II and III?

14. Is the revolving fund of \$500,000,000 provided for in section 506 sufficient?

15. Is there any danger, under the terms of this bill, that some future President, personally ambitious of extreme power, would get us into war for the purpose of wielding such power?

Senator GUFFEY. What else is there that should go in the record today? I agree with you, Senator La Follette, that we should not go ahead when the rest of the committee are not present.

Mr. PARKER. I think there is nothing further to go in the record at this time.

Senator LA FOLLETTE. I suggest, Mr. Chairman, that we take a recess subject to the call of the chairman of the subcommittee.

Senator GUFFEY. With that understanding, we will stand adjourned.

(Whereupon, at 10:40 p. m., the committee was adjourned subject to the call of the chairman.)



## TO PREVENT PROFITEERING IN WAR

FRIDAY, MARCH 6, 1936

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

The subcommittee met, pursuant to call, in room 450 Senate Office Building, Senator Tom Connally (chairman of the subcommittee) presiding, at 10:45 a. m.

Present: Senators Connally, Guffey, and La Follette.

Also present: Ralph W. Brown, special assistant to the general counsel, Treasury Department; S. G. Winstead and J. S. Zucker, Treasury Department; G. D. Chesteen and Allen T. Aiken, of the staff of the Joint Committee on Internal Revenue Taxation.

Senator CONNALLY. The subcommittee will be in order. Have you a statement, Mr. Chesteen, that you desire to have in the record?

Mr. G. D. CHESTEEN. We have prepared a discussion of about five questions from an economic and industrial viewpoint, if you want that to go in the record.

Senator CONNALLY. I think so.

Senator GUFFEY. I think that ought to go in the record.

Senator CONNALLY. How long will it take you to read that?

Mr. CHESTEEN. It is 11 pages. It won't take very long to read it.

Senator CONNALLY. Suppose we hear that now?

Senator LA FOLLETTE. That is agreeable.

Mr. CHESTER. Dr. Zucker will be glad to present it.

### STATEMENT OF DR. J. S. ZUCKER, TECHNICAL ADVISOR, INTERNAL REVENUE BUREAU, TEMPORARILY ON THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Senator CONNALLY. Briefly tell the reporter your name and what you are presenting, please.

Dr. ZUCKER. My name is J. S. Zucker, temporarily detailed to Mr. Parker's staff. This statement is an analysis of some of the effects of drastic taxation on the economic activities of the country, also a discussion of three or four questions pertaining to matters of policy with respect to the war-profits tax bill, presented here as a preliminary to the subcommittee's decision thereon.

In the Report of the Senate Munitions Committee, Report No. 944, part 2, the aims of the bill are discussed in detail, and in addition, the economic effects of drastic rate structure, as well as provisions for blocking methods of tax avoidance, are surveyed objectively. Probable results, such as curbing of profit motive, hindrance of war production, disorganization of industry, and dissipation of investments are treated.

While consideration was given in the report to the economic mal-adjustments which might ensue in the event of the enactment of an oppressive war revenue measure, it appears pertinent that the proposed bill itself be analyzed from the viewpoint of whether or not due cognizance had been given to the features discussed in such report.

#### ANALYSIS OF SOME OF THE EFFECTS OF DRASTIC TAXATION ON ECONOMIC ACTIVITIES

Admitting that the objectives of the war-revenue bill are highly meritorious, it nevertheless is of paramount interest to survey the economic effects wrought by drastic taxation such as is here proposed. Of equal importance to the attaining of revenue sufficient to run a war is the assurance that a tax law devised to carry out the above purpose will, in addition, in nowise curb the incentives to produce war materials, will not disorganize industry, and will not take away the motives for continuous economic activity.

When it is considered that in times of war the marginal producer is as necessary as the low-cost, large-scale producer, the problem can be truly appreciated. This is not an argument for the preservation of the status quo in the economic field, but rather it is an indication of the danger that lies ahead if a ruthless "maximum" tax scheme is enacted. A government should not too freely utilize the power of drastic taxation nor the power of commandeering industry, for its efforts may produce a boomerang.

Unlike the requirements of Government financing during peacetimes, when the amount of desired revenue is reasonably fixed and therefore tax rates may be devised accordingly, in wartimes the amount desired is practically limitless. This brings up the thought: Not at what rate of tax will the Treasury obtain the necessary war revenue, but at what rate of tax shall a war-revenue bill stop in order to assure a steady Government income to satisfy the requirements of a constantly replenishing war chest.

It is a well-known fact that the tendency of businessmen is to view taxes as an expense of doing business, and therefore consider it proper to charge same up to the cost of the commodity or service sold. Thus, by the incidence of taxation, the additional levies against business tend to increase prices and bring about a gradual inflation. This tendency on the part of businessmen can be reasonably curbed by invoking a tax which takes all above an exempted minimum, or substantially all, in lieu of the usual graduated income tax. We are thus confronted with the intensely debatable problem of what amount of profit constitutes a justifiable minimum to be exempted from tax; what percentage of profit shall be left to businessmen, whether engaged in business in their individual capacity or in corporate endeavor; and further, shall this percentage of profit, which may be very large in the case of large organizations, again be made subject to tax so as to leave actually only a reasonable amount commensurate with living requirements in the standard of living to which our businessmen are entitled.

To preserve initiative and the desire to risk capital, as well as to assure war productivity, require that profits be not too ruthlessly diverted by taxation from their reemployment in normal business

channels. Uninterrupted output in most fields of industry is essential, and, as stated in Senate Report 944, part 2, page 11, is—

far more important than eliminating profiteering or preventing a heavy debt being passed on to post-war administrations. Consequently, if the absolute rate of any wartime tax is so severe as to discourage investment required for reconditioning idle plants, converting plants from nonessential to essential production, building new facilities, financing larger purchases of raw materials and increased pay rolls—to name a few of the wartime requirements for capital in expanding production and eliminating any consideration of the effect of such a tax on existing production—it cannot be permitted.

In a statement by Bernard M. Baruch to the Senate Munitions Investigating Committee dated April 12, 1935, quoted in hearings, Munitions Industry, part 22, pages 6633-6643, he stated, in part:

\* \* \* the cold fact remains that ours is an economy activated by profits. \* \* \* There is no proof that it will run on psychology and there is much that it will not. Certainly we should not select an hour when the enemy is at the gates to find out whether it will or not.

The above quotation admirably brings out the fact that we function, economically speaking, largely under the impetus of the profit motive. The extent to which other motives, such as patriotism or an appeal to a sense of social justice, equality of contribution, and sacrifice, may shape the determination to remain industrially active, is, to say the least, problematical. Whether, under a stress of war and the necessity for preservation of country and family, people might rise to the support of their Government and concede to a levy approximating all of the profits above a certain minimum is a conjecture which should not be tested at a time of war in view of the dire circumstances of failure.

In justice to our businessmen, be it said that the conducting of large businesses is a matter of trusteeship for the stockholders more than the willingness of any individual to forego profits for patriotic reasons. In other words, the preservation of the investment in the business becomes a duty touched with high moral and social purposes. A confiscatory tax rate might clash with the purpose of conducting business for a profit and thus tend to effect production very disastrously.

It is also proper to consider that if a wartime tax is so heavy as to be stigmatized as unjust, there may result an increase in the devising of methods of avoidance which will have the effect of decreasing the revenue to the Government.

Economists have fashioned certain theories upon which an ideal tax is to be based. While a war-profits tax may be said to follow the benefit theory, in that every individual of a country stands to lose his all in the event of failure to win the war, predominantly the manner and measure of levy must follow the principle of the ability-to-pay theory. This theory is predicated on the ability to pay taxes without undue sacrifices. Ours is a country of varied economic endeavors. The business structure is highly complex. We are therefore faced with the practical necessity of preparing a tax law which should not have adverse effects on economic groups and classes of our people. Big business should not be discouraged to a point of sabotaging the Government. The incentive on the part of individuals to continue work should not be curtailed, for in the last analysis, the economic welfare of the country is dependent upon the economic welfare of its component parts.

Now, speaking directly on the questions which we have prepared.

Does the subcommittee wish to close all possible loopholes in existing tax law, though these are not directly connected with war conditions?

Proceeding on the premise that a maximum revenue yield is to be obtained through a war-revenue bill, the sponsors of the proposed measure have seen fit to incorporate therein many provisions which aim to thwart efforts at avoidance and also which tend to curb the taking of excessive deductions from gross income.

For practically two decades Congress has from time to time injected provisions into the income-tax law designed to distribute the tax burden justly among all classes and groups. Many loopholes for tax avoidance have been blocked. At the present time there may exist certain unsatisfactory situations which require careful study and experimentation.

Shall we say that in a wartime bill all of the conjectures which may arise with respect to possible avoidances should be summarily dealt with and revised provisions enacted so as to effectively eliminate all possibilities of avoidance? Is it not better to assume that a more detailed study, with opportunity to ascertain surrounding facts and circumstances, is in order? This will effect a gradual injection into the tax structure of new provisions tending ultimately to attain an ideal tax law.

Manifestly, the plugging of loopholes for tax avoidance is meritorious, but what may be questioned is the lack of reasonableness in approach. The wholesale redrafting of provisions when the rate structures are drastic and when the need for revenue could be no greater might result in undue disturbances, which not only may lessen the revenue yield but, what is more important in wartimes, may halt the production of war materials.

A few examples will serve to illustrate the point: (a) If it is wrong under the present law to allow depreciation and depletion on a method which involves recoupment of capital outlay based on actual wear and tear and on wastage of natural resources, and if it is considered right that there be allowed a limited percentage deduction based on income, then such a provision should be studied carefully, as a peacetime measure, with the end in view of incorporating same into the existing revenue law.

(b) If it be granted that the allowance of nontaxable exchanges constitutes a means of tax avoidance, a study should be made of its extent; of the probable value of its elimination; also, whether it is possible to substitute other provisions which, though blocking tax avoidance, will nevertheless not interfere with effecting mergers and consolidations required in the operations of large business endeavors. It is submitted that this, too, is a peacetime effort, and should not be injected into a war-revenue bill.

(c) The provisions with respect to capital gains in the present law have been eliminated. Capital losses, however, are recognized only to the extent of \$2,000. This tends to create a lack of economic balance which may have adverse effects on transactions involving capital assets.

(d) The bill proposes to tax distributions out of profits and increases in values accrued prior to March 1, 1913. The effect of this provision, no doubt, will be that corporations will attempt to impound their surplus. This, in turn, will make them subject to

the drastic provisions imposed on corporations adjudicated to have accumulated surplus improperly. If left in the bill, it will become one of the factors that will tend to disturb corporate endeavor.

(e) Under the provisions of the proposed section 23 there is injected a series of arbitrary deductions as well as limitations which are based on allowances predicated on prior-year averages. Interest, repairs, promotional, public relation, and selling expenses are limited to a sum not larger than the average annual outlay for such purposes in the preceding 3 peacetime years.

I think this is quite important so far as drafting a war-revenue bill is concerned. This, and similar provisions, will have a tendency to throw completely out of line the relationship between the concepts of statutory net income and net income, in the accounting, legal, and economic sense. It need not be argued that such a procedure will impose hardships on taxpayers, particularly in those cases where the tax based on an artificial concept of incomes will be far greater than the true net income itself.

The next question presented for your consideration pertains to dividing the bill into two parts.

Title I of the proposed bill deals with income tax exclusively. Titles II, III, IV, and V constitute an economic and industrial management bill involving war resources and war-finance control, as well as War Department supervision over the management of industries.

In view of the obvious unrelated nature of the two subjects treated in the proposed bill, may it not be advisable to sever title I and consider it as a complete bill in itself—a taxation measure? The remaining titles, being essentially economic and industrial in nature and constituting a means of wartime control over industry, might well be considered as a separate measure, probably under the jurisdiction of the Military Affairs Committee.

In the economic and industrial management bill constitutional questions may arise. For example, is there sufficient constitutional authority for title III going into effect merely upon congressional declaration of an existing emergency and not the existence of an actual war? Again, there is the matter involving the payment of "fair" compensation in the event of commandeering of plants.

Other detailed features, such as the fixing of prices, the closing of commodity and stock exchanges, the licensing of production, and distribution of commodities, are all problems decidedly foreign to the realm of taxation and should not be considered as part and parcel of a war-taxation bill.

The next question relates to drastic revenue yield irrespective of social and economic effects.

Estimated yield under the proposed bill, as made by Mr. Flynn in testimony before the Military Affairs Committee, as well as the Munitions Committee, ranges from \$15,000,000,000 down to \$6,000,000,000 per annum. Those estimates were based on the bill before it appeared in its present revised form. It covers a rate structure which is somewhat more severe than the one now in the bill.

Dealing with drastic rates makes the matter of estimated yield highly conjectural. It is dependent upon many variables. There are the factors of inflation, curtailment of production by virtue of curbing of profit motive, and probable difficulties arising in connection with administering new and radical provisions.

It is impossible to determine in advance of a war what revenue would be required, for it is obvious that a war with a weak country would cost far less than a war with a strong country or a group of countries. Furthermore, a prolonged war will require much greater financing than a war of short duration. If a revenue bill is to be effective, it must anticipate a revenue yield sufficient to cope with all eventualities, and therefore provision in such a bill should be made for a high revenue yield.

This brings us to the question of whether the consideration of maximum revenue yield should predominate the consideration of the preservation of the economic welfare of the country. Can we divert all the income yield from individuals and corporations except for an exempted minimum sufficient for living expenses and a 2-percent or 3-percent return to corporations? The bill proposes very severe rates. No other nation, so far as we know, has ever experimented with such rates.

While it is not to be gainsaid that the most important thing in connection with a war is to win such war, legislation pertaining thereto must, however, be framed so as not to assume that from a fiscal standpoint to "win the war" means ignoring basic principles of public finance as well as factors tending to the preservation of the economic well-being of the Nation.

Senator CONNALLY. That is very good. I will say, however, that in treating these other titles, they really have been reported on, one by the Military Committee and one by the Munitions Committee. So we are primarily supposed to deal with the title referring to taxation.

Dr. ZUCKER. That is title I.

Senator CONNALLY. I am rather inclined to agree with you, though, on the point that this ought to be purely a war-time tax bill, and we ought not to undertake to disturb the peacetime bill, because we will be filling up these loopholes and things in that from time to time.

Senator GUFFEY. I think this ought to be confined to a war-time tax revenue.

Senator CONNALLY. That is my view.

Senator LA FOLLETTE. Yes; but of course they were proceeding on the theory, as I understand, that they were imposing such drastic rates that they would have to try to close these loopholes.

Senator CONNALLY. Yes; in the war-time measure; but the point he brought out was that this bill undertook to also fill up the cracks in the peacetime bill. Is that what you mean?

Dr. ZUCKER. Such revisions, however, will be applicable only when the war-time measure goes into effect. From a study of the bill we would say that some of these provisions do not show a clear relation to a war-time objective.

Mr. S. G. WINSTEAD. I do not believe, though, that means for operation during peacetime. They, you see, have used the present revenue act as a basis for this bill, and they have attempted to close up what they consider loopholes in the bill which will operate during war; but it does not affect the operation of the present revenue act.

Senator CONNALLY. We will try to meet then at 2 o'clock on next Tuesday in a committee room in the Capitol.

(Thereupon, at 11:10 a. m., the subcommittee adjourned, to meet again in the Capitol on Tuesday, Mar. 10, 1936, at 2 p. m.)

## TO PREVENT PROFITEERING IN WAR

THURSDAY, APRIL 2, 1936

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

The full committee met, pursuant to call, at 10:30 a. m., in room 310, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), Walsh, Connally, Bailey, Clark, Byrd, Lonergan, Gerry, Guffey, Couzens, La Follette, and Capper.

Also present: Senator Gerald P. Nye; John T. Flynn; L. H. Parker, Chief of Staff, Joint Committee on Internal Revenue Taxation, and members of his staff; Ralph W. Brown, special assistant to the General Counsel, Treasury Department, and members of his staff.

The CHAIRMAN. The committee will come to order. What is the pleasure of the chairman of the subcommittee?

Senator CONNALLY. Now, as the chairman and members know, this tax feature of the so-called war-profits bill is a very complicated and voluminous measure.

The CHAIRMAN. May I interrupt? Where is Mr. L. H. Parker?

Senator CONNALLY. He is not here, but his representative is here and he will be here later.

The CHAIRMAN. That is all right.

Senator CONNALLY. Mr. Chesteen has really been giving more direct attention to this matter than Mr. Parker.

The CHAIRMAN. Then, that is all right.

Senator CONNALLY. I am glad Senator La Follette has come in. We have been working as best we could on this bill. Senator La Follette, I was just stating to the chairman in answer to an interrogatory that the subcommittee desired to report back to the full committee, at least partially, or tentatively, in order to get some expression from the full committee as to some of the matters involved and matters of policy involved in this bill. As I say, it is a very complicated and voluminous measure and very far-reaching in its application, of course.

We have had the Treasury Department and the tax experts working on it since the last session of Congress, and the subcommittee has had hearings, which appear in the printed pamphlet here, on the general outline and the general policies involved. And they have submitted a list of questions, 15 in number, which they regard as requiring an answer before the experts, or the subcommittee either for that matter, can go into the detailed study of the bill.

The CHAIRMAN. The subcommittee prepared those?

Senator CONNALLY. Yes; the experts prepared them for us and submitted them back to us.

The CHAIRMAN. I understand.

Senator **CONNALLY**. For instance, here is one question, as to whether or not the bill should undertake to take practically all profit out of war over a minimum of 2 percent or 4 percent, as set forth in the bill, or whether it should only be designed to take out that degree of profit which the war needs. In other words, if a concern was making, say for 5 years prior to the war, 6 percent, whether we should still allow them that normal income, or normal profit, and simply apply it to that increment that might be provoked by the war. That is one question.

Another question is as to whether or not we should confine this measure in its terms simply to the duration of the war, or whether we should undertake, as the bill undertakes, to correct a lot of peacetime legislation.

My own view is that we ought not to undertake to do that in this war measure, but we ought to confine this to a plan of taxation operative in war, and not probably conflict with the general tax measures which we enact from time to time with respect to peacetime taxation.

Those are the two biggest questions. I would like to hear from Senator La Follette.

Senator **LA FOLLETTE**. There is a third question that has been presented by the experts to the subcommittee, and I think the subcommittee felt that the full committee should give us some indication of its attitude concerning it, and that is whether or not the other titles that are combined in this tax bill should be attempted to be passed on and reported out at this session, whether we should consider the possibility of separating the titles and merely attempting to report out the title of the bill pertaining to taxation. Not that the subcommittee feels it has any responsibility for the other two titles of the bill, since those have been passed on by the Military Affairs Committee, but simply because they raise issues which do not directly relate to taxation, and whether at this late stage of the proceedings of this Congress the other two titles could along with the tax title be given adequate consideration.

I am speaking now for myself and not for the other members of the committee.

And another thing, which I do not know whether the chairman mentioned, and that is that the subcommittee—this is not in criticism of any member of it, but due to the pressure of other committee work—has been somewhat embarrassed in attempting to get a full meeting of the subcommittee. In other words, we felt it was futile for two or three Senators on the subcommittee to pass on these important questions of policy without the presence of other members of the subcommittee, because we might determine one policy, and then find that when we got to the judgment of other members of the subcommittee it might be adverse.

I want to say that the chairman has made a very persistent effort to get a full subcommittee meeting, but insofar as I know during the time that we have been working on this bill we have been unable to get a full attendance of the subcommittee.

Senator **CONNALLY**. Senator La Follette, I may state that we have undertaken a number of times to get a meeting of the subcommittee and we could not even get a sufficient number to have a meeting.

Senator **LA FOLLETTE**. That is right.



Senator CONNALLY. In other words, when we had meetings we probably would have two or three members of the subcommittee absent. I am not criticizing any of the members, because they have simply been overwhelmed with other duties, other committees, and some absences from the city.

If this was just the ordinary measure, on which every man had definite views of yea or no, we could have reported the bill a month ago probably, but it is a matter that has so many angles and aspects that it has even perplexed the experts. It is not something on which we can say we are for it or we are against it.

Senator CLARK. So far the subcommittee chairman is concerned I would like to say for the record that he made every effort to get action. And as anxious as I was to get action on it I requested that it be laid over in order to get Senator Nye and Mr. Flynn here to speak on it, both of whom I was anxious to have present.

Senator CONNALLY. I think while the committee is here this morning I would be glad to give Senator Nye an opportunity to say what he has to say about it, and also Mr. Flynn.

The CHAIRMAN. May I ask you this, Mr. Chairman (Senator Connally), is it the view of the subcommittee that this committee ought to go into these matters that do not relate to tax purposes, and that are incident to it?

Senator CONNALLY. It is not my view. The Military Affairs Committee has already reported on that part of it. As I understood Senator La Follette to say it is not so much that we would have the responsibility of these other titles, but the tying them in with the tax measure probably would bring about a legislative situation where none of them would be considered by this Congress. Is that it?

Senator LA FOLLETTE. That is correct. In other words, so far as I understand the subcommittee does not take the position that it has any responsibility to it for passing on titles 2 to 6, but we are confronted with the fact that if there should be action, if action is desired at this session of Congress, that there is a question of the exercising of judgment as to whether or not it would be wise to separate the titles and attempt to get action on one of them, namely the tax section, and permit the other sections to await further consideration at another session.

Senator GERRY. Now, I do not know that I understand just what the Senator is driving at. I have been sick too, and I have not had a chance to fully study this. What do sections 2 to 6 go into?

Senator LA FOLLETTE. They have to do with industrial management in wartime, Senator. It is not related to any question of tax structure, or rates, or anything that has to do with financing of war by taxation or levy by taxation.

Senator GERRY. Well, but doesn't it, Senator, because if you go in and take over—I have not studied carefully this bill—all business, that is just what this bill does, is it not?

Senator LA FOLLETTE. No; that is not my understanding of it.

Senator GERRY. It is practically that, is it not? And if so, why then you are going into a question of how it affects your taxes and the amount of revenue you get, are you not?

Senator LA FOLLETTE. As I see it, titles 2 to 6 have to do with questions that are not related to the tax structure, or to the rates, or how much money you are going to raise from taxation.

Senator CONNALLY. Except indirectly as they may generally hold business property.

Senator LA FOLLETTE. That is true, I grant that.

Senator GERRY. Quickly reading the testimony as I have, because, as I say, I have been sick myself, I thought that went into it quite a lot. And before I would be willing to vote I would want to know more about it.

Senator LA FOLLETTE. I will say to you that as I understood the subcommittee took the general attitude that inasmuch as those titles of the bill had been before the Military Affairs Committee, and had been reported with certain amendments to the Senate, and that then the bill has been referred to this committee, and then subsequently to this present subcommittee of the Finance Committee, our feeling was that it was not our responsibility to pass upon those titles.

Senator GERRY. The question you are getting in there, of course, is this: The Military Affairs Committee simply passed on it from the War Department point of view, as I saw it, as to the administration. They really had no hearings on it, except of the War Department, and the War Department simply said that they felt it was a question of policy for Congress to decide how they wanted to tax, and they did not go into it. But of course as soon as you begin to take things over it goes into the very complicated question of ceiling of prices, and everything else. And when you begin to take over all industry you are going to go into a question of revenue. And as far as I can see in the hearings the Treasury brings that out in their statement.

Senator LA FOLLETTE. Senator, if you will look back to the record at the time this bill was first under consideration, I think you will see that it was clearly the understanding that the bill, after its report from the Munitions Committee, was to be referred by the Senate to the Military Affairs Committee for the purpose of giving study and making recommendations regarding the titles 2 to 6, which deal with industrial management, and that the bill was to be referred to the Finance Committee for the purpose of passing upon and making recommendations concerning title 1, which has to do really with the jurisdiction of this committee, namely, taxation.

Senator GERRY. Yes; but there is a real question that comes in there, Senator. Now, frankly, we are all for the taking of excessive profits out of war, there is not any question about that, but it is just how you do it, that is all, and the general principles of policy. But when you get into how you are going to do all these things, I would like to know a lot more about it than I do when I come to it, because what you say is the technical status and you know the Senate did not pay any attention to the technical side of it. They referred it to the soldier men to see what they thought about it, and, as I saw the testimony, the military men said, of course, policy is a question for Congress to decide. But you are getting now into a matter of taxation, I am afraid; also it is a bill which refers to more than a case of war, according to the wording of this bill.

Now, for example, take this section you have on page 229, where, if Congress declared a state of emergency, this bill could go into effect now. Mr. Parker referred to that. Is not that the section?

Senator LA FOLLETTE. Yes; but, Senator, I did not feel, under this bill, which is tantamount to the understanding that was agreed to

when this bill was reported and referred to the Military Affairs Committee, as one member of the subcommittee, it was the responsibility of the subcommittee to pass on those industrial titles, and that it was our job to pass upon title 1, which had to do with the taxation.

In other words, I grant you that any individual Senator on the floor determining how he is going to vote on this bill will have to consider the titles that are attached to it, but as one member of the subcommittee, or as a member of this committee I do not feel it is the responsibility of this committee to pass upon the policy of the other titles that have already been passed upon by another standing committee of the Senate.

Senator GERRY. If the Senator will pardon me a minute I will get through. The way it strikes me, as a member of the Finance Committee, I do feel when you go into any taxation problem, and this does, raising revenue, what the Military Affairs Committee passed on really were military matters, and when you go further, and this goes a great deal further, and go into taxation problems I think it comes clearly under the Finance Committee to have a say on it, and it would influence my vote on it.

Senator CLARK. Let me say, Mr. Chairman, that you were a party to the agreement when this bill came over from the House originally, and it was not at that time in contemplation that the tax provisions contained in title 1 would be put with the rest of the titles. And there was an agreement at which the chairman of the Finance Committee, the chairman of the Munitions Committee and myself were present, in which it was agreed that the bill should be referred to the Munitions Committee, and after disposition by the Munitions Committee it should be referred to the Military Affairs Committee. And the chairman of the Finance Committee stated he did not care to have it referred there when in the Munitions Committee, and of course it went into the military matters. And it was then suggested that it be sent to the Finance Committee. But I do not see that these other provisions are in the jurisdiction of the Finance Committee, although it is possible they may in some remote degree affect the sources of taxation, any more than if the House would pass in time of war a universal military draft and it came over here and would be a matter within the jurisdiction of the Finance Committee because it was taking a lot of men out of civil employment and putting them in military employment would affect tax provisions. It certainly seems to me that the other titles of this bill do not come under the jurisdiction of this committee.

Senator GERRY. Frankly, I would say to the Senator from Missouri that I would like to know more about it before I am willing to vote. I would be glad to hear the Senator from North Dakota, but from a cursory reading of it you have a constitutional question here that has been raised already. And we are asked to vote on a bill which the experts here say there is great doubt about as to its constitutionality. And there is one provision you are leaving in it which shows that it is not even a wartime proposition. This bill can be put into effect at the present time.

Senator CLARK. Does that make it unconstitutional? Could not Congress put any bill in effect at the present time? I can say to the Senator that it is not the purpose of this bill to be put in effect at the present time.

Senator GERRY. It is in the bill.

Senator CLARK. I do not agree with the Senator on that, but as far as the constitutionality is concerned there is nothing unconstitutional about Congress putting it in effect now.

Senator GERRY. All I can say on that is that that question has been raised by the experts, and I am reading the thing as they stated it.

The CHAIRMAN. Suppose we take up these questions which we have here now. Senator Nye wants to express himself, as I understand it, on them. How many questions are there?

Senator CONNALLY. Fifteen.

The CHAIRMAN. There are 15 questions of policy, as I understand it.

All right, Senator Nye, we will hear you at this time.

Senator LONERGAN. Mr. Chairman, may I ask a question? Do I understand in this bill there are 15 different subjects treating 15 subdivisions?

The CHAIRMAN. I do not know. The chairman of the subcommittee can answer that question.

Senator CONNALLY. The hearings show that there are 15 questions of policy that the experts, after studying the bill, feel should be answered before they could draft a bill.

Senator LONERGAN. May I inquire of Senator Nye, are you going to take them up in order and give the views of your committee?

#### STATEMENT OF HON. GERALD P. NYE, UNITED STATES SENATOR FROM THE STATE OF NORTH DAKOTA

Senator NYE. Mr. Chairman, if I might be permitted to state it, I had not been aware until this morning of these specific questions that have been raised. Mr. Flynn was early advised of the desire of the committee to determine those questions of policy.

It has been very fine of my colleague, Senator Clark, to have wanted delay in this matter until I could be present, yet I think the committee has delayed unnecessarily in that respect.

Beyond what our reports reveal to have been our purpose in this legislation, I have little to add, and I shall not be, I am sure, more than 4 or 5 minutes in saying what I would like to say, and then will want Mr. Flynn to answer more specifically the questions which here arise. I hope, Mr. Chairman, it is going to be possible for the committee to hear Mr. Flynn in this day so that he can get back to his work by tomorrow morning. It is quite imperative that he do that.

When the Munitions Committee determined that it wanted to write and should write a war-profits bill it enlisted the aid of Mr. Flynn, who in turn enlisted the aid of very able experts and attorneys in writing the law. They spent months in this task, and submitted to the committee a work that the committee spent a long time in considering. I say this alone for the purpose of establishing that the bill as presented is not in any sense a hasty compilation in an effort to meet an immediate issue that was being presented.

The bill has a double purpose, as I have sensed it.

First has been the purpose of discouraging the thought, a thought that does most emphatically exist, that there is possibility of pros-

perity out of war. And in that connection a purpose has been served by writing tax rates to prevail automatically with the coming of war that would make it utterly impossible, as we have seen it, for anyone to profit as a result of war.

A second purpose has been that of making it possible to pay for the war while we fight it, rather than engaging in tremendous bond issues that fasten the costs of war upon, it can be said, generations that are unborn at the time the war is fought.

Still another purpose has been that of strengthening our economic structure to be better prepared to meet the emergency of war when it does come, and of building a preparation for war that will make us not dependent in time of war upon those who have and those who will, if we leave the issue where it is now, make themselves wholly selfish in their purposes during the war.

We have had time and again reference to experiences which the War and Navy Departments encountered during the World War, which I can state very briefly.

The New York Shipbuilding Co. was asked by the Government during the war to enlarge its capacity. They delayed and delayed and delayed in that response during that critical hour. The delay was occasioned by the question of what their margin of profit should be.

The Du Ponts were approached by the War Department in 1918, while our American boys were in the trenches, in what I suppose could be called the most critical hour during the war, and were asked to construct additional powder manufacturing capacity. The War Department made it clear to the Du Ponts that since it was uncertain how long the war was going to last, since uncertainty would jeopardize capital that was to be invested, the Government would not expect the Du Ponts to use their own capital, the Government would furnish the money. But they wanted the Du Ponts to supervise the construction of that plant. The Government assured them of a fair reward for its construction. Then the Government expressed a desire that when the construction was complete that the Du Ponts supervise the operation of that plant, for which they would be rewarded.

It was not a matter of minutes, or of hours, or of weeks, that the du Ponts delayed and refused that request of the Government. It was over 3 months before they finally consented to do what they were asked to do in time of war.

When we had developed this story of the Old Hickory plant we turned to Colonel Harris. In fact, the committee had access to the minutes of the meetings of the board of directors of the du Ponts during that period, and had a pretty definite understanding as to the cause for the delay. But we turned to Colonel Harris, who sat across the table from the du Ponts; Colonel Harris, who is a representative of the War Department, and who is thoroughly conversant with those war hours, and we asked him to account, if he could, for this failure, this refusal on the part of the du Ponts to respond to this request. And Colonel Harris, without any hesitancy, told the committee that the delay was occasioned by a difference of opinion between the du Ponts and the Government as to what the du Pont margin of profit should be for building the plant, and what their margin of profit should be for operating the plant.

Now, then, the thought occurred that in time of war, in that same war, for example, when the Government said to man, "Come on, we need your service", the man went; he did not delay; he did not have any opportunity to quibble about what his reward was to be. But when property is involved we find ourselves with very evidently a double standard on our hands, which we have tried to eliminate in the drafting of this legislation.

I think it is generally conceded, certainly the Munitions Committee is thoroughly convinced, that in time of war if we would eliminate profit from war there is only one approach to the accomplishment of that, and that is through taxation.

And in this bill, voluminous because of the necessity of writing an entire revenue bill, we have sought to provide the rates that would do two things: First, prevent, utterly prevent, the chance for anyone to profit from the war; and, second, to raise the revenue that would be needed to pay for that war while we fought it.

Some expert has taken the figures, the rates proposed in this new bill, and tried to determine what our revenue would have been under that bill during the 2 years we were at war, and has concluded that, while our actual outgo during the 2 years of war was  $8\frac{1}{2}$  billion dollars, not including our loans to our Allies, the estimated collections under the bill which we are proposing would have been \$12,000,000,000, making it appear evident that it is possible, if we have a will to do it, to pay for another war, if we must have it, while we fight it, rather than pass the burden on to other generations.

At once the question arises, Is it fair to write tax rates that apply on more than the profit which the war itself occasions? or, Is it fair to try to control by taxation, other than those who profit through the direct sale of munitions? Our bill, obviously, does not try to draw a line and determine that part of income that is traceable to the war itself. Our bill levies the rates upon one and all alike, whatever their source of income might be.

The point is made that the rates provided are far too drastic, that the motive of profit from effort in wartime would be utterly eliminated if this bill were to be made the law of the land. Personally, and I think I have the concurrence of other members of the Munitions Committee in this, I think it is high time we measured the question of what is too drastic in time of war. Should we be more solicitous?

Senator CLARK. That is on the theory, is it not, that it is just as much of an obligation on one man to put up dollars as a sacrifice for the country in time of war as it is for another man to shed his blood?

Senator NYE. Precisely. And it is not unfair to have tax rates prevail in time of war calling for sacrifice from all alike. I am sure the rates provided in this bill do leave sufficient income to citizens of the country to maintain their lives, although not on a scale such as they maintain themselves in time of peace, to be sure, but enough to maintain themselves nevertheless. And if we are going to insist that rates are too drastic it seems to me we must but remember that while the public would be expected to sacrifice more in time of war in the matter of tax rates than they do in time of peace, we should

remember that those who offer their lives and their service directly in the cause of war are giving more than is their custom, and they, too, are accustomed to better than what they are experiencing in time of war.

With that, Mr. Chairman, I am going to say no more, except to direct the attention of the members of the committee to reports which have been made by the Munitions Committee, and a second report made by the Military Affairs Committee.

If I might state it, among the officials of the War and Navy Departments who appeared before the Military Affairs Committee, of which I was a member, there was large concurrence in the features removed from the tax feature. The Military Affairs Committee gave no consideration whatsoever to the tax title in this bill, but have concurred and have given hearty approval to the remaining titles.

Personally, I hope the Finance Committee is not going to go over that ground again, unless in reviewing the consideration given by the Military Affairs Committee, it is found that the Military Affairs Committee has overlooked some salient features that must be considered in connection with this major program.

I cease, Mr. Chairman, in the hope that you can hear Mr. Flynn as far as is necessary to hear him at this time.

The CHAIRMAN. All right, Mr. Flynn.

Senator CONNALLY. Before you hear Mr. Flynn, as I understood the Senator from North Dakota, he complained that there had been some delay by the subcommittee here, occasioned by the request of his colleague, Senator Clark, to postpone the matter until the Senator from North Dakota now comes before us.

Senator NYE. I did not wish to be put in the light of complaining, because that request had been made. I only wanted to voice the thought that was in mind that had I known delay was being occasioned by any such request I should have objected and asked the committee to proceed without me.

Senator CONNALLY. I regard it as rather ungracious.

Senator NYE. I want to say in this connection that my understanding is one that has me thoroughly convinced that the subcommittee of the Finance Committee has done its very best to expedite consideration of this measure.

The CHAIRMAN. Now, Mr. Flynn, I think the committee, unless I interpret the committee's wishes incorrectly, would just like for you to take up those questions before us now, on which the committee has to pass; these 15 questions that the subcommittee has put to us. Just take them up one by one and give your viewpoint, and if you wish to say something further, that will be all right.

Senator CONNALLY. Bear in mind that I shall have to be on the floor at the opening of the Senate, Mr. Chairman.

Senator BAILEY. Let him begin by stating his connections and relationship to this bill. I do not know who he is.

The CHAIRMAN. Mr. Flynn, give that information to the reporter, just what your connections are, your full name, and so forth. You have been working with this Munitions Committee, as I understand. What is your background?

**STATEMENT OF JOHN T. FLYNN, OF NEW YORK CITY, N. Y.**

Mr. FLYNN. Mr. Chairman, I should like to say as to working for the Munitions Committee that I have been one of those employees who has been working without emolument.

Senator CLARK. I may say for the members of the Munitions Committee that Mr. Flynn has contributed his services without pay, and rendered invaluable service to the committee.

Mr. FLYNN. I am not at all offended—

Senator BAILEY (interposing). There is no reason to be offended. I want to know what your qualifications are.

Mr. FLYNN. Very good then. I am perfectly happy to give you that.

Senator BAILEY. All right.

Mr. FLYNN. I want to say, too, that I was connected with the committee when the committee was formed, and they organized an advisory council, made up of Dr. Hudson, Mr. Moffatt, and myself, and we acted merely as advisers of the committee on questions of policy and procedure and so forth. We held several sessions with them and wrote to them. And when it came time to prepare—

Senator BAILEY (interposing). What do you do?

Mr. FLYNN. I am going to give you that, Senator, and the quickest way is to give it without interruptions, if you will allow me to do it.

When it came time to prepare this bill they asked me if I would supervise the job, which I did.

Now, I have been for many years a writer on economic subjects for many leading magazines, such as Collier's Magazine, Harper's Magazine—

Senator BAILEY (interposing). Did you ever have any legislative experience?

Mr. FLYNN. I beg your pardon?

Senator BAILEY. Did you ever have any legislative experience?

Mr. FLYNN. None whatever, except in my early days as a newspaper reporter. I have had none whatever. Therefore, the first thing I did when I was asked to do this was to bring in various gentlemen who did have legislative experience. And I assembled the committee. And we got a couple of statisticians, expert statisticians, and an economist, and a lawyer, who was an expert in legislative law.

Senator BAILEY. Who was he?

Mr. FLYNN. Mr. Paul Kern, who is now the attorney for Mayor LaGuardia in New York. I mean, he is the mayor's legal adviser, and is also, I believe, the adviser for the mayor in connection with the board of estimate in connection with certain of their legislative matters.

Mr. Paul Kern and Mr. Harry N. Rosenfield, lawyers, both specialists in legislative drafting, assisted in that work. Prof. Horace Taylor, acting head of the economic department, Columbia University, Mr. A. J. Mertzke, an economist, Prof. Henry Pratt Fairchild, of New York University, sociologist, Mr. Louis Sherman, a statistician loaned by the Department of Labor, and Mr. Bernard Reis, a well-known public accountant of New York and an expert in income-tax



law and procedure, with a large office staff which he generously permitted to work on some of our problems, assisted in the work. I consulted others such as Mr. Nathaniel Peffer, an expert in international relations, on various aspects of the bill. I asked various economists, like Prof. Horace Taylor, of Columbia University, and others, to sit with us. And we spent many, many months on this subject.

As to my own qualifications I prefer somebody else to say what they are.

Senator GERRY. Haven't you had any business training whatsoever, Mr. Flynn?

Mr. FLYNN. None whatever. I have been a writer for many years, and I have been editor for a large newspaper in New York over many men in my employ.

The CHAIRMAN. What newspaper?

Mr. FLYNN. The New York Globe. I have never been a businessman.

Senator GERRY. You have been an editorial man?

Mr. FLYNN. An editorial man all my life.

For this reason I brought in experts on those subjects that I did not feel familiar with, and there was nothing I felt less familiar with than writing a legislative bill.

Senator GERRY. What businessmen did you bring in, purely economists?

Mr. FLYNN. I brought in a tax expert, Mr. Bernard Reis, a well-known accountant in New York City, an expert in tax law, who gave liberally of his time.

On the economic side, of course, I did not bring in any businessmen, but in the course of our investigations I invited a number of businessmen to my office in New York to discuss various features of the bill, particularly the features which had to do with the manner of making rates and collecting the taxes. And in that case we invited the comptrollers of a number of corporations, who very kindly came to my office and spent quite a little time discussing the measures of the bill with me.

Senator GERRY. How did you pick those men out?

Mr. FLYNN. We merely picked the comptrollers of some large corporations.

Senator COUZENS. Name some of them, for example.

Mr. FLYNN. For example, the Union Carbide Co., the Colt Arms, and I can furnish the committee the names of the men with whom we discussed this thing.

We also asked them for information about their rates of return during the last war, and so forth.

Now, I can say this to the committee, that there was no desire here in writing this bill to penalize men because they happened to be businessmen and happened to make large profits during a war.

It is also impossible to answer these questions without stating very briefly the fundamental principle which we arrived at as to the basis for the bill. And before I say that though I think it very important, Mr. Chairman, in reference to what Senator Gerry has asked. There are only 10 questions of these 15 which relate to the finance measure. The others relate to the other provisions of the bill. And I want to say that there is nothing in this bill, Senator,

which makes it effective during peacetime. I mean if there is, it certainly is not in there intentionally and ought to be taken out.

Senator GERRY. Now, what—

Mr. FLYNN (interposing). May I tell you what is in the bill, and I think perhaps I will make it clear. If there is anything in this present bill which makes it effective in peacetime, it is inadvertent and ought to be taken out.

There is a provision in the bill, which I think you referred to—

Senator GERRY (interposing). Yes.

Mr. FLYNN (continuing). Which provides that the bill shall come into operation only upon a declaration of war by Congress, and then only when Congress declares a major emergency exists as a result of that. You will find it in section 907 there.

Senator GERRY. I think I can turn to that.

Mr. FLYNN. I wish you would.

Senator GERRY. Because the section I was referring to Mr. Parker called attention to.

Mr. FLYNN. There may be somewhere in this bill some phrase which inadvertently does that, but it is not the intention of the bill.

Senator GERRY. I think it is page 229, is it not, section 512?

I have not had time to study this bill carefully, but I went over the testimony, and I want more information before I vote.

Mr. FLYNN. I am familiar with that section, Senator.

Senator GERRY. What you do here, it seems to me, and that is why I raised the question before, and the chairman of the subcommittee has raised it in the hearings, is that upon the declaration by Congress that a grave national emergency has arisen, owing to the imminence of a declaration of war, or owing to the existence of a state of war between two foreign powers, and now, of course, you have got that situation at the present time—

Mr. FLYNN (interposing). May I say something about that in answer to what you have said?

Senator GERRY. Let me finish. You have got that situation with Italy and Ethiopia at war, you have two foreign powers at war—you have a condition with Italy and Ethiopia at war where, if Congress declared a state of emergency existed, then this bill would go into effect although we were not at war.

Mr. FLYNN. Senator, may I say that if there clings to anybody's mind the belief that the President or Congress could declare an emergency now in peacetime it should be taken out of the bill. I think the committee all agree that nobody wants to give the President or Congress power to do these things except in time of war.

That was not in the bill when originally written. Criticism was made when the bill was written that it would come into effect immediately upon a declaration of war, and someone made the very just criticism, I think, that "immediately upon a declaration of war" might mean a war between the United States and Jamaica or the declaration of a war between the United States and Nicaragua, and conceivably an unscrupulous man in the Presidency, backed by an unscrupulous Congress, could declare war on Nicaragua and immediately put this bill in effect. So we changed the bill then to provide that it would come into effect only when Congress declared it to be in effect, and then only when war was declared by Congress, and not

merely that, but where Congress declared that the war was a national emergency.

I think that other section was written in there through an excess of caution to avoid something which came up at the time it was being discussed in the Military Affairs Committee. They said after all, here, you cannot do these things until the war breaks out, and taking the case of the last war, the war was brewing for some time and the Government would have been precluded from getting the advantage of the provisions for war when the declaration of war was imminent.

So far as I am concerned, I would gladly see those things come out of the bill.

Senator GERRY. May I ask—Mr. Parker called this to my attention—is not the trouble that the word “or” was used instead of “and”? Will you turn to page 229?

Mr. FLYNN. Yes; I have it.

Senator GERRY. For example, under the situation as it exists you might have two very small countries in any part of the world at war. You might have two South American countries at war, or Central American countries at war, and under the way this bill was written, if Congress passed it, some bill of this sort might get through, because it would not even have to be signed by the President.

The CHAIRMAN. Mr. Flynn, as I understand your proposition, you are in favor of these rates being applied after Congress has acted on them.

Mr. FLYNN. Yes.

The CHAIRMAN. And that will only happen actually when the United States is at war with some other country?

Mr. FLYNN. Certainly.

The CHAIRMAN. And if that is not fully contained in this bill, then you are willing that it be clarified?

Mr. FLYNN. Yes. I went all through this work with the Military Affairs Committee and the Munitions Committee, and I am perhaps able to tell you what was in the minds of those gentlemen. And if that is in the bill, it ought perhaps to be clarified, and there is no question about that.

Senator GERRY. Will you look at it? I raise this question because the constitutionality comes into that. Will you look at your bill on page 229 on line 22?

Mr. FLYNN. I think it should come out instead of being tinkered with. I think it should be written as we wrote it before it went to the Military Affairs Committee. And on page 245, section 806, it reads:

Except as otherwise provided herein, the provisions of this act shall become operative and in full force and effect immediately upon the declaration by Congress that a state of war exists between the United States and any foreign government and that the existence of such state of war creates a grave national emergency—

And that is all.

Senator CLARK. I want to say for the Munitions Committee concerning that matter that it was never the intention to put that in. This was put in in the Military Affairs Committee.

I was responsible for the original draft in the Munitions Committee myself. And I was afraid as the bill was originally presented that it made it automatically going into effect on a declaration of war, which would have had the effect in a conceivable case that the United States and Costa Rica could be at war, and this whole machinery would then go into effect. And it was, therefore, determined in the Munitions Committee that we would add to the requirement of the declaration of war the further requirement that Congress declared a state of emergency to exist as the result of war.

The CHAIRMAN. I think we understand this.

Senator GERRY. I am very glad to have your explanation.

Senator NYE. Mr. Chairman, you stated a question to Mr. Flynn, and he answered it. You asked if it was the intent of this bill to first declare a declaration of war, and that then if these rates of taxation were to be required they would have to be voted on by Congress; was that the question?

The CHAIRMAN. Yes.

Senator NYE. Is that true as respects these rates as well as these other titles?

Mr. FLYNN. Yes.

Senator NYE. It seems to me the tax rates go in effect automatically with the declaration of war.

Mr. FLYNN. No; they do not, Senator. It is only where war is declared and Congress declares a national emergency. Senator Clark brought that up in the Munitions Committee and we changed it at that time.

The CHAIRMAN. I think the committee understands what you are driving at.

Mr. FLYNN. I think that whole section 512 should be stricken out, Senator.

The CHAIRMAN. You take the first question up now, if you want to get away this afternoon, because the committee is going to have to adjourn and won't be able to have an afternoon session, as there is a bill over there on the floor in which the Senators are interested.

Mr. FLYNN. The first question is, Should the bill be designed so as to take the profit motive away from both the corporation and individual?

Of course, I do not believe that the profit motive should be taken away from either corporation or individual during war or at any other time. After all, we are in the capitalist economy, and you are not going to get anybody to operate without a profit. It is a question of just what profit a corporation would work for. And we thought a 3-percent profit, which would practically almost guarantee that to those essential industries, was enough.

Now, it is very important, Senator, in answering this question to make this distinction: There was no effort anywhere in this bill, I think, to try to limit the profits of corporations. When it came to the question of price fixing and all of those things we were a little hesitant for awhile, because we felt in time of war prices are changing, in spite of anything you can do, and the whole economic system is thrown out of gear. Certain materials become scarce and prices go up, and it is very difficult for corporations to estimate their costs. Therefore, you could not say that no corporation shall be permitted

to make more than 6 percent or 3 percent. We felt corporations and businessmen should be permitted to make their estimates for labor, material, and other things to meet changing conditions of the market, and let them make 10 percent, 20 percent, or any profit they might make. We felt, however, the profit having been made, it was the stockholder who was interested in the disposition of it afterward, and that the tax would be levied, of course, to impose on the dividend at the source, a heavy tax, in order to defray the expenses of the war. Therefore it was believed that the capitalist system would have to operate on a moderate profit during war and not to take the profit motive either from the individual or the corporation. I think you gentlemen may very well be concerned with what is a proper profit during war.

Senator CONNALLY. Now, no. 2?

Mr. FLYNN. Yes.

If the answer to issue 1 is in the negative, what maximum rates can be used without destroying the profit motive?

The CHAIRMAN. Your committee thought 3 per cent would be sufficient?

Mr. FLYNN. Our committee thought 3 percent would be sufficient. Let me say that the rates in this case were fixed by the Munitions Committee. They dictated what they thought the rates ought to be.

I believe I might also say the committee was pretty near in accord on those rates.

In the answer to no. 1, I have practically answered the second question. I think as long as you leave corporations free to operate in their actual management operations, to pay whatever price they have to pay in the hurry and haste of providing war materials, that what profit the stockholders get out of it afterward is not so important, except insofar as it involves financial business. And we considered that question very seriously, but the answer was more or less plain that in time of war very little private financing can be done, and that was recognized in the last war, in spite of our great prosperity and it was impossible for the war industries to finance themselves. And, therefore, they set up the War Finance Corporation for the purpose of providing money for the corporations engaged in necessary war operations to be financed. So we put into these other sections a War Finance Commission, a provision for a War Finance Commission.

I might also say that so far as these other sections are concerned the germ of them, or of most of them, was in the House bill.

Senator CONNALLY. We are not concerned with that, because they did not refer those to the subcommittee.

Mr. FLYNN. I was just telling you as to those.

The CHAIRMAN. Let us take the third question.

Mr. FLYNN. Yes. "Should the bill be designed to produce the maximum revenue possible, or should the social and economic effects of the bill be deemed more important?"

I think the bill should be designed to produce the maximum revenue possible, and I think the only effect to be concerned about is the economic effect, and not so much the social.

The CHAIRMAN. You would not want to destroy the economic or social system?

Mr. FLYNN. Certainly not. I think it is important, Senator, in answering that question to state that one of the reasons put down in the intentions of Congress was to protect the economic system. You will find that on page 5:

It is the intention of Congress to protect the economic organization.

Now, that is extremely important, I think, because, after all, a business can be destroyed in many ways, and one way is by inflation. And we feel that the whole problem of war profits arose out of the effect of war inflation. Wars in the past have always been fought with borrowed funds, and since the invention and development of the modern banking system, largely with central-bank funds, or bank funds made available by central-bank authority. And so in the last war we spent \$33,000,000,000 but we raised \$22,000,000,000 of it in taxes, and that \$22,000,000,000 went into the war industries. And when it goes into the war industries, it does not stay in the war industries. The people who work in the war industries make their own disposition of the funds they receive, of the profits, and their wages. Of course, they do not spend them on war measures. They spend them on peacetime industries. And this gives the peacetime industry a tremendous artificial and unwholesome prosperity, a prosperity had not only for the economic system but it is also bad for the Government, because it produces in wartime and in peacetime luxury industries, conditions which run up the prices of everything. Therefore, what we had in mind, Senator, was to try to protect the economic system itself from maladjustments due to war inflation, so that when the war was over the Nation would not then sink down into the disorganization and the inevitable deflation which must follow. In many industries which enjoyed great prosperity they were completely wiped out when the war was over. It was due to short-sightedness of trying to make as much money from the war as possible.

While certain men tried to profit during the last war and were guilty, on the whole I do not think the great number of businessmen or citizens can be accused of that. One man wants to make a lot of money out of the war, and he charges big prices, and his labor charges big prices, and the laborers in another factory hear about it, and they want more money, and presently the whole thing is thrown out of gear by the greed of the first men. We think this will protect that situation.

The CHAIRMAN. What do you say about the fourth question?

Mr. FLYNN. Let me add just one word about producing the most possible revenue. Mr. Parker has made some suggestions that the rates are too low in the lower brackets. A man getting \$5,000 only pays \$360. This compares with the present peacetime English tax as quite low. I am inclined, myself, to agree with that, but I think it would be better to pass the bill as it is now, and when a war breaks out, Congress always has the right to raise these rates. Of course the principle is to establish the matter of paying for war during its duration, and not out of borrowed funds. And of course you will have to depend on a high tax on moderate incomes to pay for a war.

Senator CONNALLY. Suppose we say that no man draws over \$20,000, the result would be that a corporation would not pay him any more.

Mr. FLYNN. That is correct. But they would have it in profit. Of course they can do it either way. That would be up to the corporation.

Senator CONNALLY. I understand.

Mr. FLYNN. But by limiting the income to \$20,000 you get it either by taxing the income or the salary. Then we felt high taxation was necessary. The committee agreed on that. The theory was not to punish these men. You take the young men, not because they are young men, but the old men are not able to fight, and they are the fighting material, the men of strength, and you have to get the cost of war from the older men who have the money to pay for it.

The next question is: "Is it sound to adopt the general principle that the most important thing in connection with war legislation is 'to win the war'?"

Of course, Mr. Chairman, I do not see how to answer that question by anything other than yes. We might all be opposed to war, but once we get into war I do not see how anybody can have any any other thought than that we want to win it.

The CHAIRMAN. We will all agree on that.

Mr. FLYNN. We will all agree on that without any discussion.

I would like to say this, that I had numerous conferences with the representatives of the War Department, and with the representatives of the Navy Department over the provisions of the bill after we had drawn them tentatively, and that we made many changes based on points indicated by the War Department or Navy Department as to things in the original bill which they thought perhaps would interfere with the efficiency of the economic machine during the war.

The CHAIRMAN. It may be that there are some of those questions which you want to skip over.

Senator BAILEY. Do you mean that the Army and Navy Departments endorse this bill?

Mr. FLYNN. Colonel Harris of the Army, the War Department, and Commander—somebody from the Navy Department, I cannot remember his name—both came before the Military Affairs Committee and said they had had these conferences with a representative of the Munitions Committee, and that as a result of them that various changes had been made, and while some of the things in the bill which were matters of detail they perhaps might not agree on, that so far as all of the provisions of the bill, except the tax provisions of the bill, which they did not presume to pass on, they felt they ought not to interfere in that, with one exception that they waived, they were in favor of the passage of the bill.

Senator CONNALLY. Those are the titles we are not passing on.

Mr. FLYNN. I am just answering the Senator's question.

Should the bill be designed to tax net income only, or should limitations be imposed on the deductions of necessary business expenses with the result that the tax rate may apply to a figure greater than true net income?"

In order that the members of the committee may understand, that has relation to certain provisions in the bill which were designed to prevent corporations from charging off too much in the way of depreciation and depletion, and perhaps cutting down their expenses by charging big salaries and spending huge amounts on promotion

and advertising, as they did during the last war. I remember during the last war I was city editor of a newspaper, and as soon as the tax rates went into effect I began to see great two-page advertisements come in from various corporations, and they began to pay big salaries, and felt they would rather dissipate it that way than to give it to the Government.

Senator BAILEY. Just on that point, I think the last war did make the American newspapers rich. Do you propose to tax the newspapers?

Mr. FLYNN. I did not get that, Senator.

Senator BAILEY. You spoke of the doubling up the advertising with the application of excess taxes.

Mr. FLYNN. Yes; to escape excess taxes.

Senator BAILEY. As to advertising?

Mr. FLYNN. Yes, sir.

Senator BAILEY. In order to avoid tax liability that happened?

Mr. FLYNN. Yes, sir.

Senator BAILEY. On a very great scale?

Mr. FLYNN. Oh, very. That was only one portion of it.

Senator BAILEY. Do you propose to put a tax on newspapers?

Mr. FLYNN. Newspapers are like any other corporation.

Senator CLARK. They come in as part of the general subject.

Mr. FLYNN. Yes; but we have put in a provision to attempt to limit that, because, after all, the sums of money paid into a newspaper are dissipated among the employees, and we put in a provision borrowed from the State of New York law. New York State has a law that a corporation can only charge for officers' salaries up to \$5,000. They can pay as much as they want, but they can only charge as an expense for the salaries of presidents and certain vice presidents, who own more than 1 percent of stock, who have salaries of any kind, they can only charge off as an expense in their income accounts \$5,000 each. Now, we put that provision in here because it would act as a limitation on paying out large salaries in order to escape certain portions of the tax.

Senator BAILEY. You did not get my question.

Mr. FLYNN. I am coming to it. I want the members of the committee to understand what this question refers to.

We also tried to prevent this dissipation of profits in promotion and advertising.

I am sorry Senator Capper is not here. He might have some views on this.

The CHAIRMAN. He might not agree with you.

Mr. FLYNN. But by limiting them they could charge off as an expense in their income account for advertising cost and promotional cost only the average of the 3 years preceding the war, which seems to me would be quite fair.

Senator BAILEY. Do you intend to bring your newspapers within your 3-percent limit?

Mr. FLYNN. There is no question about that. They are brought within that, too.

Mr. Parker raised the question, and I think the Treasury raised it, and with some degree of reason, that perhaps it was not wise to introduce into the bill any of these protective clauses against evasion, but to adopt in whole those protective clauses in the existing revenue law.



Senator BAILEY. I did not get your reference to Senator Capper. Why was that remark?

Mr. FLYNN. I wanted him to hear it. I said that Senator Capper would probably be interested in that statement.

Senator BAILEY. He is a newspaperman?

Mr. FLYNN. And I am, too, Senator. In a sense I was perhaps one of the beneficiaries of this, except that I was a salaried man during the last war, and I never saw any of it during the war.

Senator GERRY. You were not in advertising?

Mr. FLYNN. No; I was not in advertising. I was the plain city editor, and my salary never stirred.

I might say that the publisher of that paper incorporated and unincorporated as the tax laws changed in order to get the benefit of the individual taxes, and so forth. And it is true that wages very much lagged behind the salaries of executives entirely through the war, and proofs will be found as to that if you are interested in a study of war profits.

I want the committee to understand that I think as to what Mr. Parker and the Treasury are referring there is a great deal in what they say. In fact, I want to say that I have read with great care the statements of both Mr. Brown and Mr. Parker before this committee, and they were very fair statements, and I believe with most of what they have recommended I would be heartily in accord.

You see what Mr. Parker is driving at, and very plainly, if you will read his report. This bill, which seems so large, is large only because it takes the Revenue Act of 1934 and introduces into it the new rates and then adds a few protective clauses against evasion, because we felt that with these very high and drastic rates the temptation to evasion would be greater. We tried to tighten up the bill, but I think this committee may very well consider Mr. Parker's point, necessarily to leave these questions of depreciation and depletion and exhaustion and these salary and promotion charges out, and merely adopt the protective clauses of the bill of 1934 or 1935 if the committee chooses, and then as the years go by, 4 or 5 years—let us hope 10 or 20 years—before we are in war, as the Treasury Department perfects its tax provisions under the income-tax laws, let the bill get the benefit from time to time by amendment.

I am trying to answer this question 5, and I am pointing out the things to which it pertains.

The CHAIRMAN. That answer pertains largely to question 6?

Mr. FLYNN (reading):

Should the bill attempt to correct possible defects and to close possible loopholes in existing law when such defects or loopholes are a present problem not directly connected with war-revenue legislation?

I have answered them both, because question 5 refers to that.

Senator CONNALLY. You have answered 6 in your former statement there?

Mr. FLYNN. Yes; one refers to depreciation and the other also.

Senator BAILEY. Let me ask you a question. Suppose I was an owner of a newspaper, and that I borrowed some money during the war, and my profits were limited to 3-percent interest, then the charges always go up during the war?

Mr. FLYNN. Yes, sir.

Senator BAILEY. Suppose the interest was 5 or 6 percent, how would I ever pay my debt?

Mr. FLYNN. Interest is a legitimate charge-off as cost as a deduction in an income-tax statement.

Senator BAILEY. I could charge that in there?

Mr. FLYNN. Of course.

The CHAIRMAN. What you mean is 3-percent profit?

Mr. FLYNN. I mean 3-percent profit. And, by the way, Senator, I think this Finance Committee should hear this, because these questions came up in other committees. This tax law is so framed that the highest salary any man could keep after all taxes would be paid would be \$10,000, approximately \$9,900 and some odd. And the question arose, How will a man pay his insurance? Many men commit their savings to insurance. And that was a very fair question, because in the case of insurance a man who when the war breaks out is 55 years of age, and who has gotten his insurance years before, is enjoying a rate which he got by virtue of taking care of this problem early in life. And then the war breaks out and continues for some time, and when the war is over he cannot get insured again because he has let his premiums lapse and he is now broken in health, perhaps, and the rate is so high he cannot afford to pay it, and we tried to take care of that problem.

Senator BAILEY. You allow him enough to keep up his insurance, is that right?

Mr. FLYNN. I would have to qualify the answer. We put in here a provision, first of all, giving insurance companies great exemptions in taxation in return for writing into policies the provision—

Senator BAILEY (interposing). Suppose a man's premiums are \$50,000 a year, and you are limiting his salary to \$20,000, how would he pay his premiums?

Mr. FLYNN. Senator, if you will permit me I can answer that question.

Senator BAILEY. I will allow you to.

Mr. FLYNN. I have a limited time. If you want to hear the whole answer I am perfectly willing to stay here all day, but the other Senators cannot stay.

We did two things as to that. First, we provided that the insurance company should get tax privileges if they write into the policies of men that no insurance policy would lapse during the war, so that this man at the end of the war, if he could not meet his insurance policies during the war, could resume it at the old rate. And we took that up with one or two insurance presidents, and they said they thought that was quite reasonable.

And the other provision was that a man be allowed a deduction of \$5,000 for insurance.

Senator BAILEY. You contemplate the lapse of those policies?

Mr. FLYNN. No; we want to prevent that. We allow a man to write in as a deduction in his income an amount up to \$5,000 for insurance premiums. Then if he has to pay more than that on the balance of that policy and the policy is expired during the war for lack of payment of the policy it can be resumed immediately after the war at the old rate.

Senator BAILEY. I get you. The insurance company has to run on his income. The income is suspended—is that right?

Mr. FLYNN. I did not understand that sentence, Senator.

Senator BAILEY. The income from premiums is really suspended?

Mr. FLYNN. During the war?

Senator BAILEY. Yes.

Mr. FLYNN. Only on very large premiums over \$5,000.

Senator BAILEY. That is a very considerable sum in this country.

Mr. FLYNN. We took it up with the presidents of two insurance companies and they were in favor of it.

Senator BAILEY. On 6-percent stocks with a 3-percent profit, how would you pay 6-percent dividends?

Mr. FLYNN. Nobody is going to be allowed to get 6-percent dividends during the war.

Senator BAILEY. Then all 6-percent preferred stocks would go down to 3 percent; is that right? They have an obligation to do that, and then the common will get nothing; is not that a fact?

Senator CONNALLY. Mr. Chairman, I beg your pardon for interrupting, but I am compelled to go to the floor of the Senate, and if the committee wants to go on this afternoon, why, of course, then I can be here.

The CHAIRMAN. We will proceed along now for a while.

Senator CONNALLY. And I want to say that I want the committee clerk to call a meeting of the subcommittee, if this committee finishes today, for in the morning at 10:30.

The CHAIRMAN. Do you want a full committee meeting in the morning?

Senator CONNALLY. I would like to have one, but I do not want to impose a hardship on anyone.

The CHAIRMAN. Suppose the full committee meets tomorrow morning at 10 o'clock, and then we will get through and the subcommittee can then meet.

Senator CONNALLY. That is perfectly all right.

The CHAIRMAN. And now we will proceed for your convenience.

Mr. FLYNN. On this question it seems a preferred stock is a contract between the corporation and the stockholder.

Senator BAILEY. It is a contract only to the extent of the performance.

Mr. FLYNN. It is a contract if they have the earnings.

Senator BAILEY. It is not a contract if they have the earnings.

Mr. FLYNN. They will have the earnings under this bill.

Senator BAILEY. There is not any contract to pay it.

Mr. FLYNN. Senator, you misunderstood my answer. I say it is a contract by the corporation if they have the earnings to pay it.

Senator BAILEY. It does not have to pay it. There is not anything written on a preferred-stock certificate requiring payment if they have the earnings. The requirement is that the preferred should be paid prior to the common.

The CHAIRMAN. All right; proceed, Mr. Flynn.

Mr. FLYNN. Senator, I think this is a point which ought to be straightened out. If you permit 6 percent or 5 percent, or whatever the preferred-stock dividend may be, to be charged as a cost and deducted from earnings, then, of course, you open the door to all stocks in anticipation of war being converted into preferred stock, and you will defeat the provisions of the bill.

Senator BAILEY. You would hold the preferred stocks down to 3 percent?

Mr. FLYNN. Yes; hold the preferred stocks down to 3 percent, and, on the other hand, if the preferred should get the whole 6 percent, there would not be anything for the common.

Senator BAILEY. And in that event the common stock would not get anything then.

Mr. FLYNN. If the common stock has not got anything coming after 3 percent, of course, that would be the rule under any circumstances.

Senator BAILEY. Then you limit yourself to 3 percent on the preferred stock, and nothing on the balance, or otherwise there would be an accumulation of surplus under our new tax bill?

Mr. FLYNN. I would not do that.

Senator BAILEY. You would tax that surplus?

Mr. FLYNN. No. I would say that the preferred stocks get a share only to the extent of 3 percent of the earnings, but the earnings ought to be sufficient to cover both the common stock and the preferred under that rule.

Senator BAILEY. You limit them to 3 percent?

Mr. FLYNN. No; we do not limit them. We merely tax that in such a way—

Senator BAILEY (interposing). I understand. The intention is to tax.

Mr. FLYNN. We start out—

Senator BAILEY (interposing). The obligation in the certificate is to the effect that nothing shall be paid to the common until the preferred has been paid, and therefore the common would get nothing. Now, assume that would leave a surplus undisturbed. Under the new tax law we would take that?

Mr. FLYNN. Senator, there is no disposition in this bill to deprive the common of the 3-percent profit. Therefore, I see no objection to writing into this bill a provision where there is this contract between the preferred stockholder and the corporation, a provision that on all preferred stocks which have been in existence for a certain period before the war—I mean so as to remove them from a period of suspicion—that the preferred dividend might be paid. But that on all preferred stocks issued within a certain period of time before the war is declared this should not be paid, and that they should take their share along with the 3 percent.

Senator BAILEY. Then, if the preferred stocks should go to 140 or 150 under those circumstances they would lose money?

Mr. FLYNN. What they might go to, I should think, would not be the concern of this committee.

Senator BAILEY. Oh, yes. We are not here to make anybody rich, but we are trying to make them poor.

Mr. FLYNN. What we are trying to do is to provide sufficient revenue to pay for the war as we fight it and prevent anybody enriching themselves out of war. You will never succeed 100 percent in doing that.

If you have certain contractual relationships between the corporations and their stockholders, I think you have to consider them, and that this Government has no right to declare those contracts void. Has it?

Senator BAILEY. Yes; I think so. I think the doctrine is that the United States has a right to void a contract, but no State has. I believe that has been the decisions of the Supreme Court in the last few years. I do not think that is going to last. There is a moral question there that will assert itself in due season.

Mr. FLYNN. I deal with a subject as one involving a contract between a corporation and a preferred stockholder, which contract has been made at a time not suspicious and well in advance of the war.

Senator BAILEY. Let us assume that under this law the preferred stock could be paid a dividend and the common stock could not during a war. Then all stocks in the hands of the people would be preferred stocks, because they are going to get their 6 percent.

Mr. FLYNN. I have no fear under a bill like this of creating any stock, preferred or any other kind, during a war.

Senator BAILEY. If you are going to let them have 6 percent, that is the effect of it.

Mr. FLYNN. No; not at all, because I specifically stated this was 6 percent at a time not suspicious, say 6 months before the declaration of war.

Senator BAILEY. You do that in this bill.

Mr. FLYNN. I do not think corporations would try to commit themselves to 6-percent dividends. The tendency of the corporations is to rid themselves of these dividends.

Senator BAILEY. I think you misunderstand the fact that a corporation on preferred 6-percent stock simply commits itself to pay 6 percent in preference to the common stock. It is not a commitment at all.

Mr. FLYNN. Yes; but unless the corporation is going to pay the 6 percent on the stock there will be no point in people buying 6-percent stock.

Senator BAILEY. Now, just get me on this. Under the situation you have produced here there would be only one certainty in corporations, and that would be the 6-percent preferred stock. There would be nothing for the common. That would be the only way for an investor to have a chance to get the 6 percent, and therefore all investors would demand preferred stock.

Mr. FLYNN. Senator, I cannot agree with that. I think the question you are raising is an important one.

Senator WALSH. Did I understand you to say the maximum income anybody would receive is \$10,000?

Mr. FLYNN. The maximum income after all taxes paid with all deductions. A man might have tax-exempt bonds, and he will be able to charge for his State taxes, city taxes, and his \$5,000 of insurance, but after all taxes are paid the maximum income would be \$10,000.

Senator WALSH. Had you thought about the effect that would have on the large number of persons employed as servants on estates?

Mr. FLYNN. Yes; we thought it might be inconvenient. During the last war servants disappeared into munitions factories, where they were demanded and were needed, and we felt that was an inconvenience that would affect a small number of people, and was not to be compared with the inconvenience brought upon millions of people who were sent into the Army.

Senator CLARK. As a matter of fact, these people who have these large estates usually have very large reserves.

Mr. FLYNN. Yes, sir.

Senator WALSH. I was thinking about unemployment.

Mr. FLYNN. You do not have to think of unemployment during a war. During the last war people moved off of estates, and the servants who were hired got better wages in the factories than they could on the estates.

Senator WALSH. Do you think that is true of nurses?

Mr. FLYNN. I was in New Haven during the war, and even ministers' wives went to work in the munitions factories.

Senator WALSH. Have you really looked up to see how many people were employed in the munitions factories during the war?

Mr. FLYNN. Yes, sir. I have got it with me now.

Senator BAILEY. I would like to get the number. Have you the average?

Mr. FLYNN. They went not merely into munitions factories but they went into all kinds of other factories. It was competition between peacetime and wartime industries which made wages high in the munitions factories, and so they went into not merely munitions factories but in all kinds of factories. And the records of employment show that employment during the war was in excess of what is known as the normal employable population, because a very large number of people went to work during the war--men's wives and children out of school, who ordinarily are not considered a part of the employable population.

And I think, Senator, that a \$10,000 man can employ a servant or two.

Senator WALSH. Does the \$10,000 apply to those who have tax-exempt securities?

Mr. FLYNN. Oh, no.

Senator WALSH. So that everybody who has money invested in tax-exempt securities would not be reached by this law?

Mr. FLYNN. We did not feel that under the existing laws we could do anything about it.

Senator WALSH. I understand your difficulty, and something should be done about it.

Mr. FLYNN. Senator Vandenberg was most anxious about that. We worked on it. And as long as you have the tax exemptions, of course, we are quite helpless.

The CHAIRMAN. All right, Mr. Flynn, you may proceed.

Mr. FLYNN (reading):

Should the rather low taxes proposed in the bill on the individual with a modest net income be increased so as to secure more revenue?

Mr. Parker raises this question. You see, this is not a soak-the-rich matter purely. We have taxed people who get as low as \$500. A man who pays nothing now, a man who gets an income of \$2,000 will pay \$60 under this law.

Senator BAILEY. Your principle being one of conscripting property; that if we are to conscript men, you could take the property?

Mr. FLYNN. We are not talking about conscripting property. We are talking about taxes.

Senator BAILEY. That is the same thing.

Mr. FLYNN. No. There is another provision of the bill as to that. Senator BAILEY. Then you would take the small man's property just the same as you would the big man's?

Mr. FLYNN. There is no question about that. And the taxes are quite drastic compared with the present taxes, and I personally have no objection to raising the figure in the lower brackets.

Senator BAILEY. And you would reduce the exemptions of the small income?

Mr. FLYNN. Yes, sir; they are also reduced.

Senator BAILEY. The whole principle is to take a father's property just like you take charge of the young man to go to war to take his life, and there is no profit to be made from the property. I would not give anything for property without profit.

Mr. FLYNN. I think, Senator, many men in periods of depression hold on to their property very zealously, although they are making no profit.

Senator BAILEY. Of course, he is looking for profits, to be sure.

Mr. FLYNN. During the war it is proposed that the people who stay at home, and who do not go into the war, shall pay for it.

Senator BAILEY. Let us apply that to a farmer down in my State. During the war cotton went from 1 or 2 cents a pound, or just shortly after that, until they got \$200 a bale, and a farmer with his two-horse crop has at least 20 bales, and that is \$4,000. You would take his profit just as you would anyone else's?

Mr. FLYNN. Senator, we take the profit of every man in this bill who makes a profit, but do not take it all. Basing it on the income of a man who makes \$6,000, he would pay \$500, and that applies to a farmer, a man with a salary, a bank president, or a corporation chairman of the board.

Senator WALSH. Or a Senator?

Mr. FLYNN. Or a Senator. In fact, that question came up. A Senator would have to pay \$2,640; that is to say, he would have to pay the same income tax as anybody else after he had gotten all his deductions.

I am one of those hit rather well by this bill. I am not a man with a huge income, but I have a fair income, and it would hit me severely. I have no objection. I would much rather pay a large amount of my income than to see my 23-year-old son taken and shot down for any cause that I did not believe to be a good cause.

People do not apparently object when a man comes and knocks on the door and says, "I want that boy." He may be getting \$5,000 a year as a salary. He just has to pass up his \$5,000. And they put him in the Army at \$30 a month. But if they come to me and say, "You are getting \$5,000 a year and we want you to give \$340," I say you are taking my profit. All right. You can take my boy, but not my profit. I do not sympathize with that viewpoint.

Senator BAILEY. I do not see the justice of exempting \$10,000. Why not take it all?

Mr. FLYNN. But the people remaining at home at least have to go on living.

Senator BAILEY. And the boy gets \$30 a month and gets his clothes, and we can figure up how much that is.

Mr. FLYNN. He gets his clothes as long as he needs them.

Senator BAILEY. Why not put it on the same basis for all? Let us be fair about it.

Mr. FLYNN. I do not think that would be fair. Do you?

Senator BAILEY. I am asking you the question.

Mr. FLYNN. Would you be in favor of it?

Senator BAILEY. Let us get an answer to that question.

Mr. FLYNN. Let us not discuss it if neither one of us believe it is fair.

Senator BAILEY. Do not ask me questions. I am asking you for information.

Mr. FLYNN. Senator, you could not do that without the destruction of the entire economic system.

Senator BAILEY. So your bill will not work out all the way through?

Mr. FLYNN. What do you mean my bill will not work out all the way through?

Senator BAILEY. As to the proposition of stopping profits.

Mr. FLYNN. Senator, I stated my view. Why take the money if you do not need it to fight the war? The idea is to get the money to pay for the war. The bill now takes everything except \$10,000. Why take all of the \$10,000 away from the man and leave him \$30 because the country does not need that?

Senator BAILEY. You began the argument by stating that a man would come to the door and take the boy out.

Mr. FLYNN. Yes, sir.

Senator BAILEY. Therefore, you take the income and the property. I do not see why you should stop short. I do not see why you should not state to the United States Senator, "Now, we are taking this young man to war, and he has got a \$5,000 income, and he has got a wife, but we need him." And we deprive him of his income and give him \$30 a month. Why not treat the Senator the same way?

Mr. FLYNN. I will try to answer your questions.

Senator BAILEY. Just state what you think.

Mr. FLYNN. Senator, please let me answer the question.

The CHAIRMAN. You can answer.

Mr. FLYNN. You need an army of 1,000,000 men or 2,000,000 men, and the War Department decides to conscript them and makes them register, and you take the men from 25 up to 30, and you have got all the men you need for the Army. And you do not go around to the men from 30 to 35 and from 35 to 40 and say, "We are going to take you, although we don't need you, just so we will let everybody get the same dose", so you will go to the man who has an income of four or five thousand dollars a year and say, "We need \$4,000,000,000 to fight this war. It will be obtained in this way: We will, therefore, ask you to give us \$360 out of \$5,000, and \$2,400 out of your \$10,000."

Senator BAILEY. That does not put him on an equality with the soldier.

Mr. FLYNN. I am not trying to put him on an equality with the soldier, Senator. You cannot. Even if you took everything and paid him \$30 a month you would not put him on an equality. But you do not shoot him.

Senator BAILEY. You do not shoot all of the soldiers.

Mr. FLYNN. You shoot a lot of them.



Senator BAILEY. You do not shoot a lot of soldiers.

Mr. FLYNN. Senator, I think you are raising a question—

Senator BAILEY (interposing). I do not want to embarrass you.

Mr. FLYNN. I am not embarrassed in the least.

Senator BAILEY. You say that you were in favor of putting Senators down on the same basis as soldiers, and that includes Congress, and why make a distinction between Senators and people out in middle life?

Mr. FLYNN. I did not say that.

Senator BAILEY. You said you would put them down on the same basis as soldiers.

Mr. FLYNN. I did not say that, Senator.

Senator BAILEY. The record can be read.

Mr. FLYNN. If I said that, I certainly want to say that I did not mean to say it, and I do not believe I said it.

Senator WALSH (acting chairman). May we take up question 8, if you are through with your colloquy?

Mr. FLYNN. "Is it constitutional to tax gifts as income, as indicated by the bill?"

I do not know. I cannot answer that question. I am not a lawyer. We were advised by lawyers, who assisted in this, it was constitutional. We were advised by Mr. Parker and Mr. Brown then that there was a question about it. If there is a question then take it out of the bill and tax them as we do now.

Senator WALSH. The next is question 9.

Mr. FLYNN (reading):

Is it constitutional to require the filing of joint returns by husband and wife as proposed in the bill, such a provision affecting the present community property system?

That is a question of law, on which I have no capacity whatever to answer. I would tax them if the lawyers say it is that way, if the lawyers say it is constitutional. If they believe it is unconstitutional I would most certainly leave it out of the bill.

Senator WALSH. Question 10, please.

Mr. FLYNN (reading):

The bill taxes all gains from the sale of capital assets, but disallows all losses from such sales, except to the extent of \$2,000—that is, if a man has \$50,000 of gain from the sale of capital assets and in the same year has \$80,000 of losses from such sales, the bill proposes to tax the man on \$48,000, regardless of the fact that he had a net loss of \$30,000. Is this a sound policy?

Senator, one of the things we had in mind in the bill was to discourage speculation of all kinds in securities, as well as in commodities. Nothing, it seems to me, during a time of war, so disrupts your system and adds to inflation as speculation in commodities. We saw it begin in England only the other day, when they had a man convicted in England, Mr. Howson, known as the Tin King, because he had begun speculation in shellac, shellac being an important ingredient in the manufacture of shells. He went out to get a corner on shellac. There are men who will do that. I do not believe all the businessmen in America will do that, but there are men who will do that. We believe during the war there should be no speculation. That was put in there for that purpose. Whether there is any question as to its legality or constitutionality I do not know.

Senator CLARK. So far as the constitutionality is concerned, I may say that that very provision is in the laws in my State now and has been upheld.

Senator BAILEY. You mean in your State?

Senator CLARK. In our State; yes.

Senator BAILEY. We bring this within the amendment of the Constitution to tax incomes?

Senator CLARK. Yes, sir.

Senator BAILEY. And incomes are defined as gains, and gains against losses. Income means income.

Mr. FLYNN. Yes. The question was raised under the sixteenth amendment as to whether it was unconstitutional.

Senator BAILEY. The Supreme Court has held it meant net income. And if it does, of course, you deduct your losses.

Mr. FLYNN. Senator, a man goes into various transactions and buys stock in the United States Steel Corporation, and he buys stock in the Union Carbide Co., and the Steel Corporation has a loss during the year of several million dollars, and therefore that stock makes no profit, but the stock in the Union Carbide Co. makes a very large profit and he gets a large dividend from it. He is not allowed to offset the loss in the Steel Corporation against his profits in the Carbide Co.

Senator BAILEY. He might lose his fortune in one company.

Mr. FLYNN. He might do that, and make very little in another company.

Senator BAILEY. And he has to pay taxes on that amount he made in the other company?

Mr. FLYNN. Yes; he is not allowed to offset.

Senator BAILEY. You need not trouble yourself about that United States Constitution amendment which says "income." It does not say "losses."

Mr. FLYNN. Senator, I am not talking about the Constitution. I do not feel that I am able to do it.

Senator CLARK. It also says "income from whatever source." It does not say anything about setting up an income from other sources.

Mr. FLYNN. We also tax a prize fighter. I believe he has to pay immediately on that particular venture. He may engage in another prize fight 6 months hence and lose money. I may be wrong, but I think that is the law. Of course, that is on amusement ventures. Is that right, Mr. Parker?

Mr. PARKER. They do collect it in advance, but he would have a right to file a return and get a refund.

Mr. FLYNN. He would be allowed to offset the two?

Senator WALSH. May I ask you a general question, Mr. Flynn? I understood that you and your associates were engaged in trying to draft a bill as to property as well as human life, and also had in mind levying sufficient taxes to help pay for any war.

Mr. FLYNN. Yes, sir.

Senator WALSH. And one of the things by which you were motivated was something that might be a deterrent in going to war?

Mr. FLYNN. We were motivated very considerably by that, Senator. We feel men do a great deal of thinking with their unconscious minds. And when this bill was being prepared there was a great deal of talk around this country, and some of it may have

been irresponsible, but I heard it from very responsible men, that maybe we would have to fight our way out, that there would be a war. And that statement came from one of the most distinguished men in New York.

Senator WALSH. You have answered my question?

Mr. FLYNN. Yes, sir.

Senator WALSH. You hope this bill will tend to discourage war?

Mr. FLYNN. Yes, sir; discourage it.

Senator WALSH. And check sentiment developing for a war, and prevent Congress from going into war?

Mr. FLYNN. We want people to stop thinking that war might lead to prosperity.

Senator WALSH. Are there any other questions?

Senator CLARK. And many people who are now shouting that war is inevitable with this, that, and the other country might decide that it was not if the profits were taken out of war?

Mr. FLYNN. Yes; that is right.

As to these other questions, they relate to other sections of the bill.

Senator LA FOLLETTE. Just a moment, Mr. Flynn. As I understand, it is your position, is it not, that regardless of whether a war comes or not that this is the sound method of financing it?

Mr. FLYNN. That is correct, Senator.

Senator LA FOLLETTE. In other words, that the rates in this bill, or the motivation behind this bill, is not dictated by a desire to prevent war, but it is dictated by the proposition that if we are in a war this is the sound way to conduct the financing of it?

Mr. FLYNN. That is correct. And I would like to add to that a sentence on two questions which have been asked here.

Mr. Parker has raised a question, which I am disposed to concur in to some extent. He says he thinks the rates in this bill will not be adequate to pay the costs of a war, and I am disposed to think that is true. I think it is very true when you put taxes on these higher brackets in many cases incomes will not materialize, and then you will have to turn to the lower brackets for the money. I also think it is true that when a war breaks out if the taxes are not adequate you may have to turn to various luxury taxes and sales of various kinds, because during a war you must get the money. But whatever you do the fundamental proposition at the bottom of the whole bill is that the war ought not to be fought with funds borrowed through the central banks, and it should be fought with money put up by the people at home for fighting the war. The fundamental concept of that is that if you fight a war with borrowed funds you produce a spurious prosperity, and the war then becomes a source of prosperity to the people.

Senator BAILEY. On that point, as a practical question, suppose we had to fight a war tomorrow; do you assume the American people have got the funds available to fight the war?

Mr. FLYNN. I think they certainly have the funds to get started, Senator. I think out of an income of \$50,000,000,000 they could find four or five billion dollars to fight a war with for some time. Of course, it would be a very hard thing. The point of this bill is to get away from the thought that war economically is a good thing. Of course, it is a sacrificial episode, and somebody must pay for the war, either the generation who fights the war or the next generation.

Of course, the Government may have to make some initial loans until funds begin to flow in from the war-profits bill. And it may be that no kind of war-profit taxation will provide enough, and the Government will have to do some borrowing, but we believe we should make the effort, as far as possible, to prevent that, at least to hold it down to the very minimum.

Senator LA FOLLETTE. One other question, Mr. Flynn. Looking back on the experience of the World War, is it not a fact that the delay in enacting wartime tax legislation was very great, and that therefore a great deal of revenue, which otherwise would have been attained, even under the relative low rates of the war-tax bill, escaped paying any war-profits tax?

Mr. FLYNN. There is no doubt about that.

Senator LA FOLLETTE. And is not there a justification in that experience for the enactment of this legislation as the foundation upon which any war revenue would be raised?

Mr. FLYNN. Precisely.

Senator LA FOLLETTE. And that to that extent you would have prevented the large amounts of profits from escaping their fair share of wartime taxation, simply due to the fact that Congress would take a number of months, or a long period, before it enacted any wartime legislation? And, as a matter of fact, the highest rates were provided in the 1918 revenue bill, and the war ended in November after that bill was enacted.

Mr. FLYNN. It was not until the war was nearly over.

Senator GERRY. I would like to say this in that connection, because I was a member of the Finance Committee when the war commenced, and we enacted the first revenue bill, and my recollection is we passed that bill in the summer, did we not, Mr. Parker?

Mr. PARKER. The 1918 act?

Senator GERRY. The 1917 act.

Mr. PARKER. You passed one in March, but that did not amount to much.

Senator GERRY. That was before the war?

Mr. PARKER. The next one was on October 3, 1917.

Senator GERRY. And then we put the heavy income tax on, because I remember I put the amendment in which went to about 65 percent in the higher brackets?

Mr. PARKER. Yes, sir.

Senator GERRY. And that, plus State income taxes, put some large incomes at 70 percent or more. I know, because I introduced that amendment, as I said.

Mr. PARKER. Yes, sir.

Senator GERRY. And then we put an excess-profits tax on.

Mr. PARKER. Yes, sir.

Senator GERRY. And we paid over 29 percent of the cost of the war, which was higher than any other country. Great Britain has always paid as much as she thought she could, and we paid more. I think that is correct, too, Mr. Parker.

Senator LA FOLLETTE. The British rates were higher than ours.

Senator GERRY. The British rates when we got through were not.

What I am trying to show is that while I am not saying we have not learned, I think that the original war-revenue bill was a great achievement, and a great credit to the Democratic Administration

and to President Wilson, for the way we put the taxes on and tried to take the great profits out of war. Of course, we have learned by experience we did not succeed entirely.

Senator LA FOLLETTE. You will remember that the rates which my father offered were much higher and were defeated.

Of course, that is a matter of history, and all I am trying to say is that the long delay after we got into the war, before we got our maximum rates in operation, would justify in my opinion our enactment in peacetime of a basically sound tax structure for war purposes, which will be available the moment war starts.

Senator WALSH. Do these rates expire automatically at the end of the war, or do they continue for a period afterward?

Mr. FLYNN. No. The bill provides that those rates automatically expire.

Senator BAILEY. Let us get this statement for the record and see if I am right: The excess-profits tax law passed February 19, 1919, that is the date it was signatoried by the President, but it related back to the whole year of 1918?

Senator LA FOLLETTE. Yes; but even so a whole year of war had gone by when those taxes were applied. My point is, Senator, whatever you may think about this bill, the experience of the last war justifies the effort to write into law in peacetime such legislation for a tax structure for war purposes which goes into effect at the time your war is declared, rather than permitting people to make profits out of it while Congress is getting around to the job of passing wartime legislation.

Senator BAILEY. The only question I made was that the act of 1917 was retroactive.

Senator GERRY. It was retroactive so that it included everything from the time it started.

Senator BAILEY. Yes; from the time it started in.

Senator GERRY. I think the bill came to the Finance Committee in May.

Senator WALSH. May we have your final statement, Mr. Flynn, so we can adjourn?

Senator LA FOLLETTE. Mr. Parker will bear me out in the statement that the maximum rates were not applied until the year the war expired.

Mr. PARKER. They were retroactive, Senator, but we did not get the money in.

Senator WALSH. He is speaking about the La Follette bill.

Senator GERRY. In 1917 we passed the first excess-profits tax on October 3. That was retroactive for the year 1917, and those rates on the corporations, if they made over a certain sum, between 6 and 8 percent, the first bracket was 15 percent, and I think the next bracket was 30, and the next bracket 45, and finally a bracket of 65. And, of course, not many people got up in the 65 bracket. And while those rates looked high, they were not what you might call the effective rate. And in the same way on the individuals we went up to 65 percent. But it was not entirely effective, because you did not get your 65 percent on an individual unless he made over a million dollars, and the lower incomes were not very heavily taxed, and it did not produce the money that it might have.

Now, in 1918 there was a much higher rate brought in on men of lower incomes and lower profits, and it started off with 30 percent under the excess-profits tax, to 80 percent under the war tax. But the act passed in 1918 affected all profits in 1918.

Senator LA FOLLETTE. Certainly; but my point is that if we can get it into legislation before any war starts how much more effective-ness it will have when the war does start.

Senator GERRY. Certainly.

Senator LA FOLLETTE. Yes; certainly. And can we not write a bill based upon our previous experience, so that if we are ever confronted with another war, horrible as it is, when Congress declares war then your structure will become effective as to taxation and produce revenue, instead of letting a whole year go by, in which people lucky enough in the first year to make their profit will contribute less than the people who pay taxes on their profits the second year of the war.

Senator WALSH. This is your final statement, Mr. Flynn?

Mr. FLYNN. This is my final statement; yes. In the meantime, however, while we are waiting for these rates and returns to come into the Government, the Government embarked upon a policy of borrowing money, and borrowed billions, and the price structures were sky high, and wages, and everything else, and we had the war inflation in the most aggravated form.

Senator BAILEY. That was due to expenditures rather than to borrowing, was it not?

Mr. FLYNN. Senator, I have some authorities that I want to close with. It was not due to expenditures, it was due to the creation of new purchasing power. You cannot have inflation unless you create new and artificial purchasing power. If you take taxes away from one man and give them to the Government, then the Government spends them instead of him. If you let him have his money, then you create another loan from the central bank where the Government is borrowing, and he can spend his money, and the Government spend its money, and you have got an artificial inflation.

Senator BAILEY. You are not arguing against our present principle of borrowing, are you?

Mr. FLYNN. Senator, no; I am not. I do not want to mix up my views on this bill with the present Government policy.

Senator BAILEY. You do not think that is a bad view?

Mr. FLYNN. I am discussing the war-profits tax bill, and the present tax situation is not before the committee now.

Senator WALSH. What is your authority you wish to present?

Mr. FLYNN. I want to call attention to the fact that at the beginning of the last war a petition was presented to Congress, and it is in this report [indicating], and I recommend that you gentlemen read it, signed by about 250 economists of America, economists of every school, economists of the extreme classical school, of the radical school, and the liberal school, men like Dr. Sprague of Harvard, Dr. Commons of Wisconsin University, and Dr. Fischer of Yale, and practically the entire Yale economic faculty, and almost the entire Harvard economic faculty, and also the entire economic faculty of Wisconsin, about 30 or 40 leading universities of America, and they

signed a petition to Congress, in substance, asking them to pay for the war out of taxes, rather than out of borrowed funds.

Senator BAILEY. Most of those economists were people who did not have to pay much taxes?

Mr. FLYNN. What has that got to do with it?

Senator BAILEY. A great deal.

Mr. FLYNN. The doctor who treats you does not have to pay your doctor bills, but he knows how to prescribe for you.

Senator GERRY. That is your theory.

Mr. FLYNN. I think I ought to be permitted to finish this statement.

Senator WALSH. Go ahead, Mr. Flynn.

Mr. FLYNN. These economists described what would happen as an argument against the borrowing policy. And if you will read that argument, it sounds almost like a historical discussion of what happened during the war. Congress refused to adopt that policy, and adopted a policy of moderate taxation and very heavy borrowings, and they produced an inflation which collapsed as soon as the war was over, which did infinitely more harm to big industry and small industry than they did during the war. You will find that on page 29 of this document.

Senator GERRY. I want to say something about that, because I was a member of the committee.

Senator WALSH. Wait just a minute, and let Mr. Flynn finish.

Senator GERRY. All right.

Mr. FLYNN. That is to be found on page 29 of the report To Prevent Profiteering in War. This was in the Seventy-fourth Congress, first session, report no. 577. It is found on page 29 of that report, together with the views of those who signed it. And these were economists who agreed on this, no matter whether they were Communists or extreme classical economists.

Senator GERRY. As a member of this committee then, I want to say this: Professor Seligman, of Columbia, and Professor Adams, of Wisconsin—and others appeared before the committee and gave us information and advice during the war, and we also had the experience of England, and we taxed more and paid more as we went than any other country, and there is not any doubt about that.

I think, from our experience which we gained from the war, that there is not much question but that we could tax everywhere and pay more, but there is always the danger of when you tax too much in war you may lose revenue, which the Treasury officials have brought out in these hearings in regard to this bill.

The main point, as I see it, is to win the war and get as much revenue as you can while you are winning the war without stopping the production you need.

Senator LA FOLLETTE. Just one moment. I want to put in the record at this point the total amount of ordinary receipts, which I think, of course, will indicate that while profits may have grown while the war went on, they are a pretty good indication of the lack of stepping up of taxation during the war, and what will happen if we wait until the war is upon us to enact the legislation.

During the fiscal year of 1917 the ordinary receipts were \$1,124,-324,795.

During the year 1918 they were \$3,664,582,865.

And during the year 1919 they were \$5,152,257,136.

Mr. FLYNN. And the war was over then, Senator.

Senator LA FOLLETTE. Yes; and in 1920 they were \$6,694,565,389.

Mr. FLYNN. And the war was over then, and the damage had been done by the inflation.

Senator CLARK. Mr. Flynn, did you finish what you had to say?

Mr. FLYNN. Yes; I have finished.

Senator CLARK. You have had so little opportunity to have any continuity to what you were submitting that I did not know whether you had finished or not.

Mr. FLYNN. Yes; I have.

Senator WALSH. The committee will stand adjourned until tomorrow morning at 10 o'clock.

(Whereupon, at 12:55 p. m., an adjournment was taken until Friday, Apr. 3, 1936, at 10 a. m.)



# TO PREVENT PROFITEERING IN WAR

FRIDAY, APRIL 3, 1936

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

The full committee met, pursuant to adjournment, at 10 a. m., in room 310, Senate Office Building, Senator Pat Harrison presiding.

Present: Senators Harrison (chairman), King, Walsh, Barkley, Connally, Bailey, Clark, Lonergan, Gerry, Guffey, Couzens, Keyes, La Follette, and Capper.

Also present: L. H. Parker, chief of staff, Joint Committee on Internal Revenue Taxation; G. D. Chesteen, Joseph S. Zucker, of the Joint Committee on Internal Revenue Taxation.

Ralph W. Brown, P. J. Mitchell, and S. G. Winstead, of the Treasury Department.

The CHAIRMAN. We will proceed.

## STATEMENT OF L. H. PARKER, CHIEF OF STAFF, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

The CHAIRMAN. Mr. Parker, yesterday Mr. Flynn was before the committee and he discussed these 15 questions of policy drawn up by the experts and submitted by the subcommittee to the full committee. Are you familiar with them?

Mr. PARKER. Yes; Senator. I think the difficulties of drafting the bill would be considerably reduced by following along the lines of Mr. Flynn's statement, because he stated on most of the points on which we had made suggestions he had no objections.

Senator CONNALLY. Is it not a fact that on the points you criticized he was right?

Mr. PARKER. In respect to the points that had given us most trouble from a technical point of view, Mr. Flynn stated that he had no fault to find with our criticism. Now, of course, the committee would still have to decide the maximum rates, as to whether you would want to lower those or not; and then there are two other questions that I am anxious for the committee to decide. If the first one is answered a certain way, you do not have to answer the second one.

As you know, Senator, we have a bill pending in the House that is going to completely change the structure of our Income Tax Act, if it passes; and it might be well for the committee to consider the question whether they want to wait and have this bill follow the new revenue bill and take the same form or whether they want to report this bill in the form of a 1934 act, which, of course, may soon become obsolete.

Now, the most difficult proposition we have—if you are going to follow the 1934 act, as this bill is drafted—will be to keep track of this declared value. One of the essential elements of the tax on corporations is the declared value for capital-stock purposes and excess-profits taxes. Those taxes, as the bill is now proposed in the House, are to be stricken out. Of course, that is going to make some trouble, if we have to go back 10 or 15 years and resurrect this declared value, and this proposal is that the structure of the new bill will be adaptable to all time. For instance, if you abandon your excess-profits taxes on corporations under the new form of bill, you could raise your undistributed-profits tax so as to practically do the same thing. That is, if the corporation did not declare out its net income in dividends, why, you would get this big tax on them in another way.

The CHAIRMAN. Has the subcommittee given any consideration to that?

Senator CONNALLY. Oh, yes. We haven't voted on it, but we have gone all over those matters. Personally, my view is that the declared value is not the best standard, because if they adopt arbitrarily the declared value as of 1934, there might be a lot of changes, a lot of new corporations. I do not see how you can get away from the basis of the invested capital, myself. It seems to me that is the fairest test. Whatever the company has invested ought to be the test of its earning power, it seems to me.

Mr. PARKER. Of course under this new bill now, you might discard it altogether, because under the new bill, you have a tax on the amounts retained. You increase the rate in all cases, so the rate on the individual will be very high, and if you also raise this tax on the undistributed net income of the corporations, they would have to distribute or pay practically all the earnings in tax. Of course, if they were obliged to retain the earnings you might have to put in some provision whereby they could retain a certain part of this net income, if they were authorized to do so by the Secretary of War, if such retention were necessary for war purposes.

The CHAIRMAN. The object is, as I understand it, that in times of war, after a declaration of war, that we take the excessive profits out. Now, whatever analysis you apply is an immaterial thing, whether you do it through the dividends that have been declared on earnings or whether you do it through an excess-profits tax, or what not. It would seem to me, just offhand, that if we want to pass this bill, it would be better to have it reconciled with the provisions of the new tax bill, if it is liable to be changed from the present law.

Senator CLARK. Mr. Chairman, the only difficulty, it seems to me, in this matter is this: That will simply postpone this bill to another session. We have now been trying for a year and a half to get consideration of this bill. We adopted the structure of the 1934 act because that was the law. You know we have a tax bill every year. The tax bill usually comes very late in the session, it is usually passed very late in the session, too late to give consideration to a bill of this character.

It seems to me that the important thing is to establish the principle that you are going to have a system of taxation based on whatever the law is existing then, to raise revenue for the purpose of con-

ducting wars, and merely, during the progress of the war, stop profiteering during the war. If we get consideration of this bill, put it on the statute books, and then, if the tax bill is amended, this law can be changed to conform with that.

On the other hand, as a practical matter, if we wait every year until some new tax bill will come along we do not know whether it will pass or not, we do not know whether it will be agreed to, we do not know whether it will be passed out in the House. To say this is to be postponed until after the House passes the bill, we do not know whether the House will pass the bill or not, or whether the Senate will pass the same bill based on the House bill. It simply means we would never reach a consideration of this matter.

The CHAIRMAN. There is no question but what, if you wait, this thing will be delayed considerably.

Senator CONNALLY. Mr. Chairman, let me ask Mr. Parker a question. My theory about this war-profits bill is that it ought to be entirely a war-profits measure that goes into effect from the time of the declaration of war, the declaration of an emergency, as explained yesterday.

Senator CLARK. I agree with that.

Senator CONNALLY. Insofar as possible it ought to be superimposed upon the peacetime taxation, to the extent that the administrative provisions, insofar as they are applicable, ought to apply to wartime as well as peacetime.

Is there any way that we can adopt a general clause in this bill, that is, a sort of a saving clause, that will make it harmonize with the peacetime measure?

Senator CLARK. That is what we are trying to do.

Senator CONNALLY. That is what I have in mind.

Senator CLARK. I agree that that is very desirable. That is the reason this bill is so long. I do not think you ought to hold up consideration of this bill in contemplation of the fact that it may be changed. It is easier to pass this bill and then make it conform.

Senator CONNALLY. I was going to say that if you do not have some joint clauses everytime we pass a new tax bill we will throw the war bill out of the window. They won't jibe.

Mr. PARKER. You could of course adopt the policy of enacting the war bill in the way it is, as amended, and then when you pass a new revenue act you could amend the war revenue bill every time. That would not be so difficult; it would mean a little printing, but I do not know how you are going to put a general provision in there.

Senator CONNALLY. I do not know either. I am asking you, because you are the expert and I am not.

Mr. PARKER. You are looking at the future. You could not make it general. Once in a while you get something in the peacetime bill that you do not want in the war revenue bill.

Senator CONNALLY. How would it be to put a clause in there that in time of war rates under this bill beyond rates under the existing peacetime taxation shall apply, whichever one is the greater?

Mr. PARKER. If it was only a matter of rates, of course, you could make a very short bill. For instance, you could say, "In case of war the peace-time rates shall be doubled, but the tax shall not be in excess of 90 percent of the net income, or something like that?"

Senator CONNALLY. I do not know, of course, what the legislative program is over there, but I would like very much to get the bill reported out of this committee, get it on the calendar as promptly as possible, and then, if the Senate does not pass it, all right.

The CHAIRMAN. What you want done is to get an expression from the full committee as to these 15 points and then let the subcommittee go ahead and hold hearings and make a recommendation to the full committee?

Senator CONNALLY. That is it exactly. We will try to amend the bill in the fashion that the full committee wants it.

The CHAIRMAN. It strikes me that Mr. Flynn, yesterday, was very fair in reference to a question that had been raised; that is, that on the declaration of an emergency, without an actual declaration of war that this country was actually engaged in, these high taxes be applied.

Senator CLARK. That was amended in the Military Affairs Committee. As a matter of fact, I do not remember that attention was called to it yesterday. That was put in there as an additional precaution so the thing would not go in effect and prevent the war.

Senator GERRY. Why cannot that be amended?

Mr. PARKER. As to titles II and VI, this committee can amend that, because it would have to do with the going into effect of the war rates of taxation.

Senator CLARK. I do not think there are any two arguments about that.

The CHAIRMAN. Suppose we take up these 15 points now, so that we can get along. We know pretty well what these questions are, following the discussion yesterday, and if you just want to get an expression from us, we can get it pretty quick. Let us take the first question:

Should the bill be designed so as to take the profits motive away from both corporation and individual? Mr. Flynn said he did not think so.

Mr. PARKER. That is correct.

The CHAIRMAN. "Should the bill be designed so as to take the profit motive away from both corporation and individual?" Those in favor of that will raise their hands.

Senator BARKLEY. Mr. Chairman, if you answer "yes" on that first question, does that mean on all corporations engaged in business regardless of whether they are engaged in manufacturing anything that goes into war?

The CHAIRMAN. Yes. I do not think anybody wants to take away the motive of profit from the corporation or individual.

Senator BARKLEY. I am not going to vote "yes" on that.

The CHAIRMAN. All in favor of voting "aye" will raise their hands.

Senator CONNALLY. You won't take all the profit out.

Senator CLARK. I can say, Mr. Chairman, it was never the intention of anybody connected with the drafting of this legislation that you should take the profit motive away from either individuals or corporations. You want to leave them the profit motives, but you want to levy a sufficiently heavy tax so you may be able to carry on the war out of current expenses.

The CHAIRMAN. Well, without objection, then, the answer will be "no."

The second question is:

If the answer to issue 1 is in the negative, what maximum rates can be used without destroying the profit motive?

Why do not we leave that to the subcommittee to make a recommendation on that? As I understand it, that was made 3 percent.

Senator CONNALLY. If you leave it to me personally, I am going to favor a slightly higher rate of profit than the munitions committee recommended.

Senator CLARK. As one member of the munitions committee, I would be very glad to have the subcommittee's opinion on that thing. It is a matter of judgment. I do not think that we hit the proper figure when we say 3 percent. Maybe it ought to be 4 percent. I do think you should consider the principle of keeping the rate of profit low enough and the tax high enough not only to stop profiteering but to make everybody make the necessary sacrifices to carry on the expenses of war. I think the subcommittee should take that up and make a report on it.

Senator CONNALLY. Now, Mr. Chairman, one issue is to take practically all the profit out and the other issue is to establish a standard of what was earned prior to the war, and then take out the added profit that war confers. Now, that is impractical. You cannot have one rate of tax for one corporation, because its profits were so-and-so and another rate for another corporation. I think it would be impossible to administer it.

Senator GERRY. Mr. Chairman, the subcommittee has got to go into it very thoroughly with the Treasury experts. The thing that struck me, reading over the hearings casually, is that the Treasury Department is much worried because of the fact that if this were adopted you would cut the revenue down. It is a very difficult thing to work out.

Senator CONNALLY. My own view about that is to allow corporations 4 percent to start with, and on the net 3 percent take three-fourths of that, or one-half of that, and one-half of the next 1 to 6, I would take one-half of that. That would be 5 percent, and then from 6 to 8 I would take three-fourths of it, which would be  $5\frac{1}{2}$  percent. After 8 percent I would take it all, and there would still be a motive in there to make a profit.

Senator GERRY. Quite frankly I am not prepared to vote on that until I hear more from the Treasury and from the experts. I think that is the thing you have got to work out. It is a very difficult proposition.

Senator CONNALLY. I think the rates in the munitions bill are too low.

The CHAIRMAN. As I understand it the suggestion is that during war times we give them 3-percent war profits, is that right?

Senator CONNALLY. That is the munitions committee bill. I favor a little more.

Senator GERRY. I think it would stop your industries to have it only 3 percent.

Senator CONNALLY. I am in favor of giving them more.

The CHAIRMAN. I do not think you should give them 6 percent during war times.

Senator GERRY. My State is an industrial State. A lot of our people during the last war built factories and they were making a lot of money, and then the war ended and they had to scrap the factories. Now they are a lot wiser than they were then. That is all there is to it. The Treasury and the experts advise that you have got to go into that very carefully, otherwise you get into trouble.

Senator BARKLEY. How can we, or Congress, or anybody, in advance of a war, decide that tax rate is going to be levied when the war comes? I am sympathetic with all these efforts to stop war and stop profits made out of war, but when people get mad they are going to fight. What I mean is I do not know how one Congress is going to bind a future Congress 10 years from now, or 15 or 50 years from now that is going to get into a war as to the rate of taxation, or what it will do with respect to the method by which that war is going to be fought.

Mr. PARKER. I think, Senator, the most important thing is the form of the bill. The rates can be changed in 2 days, but the form of the bill is, I think, a useful thing to have on the books.

The CHAIRMAN. Shall we pass on that proposition or not? Shall we leave that to the subcommittee and let them work it out, and then let us have a discussion after having the views of the Treasury Department?

Senator CONNALLY. Yes.

The CHAIRMAN. The third question:

Should the bill be designed to produce the maximum revenue possible, or should the social and economic effect of the bill be deemed more important?

Senator GERRY. Mr. Flynn was very emphatic on that. He said the main point is the revenue.

The CHAIRMAN. Yes; he said it ought to be the revenue, but the economic system should not be destroyed.

Mr. PARKER. If revenue is the most important thing that means we have got to place a higher tax on the small incomes.

Senator CONNALLY. Not necessarily.

Senator CLARK. As far as that part of it is concerned, Mr. Parker, if you mean by the question as to whether absolutely the last penny that can be raised shall be provided for in this bill, I personally do not think we ought to do that without considering the social and economic consequences of that. I think the purpose of this bill ought to be to put in as high rates as practical, but I do not think we should entirely disregard the social and economic consequences.

Mr. PARKER. Of course, too high rates will not always bring in the greatest revenue. You will have to consider that.

Senator CLARK. I understand.

The CHAIRMAN. Without objection then, it is the opinion of the committee that we ought to get as much revenue as possible without destroying the social and economic system during the war.

Senator GERRY. You cannot hold up the war.

The CHAIRMAN. All right. The next point:

Is it sound to adopt the general principle that the most important thing in connection with war legislation is "to win the war"?

Without exception, we will all agree to that. The next question:

Should the bill be designed to tax net income only, or should limitations be imposed on the deduction of necessary business expenses with the result that the tax rates may apply to a figure greater than true net income?

Senator CONNALLY. The reason for that is that the munitions bill limits practically the income of any man, no matter how big an income, to around \$20,000. I suppose he has got to have some cigarettes and other things. Now, for instance, Mr. Flynn brought in the interest question.

Senator BAILEY. If we vote "yes", on that question, will it result in the tax being raised to a figure greater than the true-net income?

Mr. PARKER. For instance, there is a limitation on interest, that you cannot take off more interest than you have averaged over the prior 3-year period, something like that. As a matter of fact, when you go into a war you may have to borrow some money, and your interest charge may be greater. Now, you have to pay out that interest. Naturally there is a deduction and you haven't got the money, and when you are limited in that deduction for interest you are taxing something more than we are thinking of in an accounting sense as a true net income.

Senator BAILEY. When you tax anything more than net income you will have a tax on capital. It is perfectly plain. When you get more than net income you get into capital.

Senator CONNALLY. After all, is there any income except the net income?

Senator BAILEY. No.

Senator CONNALLY. If I spend a thousand dollars and make \$1,500, I have made but \$500.

Mr. PARKER. It is true, however, even under existing law, that an individual may be taxed on a sum greater than his net income, since all expenditures are not allowed as a deduction.

Senator CONNALLY. If you do that I think you are going to run into the other proposition of disturbing the economic set-up. If you interrupt the method of doing business by these measures you are disturbing the economic set-up.

The CHAIRMAN. Well, is there any objection to the sentiment of the committee being expressed, that the bill be designed to tax net income only?

Senator CONNALLY. That is right.

The CHAIRMAN. Without objection, then, that is the sentiment of the committee.

The sixth point is:

Should the bill attempt to correct possible defects and to close possible loopholes in existing law when such defects or loopholes are a present problem not directly connected with war-revenue legislation?

We had better not consider that.

Senator CLARK. Mr. Chairman, I do not think it is desirable to load this bill down. I think it would complicate the bill unnecessarily.

The CHAIRMAN. Without objection then the answer to that will be "no."

Senator CONNALLY. By that I understand the committee takes the view that this bill ought to be purely a war-tax bill and not interfere

in any wise with the normal peacetime tax bills which we enact from time to time.

The CHAIRMAN. We have been working to clog up the loopholes for a long time.

Senator LA FOLLETTE. And we will continue to work on that.

The CHAIRMAN. The seventh point is:

Should the rather low taxes proposed in the bill on the individual with a moderate net income be increased so as to secure more revenue?

Senator CONNALLY. That is what Mr. Parker had in mind a moment ago when he mentioned the fact that if you try to get a lot of revenue you have to increase the tax base as carried in this bill in regard to the individual and increase the rate on the man of moderate income, is that right?

Mr. PARKER. That is right. We pointed out that under this bill a man even with a \$5,000 net income pays \$340 tax. In England right now, in peacetime, he is paying \$630. It just seemed to me apparent that when you get into a war, when you consider what the soldier gets, just as Mr. Flynn said, he did not see why the tax on the \$5,000 income should not be increased.

The CHAIRMAN. Is not the answer to that found in one of the answers made above, that we should get as much money as possible without destroying the social and economic system?

Mr. PARKER. I do not see how that will destroy the economic system, on that particular point. A man with a \$5,000 income, if he paid a tax of \$600 and he had \$4,400 left in wartime, when you are only paying the soldier \$60 a month, is pretty well off.

Senator LA FOLLETTE. They do not even go as low as that in peacetime, in an emergency. I offered an amendment on that last year.

Senator WALSH. Mr. Parker, is it a fact that of the yearly income of this country, 10 percent of it goes to people who have an income of over \$5,000, and 90 percent to people under \$5,000 a year? I saw some figures to that effect. Is that approximately correct, that 90 percent of all the income goes to people having an income of less than \$5,000?

Mr. PARKER. I think that is true.

Senator WALSH. Haven't you got to tax those people to get some money?

Mr. PARKER. Yes; especially under this bill, where there is every inducement not to pay big salaries and not to have the opportunity to create big incomes. That is, under the structure of this bill, the net income of the wealthy, I believe, will decrease rather than increase.

Senator CONNALLY. The answer would be "yes" then, Mr. Chairman, would it?

Senator GERRY. Why don't you leave that up to the committee that will take this up—the subcommittee? I think when you get into the rate structure the committee is going to find that you are going to discover a great many things which you did not think of which go into the question of revenue.

Senator CONNALLY. The subcommittee will assume the responsibility, but as to the general view I think the answer will be "yes."



The CHAIRMAN. Without objection, that will be the answer.  
The eighth point is:

Is it constitutional to tax gifts as income, as indicated by the bill?

Mr. PARKER. I do not think so, from the best information we can get.

The CHAIRMAN. Let us leave that open.

Senator CONNALLY. Why cannot we treat gifts under this bill like we do generally?

Mr. PARKER. I assume if the committee thinks that this is unconstitutional they certainly will not want to do anything that is unconstitutional.

Senator BARKLEY. Why cannot they be taxed as gifts?

Mr. PARKER. This is an income-tax bill. We haven't interfered with the gift and the estate taxes; we haven't interfered with those taxes.

Senator COUZENS. Is there any reason why we should not do it during war periods, rather than in other periods?

Mr. PARKER. I cannot quite see, Senator, what the law has to do with the transfer of property by death or by gift. Supposing a man is unlucky enough to die in a war I do not see any difference between the possibility of a man's death in war or in peace time. We have got a 70-percent estate tax rate. We are going after the income. It does not make any difference whether the property is transferred to somebody else, the income will still arise, and we are going to take all the income away, so why do we want to take all the principal away?

Senator CONNALLY. Is there any reason why a war would increase the inheritance any? Of course, a man's death is just an incident that might happen in war just as it might happen in peace times. There is no reason why his estate should be penalized more because he happened to die after the 1st of July, during the period of a war, rather than on the last day of April, just before the war was declared?

Senator COUZENS. I do not think it ought to be heavier during the war. As a matter of fact, the soldier might be killed on the battlefield, and you take all the property of his wife and children away from him.

Senator GERRY. As a matter of fact, it would be pretty near impossible to settle the estate because you could not arrive at any value on it.

The CHAIRMAN. Why would not it encourage patriotism if a fellow has got a big estate, and he has got a family and wants to volunteer for war, and give the estate to his family? Why should he be penalized for risking his life?

Mr. PARKER. You take most of the income, anyway.

The CHAIRMAN. You take 70 percent, anyhow.

Senator BARKLEY. It would be important as to the question of policy, regardless of the constitutionality, to change the gift tax during the war.

The CHAIRMAN. Those in favor of taxing gifts any different in time of war will raise their hands. Those opposed will raise their hands. We will leave that out.

The ninth point is:

Is it constitutional to require the filing of joint returns by husband and wife, as proposed in the bill, such a provision affecting the present community property system?

Senator CLARK. That is a question of constitutionality.

The CHAIRMAN. Without objection, it will be left out.

The tenth point is:

The bill taxes all gains from the sale of capital assets, but disallows all losses from such sales, except to the extent of \$2,000—that is, if a man has \$50,000 of gain from the sale of capital assets and in the same year has \$80,000 of losses from such sales, the bill proposes to tax the man on \$48,000, regardless of the fact that he had a net loss of \$30,000. Is this a sound policy?

Why don't you leave it the same as it is now?

Mr. PARKER. That was a rather serious question, I think, because our capital gains and losses apply to real estate, business, buildings, and all kinds of exchange. You may not except buildings for war purposes. If a man makes a gain, he has to pay a tax on it; but if he sells something at a loss, he cannot get credit for the loss. It seems to me you would freeze transactions too much.

The CHAIRMAN. What you would do is go back more years than just one.

Mr. PARKER. I would use the same rule as we have in the present law. It seems to me that is strict enough. If a man sells some property for \$100,000 and the next day he sells another piece of property at a loss of \$100,000, I do not see why that is not a wash-out.

The CHAIRMAN. In other words, we should place the same provision in the wartime measure as under the present law?

Mr. PARKER. Under the present law a man cannot be taxed on gains except to the extent that they exceed losses.

Senator GERRY. The question that comes in there, Mr. Parker, is where you have got a wartime proposition and you want to build a factory and invest \$250,000, you have got to have some reason for it. You may have a loss on one thing and gain on another. Also you have got the old question of capital gains and capital losses. The English never tax capital gains and capital losses, and one of the great questions that we have got to meet some day is whether we should not stop taxing capital gains and capital losses, because a lot of people will not sell now when they have a profit. Doesn't that question go into it?

Mr. PARKER. Yes, Senator.

The CHAIRMAN. Mr. Parker, the answer ought to be "no" to no. 10?

Mr. PARKER. That is right, Senator.

The CHAIRMAN. All in favor of answering that question "no" will raise their hands. Those who favor answering "yes" will raise their hands. The answer will be "no."

Senator CONNALLY. These industrial management provisions; do you want to go into those?

The CHAIRMAN. Do you want the committee to go into those?

Senator KING. Mr. Chairman, I have had to attend the Appropriations Committee meeting, and I do not know what discussions have taken place.

The CHAIRMAN. Senator King, all they are asking is an expression of the full committee, and this bill is going back to the subcommittee.

Senator KING. Let me complete this statement. If it is contem-

plated that the Federal Government shall erect a munitions plant and destroy private plants and depend entirely upon the Federal Government to prepare guns and munitions of war, and all that sort of thing, I am opposed to it.

Senator CONNALLY. That is not in it.

Senator CLARK. This is an entirely separate proposition.

The CHAIRMAN. The eleventh point is:

Should the bill be kept in its present form or should it be divided into two separate bills—one dealing with revenue and the other with industrial management and control?

In other words, the question is whether you are going to separate a bill into parts, separate titles?

Mr. PARKER. Six titles, but the first title is a tax title and titles 2 to 6 are the industrial-management titles, and so forth.

Senator COUZENS. From the discussion we had yesterday it seems to me wholly impractical to separate these sections, because otherwise it would not convey to the public just what we are driving at. It seems to me this is one piece of legislation that ought to be kept together.

Senator CONNALLY. I think, Mr. Chairman, the Senator from Michigan is right, for this reason: All we have before us to base legislation for taxes on is the McSwain bill, which is a rather large bill, an industrial-control measure. We are getting this legislation on the pretext that it is a tax bill. I think we ought to deal with it in its entirety.

The CHAIRMAN. All in favor of dealing with this bill in its entirety and not have it separated will say "aye." Opposed "no." The ayes have it.

Senator LA FOLLETTE. It seems to me the balance of these questions have to do with the industrial management titles. As I stated yesterday it is not my understanding that this committee has any jurisdiction over those titles of the bill. They have already been to the Military Affairs Committee and they have reported on them after hearing those titles, and as I understand it the Military Affairs Committee excluded from its consideration the tax features of the bill. Was not that the understanding that was entered into, that that feature of the bill come to this committee?

The CHAIRMAN. I think you are right. The next point—

Senator CONNALLY (interrupting). Wait a minute. I agree with that in the main, yet this whole bill is before us. It is up to us to vote it up or down. If it contains, even in the other sections, something to which we object, we would not vote for the tax features ourselves.

Senator COUZENS. May I suggest we can easily explain that in the report that goes to the Senate?

The CHAIRMAN. On this whole revenue question now, on the question of whether or not it shall apply in case of a grave national emergency, or when there is a war between two other countries that might affect this country, I think we ought to clear that proposition up.

Senator LA FOLLETTE. I agree with that, because that really touches the tax feature, but the balance of these questions relate to titles 2 to 6, and it seems to me that if this committee undertakes to go over

the same ground that was gone over by the Military Affairs Committee, we are undertaking a terrific task. We will have to hold hearings, we will have to call in the same people, or other people, that the Military Affairs Committee heard. It would be a duplication of their work, and it seems to me it would greatly simplify the proposition if this committee took the position that it did not pass either favorably or unfavorably upon titles 2 to 6, that that is the responsibility of another committee which has discharged its responsibility by reporting those titles to the Senate, with suggested amendments. I think we should report the bill with the statement that this committee considered the tax features of the bill, and then leave to the Senate the question of what shall be done with the bill in its entirety.

Senator COUZENS. The chairman of the Military Affairs Committee could handle sections 2 to 6.

Senator GERRY. Of course you would strike out the provision.

Senator LA FOLLETTE. That has to do with the tax feature?

Senator GERRY. Yes.

The CHAIRMAN. I think it is agreed that the phraseology in the twelfth proposition shall be changed.

Mr. PARKER. There is only one question, that is a practical question, in proposition no. 14, that is whether that \$500,000,000 is a sufficient amount. I do not know whether the committee wants to go into that or not. That is a revolving fund. You see under the bill corporations are not going to be allowed to accumulate their earnings and will have to borrow from the Government.

The CHAIRMAN. We will pass over 13. That is a matter for the War Department.

Mr. PARKER. Yes, Senator.

The CHAIRMAN. Fourteen:

Is the revolving fund of \$500,000,000 provided for in section 506 sufficient?

Senator COUZENS. Sufficient to do what?

Mr. PARKER. Under this bill everybody is going to be taxed. Now, the \$500,000,000 is to make loans, and so forth, for your war industries to expand, build plants, and so forth.

Senator COUZENS. As a matter of fact we can be here at that time and increase that any time that we want to.

Senator GERRY. Mr. Chesteen calls my attention to a feature, Mr. Chairman, that in the 1918 bill there was a certain amortization allowed. It comes into the tax feature of the bill really, and in this bill, under no. 14, there is simply a revolving fund provided for in section 506. I think that goes right into the taxing question. Mr. Chesteen seems to think so, and he has called my attention to it just now.

The CHAIRMAN. That is what question?

Senator GERRY. That is under fourteen.

Mr. PARKER. During the last war we put in the amortization provision so the people who built a plant which was only useful during the war could take whatever losses they had on the plant and charge them off against their war income. No such provision is provided in this bill. It probably ought to be provided, unless the Government has ample funds to do the financing.

Senator GERRY. In New England they spent money that they never got back in a lot of cases where they built plants in 1918. Unless you can get some amortization they are all singed cats, they will be scared to death. That is what the Treasury is really afraid of. You will hold up your war emergency efforts.

Mr. PARKER. That might be a good question for the subcommittee to go into.

Senator GERRY. Why cannot the subcommittee go into that particular question?

Senator LA FOLLETTE. Senator, just speaking for one member of the subcommittee, I think we ought to go into any question that is related, directly or indirectly, to the tax feature of the bill. What I was trying to suggest was it would be an enormous task which I, as one member of the subcommittee, would not want to undertake at this stage of the proceedings, to go into the general question of whether the War Department can handle this thing, or anything of that kind.

The CHAIRMAN. You will have the Treasury representatives before you in the subcommittee, will you not?

Senator CONNALLY. Yes.

The CHAIRMAN. Do you want to pass on this revolving-fund proposition?

Senator COUZENS. I move it be approved as in the bill, because the Congress can always change that whenever necessary. I think that establishes the principle. That is all that is particularly necessary at this time, that we establish the principle.

Senator GERRY. Mr. Chairman, I do not agree with that. I think that is a pretty dangerous principle. Why cannot the subcommittee take it up and consider it with the Treasury experts? The Treasury is objecting to it.

Senator COUZENS. Are they objecting to any loan at all?

Senator GERRY. No; they are not objecting to any loan at all, but they are objecting to the amortization features of it.

Senator GUFFEY. I think the object of the bill is to delay war and hold up war.

Senator GERRY. The main object is to win the war. If you write this bill wrong, you may lose the war.

Senator COUZENS. Well, you cannot contemplate years and years in advance what amortization and obsolescence means at all. It seems to me that matter can be dealt with more currently than it can years and years in advance.

Senator GERRY. Of course, that goes to the whole bill, too, Senator.

Senator COUZENS. I do not believe that we should attempt to go into too much detail to lay down the general principles on what we would contemplate doing during the war. I think we should work out the details as we approach the period of war.

Senator GERRY. I still think you should have something in the bill in regard to amortization.

Senator COUZENS. Amortization of what?

Senator GERRY. I would like to hear the Treasury representatives on that. I am not prepared to vote, when the Treasury says there is a question that is really important to be brought up on it. We did it in 1918. I think the subcommittee ought to consider it.

Senator **CONNALLY**. We shall. That is one of the industrial sections.

The **CHAIRMAN**. When the subcommittee makes its report to the full committee we can have the Treasury representatives here on that question.

Senator **GERRY**. All right; that is satisfactory.

The **CHAIRMAN**. The fifteenth question is:

Is there any danger under the terms of this bill, that some future President, personally ambitious of extreme power, would get us into war for the purpose of wielding such power?

It does not seem to me that we ought to pass any opinion on that. Is there any danger, under this bill, that some future President, personally ambitious of extreme power, would get us into war for the purpose of wielding such power?

Mr. **PARKER**. That is taken care of by Senator Gerry's suggestion that the war revenue bill only should come into effect on the actual declaration of war between the United States and a foreign power and, in addition, that Congress should declare a national emergency to exist.

The **CHAIRMAN**. Is there anything else you want us to take up?

Senator **CONNALLY**. I think not, Mr. Chairman.

Senator **WALSH**. I would like to ask Senator Connally if the subcommittee have consulted with the Treasury?

Senator **CONNALLY**. Yes.

Senator **WALSH**. Has the subcommittee consulted the Army authorities, as to whether or not these rates would have any effect, in their judgment?

Senator **CONNALLY**. The Army authorities have passed on that in the hearing before the Military Affairs Committee. I stated already that my own personal view is that the rates of profit allowed under this bill were not large enough, in my view, as a member of the subcommittee. I expect to favor an increase in profits.

Senator **WALSH**. I thought, Senator, that it was quite possible that the Secretary of War might assign somebody to make a special study in a financial program of this kind, as to what effect, if any, it would have on the success of military operations.

Senator **LA FOLLETTE**. It is my understanding, Senator, that the representatives of the War Department that appeared before the Military Affairs Committee took the position that that was a matter for the Treasury and they had no advice to give on that phase of it.

The **CHAIRMAN**. That will be all then.

(Thereupon, at the hour of 11:15 a. m., the full committee adjourned.)

Thereupon, at 11:15 a. m., the subcommittee, composed of Senators Connally (chairman), Guffey, Bailey, and La Follette, was convened.)

#### **STATEMENT OF G. D. CHESTEEN, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION**

Mr. **CHESTEEN**. We are prepared to submit to you the information that we have gathered from the Bureau of Internal Revenue and let you pass on that. After that you might want a more detailed

study made of the whole question. We thought we would wait until you passed upon that evidence first.

Senator CONNALLY. Let me ask you: The real question that we have got to determine is the matter of economics for you people to work out, that is the basis of taxing corporations, whether on the declared value or the invested value?

Mr. CHESTEEN. Yes.

Senator GUFFEY. What do you mean by invested value? The historic cost, less depreciation, or the reproduction value?

Mr. CHESTEEN. In the last war we taxed corporations on the basis of the capital actually paid into the corporations.

Senator GUFFEY. That is the historic cost.

Mr. CHESTEEN. Plus the surplus that it has built up during the history of the corporation.

Senator GUFFEY. I think that is a fair way myself.

Senator CONNALLY. After you determine that, the next thing is the rate?

Mr. CHESTEEN. The rate. Of course; then you have the question of rates on individuals.

Senator CONNALLY. The two questions, the basis of taxation, the rate on corporations, and the next one is on individuals; is that right?

Mr. CHESTEEN. That is right.

Senator CONNALLY. Are those the three big questions in the bill?

Mr. CHESTEEN. You have another question that was mentioned here this morning; that is the question whether or not you are going to insert in the bill provisions for loss of value of war plants. In the last war we had a provision which provided that a taxpayer with facilities for the production of articles contributing to the prosecution of war be allowed a reasonable deduction for the amortization of the plant.

Senator CONNALLY. Shipyards, for instance?

Mr. CHESTEEN. That was just a general provision, and the commissioner promulgated regulations to regulate the amount that was deemed by him to be a reasonable deduction.

Senator LA FOLLETTE. It was subject to some abuses, wasn't it?

Mr. CHESTEEN. Well, I think the Couzens committee thought it was, because they criticized it somewhat.

Senator LA FOLLETTE. That is my recollection.

Mr. CHESTEEN. Still, when you take the total deductions, consider the tremendous war plants we had in the country, I doubt very seriously whether the deductions as a whole were excessive. In individual cases I think that is true. I think the Couzens committee report indicates that.

Senator CONNALLY. For instance, take a little old wooden-ship building plant. I had some in my State that were a complete loss after they got through the war. Nobody wanted the ships, and they just had to junk them and sell the plant for scrap.

Mr. CHESTEEN. That was true throughout the shipping industry.

Senator LA FOLLETTE. Of course, it offers some inducements for wooden ships, or something of that kind.

Senator CONNALLY. The Government was backing them to start up, as an inducement to shipbuilding.

Senator BAILEY. Don't we have in mind that the munition manufacturers and others producing war material ought to have a net profit of 3 percent? Was not that covered yesterday?

Senator CONNALLY. That is in the bill.

Senator BAILEY. I am just assuming that to be the principle. If that is the principle, then you must allow for the loss on the capital investment at the end of the war, otherwise you would not get the 3 percent.

Senator CONNALLY. Otherwise he would not build his plant. The theory I have about this thing is, if we do not leave some reasonable element of profit in there, and also some hope that he might write off his actual bona-fide losses, the manufacturer would say, "I am not going to expand my plant, I am not going to invest new money to manufacture any war material because I haven't got any chance of getting it back."

That is, to my mind, a very practical proposition. We are all selfish, and we are patriots. A manufacturer says, "I will just quit during the war. I do not know why I should put into my plant my profits when I do not get anything. I will get everything I can."

Mr. CHESTEEN. Well, it was mentioned yesterday by Mr. Flynn, and it is disclosed, of course, in the audit of the war returns on the last war, that taxpayers faced with the problem of spending millions of dollars for war plant were also faced with the problem that if peace is declared tomorrow the plant will be worth very little. They are going to consider a long time before they make that expenditure, unless they know they are going to get the money somewhere to reimburse them for the expenditures.

Senator CONNALLY. Under the industrial provisions the Government could take charge of a plant and put its own money in it and expand it.

Mr. CHESTEEN. There is a provision to that effect.

Senator CONNALLY. Now, on the question of salaries, I thought about that a lot. If you say a man shall not get but \$20,000 in the form of salary, the corporation will not pay him but only \$20,000. It gets it back through dividends. I would like to differentiate, if I could, between salary and income from property. I think a man with a big salary, which is fictitious lots of times, ought to be stuck hard, although it goes contrary to the idea of earned income, of which I never did think much. I think we would have to treat that salary as any other income.

Mr. CHESTEEN. A few years ago Senator Gore introduced an amendment to limit salaries of corporation executives to some \$75,000 or \$80,000.

Senator CONNALLY. What they would do would be just not to pay any more than that; that is all.

Now, the first thing we will take up, according to my notions, will be the basis of taxing these corporations, whether on declared value or invested capital.

The next thing will be the rates on corporations, the rate of tax. Is that right?

Senator LA FOLLETTE. Yes.

Senator CONNALLY. Then we have got the individual rate.

Senator BAILEY. Then you have the point about the amortization or charge-off at the end.



Senator LA FOLLETTE. That, it seems to me, would naturally fall in the subdivision that you would have to put the corporation.

Senator BAILEY. You would have to create, would you not, a reserve for what you would call the obsolescence?

Senator CONNALLY. They charge depreciation every year.

Mr. CHESTEEN. England had a much broader provision in the last war for amortization than we did.

Senator BAILEY. Suppose you charge-off reserve for obsolescence, with the understanding that adjustments be made after the war, and let him make his profit, holding it in reserve as against the day when he destroys the factory?

Mr. CHESTEEN. In the last war the provision as written provided for a tentative allowance, and the commissioner, by regulation, allowed 25 percent.

Senator CONNALLY. It was left to his discretion, was it not?

Mr. CHESTEEN. He allowed 25 percent arbitrarily, when they filed their 1918 returns. Then the 1921 act made permanent the provision for passing upon the deduction. The 1918 act simply said after the war the law would be amended so as to provide for final deduction, but during the war there was a tentative deduction only, to the extent of 10 percent at the time returns were filed.

Senator BAILEY. For the purpose of reserve?

Mr. CHESTEEN. For amortization. Then when the return was audited the final allowance was made.

Senator CONNALLY. Then suppose you be prepared at our next meeting with the basis of taxing these corporations, whether the declared value or invested capital and the rates on corporations. If we get through with that on Monday, we will do pretty well.

We will recess until Monday at 10 o'clock.

(Whereupon, at the hour of 11:30 a. m., a recess was taken until Monday, Apr. 6, 1936, at 10 a. m.)



# TO PREVENT PROFITEERING IN WAR

MONDAY, APRIL 6, 1936

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

The subcommittee met, pursuant to adjournment, at 10 a. m., in Room 310, Senate Office Building, Senator Tom Connally presiding. Present: Senators Connally (chairman), Bailey, Guffey, and La Follette.

Also present: G. D. Chesteen, Allen T. Akin, and Joseph S. Zucker of the Joint Committee on Internal Revenue Taxation.

Ralph W. Brown, S. G. Winstead and P. J. Mitchell, of the Treasury Department.

S. E. Rice, office of the Senate legislative counsel.

Senator CONNALLY. The committee will come to order. Mr. Chesteen, we will be glad to hear you.

## STATEMENT OF G. D. CHESTEEN, OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Mr. CHESTEEN. We want to discuss with you, first, various plans for the taxing of corporations. The Nye bill sought to tax corporations by utilizing the declared value provided by section 701 of the Revenue Act of 1934. That value was used as a basis on which the corporation tax was levied, something like 4.7 percent of that declared value being free from taxes.

The first plan we want to discuss is the plan used during the last war, which is known as the invested capital scheme.

That scheme provided that the invested capital of a corporation should consist of cash or property paid in to the corporation at the time of incorporation, plus earnings or profits left in the business, plus any capital paid in by the stockholders or contributed by them in any way prior to the beginning of the taxable year. Then followed a number of limitations and adjustments to the invested capital, such as the limitation on intangible property like patents, goodwill, and so forth.

Senator CONNALLY. How about deductions in the way of obsolescence or depletion?

Mr. CHESTEEN. That was merely the plan of fixing the amount of the capital which the corporation had at the beginning of the taxable year, for the purpose of determining the amount free from excess profits tax.

We took that value, whatever it happened to be, and 8 percent of that value plus \$3,000 constituted the amount of income that was free of excess profits tax.

What constitutes invested capital, however, is so elusive as to be virtually impossible of computation.

I think some of those criticisms are a fairly true picture of the difficulties we have had with the excess profits tax. I know that we

That scheme, however, could not be applied to many corporations because of the method and manner of organization. We could not determine their invested capital. Probably their books did not show all of the capital that had been paid in. The manner of organization many times was such that their capital was abnormally low, or there might be some abnormal condition in income.

So there was a second section of the law that provided if a corporation's capital, due to the manner and method of organization, was abnormally low, it could be taxed by taking the average tax found by the first method I have described, for representative corporations.

Under that scheme the Bureau usually found the five or six most desirable corporations that seemed to be similarly situated that did have invested capital, and took the average tax paid by those corporations upon final determination as a measure of the tax.

Then, we had a third class of corporations where a part of the income of the corporation was from personal services and a part of it from capital, so it was necessary to provide for a third means by which those corporations could be taxed.

Section 303 of the 1918 act provided that where part of the business was personal service, and part of the income was from capital, that we first computed the amount of tax on the income that was from capital by using section 326 for determining its capital. After that was done, then the tax on the personal service portion was usually based on the rate of tax that had been found on the portion that was income from capital.

There was a limitation that in no event should the tax be less than 20 percent.

Those three scales were applied to the various classes of corporations falling within the classes described.

The sections necessary to set up the whole scheme of tax were complicated and covered a number of pages in the internal-revenue law, and if we were to attempt to restore those sections to a war bill at the present time, all we could hope to do would be to take the sections just as they are and try to superimpose them in the present peacetime law.

**Senator CONNALLY.** You mean just put them on top of the other?

**Mr. CHESTEEN.** Yes; put them in the proper place, because if we attempt to revise these sections and correct any defects that have been disclosed in the last 15 years it would take too much time, and we would not be able to get around to a bill.

The Nye committee considered this plan, and we do not know to what extent they went into the experiences which the Bureau had with the war-revenue acts.

**Senator CONNALLY.** Did they not have hearings?

**Mr. CHESTEEN.** So far as we know they examined the reports of the Couzens committee which set forth criticism of individual cases that had been handled by the Bureau. They also covered in their reports the testimony or statements rather, that had been given by a number of tax attorneys and public officials. For example, they quoted in their report the statement of Professor Seligman, who, I believe in an essay in 1925 said [reading]:

Section 13 (b) adopts the declared value that has been legislated in section 701 of the Revenue Act of 1934 for capital-stock purposes, but this section adds a few changes because it was the assumption

They also quoted Dr. Adams, who was formerly chairman of the advisory tax board of the Bureau of Internal Revenue. Dr. Adams said in an article about 1920 or 1921:

The intricacy of the excess-profits tax is such that it is hardly an exaggeration to say that it takes more time to teach an accountant to master its mysteries than the average accountant can be retained in the service after he has attained such mastery. \* \* \* Ten years would be a radically short time required in which to bring the taxpayers and the administrative authorities of the country to a point where the excess-profits tax could be reasonably well enforced.

The War Policies Commission analysis of testimony, prepared by its executive secretary, Mr. Robert H. Montgomery, a recognized expert on taxation, states that:

Some of the provisions of the laws were so highly complicated that they could not even be litigated because they could not be reduced to logical argument pro and con. The determination of what constituted invested capital was an insoluble problem during the continuance of the tax, and is still unsolved. Some of the fundamental principles of invested capital are now in the courts and will be there for years to come.

Secretary Houston, in his annual report for the fiscal year 1920, urged the repeal of the excess profits tax. Of course, he was looking then to a peace time law, and not the war period. He said:

The reasons for the repeal of the excess-profits tax should be convincing even to those who, on grounds of theory or general political philosophy, are in favor of taxes of this nature. The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its application and difficult of administration, despite the fact that it is limited to one class of business concerns--corporations. Moreover, it is rapidly losing its productivity. The invested capital of the average corporation, earning profits high enough to subject it to the excess-profits tax, is now estimated to be increasing at the approximate rate of 12 percent a year, while the income of the average corporation is almost certainly declining at as great a rate. Both movements cut into the productivity of the tax. If the present changes in capital and income continue for sometime in the future, as now seems probable, large reduction may be expected in the yield of the excess-profits tax. For the present fiscal year the profits tax, with collection of back taxes, is estimated to yield about \$1,250,000,000, and for the fiscal year 1922 about \$800,000,000 as against an estimated yield for the fiscal year 1920 of slightly over \$2,000,000,000.

Secretary Glass in his report for the fiscal year ended June 30, 1919, said:

The Treasury's objections to the excess-profits tax, even as a war expedient, \* \* \* have been repeatedly voiced before the committees of the Congress. Still more objectionable is the operation of the excess-profits tax in peacetimes. It encourages wasteful expenditure, puts a premium on overcapitalization, and a penalty on brains, energy, and enterprise, discourages new ventures, and confirms old ventures in their monopolies.

Of course, both of those statements by the Secretaries of the Treasury were made with a view of peace-time taxation and not with respect to war.

Upon the basis of those statements and the evidence which the Couzens committee brought out in its report to the Bureau, the Munitions Committee decided this scheme was too difficult to attempt to restore for a war-time bill, and for that reason they discarded it.

semblance of opposition to the theory that the values are too high, because the indication here is that the ratio of declared to book value is only 84 percent, and the ratio of declared value to market value is only 81 percent, so that they are evidently not high. We have never had a final court decision as to how to compute the invested capital of a consolidated group. That question came up at the time we had the United States Steel Corporation refund, and we had conflicting opinions by the board and by the courts, and that question has never been settled by a final decision by the Supreme Court. There are numerous other questions, like the question of what constitutes the same interest in connection with a consolidated group.

So, we could go through the excess-profits-tax law and pick out many terms which have been litigated and which the courts differ in their views, and which have not been decided, so that if you restore the language, you restore it with all those possibilities of confusion and litigation which would certainly follow in the event of another war.

I think probably Haig in his book on the British excess-profits taxes gives a better picture of some of the economic disturbances that result from an excess-profits tax. We do know that salaries were increased greatly during the war. The beginning of our big salary idea dates back to the war period, and after the war they continued to boost them. Bonuses were distributed because the corporation figured that we, because of the 82-percent tax saving the corporation was making a small portion of the expenditure. They engaged in a lot of advertising that ordinarily they would not have done. So that the scheme does encourage extravagance for the great companies that realize they are going to pay the tax and they might as well distribute it in various ways.

In view of that, the Nye committee sought to inject into the law a provision to restrict expenses like repairs and advertising, and other expenditures of a like nature.

The second scheme we want to discuss with you is the scheme which was put into the bill by the Nye committee, the declared value of 1934, and Mr. Zucker has all of the data on that, and I think he probably should run over that briefly with you and give you our findings.

Senator CONNALLY. The committee wants to decide right away, as soon as it possibly can, which one of these methods we are going to use, so that we can go to work on drafting this bill.

Mr. CHESTEEN. Suppose we give you a summary.

Senator CONNALLY. We will be glad to hear you, Mr. Zucker.

#### **STATEMENT OF JOSEPH S. ZUCKER, TEMPORARILY ON THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION**

Mr. ZUCKER. As Mr. Chesteen just stated the Nye bill proposed a method of taxing corporation using declared value for corporations as a basis upon which to compute a fair return which would be left tax free, and the rest would be taxed at certain graduated rates as given in the proposed Nye bill.

There are other refinements which are mentioned in section 13 of the proposed bill, which deal with how to determine adjustments to declared values.

of the Nye committee that the declared values are too high, and they give the Commissioner the authority to reduce high values to a lower point, without making any provision for making them higher, even at the request of taxpayers.

Then there is also a provision which gives the Commissioner authority to make appraisals of valuations of corporations that either have not filed capital-stock tax returns, or have not been in existence 1 year prior to the effective date of the act.

All of this is to insure that the basis upon which the corporation tax is levied shall not be too high. That is the whole purpose of that provision injected into section 13.

In following out the premise of the Nye committee, it suggested itself to us that we might take a representative group of corporations for study; and we did that. We used 14 companies, probably the largest in the United States, that might be affected by a war. Here is a list of the 14 companies which are given key numbers, but we have the names of them. The table is as follows:

SCHEDULE 1.—Declared value

Corporation	Adjusted declared value (1934)	Book value Dec. 31, 1933	Market value of stock Dec. 31, 1933	Ratio of declared value to book value	Ratio of declared value to market value
1.....	8,250,000	14,888,765	20,833,147	55.41	39.60
2.....	5,000,000	26,923,727	5,614,343	18.57	91.79
3.....	22,231,000	10,395,063	37,438,612	213.86	59.97
4.....	583,911,000	237,310,136	605,186,302	227.09	96.48
5.....	260,380,000	478,600,000	110,931,132	55.11	237.80
6.....	40,000,000	36,122,720	86,360,000	110.73	46.31
7.....	20,401,000	22,639,392	11,403,359	90.11	178.90
8.....	14,826,000	26,246,077	22,826,397	56.48	64.95
9.....	349,556,000	500,141,424	1,180,825,945	69.89	29.60
10.....	1,013,909,737	871,497,357	1,684,339,246	116.34	60.19
11.....	224,000,000	119,656,258	334,103,231	187.20	67.04
12.....	34,000,000	45,851,059	23,617,511	74.15	143.96
13.....	150,000,000	490,434,325	179,336,126	30.58	83.64
14.....	1,363,654,000	1,937,475,000	738,031,867	69.05	184.76
Total.....	4,090,118,737	4,818,195,503	5,040,847,218	84.88	81.13

Since the proposed bill attempts to freeze the declared values as of 1934, we took the income-tax returns and the capital-stock-tax returns of these 14 companies for the same year.

Mr. CHESTEEN. Some of those presented are among the largest groups in the country, so we did not take the smallest, but the very large groups, in many instances.

Mr. ZUCKER. You can see that the adjusted declared value of no. 10 is \$1,013,909,737.

The book values shown in the second column were either taken from the returns, or from Moody's, representing the figures given by the corporations themselves to Moody's.

The market value of the stock was obtained from stock-exchange quotations.

The real purpose of the chart is to show two things; first, that when taken in the aggregate the statistics tend to run in some

That would indicate, if we are to adopt the declared value as the basis, that the thought of the Nye committee that the Commissioner should be given only authority to revise values downward, would perhaps have to be amended so that there could be some upward

revisions, if we want to avoid hardships, as on the face of it it would appear corporations have understated values rather than overstated values.

Secondly, I particularly want to call attention to the fact that we take them in the aggregate, we get a reasonable figure; when we break them down as individual corporate units, we find the declared values are used largely by the corporations not so much to report what is their true values, but for a basis for arriving at the figure that will best suit for capital-stock tax and excess-profits tax purposes.

Secondly, I partially want to call attention to the fact that when we take them in the aggregate, we get a reasonable figure; when we break them down as individual corporate units, we find the declared values are used largely by the corporations not so much to report what is their true values, but for a basis for arriving at the figure that will best suit for capital-stock tax and excess-profits tax purposes.

If we look at the fourth column we find, for example, corporation no. 2 with the ratio of its declared value to book value of 18.5 percent, while corporations nos. 3 and 4 show more than 200 percent.

Senator CONNALLY. Those are groups?

Mr. ZUCKER. No; those are individual corporations. We just used 14 companies. They may be consolidated units of course but they are large enterprises.

Mr. CHESTEEN. Some of these groups, I think, run fifty or a hundred corporations to the group.

Senator LA FOLLETTE. Subsidiaries, you mean?

Mr. CHESTEEN. Yes.

Senator CONNALLY. That shows a very wide variance of percentage, some as high as 227 percent, and another 18 percent.

Mr. ZUCKER. It would indicate if we were to impose severe wartime taxes and would limit all corporations to the use of the declared value such as they have already declared for 1934, that there would be very wide discrepancies between capital structure, which would constitute the basis upon which the corporate tax would be levied in the various companies, and that manifestly it might work a hardship on some, whereas others may be paying their just taxes.

The total declared value here is \$4,000,000,000 for this group, and in order that we get an idea of what it represents in comparison to the aggregate, the total declared value for the entire country as shown in the corporations' return for 1934 was \$91,508,121,290.

Senator CONNALLY. That is for corporations?

Mr. ZUCKER. Yes; that is for corporations, the total returns.

We also have some figures which show the net income for this group in 1929. We took 1929 because we tried to find a boom time, comparable to what might occur in wartime in the operations of these companies, since they would all be affected in making war material. They are largely steel, chemicals, motors, aviation, and "natural resources" corporations. We find that these 14 companies during the prosperous 1929 year reflected in their returns about 7.5 percent of all of the income reported by all corporations, so we have, we think, taken a comparable group for study.

For 1933, which was a bad year, they represented 3.5 percent of the aggregate net income of all corporations. For 1934, the year for which these figures are given, they represented approximately 4.5 percent of all of the income of corporations.



In order that we may carry further this study, we made a schedule which shows the estimated market value of all corporate stock for the United States. This schedule itself only shows the market value of the 14 companies. We were handicapped somewhat in view of the lack of market information made available for corporations for the entire country, so we took the book value for all of the monied corporations, banks, insurance companies, and so forth, and we took the actual market values for the rest. The figure for the country for 1934 is \$109,012,306,000.

We used all of the data which was available in Moody's, then we took the Stock Exchange values, and also took the figures from the book values as shown by these corporations.

What we have here, comparing it to the capital-stock values reported, the \$109,000,000 represents stated commercial value for these companies as against \$91,000,000,000 declared by them, so that in the aggregate we can find somewhat a refutation of the Nye findings, that the declared values are not high, but are rather lower than they were assumed to be.

If we are going to use these smaller capital bases upon which to determine the exemption, there will be a larger tax yield.

As the result of looking at the factual data, I think it is worthy to present to the subcommittee two thoughts. These schedules given here, first in aggregate values prepared for 1934, show capital-stock values are not high; secondly, we find ourselves at an utter loss in parceling out justice as between the various corporations, because figures representing the ratio of declared value to market value, or to book value, vary tremendously between single corporate endeavors.

Perhaps there is one other thought, and that is this, I believe the attempt of the Nye body to inject the use of the declared value was predicated largely on the fact of the existence in the Revenue Act of 1934 of the tax methods for capital-stock tax and also for excess-profits tax.

The advantage pressed was that we now have an opportunity for building up experience with the use of that type of tax, and in a war bill we might as well follow the trend of existing taxation in peacetime. But, with the present possibility of its complete elimination in the tax bill now under consideration that advantage is taken from underneath the use of the declared value as a basis.

Senator LA FOLLETTE. I am not familiar with what appeared to cause the Nye committee to take this base, but I wonder if you know whether or not one of the considerations was the difficulty we experienced during the war with this problem so far as excess-profits tax is concerned?

Mr. ZUCKER. Yes; I think the report of the Munitions Committee, Report No. 944, expresses the fact that it would be hard to restore the invested-capital base, and resorted to this declared value as an alternative.

Senator CONNALLY. The ordinary corporate tax we have had here before was a percentage of the net income, was it?

Mr. ZUCKER. A percentage of the net income, and recently we have had the use of a graduated rate applied to corporations, but also based on the net income not in relation to their investment.

Senator CONNALLY. That is what I say, the income net, not, however, bearing any relationship to the capital?

Mr. ZUCKER. No, sir; and the proposed bill now pending, so far as I know, will also ignore the variations in the capital used in the business between the various corporations, but will only vary in application of rates depending upon the size of the income and the amount which will not be distributed.

Senator CONNALLY. Have you concluded, Mr. Zucker?

Mr. ZUCKER. Yes; I have, unless you want to ask some questions.

Mr. CHESTEEN. The third method we considered was to take the present scheme of taxing corporations, which is a flat tax on the income, and boost that rate to, say, 30 or 40 percent.

England, during the last war, had a rate of 30 percent flat corporate tax. We think you might well consider that plan by taking a 30- or 40-percent flat tax, then in addition to that, impose an additional tax or supertax upon that portion of the net income that has not been distributed during the taxable year.

That is the principle that is being considered now in the House, as the result of the President's recommendation, and we considered this phase for an additional scheme.

The Treasury, I believe, in presenting the matter over there, claimed that statistics show corporations have retained something like 25 percent of their net income over a period of 10 or 12 years. That would indicate that corporations as a whole find it necessary to retain about 25 percent of their income for expansion, or to absorb non-deductible items in their annual returns.

If we would take the view that corporations should be allowed to continue the same rate of expansion during war as they have during peacetimes, you might impose a supertax by permitting corporations to retain 25 percent of their war income, and all over that, tax it at 75 percent or 80 percent. If you tax it around 80 or 85 percent it would have an advantage in that you will find the stockholders would not retain it in the corporation, because it could be paid out, and on their individual returns they would probably be taxable at a less rate.

Senator CONNALLY. Once you did have the normal tax of 30 or 40 percent it would not operate equitably because some concerns that had a lot of business and made big profits during the war would pay only 30 percent of that income, whereas others might not have their income boosted at all, and would be subject to a heavier tax burden.

Mr. CHESTEEN. Yes; we are forcing the distribution of all of the income except what is regarded as necessary to expand the business, and if they do not distribute it we take a substantial portion of it as supertax.

We thought that scheme had considerable merit, because we undoubtedly could whip a provision like that into shape in much less time than we could attempt to revise either one of the other two schemes and put it into an act.

Mr. ZUCKER. And it is in consonance with the present provisions of the new tax bill. It eliminates some of the objections that have been raised to the use of the invested-capital method. Also, it does not fall into the inequalities which are apparent in the use of the declared-value method.

Senator CONNALLY. Those are the three plans you gentlemen have?

Mr. CHESTEEN. Yes.

Mr. ZUCKER. It has a further advantage to the corporations in that by the use of the experience of the last 10 years statistics have been gathered by the Treasury which indicate the amount of reserves that have been maintained by corporations to take care of the needs of the business, and we could, by allowing a portion of the undistributed income to remain tax free, as Mr. Chesteen indicated, between 20 and 30 percent, in wartime insure a proper conduct of the business along the lines of necessary expansion which the war might require and might take care of all of their financial needs, by the retention of that portion of the earnings required each year.

Mr. CHESTEEN. It has this weakness, in that you do not limit the corporation to a fixed return on their capital. Obviously 25 percent will depend on the amount of the income and if the corporation had a large income they could retain a large amount.

Senator CONNALLY. Without relation to its capital?

Mr. CHESTEEN. Yes; without relation to its capital.

Senator CONNALLY. Mr. Brown, do you care to submit your views on this third plan just proposed?

#### STATEMENT OF RALPH W. BROWN, OF THE TREASURY DEPARTMENT

Mr. BROWN. This is the first time I have heard that, but it is an interesting suggestion, and I think possibly deserves some consideration. I am a little bit concerned, however, about allowing such a large amount as 25 percent to go untaxed altogether, for the purposes of war revenue.

Of course, as Dr. Zucker has stated, there will be necessary expansion in time of war, and it will be more in some industries than in others, particularly the essential war industries.

The Nye bill does attempt to make some provision for matters of that sort by providing a revolving fund of half a billion dollars from which the War Department may make loans to industry, presumably for expansion purposes.

I imagine they would contemplate that a plant like the Du Pont Co., for example, would possibly obtain loans from the Government and therefore there would not arise after the war any question of amortization, a large amortization allowance which they might get the advantage of, and later on be able to use those plants for productive peacetime purposes, as for example rayon mills, and things of that sort.

Of course there is an interrelationship between the operation of the war machine and the income tax, and whether you contemplate that the industry itself will finance the necessary expansion, or whether the Government attempts to do that, or whether one or the other can do it, raises questions for very serious consideration by this committee.

I do think I should say in connection with Mr. Chesteen's proposal, that any of these plans should be on such a basis that the Bureau accumulate peacetime experience. It is a little awkward to go along for a period of say 10 years on one basis, then suddenly overnight have to shift over onto another basis with which you have

not had experience, and for which many of the provisions and doubtful points have not been clarified by final decision.

I think the merit of the Nye bill proposal depended in a large part upon the continuance of the capital tax and its companion, the excess-profits tax.

It was an ingenious plan that was worked out for peacetime taxation, inasmuch as one did more or less offset the other, and so long as your rates are low there is not very much danger. We would be building up, of course, experience which would be very valuable when you came to wartime.

It is contemplated, or at least proposed that the capital-stock tax after this year will be repealed, and its companion, the excess-profits tax. I think that works against the suggestion of the Nye committee to some extent.

In addition, there is under consideration on the House side, of course, the recommendation made by the President for a single tax; that is, we will do away with the capital-stock tax and its companion, the excess-profits tax, and have a single tax which will be levied under the proposal as originally made to levy it on the undistributed current earnings at graduated rates.

Under the plan reported out for the purpose of hearing by the Ways and Means Committee, it is proposed to use the amount undistributed as a measure for determining the tax applicable on the entire income for the year. For example, if the corporation had a net income of \$600,000 and paid out in dividends \$420,000 during the year, leaving \$180,000, then that \$180,000 would determine the rate which would apply to the \$600,000. I don't recall offhand the rate, but let us say it was 15 percent, that would mean that 15 percent of \$600,000 would be the tax.

If that is adopted in the House, and also by the Senate, of course, that will be our single corporation tax, it will be the tax upon which the Bureau will be accumulating experience in the meantime.

Whether the committee would wish to recommend a different basis for wartime taxation and to pass it at the same session it passes a peacetime bill, I think is a matter to which the committee would want to give some consideration.

There are other bases for a wartime tax and I do not know whether it is worth while to do more than mention them. One proposal is to appraise the going-concern value of corporations as of a certain time, say at the outbreak of war. That has the disadvantage of imposing a perfectly tremendous task upon the Bureau. It means 550,000-odd corporations would have to be appraised, and anyone who is familiar with the difficulties of valuing property will appreciate what a task that is.

On the other hand, of course, possibly going-concern value comes nearer to reaching the true capital for the purpose of computing the amount of earnings that you are going to exempt before you impose the tax they propose in their scheme.

Senator BAILEY. The rule of law in condemnation proceedings is that the going concern value must be considered.

Mr. BROWN. That is correct; but as I said, Senator Bailey, it is a tremendous task, and unless we have administrative machinery which works more rapidly than the present machinery for determining

valuation, I am afraid the war would be all over before we even made a dent in the problem.

Then there is the further basis for taxation which is to take the amount over an average of peacetime years, taking some period before the war which you consider to represent a normal period for corporations, and take the excesses of profits over that normal period to tax at a very high rate on the theory that possibly such profits are brought into being in part at least, by war activity. I think something along that line was the proposal which Mr. Baruch made to the Munitions Committee.

The most serious thought from the Treasury point of view is just how this ties into the bill that is pending on the other side. Assuming for the sake of argument that will be passed, of course apart from the question after impression it would create, there is the question of whether we should have a wartime tax bill for which we are not accumulating experience in time of peace.

Senator CONNALLY. Of course it would be highly desirable if we could work out a plan which would integrate itself more or less into the peacetime conditions.

Mr. BROWN. I think so, Senator, and that is why I think Mr. Chesteen's plan deserves some thought. I have not had a chance to consider it, because I only heard it for the first time this morning, but it does combine some of the features of the Presidential plan, and I concede that we want to have a wartime tax bill. I certainly do not, on behalf of the Treasury, wish to delay consideration of a wartime bill or its reporting out by the committee, if it intends to report a bill, but I do think the Treasury would like to consider a little further Mr. Chesteen's suggestion, and also just how the committee's plans tie into the present legislation in the House.

Senator CONNALLY. How long would it take the Treasury to give some views on that?

Mr. BROWN. I think in 2 or 3 days we can give out views.

Senator CONNALLY. I think we ought to have it, but I am very anxious to get ahead with the bill as rapidly as we can.

Mr. BROWN. As I say, we do not want in any way to delay your consideration of this war-profits bill, but the situation is rather different from the time when it was referred to your subcommittee, in view of the administration suggestions.

Senator CONNALLY. Do you suppose you can get some views together by Wednesday?

Mr. BROWN. I think so, Senator.

Senator CONNALLY. Then we will fix Thursday for you to come back on that.

Mr. BROWN. I should like to say I concur in the remarks of Mr. Chesteen and Mr. Zucker with respect to the use of the invested capital theory, and also their remarks with respect to the Nye bill; they are substantially the views of the Treasury.

Senator CONNALLY. You mean the criticisms?

Mr. BROWN. The criticisms of the invested capital, as well as the Nye bill, as well as the favorable comments which they made, because there are things to be said in favor. However, almost any basis that you take for high taxation in time of war, particularly which involves determination of the capital, you will run into difficulties, which so far no one has found a satisfactory answer to.

Senator CONNALLY. Mr. Chesteen's plan, of course, was only tentative, and I would like for the Treasury to also study the proposed rates so that we can have a definite basis on which to proceed.

Mr. BROWN. Of course when you come to rates it is a very difficult problem, inasmuch as I am not certain that any two persons would altogether agree as to what profits would be permitted consistent with the continuance of the profits motive. I don't know how the Treasury or any other group could undertake to say what that point will be.

Senator CONNALLY. Of course the committee would have to determine it finally, but we would like to have some estimate.

Mr. CHESTEEN. Would you not like to have the Treasury study the possible yield by taking a year like 1929, which is a year of high activity, and see what the scheme would produce in a year like 1929, or we could make a throw-back to 1918 if you wanted to, instead of 1929, but I think 1929 would probably be better.

Senator BAILEY. I think we will have to predicate this on what Mr. Harding calls "normalcy."

Mr. CHESTEEN. Take a year like 1926.

Senator BAILEY. 1926 is a good year. Stocks today are 13 percent higher than 1926, which is the heyday of Coolidge prosperity, and we are now 13 points better.

Senator CONNALLY. Then you all might go ahead and develop your ideas, but we will have to defer that point at this time.

Mr. CHESTEEN. In view of this proposal now pending before Congress, that struck us as being a possible solution of this question.

Senator LA FOLLETTE. You would leave the Treasury without experience upon which to proceed.

Mr. BROWN. And experience is very important.

Senator BAILEY. I would like for us to get up a reasonable bill. I do not want to get up what would bring about such a situation that we would not fight under any circumstances, and this bill would do just that, we would not fight if they stole our shirts, and I want a bill that will still make it possible for us in America to fight. We may have to fight, but not between now and the next session.

Senator CONNALLY. What is the wish of the committee, we will defer that decision until Thursday.

Senator LA FOLLETTE. Yes; but if it is convenient for the committee, we would like to go on with this matter tomorrow.

Senator CONNALLY. We can go with it right now, until noon. Let me suggest something: Why should not we determine at this time what we will do with this? The committee voted the other day to knock out of the bill all attempts to take the profit motive away from business, and I think the draftsmen and Mr. Chesteen and others can be instructed to take this bill and delete from it those clauses.

Mr. CHESTEEN. Those are administrative changes.

Senator CONNALLY. You are bound by the committee's action.

Senator LA FOLLETTE. Let us take out the attempt to clog up loopholes which would manifestly result in very high rates.

Senator BAILEY. That is in normal operation?

Senator LA FOLLETTE. Yes.

Mr. CHESTEEN. There is one important question in connection with those changes that you probably want to pass on now; that is filing quarterly returns. The Nye bill provides that the taxpayers shall file quarterly returns.

Senator BAILEY. File what?

Mr. CHESTEEN. File quarterly returns, tentative returns in the first 3 months, and it estimates its tax for the whole year, and it files another return at the end of 6 months—this is for corporations only, not individuals—then it files tentative returns at the end of 9 months and pay for another quarter, and at the end of the year it files a final return and pays the last quarter, and if it has underestimated its tax in the first quarters a penalty is imposed of some 10 percent for guessing wrong. Now, do you want to change the present system of filing returns which requires a return only once a year?

Senator BAILEY. That is for getting information, that is all that this requirement is.

Senator LA FOLLETTE. There is another objective, I suppose, back of that quarterly return idea, and that is to get the revenue currently.

Senator BAILEY. Well, the Government has no trouble in getting the money. It can borrow it. It does not make much difference.

Senator CONNALLY. It seems to me that is a pretty heavy burden on these fellows, to have to file four returns, to make estimates and then guess wrong.

Mr. ZUCKER. It is also important, I think, to bear in mind that in the first quarter they will have two taxes to pay. They will have the taxes for the prior year, plus the first quarter for the current year. The object of the Nye proposal is to get as much revenue as they could as soon as the war starts.

Senator BAILEY. Yes; but our basis of taxation is on the annual income.

Mr. ZUCKER. That is the basis of taxation in America.

Senator BAILEY. It is not on the quarterly income and the monthly income. We have taken the year as a standard, but under Mr. Nye's theory you have set up a new idea altogether.

Senator CONNALLY. Does the committee want to vote on that feature?

Senator BAILEY. I move we make it like it is now, on the annual income.

Senator CONNALLY. Senator Bailey moves the clause be stricken out requiring quarterly returns. As many as are in favor of that motion say "aye." Contrary-minded "no." The "ayes" have it and the motion is carried.

Senator BAILEY. Now, I will be perfectly willing to move that out, that a corporation be required, under a suitable penalty, to file balance sheets monthly or quarterly instead of by the year. If you wish to get the information as to the return, that is all right.

Mr. BROWN. On that point, Mr. Chairman, the Treasury reports concur in the views of the committee as to the difficulty of filing accurate quarterly returns. The deputy commissioner in charge of the income-tax unit did make a suggestion, which I will mention, because I think it completes the picture, that possibly you might take a ratio of net taxable income for the preceding taxable year to gross

receipts as a basis for a rule of thumb to determine the amount of taxable income on which you pay a tax on the quarterly basis. In other words, you take the ratio of net taxable income to gross receipts of the preceding year as a rule of thumb to apply to the income of the taxable year, so that your gross receipts, if they were coming in at a certain rate, you take that ratio, and that would be the tentative amount of tax, subject to adjustment later in the year. Of course, the filing of an actual return, involving the closing of the books and taking inventory, and all those considerations, would be well nigh impossible.

Senator CONNALLY. On a quarterly basis?

Mr. BROWN. On a quarterly basis; yes.

Senator BAILEY. You are absorbing his capital while he operates. He has to earn the money to pay the taxes at the end of the quarter.

Mr. BROWN. If the vote had been the other way it would have been a possible scheme, apart from the question of "how are you going to get the money to pay on a quarterly basis?". That raises another question altogether. Of course, whether the corporation would have cash in hand to pay taxes, that is another point.

Senator BAILEY. That is one of the points. You cannot collect the money that way.

Senator CONNALLY. Is it practical to require the filing of a quarterly balance sheet? Would that be any aid to the Treasury?

Mr. ZUCKER. Ordinarily, of course, as Senator Bailey stated, the corporate enterprises, the large ones, do have balance sheets which they make every month, but the manner of determining the income is on an annual basis. The smaller corporations would fall victim to the same provision and would have to make estimates along lines which, perhaps, would not be anything else but merest guess. Sometimes it would hit an industry that has a slow period in the first quarter, and it cannot at all estimate what its seasonal activity might be in the second or third quarter.

Senator CONNALLY. Well, there would be no objection to filing the balance sheet if they prepared one, would there, as of that date?

Senator BAILEY. Many do file a balance sheet at the end of the quarter, and every corporation that is well managed will have a balance sheet every month. The little ones have one every quarter, so they know where they stand at the end of every quarter, and so the bank would know if they wanted to borrow any money.

Mr. ZUCKER. We thought as a suggestion to the subcommittee for its consideration, one which might preserve the thought of the Nye committee, that is, to get revenue as soon as possible, would be to permit voluntary payment, with the Government giving interest in the form of a discount on the tax. Some such provision has been in vogue in connection with individuals, and a similar provision was tried in the 1917 law.

Senator CONNALLY. How did it react?

Mr. CHESTEEN. It was abolished, according to the records, on a recommendation of the Secretary of the Treasury.

Senator BAILEY. It did not operate long?

Mr. CHESTEEN. No.

Senator CONNALLY. In time of war they are not going to pay the tax in advance in order to take a 2- or 3-percent discount, when they figure that by retaining it in their operating capital they would make more out of it.



Senator BAILEY. Then you have a great system of refunds to pay. A man may pay the taxes on the first quarter and then lose money on the second, and make money on the third.

Senator CONNALLY. The motion is that they will be required to file a balance sheet every 90 days.

Senator LA FOLLETTE. Would it be of any service to the Treasury in estimating what the yield would be for a year? You are so far behind that you would not know much about it, would you?

Mr. BROWN. I am afraid the answer is "no." It would be of little value. From a social point of view it may be of interest. All that was gone into quite thoroughly, of course, during the consideration of the Securities Exchange Act. I think reference to the testimony taken at that time will show pretty well the feeling of the industry, as well as those who were sponsoring the bill on that particular subject. But, of course, the desire that the public be informed with respect to the internal financial status of a corporation is a social purpose which runs along in peace time as well as war times.

Senator BAILEY. I do not think we are running into social purposes in informing the public, in the course of a war. I am afraid if we inform the public how much we are paying out to the corporations on account of A. A. A. benefits, as we read in the papers this morning, you would bust it up. That works both ways. The idea is to enable the Government to collect the tax, not to gratify the curiosity of people as to the financial status of a corporation.

Mr. BROWN. To answer the question is that I do not think it would serve any purpose, so far as the Bureau is concerned, unless you would actually close the books on a quarterly basis and having an accurate return.

Senator LA FOLLETTE. I will withdraw the motion.

Senator CONNALLY. The Senator withdraws that motion. What else shall we proceed to? Individual rates?

Senator LA FOLLETTE. I thought perhaps, in view of the fact that it had been suggested the Treasury give consideration to these alternative bases for corporation taxes, that we might proceed for the balance of the time until 12 with a consideration of the individual rates.

Senator CONNALLY. That is satisfactory to me. I think it might be well for you gentlemen to get us up a little table of the proposed rates, as we discussed them here, and then get the consensus of the committee as to the change in rates.

Mr. BROWN, do you have anything to submit? You were here the other day when the full committee voted to increase the normal rate in the small-income bracket, were you not?

Mr. BROWN. Yes; I was here.

Senator CONNALLY. Did we take a vote on that before the full committee?

Senator LA FOLLETTE. Yes.

Senator CONNALLY. What does the Nye committee do in respect to that?

Senator LA FOLLETTE. Have you got some tables there that would be helpful?

Mr. ZUCKER. Yes.

(The tables referred to are as follows:)

## SCHEDULE 2.—Individual rates

## NORMAL TAX—10 PERCENT

Surtax	Rate, percent	Bracket	Total
Surtax net income:			
1st \$1,000.....	0	0	0
\$1,000 to \$2,000.....	6	60	60
\$2,000 to \$3,000.....	9	90	150
\$3,000 to \$4,000.....	12	120	270
\$4,000 to \$6,000.....	22	440	710
\$6,000 to \$7,500.....	35	525	1,235
\$7,500 to \$10,000.....	48	1,200	2,435
\$10,000 to \$15,000.....	60	3,000	5,435
\$15,000 to \$20,000.....	70	3,500	8,935
\$20,000 to \$30,000.....	80	8,000	16,935
Over \$30,000.....	85		

INCOME TAX, MARRIED MAN, NO DEPENDENTS; COMPARISON OF TAX PAYABLE <sup>1</sup> ON SPECIFIED NET INCOMES; PROPOSED WAR PROFITS TAX BILL AND GREAT BRITAIN PEACE TIME RATES <sup>2</sup>

Net income	Great Britain		Proposed rates	
	Tax	Percent of net income	Tax	Percent of net income
\$1,000.....	\$5.63	0.05	None	.....
\$1,500.....	50.63	3.37	550	3.33
\$2,000.....	95.63	4.78	100	5.00
\$2,500.....	182.81	7.31	180	7.20
\$3,000.....	272.81	9.09	250	8.66
\$3,500.....	362.81	10.36	355	10.14
\$4,000.....	452.81	11.32	450	11.25
\$4,500.....	542.81	12.06	560	12.44
\$5,000.....	632.81	12.65	670	13.40
\$6,000.....	812.81	13.54	990	16.50
\$7,000.....	992.81	14.18	1,310	18.71
\$8,000.....	1,195.31	14.94	1,760	22.00
\$9,000.....	1,420.31	15.78	2,275	25.27
\$10,000.....	1,615.31	16.45	2,855	28.55
\$12,000.....	2,205.31	18.37	4,135	34.45
\$14,000.....	2,795.94	19.89	5,535	39.53
\$16,000.....	3,414.69	21.33	6,935	43.35
\$18,000.....	4,084.69	22.68	8,535	47.41
\$20,000.....	4,754.69	23.77	10,135	50.67
\$25,000.....	6,704.69	26.81	14,535	58.14
\$30,000.....	8,792.19	29.30	19,035	63.45
\$40,000.....	13,242.19	33.10	28,485	71.21
\$50,000.....	18,242.19	36.48	37,985	75.97
\$60,000.....	23,517.19	39.19	47,485	79.14
\$70,000.....	28,792.19	41.13	56,985	81.40
\$80,000.....	34,204.69	42.75	66,485	83.10
\$100,000.....	45,304.69	45.30	85,485	85.48
\$200,000.....	104,929.69	52.46	180,485	90.24
\$500,000.....	294,804.69	58.96	405,485	93.09
\$1,000,000.....	613,554.69	61.35	940,485	94.04

<sup>1</sup> Personal exemption: Single person, \$500; married person, \$1,000; each dependent, \$200. Personal exemption credit for both normal and surtax.

<sup>2</sup> Great Britain taxes taken from p. 26 of A Summary of the British Tax System, by Magill, Parker & King.

Mr. CHESTEEN. Perhaps you would want to think about this question before we approach the rates. The Nye bill fixes the exemption for a single person at \$500, for a married person \$1,000, and \$100 for dependents. Do you want to let those stand or do you think those should be raised?

Senator CONNALLY. Suppose he had \$800 income, the expense of calculating and filing a return on that income would more than offset what you would get, would it not?

Mr. CHESTEEN. Well, in the last war we had, I think, \$2,000, and \$250 for dependents. So this is pretty severe. It goes down to one-half of that.

Senator CONNALLY. It may be \$800 for a single man.

Mr. CHESTEEN. You know the cost of living will go up during the war period, and I do not think anyone would contend that you can live during the period of war on less than \$500 a year in any of the cities.

Senator CONNALLY. How would \$800 and \$1,500 be? I believe in time of war we ought to go down pretty far, not necessarily for the purpose alone of getting the revenue, but to let everybody know that it is war and they have got to pay some money that they would not pay otherwise, that they are making some sacrifices.

Senator LA FOLLETTE. Then you will get some additional revenue too by lowering the base.

Mr. ZUCKER. I think if you consider the rates in conjunction with the exemption you can probably see the effect of it. The exemptions here were taken from the Nye bill, except for one change. The dependent allowance here is \$200. The dependent allowance under the Nye bill is \$100.

Senator CONNALLY. You mean on the first sheet?

Mr. ZUCKER. It is right at the bottom of the second sheet.

Senator CONNALLY. Oh, yes.

Mr. ZUCKER. These schedules are an attempt to clarify, or rather to put into figures the statement made by Senator La Follette at the last session, to utilize the British rate as a yardstick for comparison, and also to follow out the suggestion, and I think the vote of the Senate Finance Committee of bringing up into the higher brackets those that are now in the middle class incomes.

Senator CONNALLY. These proposed rates here are the Nye rates?

Mr. ZUCKER. No; these are rates that we have prepared following, as you will notice in column 1, the British rates now in effect in peacetime, in order to make the lower rates of the Nye committee reasonably comparable and somewhat in excess of the present British rates. We haven't any statistics as to the yield which will come from them. This is only put forward as a suggestion.

Senator CONNALLY. Well, you took as a basis, though, the exemption of a single person of \$500.

Mr. ZUCKER. Yes, sir; we took the exemptions in the Nye bill, subject to your voting otherwise on it. We thought we would take them as they were.

Senator CONNALLY. In other words, a man earning \$1,000 would pay nothing?

Mr. ZUCKER. A man earning \$1,000 would, under the proposed rates, pay nothing.

Senator LA FOLLETTE. That is a married man with no dependents?

Mr. ZUCKER. A married man with no dependents.

Senator CONNALLY. Yes.

Mr. ZUCKER. To that extent this is a little less severe than the present British rate, but we thought, in view of the standards of living not being exactly comparable, since the prices there are lower than they are here, we would have to allow that.

Senator CONNALLY. A man making \$1,500 pays \$50?

Mr. ZUCKER. He would pay \$50. I think it might be well if you look at the effective rates which we computed from the Nye bill, in the hearings of the subcommittee, found in appendix 3, page 5, part 1 of the hearings.

Senator BAILEY. I do not see why a man getting \$1,000 net income should not pay \$5.63, as they do in Great Britain.

Senator CONNALLY. That is a married man?

Senator BAILEY. Yes; you ought to get everybody into the war.

Mr. ZUCKER. That means you would put the married man's exemption to lower than \$1,000, Senator Bailey. To produce any money you would have to do that.

Senator BAILEY. This \$1,000 is over and above the exemption?

Mr. ZUCKER. No, sir; this is the total income.

Senator CONNALLY. The exemption is \$1,000, you see.

Senator BAILEY. I did not know that.

Senator LA FOLLETTE. This is a married man with no dependents, who has \$83 a month and who has a deduction of \$1,000, isn't that correct, he has an exemption of \$1,000?

Mr. AKIN. These figures mean that his taxes must come out of his net income.

Senator BAILEY. In other words, this is a taxable income, a tax on an income of \$1,000?

Mr. ZUCKER. Yes; they give him that much exemption for being a married man.

Senator BAILEY. That is over and above all his exemptions?

Senator CONNALLY. That is an exemption from tax, because you do not start to tax him until he has had his \$1,000 deduction. That is a deduction in that sense.

Mr. AKIN. If he is an ordinary wage earner making \$83 a month, without making any contributions, or anything like that, but just has that \$1,000, we do not tax him anything.

Senator BAILEY. He is charged, however, his local tax?

Mr. AKIN. This man has no tax.

Senator CONNALLY. It is immaterial whether he pays taxes in the State or county, because that takes him out of it, if his net income would be \$1,000.

Senator BAILEY. Why not put him in for \$10?

Senator CONNALLY. My idea was to start at \$800 and probably tax the next \$200 at \$5 apiece, giving him an exemption on \$800.

Senator BAILEY. I should think if he had that much money he ought to pay \$10.

Senator LA FOLLETTE. As I understand it, Senator, you would not propose to reduce the exemption on a married person to \$800?

Senator CONNALLY. The Senator here wants to make him pay \$10. How are you going to arrive at that unless you lower the exemption to \$800 and tax the other \$200 at \$5 apiece, that is, \$5 each hundred?

Senator LA FOLLETTE. Under the present law, for example, in peacetime we have a \$2,500 exemption for a married person and \$1,000 for a single person. Now, it would seem to me that \$800 for a married person would be an awfully low exemption.

Senator BAILEY. I was trying to make it a small sum, a small tax.

Senator CONNALLY. \$1,000 is awfully low for a married man. When I said \$800 I was thinking about a single man.

Senator BAILEY. He has his home and his salary, and the boys are at the front fighting. Why should not he pay? Why should he not make a small contribution?

Mr. ZUCKER. Of course out of the \$1,000 he is paying a good deal of indirect taxes.

Senator BAILEY. That falls on us all. Every time you buy a package of cigarettes you pay a tax.

Mr. ZUCKER. During the last war the exemption was \$2,000.

Senator BAILEY. I know we were busted during the last war.

Senator CONNALLY. Under the British law he pays \$5.63.

Mr. AKIN. Yes.

Senator CONNALLY. What is the British exemption? \$800?

Mr. AKIN. \$800.

Mr. CHESTEEN. It is about \$800.

Senator CONNALLY. I do not care about taxing very much, but I want everybody to feel the pinch of war.

Senator LA FOLLETTE. I would think if you went to \$1,500 for a married person it would be \$500 less than the exemption in the last war, and \$800 for a single person, that you would reduce the exemptions commensurate with the conditions that confront people during the war.

Senator BAILEY. Well, my view was not based on that, it was based on the capacity to pay. Say he got \$1,000 net income, after paying local taxes, interest, and other expenses, he has \$1,000, in war why should not he contribute \$10 a year, or more? That is all it figures out. We come down on the \$10, because he gets \$1,000. That is one-tenth of 1 percent, which puts him in the war, otherwise he has no interest in it.

Senator LA FOLLETTE. When you are dealing with exemptions you are arbitrarily fixing a place where the tax does not apply, just as you do in peacetimes, and it is just a matter of judgment and opinion. It seems to me if you reduce the exemption on a married person to \$1,500 during wartime, when you know the cost of living is going to be high, it would be more fair. Nobody knows what the cost of living would be during the war, but under the present situation you are collecting about 68 percent of our taxes from indirect taxation; isn't that right?

Mr. ZUCKER. Yes.

Senator LA FOLLETTE. That falls the heaviest on the group that is in the income bracket where they have to pay out nearly everything that they receive for their actual living.

Mr. CHESTEEN. Even under the Nye bill, with all the economic provisions in titles II to VI, they admit there will be a considerable inflation in the war period. Of course, that will fall heaviest on people with low incomes. If you reduce the exemption to \$1,500 I think you should not lose sight of the fact that the cost of living of those people will go up during the war period.

Senator BAILEY. Well, you haven't predicated these schedules on the rising cost of living during the war. I do not think you could do that.

Mr. CHESTEEN. No; these are not predicated on that.

Senator CONNALLY. Is this table based on the proposed Nye rates?

Mr. AKIN. Those tables are based on a rate approximating the lower income-tax class of the British rates.

Senator CONNALLY. In the British rates you have 61 percent in the last line and we have 94 percent.

Mr. AKIN. I said only in the lower income-tax brackets. We use rates comparable to the Nye rates in the higher income brackets.

Senator LA FOLLETTE. What I suggested at the last meeting was, in view of the action of the full committee, that we ought to tax heavier in the lower brackets. I simply suggested that as being helpful, to take the British rates in the so-called lower brackets, to see what kind of a curve and what kind of a schedule you have if you shot it in under the Nye rates. If these are higher rates, we will have to exercise judgment about those too.

Senator CONNALLY. Some of these rates look pretty stiff to me. Here is a man with a \$2,000 income and he pays \$95; the \$2,500 man pays \$182; he pays nearly twice as much on that last \$500 as the other fellow pays on the \$2,000.

Mr. ZUCKER. That is the British existing rate today.

Senator CONNALLY. I know it is, but it seems to me that is a pretty big jump.

Mr. ZUCKER. That is because it is predicated on the ability to pay. The man making over \$2,000, according to their concept, has the ability to sacrifice, to pay a larger proportion in taxes.

Senator CONNALLY. These rates on \$4,000 and \$5,000 seem to me to be reasonable. The British rate on \$4,500 is \$542, and on \$5,000 it is \$632; on \$6,000 it is \$812. I do not think those are high.

Senator BAILEY. You notice ours are higher than the British rate in those brackets.

Senator CONNALLY. What?

Senator BAILEY. Our proposed rates are higher than the British rates. The British rate on \$1,000,000 is \$613,000, and our rate is \$940,000.

Mr. CHESTEEN. That is because it is approaching the Nye schedule.

Senator CONNALLY. These are not the Nye rates in the lower income. The Nye rates are the higher-income brackets.

Senator LA FOLLETTE. You can find those on page 5, Senator. The comparable table is here. You can see what the Nye rate is.

Mr. ZUCKER. The maximum rate proposed in the Nye bill is 99 percent on the amount in excess of \$1,000,000. What this schedule contemplates is taking, under no circumstances, more than 95 percent. We have here a 10-percent normal tax and the maximum surtax rate applicable to incomes over \$30,000 of 85 percent. These figures are all merely tentative rates; they are just presented for consideration.

Senator BAILEY. Under the Nye rate, on page 5, a man who makes \$1,000,000 pays the Government \$980,000, or a little bit less than that, which leaves him \$20,000. The common sense of that does not appeal to me. He would have to disrupt his whole economic fabric. Talking about social effects, that would be an utter disruption to a man who has been running his family on an overhead of \$500,000 and to instantly cut him down to \$20,000.

Senator CONNALLY. These rates they propose now will allow him \$60,000.

Mr. CHESTEEN. These are really not proposed rates; they are just an adaptation of Senator La Follette's suggestion to the rate in the higher brackets; that is all.

Mr. ZUCKER. In connection with that thought of the \$1,000 was paying taxes, Senator Bailey. We would have a mass of returns which would be filed, and the total revenue in wartimes from these returns probably would not be more than \$10,000,000 or \$15,000,000.

Senator BAILEY. What would not be more than 10 or 15 million dollars?

Mr. ZUCKER. If we were to carry your suggestion into effect in this law—that is, that anyone making \$1,000 should pay \$10 tax.

Senator BAILEY. You mean it would not yield that?

Mr. ZUCKER. The yield would be negligible compared to the millions of returns that would have to be filed to produce that yield.

Senator BAILEY. From the standpoint of this bill, the bill attempts to put everybody into the war. That is the conception of the bill. It puts us on an equal footing with the soldier, and consistent with that we might put a tax on a fellow with \$1,000 income. I would not insist on it.

I would not think about voting to cut a man's income from \$1,000,000 to \$20,000 a year. I do not care anything about him, but I think he would have to break up his house.

Senator LA FOLLETTE. You can get some idea of what a reduction of exemptions would do in this tax year from some estimates that I got from the Treasury on proposed reductions in the exemptions now, reducing the married man's exemption from \$2,500 to \$2,000 and a single person from \$1,000 to \$800. The Treasury estimates that that would produce about \$45,000,000 of additional revenue, and Mr. Parker estimated it would bring in about 1,400,000 new taxpayers, but that the 1,400,000 new taxpayers would produce only about \$7,000,000 of the increase and the balance would be produced by cutting the exemptions down from those people who are in the brackets above the new taxpayers. So there is a point where you have to consider how much you are really going to get in net increases in revenue when you reduce the exemption. I mean you have got the problem of administration, examining the returns, collecting the data.

Theoretically I agree with you, Senator, that every person, both in peacetime and in wartime, should pay taxes to the Federal Government, but when you come to apply that theory you have to be governed to a certain extent by the practical aspects of the situation.

Senator BAILEY. I am not very greatly concerned about that, but I will not make any motion to that effect.

Senator CONNALLY. We will have to determine that sooner or later. Somebody will have to make a motion. Had not we better determine this exemption early in the hearing, because all the rates will be based on that?

Mr. CHESTEEN. Yes; and the contributions.

Senator LA FOLLETTE. I would be willing to suggest for the consideration of the committee that we make the exemption in wartime for a married person \$1,500 and for a single person \$800.

Senator BAILEY. With \$100 for each child, as it now reads in the bill?

Senator LA FOLLETTE. I think personally it should be \$250.

Senator CONNALLY. I think it would be better to put it in as \$200.

Senator LA FOLLETTE. \$200; all right.

Senator BAILEY. Why not make it \$250? A man has got to take care of his child. \$250 is a very small sum.

Senator CONNALLY. The motion is then that the exemptions for a single person be \$800 and for a married man \$1,500, and \$250 exemption for each child, for each dependent child.

Senator BAILEY. And that the definitions be as they are now in the existing law.

Mr. ZUCKER. There is only one thought, if I may be permitted to state it, and that is, if you make the exemption on the single man more than one-half of what it is on the married man then there will result an apparent disadvantage to a married couple filing separate returns. Ordinarily you make the exemption a little lower for the single man than half of what you allow for the married man.

Senator BAILEY. Why not leave that on the joint returns? Why not reduce it on the single man and make it a higher exemption for the husband and wife?

Senator CONNALLY. Are they filing a joint return or a single return as they see fit?

Mr. ZUCKER. The Nye bill requires the compulsory filing of a joint return.

Senator CONNALLY. We knocked that out.

Mr. ZUCKER. If we are going to give them the option of filing single or joint return—

Senator CONNALLY. They are not single people.

Mr. ZUCKER. A husband and wife, if they are earning money separately, may file single returns today.

Mr. CHESTEEN. They permit it under the present law, Senator; they permit them to file separate or joint returns.

Senator LA FOLLETTE. If we are giving any advantage, it seems to me it ought to go to the married person.

Senator BAILEY. That is right.

Senator CONNALLY. Why not make it \$800 and \$1,600?

Mr. CHESTEEN. Either that or \$750 and \$1,500.

Senator BAILEY. Now you are getting too low.

Mr. CHESTEEN. \$800 and \$1,600.

Senator CONNALLY. How about that, Senator La Follette?

Senator LA FOLLETTE. I suggested last year—I did not get anywhere with it—that we should reduce the exemptions even now in these times from \$2,500 for a married man to \$2,000 and from \$1,000 to \$800 for a single person.

Senator BAILEY. It is \$2,500 now?

Senator LA FOLLETTE. Yes.

Senator BAILEY. You would not reduce the exemption for children from \$400? The present exemption per child is \$400.

Senator CONNALLY. He is talking about peacetime.

Senator LA FOLLETTE. In peacetime.

Senator CONNALLY. Then the motion is to change this to \$1,600 and \$800; is that right?

Senator LA FOLLETTE. Will that take care of the situation?

Senator CONNALLY. If they have any children, of course, they have the married rate, they will file joint returns in order to get the married rate, and in order to get the exemption for dependents.

Mr. AKIN. It would not make any difference, under the present law, whether they chose to do that or not.



Mr. CHESTEEN. We split the exemption under the present law between them.

Senator BAILEY. All you gentlemen have to do is to so fix it that they cannot take advantage of it, just as we have it now. The husband and wife cannot take advantage of it. They would not get under \$800 exemption if they filed separately.

Senator CONNALLY. Those in favor of the motion to make it \$800, \$1,600, and \$250, say "aye." Those opposed "no." The motion is carried.

Mr. CHESTEEN. Now, we probably want to decide the question of earned income. The Nye committee cut out the credit for earned income.

Senator CONNALLY. I am in favor of cutting out the credit for earned income, because that is where the big-salaried people would get a big advantage over the man that has got a little saving and property.

Mr. CHESTEEN. Under the present law the earned income benefit is limited—very limited.

Senator CONNALLY. It takes a lot of calculating and computing.

Mr. CHESTEEN. That is true.

Senator BAILEY. What is your distinction between income and earned income in the existing law?

Mr. CHESTEEN. Well, I believe the income of every individual, if his income is not over \$3,000, is presumed to be earned income. If he actually earns an income in excess of that figure, he may claim earned income up to the extent of \$14,000. That is the maximum.

Senator BAILEY. If he earns any more he does not get the benefit of it?

Mr. CHESTEEN. No; he does not get the benefit of it.

Senator BAILEY. That is a special rate on earned income?

Mr. CHESTEEN. Yes; it is 10 percent.

Senator CONNALLY. That is for personal services and salaries; that is all.

Mr. CHESTEEN. He gets a deduction of 10 percent on earned income in addition to all other deductions for computing the amount of normal tax; that is all. It amounts to a few dollars at most.

Senator LA FOLLETTE. I do not think it makes enough difference to worry about it. I think you might as well retain it.

Senator CONNALLY. Well, the Nye committee cut it out.

Mr. CHESTEEN. They cut it out.

Senator CONNALLY. Could you continue that just like it is in this bill?

Mr. CHESTEEN. I think it is not any great trouble to change.

Senator BAILEY. Why put it in? This limits the income under any circumstances.

Senator CONNALLY. You mean cut it out of the Nye bill?

Mr. CHESTEEN. They have cut it out of the law. Do you want to put it back or leave the Nye bill as it is in that respect?

Senator CONNALLY. I think it is the view of the committee to put it back.

Mr. CHESTEEN. Do you want to recognize an income to the extent we recognize it under the present law?

Senator BAILEY. I do not quite see why we should since we have rates which keep the income down, whether it is earned or unearned. Suppose a man gets a salary of \$1,000,000, under these rates he is cut down to \$40,000.

Senator CONNALLY. What do you think about that, Senator La Follette?

Senator LA FOLLETTE. Personally I think we have reduced it now in the law to a point where it really is not an important part, so far as that is concerned.

Senator CONNALLY. We will leave it out then.

Senator LA FOLLETTE. It used to be up to \$30,000.

Senator CONNALLY. Suppose we leave it like the Nye bill has it? Just cut it out. Can we do that easily?

Mr. CHESTEEN. We can do that, or leave it like it is in the present law.

Senator CONNALLY. I think it ought to come out, because we are trying to avoid the payment of bonus and salaries and so on that are too high.

Senator LA FOLLETTE. Leave it the way it is.

Senator CONNALLY. All right; leave it the way it is.

Senator BAILEY. If you feel we need to vote on it I will vote for it.

Senator CONNALLY. By tomorrow I wish you would revise these tables a little bit and we will go over these rates tomorrow, these individual rates.

Mr. CHESTEEN. I wonder if you would like for us to work up tables? You can indicate the maximum and minimum rates that you want to set up.

Senator CONNALLY. Could not you split up the difference between the Nye committee rates and the British rates?

Mr. CHESTEEN. You give us a maximum rate and we will work downward.

Mr. AKIN. Senator Connally, on your low income-tax brackets it is essential that a high normal rate be levied if you are going to get any tax from people in the low-income class.

Senator LA FOLLETTE. We had 12 percent during the war and they proposed 10 percent, the Nye committee.

Mr. AKIN. They proposed 6 percent. We proposed, in this study here, 10.

Senator CONNALLY. You are suggesting 10 percent flat normal rate and go all the way up?

Mr. MITCHELL. In explanation of the English rate, if I may say so, Senators the present rate here, after that exemption is taken off for the first \$1,125, the rate is 11 percent. The income in excess of both the personal exemption and in excess of the first \$1,125 then begins at 22½ percent. So that substantially you may say the standard rate is 22½ percent.

Senator BAILEY. Let me put a question to you gentlemen and to the committee. Assume that a man has a salary, an income of \$20,000 a year, has two servants and three children in school—and the cost now in high school is at least \$1,000 a year—and assume that a war came; he would have to take his children out of the schools. His income is cut to \$10,000 and he might have to discharge his servants.

Mr. CHESTEEN. I think that is probably one thing you have to consider in your rate question, whether or not you are going to adopt the policy of requiring people of wealth to pay the living expenses partly out of the capital, or whether you want to leave them a sufficient amount to pay their living expenses. That is a matter of policy.

Senator BAILEY. I am just assuming the Nye committee has not thought of it.

Senator CONNALLY. What do you think of this kind of scheme, Senator Bailey: If a man has a million-dollar income and we take as much of that million as we want to take, that will be the percentage of it, and then we can figure back the rates.

Mr. CHESTEEN. We would like to have you indicate the maximum rate that you want, whether you want to stop as the Nye committee did, at 99 percent, or whether you want to stop at 90, 85, or 80, or whatever figure you fix as the maximum rate beyond which you do not want to tax any income at a greater rate than that. Then we will work the schedules backward, taking that maximum rate. If you say you want to stop at 85, we will work up a schedule that has a maximum rate at 85.

Senator CONNALLY. At what point? \$5,000,000 or \$10,000,000?

Mr. CHESTEEN. Well, that is something that you can decide, or we can use our own judgment.

Senator CONNALLY. I think if a man has got \$1,000,000 and we take 75 percent away from him, that will be pretty fair taxation.

Senator BAILEY. We take 62 percent now.

Senator CONNALLY. Not on the \$1,000,000.

Mr. CHESTEEN. We take six-hundred-and-some-odd.

Senator CONNALLY. The British take \$613,000. How about 80 percent of a million, and then above that you can take 85, if you want to?

Mr. ZUCKER. We take \$679,000 now under the 1935 law.

Mr. CHESTEEN. We have very severe rates now. When you get into the higher brackets, the 1935 rates are pretty severe. They are almost equal to the British wartime rates.

Senator CONNALLY. These rates in the lower brackets—the British rates in the lower brackets seem to me to be about right.

Mr. CHESTEEN. The Nye rates do not have very much relationship to the British rates.

Senator LA FOLLETTE. These are not the Nye rates, Senator.

Senator CONNALLY. I mean the Nye rates are much lower than the ordinary incomes of the British, and yet when they get up to \$5,000,000 it takes \$4,994,000. I thought it took everything above \$20,000.

Mr. CHESTEEN. They take off 1 percent above \$20,000. When you get to five million you have left about \$40,000. For every million over one million you pick up \$10,000.

Senator CONNALLY. I am like Senator Bailey, I do not care anything about that individually, but I just do not want to interrupt the whole establishment.

Senator BAILEY. Here is a man with \$10,000; the tax will be \$2,855. That is nearly \$3,000. Now, you are going to pay a State income tax also. His income would be reduced to \$7,000. If he had two children in college he would have to take them out.

Senator CONNALLY. He would pay \$2,855, according to this table, on \$10,000.

Senator BAILEY. Yes. The rate in my State is 6 percent.

Senator LA FOLLETTE. You have got to go into those so-called lower brackets if you really want revenue.

Senator BAILEY. Yes. You do not want to turn the children out of school.

Senator CONNALLY. The British rate on \$10,000 is \$1,645, and you have here the proposed rate on \$10,000 of \$2,855.

Mr. CHESTEEN. That is more severe than the British rate.

Senator LA FOLLETTE. Of course, this is the British peace-time rate.

Mr. CHESTEEN. We could work up a schedule and use it as a guide and see what the British war rate was.

Senator CONNALLY. Do you want to determine the maximum here this morning, gentlemen?

Senator LA FOLLETTE. I think we ought to let that go until we get more information.

Senator CONNALLY. It is 12 o'clock. I would like to have another meeting in the morning at 10 o'clock.

(Whereupon at the hour of 12 o'clock noon, a recess was taken until 10 a. m. of the following day, Tuesday, Apr. 7, 1936.)

# TO PREVENT PROFITEERING IN WAR

TUESDAY, APRIL 7, 1936

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

The subcommittee met, pursuant to adjournment, at 10 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding. Present: Senators Connally (chairman), Guffey, and La Follette.

Also present: G. D. Chesteen, Joseph S. Zucker, and Allen T. Akin, of the Joint Committee on Internal Revenue Taxation; Ralph W. Brown and P. J. Mitchell, of the Treasury Department; and S. E. Rice, office of the Senate Legislative Counsel.

Senator CONNALLY. All right, gentlemen. We were talking about the rates, were we not, Mr. Chesteen?

Mr. CHESTEEN. Yes, sir.

Senator CONNALLY. Individual rates?

Mr. CHESTEEN. Individual rates.

Senator CONNALLY. All right.

Mr. CHESTEEN. We have another schedule, if you want to consider that now, or do you want to wait?

Senator CONNALLY. You mean you made up a new schedule?

Mr. CHESTEEN. Yes.

Senator CONNALLY. Well, we might pass it around and look it over.

(The schedule referred to is as follows:)

SCHEDULE 3.—*Individual rates—second proposal, normal tax—10 percent*

Surtax	Rate	Bracket	Total
<b>Surtax net income:</b>			
First \$1000.....	0	0	0
\$1,000 to \$2,000.....	6	60	60
\$2,000 to \$3,000.....	9	90	150
\$3,000 to \$4,000.....	12	120	270
\$4,000 to \$6,000.....	15	300	570
\$6,000 to \$8,000.....	18	360	930
\$8,000 to \$10,000.....	21	420	1,350
\$10,000 to \$14,000.....	25	1,000	2,350
\$14,000 to \$18,000.....	30	1,200	3,550
\$18,000 to \$24,000.....	35	2,100	5,650
\$24,000 to \$30,000.....	40	2,400	8,050
\$30,000 to \$40,000.....	50	5,000	13,050
\$40,000 to \$50,000.....	60	6,000	19,050
\$50,000 to \$75,000.....	70	17,500	36,550
Over \$75,000.....	80		
<b>Personal exemptions:</b>			
Married person.....			\$1,600
Single person.....			800
Each dependent.....			250

*Married person, no dependents, tax payable on specified net incomes*

Net income	Second proposal, personal exemption		H. R. 5529, \$1,000 personal exemption		Revenue Act, 1935 \$2,500 personal exemption	
	Tax	Percent of net income	Tax	Percent of net income	Tax	Percent of net income
\$1,000	\$0		\$0		\$0	
\$1,500	0		30	2.00	0	
\$2,000	40	0.20	60	3.00	0	
\$2,500	90	3.60	90	3.60	0	
\$3,000	164	5.40	120	4.00	8	0.03
\$3,500	244	6.90	150	4.28	26	.07
\$4,000	336	8.40	180	4.50	44	1.10
\$4,500	431	9.57	200	5.77	62	1.40
\$5,000	538	10.76	340	6.80	80	1.60
\$5,500	770	12.83	500	8.33	116	1.90
\$6,000	1,020	14.57	800	12.28	172	2.60
\$7,000	1,282	16.02	1,320	16.50	248	3.10
\$8,000	1,564	17.06	1,880	20.88	329	3.70
\$10,000	1,854	18.54	2,640	26.40	415	4.20
\$12,000	2,400	20.75	4,160	34.66	602	5.00
\$14,000	3,100	22.78	5,680	40.57	809	5.80
\$16,000	3,910	24.43	7,200	45.00	1,044	6.50
\$18,000	4,710	26.16	8,720	48.44	1,299	7.20
\$20,000	5,530	27.65	10,240	51.20	1,589	7.90
\$25,000	7,780	31.12	14,000	56.84	2,099	10.90
\$30,000	10,250	34.16	19,610	65.36	3,569	11.80
\$40,000	16,090	40.22	29,810	74.52	5,079	14.00
\$50,000	22,930	45.86	39,710	79.42	6,869	17.70
\$60,000	30,930	51.55	49,010	82.02	12,329	20.50
\$70,000	39,770	56.33	59,510	85.01	18,549	23.60
\$80,000	46,910	58.83	69,410	86.76	21,269	26.60
\$100,000	65,110	65.11	89,210	89.21	32,469	32.50
\$200,000	158,110	77.55	188,210	94.10	95,344	47.70
\$500,000	428,110	85.02	488,210	97.04	304,144	60.80
\$1,000,000	875,110	87.21	980,210	98.02	679,044	67.90

Senator CONNALLY. You may discuss it briefly. Is this based on a normal rate of 6 percent?

Mr. CHESTEEN. It is based on a normal rate of 10 percent and above \$75,000 the surtax rate is 80 percent and, of course, the 10-percent normal tax also will apply, making the maximum tax above \$75,000 90 percent.

Senator CONNALLY. Wait a minute. On \$2,000 you make him pay \$60. How do you get that out of \$400?

Mr. ZUCKER. The first column is the proposed rate. The second column represents the rates as they are now in the Nye bill.

Mr. CHESTEEN. The Senator is looking at the top sheet instead of the second sheet.

Mr. AKIN. That is the surtax net income, that is the base. That \$60 would be the \$60 of surtax on the amount between \$1,000 and \$2,000, in excess of the personal exemption of \$1,600.

Senator CONNALLY. Oh, yes. That is on the other page.

Mr. CHESTEEN. Yes; on the second page. The second column gives the tax.

Senator CONNALLY. On \$1,000 he would not pay anything. When he gets to \$2,000 he would pay how much?

Mr. CHESTEEN. \$40.

Senator CONNALLY. That is based on a normal tax of 10 percent above his exemption?

Mr. CHESTEEN. That is right.

Senator CONNALLY. That is higher than we ever had.

Mr. AKIN. In the war period we had 6 percent and 12 percent.

Senator CONNALLY. Where did the 12 percent start?

Mr. CHESTEEN. My recollection is that under the 1918 act the 6 percent applies on the first \$4,000. Six percent upon the first \$4,000 net income, subject to a normal tax and 12 percent upon the excess.

Senator CONNALLY. According to this, then, a man with \$1,000,000 would pay \$875,110 tax.

Mr. CHESTEEN. That is right. That is an effective rate of 87.21 percent.

Senator CONNALLY. That is an effective rate of 87.51 percent, is it not?

Mr. CHESTEEN. On the second page, in the second line is the tax and in the third line is the effective rate. This schedule was computed on the basis of a \$1,600 exemption for a married man with no children. The rate, after \$75,000, is 80 percent surtax and 10 percent normal tax, making a total tax burden above \$75,000 of 90 percent.

Senator CONNALLY. Well, now, in compiling these tables did you try to relate them somewhat like they have been related heretofore, assuming a higher rate both at the bottom and at the top? Did you graduate them?

Mr. CHESTEEN. Yes; this schedule follows somewhat the plan we discussed with you yesterday and the plan mentioned by Senator La Follette the other day in reference to the lower brackets, and also mentioned by Mr. Parker, that he thought we might boost the rates in the Nye bill in the lower brackets, so we followed somewhat the plan of yesterday, only we began with \$75,000, we stopped the graduation and made it 80 percent plus the normal tax which would be 10 percent, or 90 percent applicable to all income above \$75,000.

Senator CONNALLY. You mean you taxed all income above \$75,000 90 percent?

Mr. CHESTEEN. Ninety percent.

Senator LA FOLLETTE. Where is that shown?

Mr. CHESTEEN. That is shown on the first page, I believe, 10 percent normal tax over \$75,000, and in the third column it shows the rates that apply. The graduation begins at 6 percent and goes up to 80 percent on \$75,000 and above. That means the total load is 90 percent above \$75,000.

Senator CONNALLY. What is that?

Mr. CHESTEEN. The total load is 90 percent on all income above \$75,000. In other words, if there is another million added on to the million we have here we will take \$900,000 of every million.

Senator CONNALLY. Let me say to Senator La Follette that this is based on a 10-percent normal rate.

Senator LA FOLLETTE. Yes.

Mr. CHESTEEN. It is based on a 10-percent normal rate and the graduation indicated by the first sheet in the third line, which begins at 6 percent and runs up to 80 percent on \$75,000 and above.

Senator CONNALLY. It begins at 6 percent?

Mr. CHESTEEN. Yes.

Senator CONNALLY. What would you put on when you get to \$6,000?

Mr. CHESTEEN. From \$1,000 to \$2,000, the surtax on net income, that is above the exemption, the rate of surtax would be 6 percent in addition to the 10-percent normal tax.

Senator CONNALLY. I see.

Mr. CHESTEEN. The second sheet merely carries into effect the rates indicated in the third line of the first sheet.

Senator CONNALLY. This is the net income?

Mr. CHESTEEN. This is net income, that is right, before any exemption. On the second sheet, where you see the computation, we begin with the actual income, before we apply the exemption.

Senator CONNALLY. Before you apply the exemption?

Mr. CHESTEEN. Yes. The \$1,500 there has no tax at all, because we have a \$1,600 exemption for a married man. Now, on \$2,000 the tax is \$40, because he has a \$1,600 exemption; therefore he has \$400 subject to a 10-percent tax, or \$40.

Senator CONNALLY. As against \$60 in the Nye bill.

Mr. CHESTEEN. That is right. Of course, the Nye bill has a lower exemption. Now, you get up to \$10,000, and I believe the schedule we had yesterday had something like \$2,850. Here we have a tax of \$1,854 on \$10,000, and an effective rate of 18.54.

Senator CONNALLY. Where does the Nye rate start that 99 percent?

Mr. CHESTEEN. Above \$20,000.

Senator CONNALLY. Everything above \$20,000?

Mr. CHESTEEN. Everything above \$20,000 is subject to a 99 percent rate under the Nye bill. Now, this is, of course, graduated much higher. We graduate up to \$75,000, and from \$75,000 this takes 90 percent, where the Nye bill takes 99 percent from \$20,000 on.

Senator CONNALLY. You do not graduate much, though, after you get to \$75,000?

Mr. CHESTEEN. We do not graduate, we just take 90 percent from there on. We did not care to add an additional graduation because we thought that was a matter of policy for you to decide, if you wanted to graduate from \$75,000 on, you could graduate it up to any figure.

Senator CONNALLY. Let us see what a man with a \$40,000 income would pay. He would pay \$16,000.

Mr. CHESTEEN. He pays a 40-percent tax. I think this should be pointed out to you: Every time we find a man who has a large income, it does not necessarily follow that he has all cash. A man with a small income is a person who gets a small salary, usually as cash, or he gets dividends, but a man with a large income does not necessarily have all his income in cash.

Senator CONNALLY. It is in stocks and bonds?

Mr. CHESTEEN. Yes. Now, he may get it in stocks or he may get it in securities of some kind, and if you insist on taking practically all of it for tax, it simply means that he may be forced to convert all the securities into cash at that point. With the economic restrictions that we have in this bill I question very seriously whether a man who has a large volume of securities could cash them or dispose of them. The result would be that he would have to sacrifice them and you would probably get very little tax out of the transaction.

Suppose a man got \$1,000,000 in securities of some kind, and he found, under the Nye bill, he had to pay \$985,000 in tax; under these restrictions in the stock market the market for those stocks might be a very poor one for whatever securities he had and he might get a very paltry sum. Therefore you would get very little revenue,



because if he was forced to dump them on the market in order to get the cash with which to pay the tax there would not be any choice for him, that would be the fair market value that he would receive.

Senator CONNALLY. Well, I think pretty well of these new rates that you have got revised here.

Mr. CHESTEEN. I realize these are very severe rates. I am just judging this by the experience I have had with large individuals who get their income from various sources. It is a common thing to find they have stocks, notes from the sale of real estate, and other forms which is not cash, and these rates will undoubtedly impose very great hardships on them, because here you find a taxpayer who has a million dollars income and you are demanding \$875,000 in tax. Let us suppose that he has sold real estate and has a large portion of it in notes; I believe under the present law if he gets more than 30 percent in cash then all profit is returnable in the year of the sale of the real estate. It is possible for an individual with that kind of income from the sale of real estate to have \$675,000 in notes and mortgages representing the sale of property.

Senator CONNALLY. That might be true to a lesser degree under the 1935 act. You would take \$675,000, would you not?

Mr. CHESTEEN. Yes; it is possible to have hardships under the 1935 act, only this increases the degree of severity, that is all.

The other answer is this: If he has held real estate for a certain length of time, he only reports a part of the profit, therefore the hardship is more or less reduced because of the fact he does not report all of the profit.

Senator CONNALLY. There would be no drafting difficulties about that. You could easily put this in the bill?

Mr. CHESTEEN. The schedule of rates?

Senator CONNALLY. Yes.

Mr. CHESTEEN. Yes; there is no difficulty about that.

Senator CONNALLY. What shall we do? Mr. Brown, have you folks had any opportunity to look at these schedules?

Mr. BROWN. I haven't seen these schedules until this morning. I was not able to do very much on rates yesterday because most of our actuarial staff were at the Ways and Means Committee.

Senator CONNALLY. Yes; of course.

Mr. BROWN. I think today, however, we shall be able to examine them.

Senator CONNALLY. What was it we told you to get for us Thursday?

Mr. BROWN. You wanted to know about the basis of the corporation tax.

Senator CONNALLY. Yes.

Mr. BROWN. We will be able to get an answer for you by Thursday, as we promised you.

Senator LA FOLLETTE. How would this curve, on the second proposal, look on the chart, just tentatively?

Mr. AKIN. Where we have the present curve running like this [indicating] under the proposal I think this curve would start like this [indicating] and come up. The curve would be severe at \$75,000, it would be just as steep, but the break would come in here up to \$75,000, which would be about right in here [indicating], then you would come up straight.

Senator CONNALLY. What is the lower curve?

Mr. AKIN. This lower curve is the British peacetime rates from \$1,000 to \$1,000,000.

Senator CONNALLY. And the other is the Nye bill?

Mr. AKIN. This is the proposal we submitted yesterday. The Nye proposal would even come a bit steeper here.

Mr. CHESTEEN. That begins at \$20,000 with 99 percent.

Mr. AKIN. We plotted this on a \$100,000 scale, so the Nye proposal, in comparison with this, instead of being like this [indicating] would come up straight and then come over.

Mr. CHESTEEN. And then drop.

Mr. AKIN. I will plot all of the proposed plans, Senator, if you care to.

Senator LA FOLLETTE. Yes; I wish you would.

Mr. BROWN. We have the British rates here, if you want them for the record.

Senator CONNALLY. Did you put them in the record yesterday?

Mr. BROWN. No.

Senator CONNALLY. Are they the war rates or peacetime rates?

Mr. BROWN. They are essentially the war rates, Senator.

Senator CONNALLY. Suppose you put them in the record.

Mr. MITCHELL. The table is given in this fashion, Senator, if I may suggest, so as to be informed as we go along: The table shown begins at the surtax brackets, namely, 2,000 pounds, or \$10,000, and the effective rate is given in shillings and pence. I would be very glad, for the purpose of the record, to translate them into percentages, so I could take each step and give you the effective rate under essentially war conditions with a normal tax of roughly 30 percent.

Senator CONNALLY. Go ahead.

Mr. MITCHELL. Now, we have here three schedules setting forth the effective rate on various incomes, beginning with 2,000 pounds, or the equivalent of \$10,000, up to and including incomes of 150,000 pounds, or, roughly, \$750,000. Now, one of those tables shows the effective rate as to single persons; another shows the effective rate with respect to married couples without children, and the third table shows married couples entitled to an allowance for three children. The tables, unfortunately, are slightly further complicated by the fact that they are split as between earned income and investment income.

If the Senators please, perhaps the best comparative column would be found in the earned income column, and if the Senators desire to do so, I will write into the record the effective rates as to those incomes, using the earned-income columns.

Senator LA FOLLETTE. For the purpose of comparison with this table, a married person with no dependents would be the most comparable with what we have here?

Mr. MITCHELL. Yes; I think that would be the most illustrative, Senator.

Senator CONNALLY. Will you put those two tables in the record, please?

Mr. MITCHELL. Do you want each of the three tables written into the record or merely the married couples without children?

Senator CONNALLY. I think that is sufficient, the married couples without children.

Mr. MITCHELL. I think that is sufficient to illustrate it.  
(The table referred to is as follows:)

*Schedule Showing Effective Rates of Income and Surtax in United Kingdom of Great Britain and Ireland, Year 1920-21*

(Source of figures: Report of Commissioners of Inland Revenue for year ended Mar. 31, 1921, pp. 92 and 133)

Income	Effective rate (percent)	Amount of tax	Income	Effective rate (percent)	Amount of tax
\$1,335.....	2.5	\$38. 37	\$30,000.....	30.25	10,875.00
\$1,810.....	4.10	75. 30	\$35,000.....	38.38	13,433.00
\$2,200.....	5.8	127. 60	\$40,000.....	40	16,000.00
\$2,710.....	8.3	224. 93	\$45,000.....	41.66	18,747.00
\$3,300.....	11.60	384. 78	\$50,000.....	42.91	21,455.00
\$4,220.....	15	633. 00	\$75,000.....	47.08	35,310.00
\$5,330.....	17.5	932. 75	\$100,000.....	49.10	49,160.00
\$6,135.....	18.75	1,160. 31	\$125,000.....	50.83	63,637.50
\$7,230.....	20	1,446. 00	\$150,000.....	51.66	77,490.00
\$10,000.....	22.08	2,208. 00	\$200,000.....	53.75	107,500.00
\$15,000.....	27.5	4,125. 00	\$250,000.....	55.00	137,500.00
\$20,000.....	31.25	6,250. 00	\$300,000.....	57.5	287,500.00
\$25,000.....	34.10	8,540. 00	\$750,000.....	58.33	437,475.00

NOTE.—It should be noted that the highest tax year under the British system does not coincide with our highest war-tax year. The highest British rates during the period approximately corresponding to the war years began for the year ended Apr. 6, 1919, when the normal or standard rate of tax reached 6 shillings in the pound, or 30 percent. Such rate continued through 1921 and 1922, dropping back to 25 percent in 1923 and to 22½ percent in 1924. Likewise the surtax ran to a maximum of 22½ percent in 1919 and 1920 on incomes in excess of \$50,000; to 30 percent in 1921 on incomes in excess of \$150,000, reaching 37½ percent in 1930 on incomes in excess of \$250,000, and 41¼ percent in 1931, which surtax rate of 41¼ percent continues to the present time. Surtax begins at \$10,000. The current normal or standard rate is 22½ percent. It will thus be seen that the war year tax rates were lower than those now prevailing. The personal exemption in the taxable year 1920-21 was \$225, or \$1,125, in the case of married persons without dependents. The current exemption is \$150 or \$750. In the table here presented, the effective rates for the year 1920-21 are given; that is to say, a normal rate of 30 percent and a maximum surtax of 30 percent, since they are the highest rates obtaining during a period approximating the war period. The figures given are the effective rates on all earned income in the case of married persons without children. The table uses \$5 as the equivalent of 1 pound.

Senator CONNALLY. Have you finished your statement?

Mr. CHESTEEN. Yes; unless you want to ask some questions.

Senator CONNALLY. We will hear from Dr. Zucker.

Mr. ZUCKER. I was going to suggest that Mr. Chesteen state to the subcommittee what I just found out from Mr. Akin that the surtax—

Senator CONNALLY (interrupting). You are speaking about these proposed rates?

Mr. ZUCKER. These proposed rates; yes. The Nye bill exempts from surtax the first \$3,000 of income. The way this is worked out it will exempt from surtax the first \$2,600. That is all I want to add.

Senator LA FOLLETTE. This takes in \$400 below the Nye bill?

Mr. ZUCKER. That is right.

Senator CONNALLY. These are net incomes, of course.

Senator LA FOLLETTE. The surtax bracket would start, under this proposal, with \$2,600 and above, and under the Nye bill it starts with \$3,000 and above.

Senator CONNALLY. Yes. What is it after \$2,600?

Mr. ZUCKER. Six percent. The normal rate is 10 percent.

Senator CONNALLY. A man with \$20,000 would pay \$5,530?

Mr. ZUCKER. He would pay \$5,530, or over 27 percent.

Senator CONNALLY. Under the Nye bill, he would pay \$10,240?

Mr. ZUCKER. That is right.

Senator CONNALLY. I do not suppose you have had time to make any estimate on the relative yields?

Mr. BROWN. No, Senator. That is what I wanted to take up with the actuaries.

Senator CONNALLY. Of course, under this Nye bill it looks to me like, when you get into the higher brackets, it is going to be pretty hard to estimate, because you take so much of it, you might not get any revenue.

Mr. BROWN. You can only make some kind of approximation based on past experience with high rates.

Senator LA FOLLETTE. Of course, there are very few returns up there in those higher incomes.

Mr. BROWN. That is true.

Senator LA FOLLETTE. When I was looking over some of the statistics—I am not so sure that I am carrying it in my mind correctly, but I think there were relatively very few returns above \$1,000,000 during the war.

Mr. BROWN. That is right, and therefore there is a large margin of error. If you change one of those elements, it makes a big change in the percentage.

Senator LA FOLLETTE. I mean the total yield, compared to what you would take in from the income tax, even if you make a mistake in those relatively small number of returns, does not affect your estimate of the volume.

Mr. BROWN. No. It is largely a matter of equity, having it appear that all taxpayers are treated with an even hand, relatively.

Senator LA FOLLETTE. That is right.

Senator CONNALLY. Is there anything else you want to submit?

Mr. ZUCKER. No, sir; I think Mr. Chesteen has covered the point.

Senator CONNALLY. Senator La Follette, what do you think of waiting until Thursday to vote on this?

Senator LA FOLLETTE. I think we ought to have more members present.

Senator CONNALLY. I think so, too. In the meantime the Treasury would be studying these rates, and you can give us your views Thursday.

Mr. BROWN. Yes.

Senator CONNALLY. And we can have copies of these hearings sent to the other Senators, so they might have a chance to look it over.

Mr. ZUCKER. We think it meets with the thought expressed by Senator Bailey yesterday; that is, leaving a sufficient amount, after payment of taxes, to take care of the needs of the standards of living to the higher income bracket families.

Senator LA FOLLETTE. A married man with no dependents with \$1,000,000 net income would have \$124,890.

Mr. ZUCKER. Yes, sir.

Senator LA FOLLETTE. And a man with a \$200,000 income in the same situation would be left \$44,890.

Mr. ZUCKER. That is right.

Senator LA FOLLETTE. He ought to be able to get along on that.

Senator CONNALLY. What other matters do you gentlemen want to present?

Mr. CHESTEEN. We have a number of things in the bill that we would like to get your reaction on. On page 62 there is a provision for a general auditor to be appointed by the Speaker of the House of Representatives and approved by resolution of the Senate. According to the way the section is written the auditor has power to call upon the Commissioner of Internal Revenue for any records or returns of taxpayers during the period of the war, to subpoena witnesses, administer oaths, and "upon request by any Member of Congress, produce for the official use of such Member all details of any record, file, or document relating to any tax imposed by this title." As I see it, that would give publicity to returns currently.

Senator CONNALLY. I was always in favor of reasonable publicity of returns, but if you put it this way, that any Member of Congress may request that information, you will just have him around all the time on the floor.

Mr. CHESTEEN. It is something new in tax legislation.

Senator CONNALLY. What does he do besides that? Nothing?

Mr. CHESTEEN. He simply serves the Members of Congress in producing these records, subpoenaing witnesses, administering oaths.

Senator LA FOLLETTE. If the subcommittee wanted to consider the question of whether income-tax returns during the war shall be public records and desire to follow this general line of approach, the same provision could be made applicable to the joint committee which now has the power to obtain returns.

Senator CONNALLY. Exactly. That function can be performed by anybody. I would be in favor of striking that clause out. You make a note of that, Mr. Chesteen, and we will act on that when some more members are here.

Senator LA FOLLETTE. What is the purpose back of section 64; do you know?

Mr. CHESTEEN. This is the purpose back of it—

Senator CONNALLY (interrupting). It is a tax-free bond, isn't it?

Mr. CHESTEEN. No; I do not believe there is any explanation in the record, or in the reports on it, but this is my interpretation of the section: During the last war we had subcontracts, various subcontracts, between corporations in which the contract provided that the lessee of one of the parties shall not only pay a certain amount of profit but shall assume the tax that would be imposed upon that profit to the lessor, or to the other party to the contract, and, consequently, if the contract resulted in \$1,000,000 profit to the first party, then the tax imposed on that became due from the other party to the contract and, of course, that in turn became income to this individual, because he had \$1,000,000 plus, we will say, \$800,000 tax. That is a mathematical computation that, by a formula, is very easily computed; but if you attempt to do it in longhand arithmetic, it, of course, is an endless chain. I think this is to prevent a contractor from saddling his tax upon the lessee or the other party to the contract and therefore getting income free entirely from any tax.

Senator LA FOLLETTE. Of course, if I understand it correctly, it might be desirable, under very heavy rates anyway, to prevent that sort of thing.

Mr. CHESTEEN. Well, that is just a matter of policy.

Senator CONNALLY. In addition to that, my understanding is that there are certain corporations that issue certain bonds that they call covenant bonds, where the obligor shall pay any income tax, or other tax, that might be charged by reason of the interest which he shall receive. Is that what they call it?

Mr. CHESTEEN. Tax-free covenant bonds. We do not recognize those any more, except those that are outstanding. That practice came about under the revenue acts prior to 1916. Tax-free covenant bonds only provide for a payment of 2 percent normal tax. They are not tax-free bonds. The corporation pays 2-percent income tax for the holder of the bonds. If you hold a tax-free covenant bond and clip your coupon, you report the entire coupon, of course, in the income-tax return, and after computing the tax you only get credit for 2-percent tax paid by the issuing corporation, even though you may be subject to 75 percent of the tax.

Senator CONNALLY. Would not this affect those bonds?

Mr. CHESTEEN. I do not know whether it would affect those or not. Under the bill it possibly would.

Senator CONNALLY. It would probably not affect those outstanding.

Mr. CHESTEEN. I do not think it is directed to those, because in the peace-time law we are not recognizing withholding for income-tax purposes except those bonds that were outstanding, I think, prior to July 1, 1934; but I think it is directed at the type of transactions that I mentioned, because that was a frequent thing among certain contractors. That of course under the Nye bill, they thought, would be a loophole.

We have the pink-slip provision also in this bill, under section 55.

Senator CONNALLY. Before we get off that page, though, I want to talk to the drafting man about section 65.

Mr. CHESTEEN. For the purpose of restraining the assessment and collection?

Senator CONNALLY. I just want to call his attention to that and let him work on it, to see how far we can go along that line under the law.

Mr. RICE. All right.

Mr. CHESTEEN. You know during the last war we had no such provision as we have now for the Board of Tax Appeals, where the taxpayer could go and challenge the correctness of the computation. In the 1918 act the Commissioner imposed the assessment and the taxpayer was required to pay the tax and then he could resort to the courts for the determination of his rights. This provision, of course, goes back to that policy.

Senator CONNALLY. You ought to look into whether this would affect the Board of Tax Appeals. It is not our purpose to do that.

Mr. CHESTEEN. Well, the Board of Tax Appeals provision is still retained in here, I believe, but not for this purpose, not for the assessment or collection of it. I think it is retained after the assessor collects; then the taxpayer can contest; he can go before the Board

and contest the validity of the assessment and collection, not before it is due and payable.

Mr. BROWN. We rather feel that the tax ought to be paid before it goes to the Board of Tax Appeals. I mean, after all, we ought not to have our revenue postponed.

Senator LA FOLLETTE. No; I think that is essential in the revenue bill.

Mr. CHESTEEN. That was the policy of the Nye Committee. They wanted to get the money in. They thought if we are going to let the taxpayer contest it before the Board of Tax Appeals we would not collect a great portion of the revenue until after the war was over, probably.

Senator LA FOLLETTE. I think it is essential that you collect the tax and let them have their redress afterward.

Mr. BROWN. We thought that was the policy, although the actual wording of the bill seemed to us to leave it discretionary with the Commissioner. We felt that the burden of the decision ought not to be imposed on the Commissioner; it ought to be all one way or the other.

Senator LA FOLLETTE. Personally, I think during the war you ought to collect the revenue.

Senator GUFFEY. I thoroughly agree with you, Senator. Make them pay it first.

Mr. CHESTEEN. We have the pink-slip provision, I believe, restored in section 55.

Senator LA FOLLETTE. Personally I am in favor of making income-tax returns made a public record. I am not in favor of the pink slip. I think it has all the disadvantages of making the income-tax returns public record and none of the advantages. I personally have believed for a long time that you are never going to have an effective income-tax system until you make the income-tax returns public records.

Mr. CHESTEEN. We also have in the bill a provision which makes subject to tax dividends received by one corporation from another corporation. Under the present income-tax law one-tenth, I believe, of the dividends received by a corporation is subjected to tax. Prior to 1935 the dividends received by one corporation from another corporation were entirely free from tax. The assumption was that the other corporation had paid a tax upon dividends and therefore they were not subject to tax in the hands of the receiving corporation. This bill goes further than the present law.

Senator GUFFEY. What year was the present law about consolidated income returns changed?

Mr. CHESTEEN. The present law only has consolidated returns in the case of railroads.

Senator GUFFEY. Public-utility holding companies have it.

Mr. CHESTEEN. That is only for railroads, I believe.

Senator LA FOLLETTE. It is only for railroads.

Senator GUFFEY. Have they stopped the utilities from making consolidated returns?

Mr. CHESTEEN. Yes.

Senator LA FOLLETTE. The railroads are the only ones.

Mr. CHESTEEN. This bill retains consolidated-returns provision for railroads.

Senator GUFFEY. It does not apply to a chain of newspapers, does it?

Mr. CHESTEEN. There is no exception in the case of newspapers.

Mr. BROWN. We suggested that that be stricken out, because very few railroads avail themselves of that option. It is optional with them, and it did not seem to have very great significance. We might as well do away with it.

Senator LA FOLLETTE. What does this bill do for the corporate dividends?

Mr. CHESTEEN. Senator, before you came in we explained that this bill makes taxable dividends received by one corporation from another. As you know, under the present law we only tax one-tenth of the dividends received. We allow a deduction of 90 percent of the dividend. The Nye bill taxes the entire amount.

Mr. BROWN. The bill pending on the other side, Senator, proposes to do away with the deduction. The specific recommendation is:

It is recommended that the present deduction allowed corporations for dividends received from other corporations be abolished, so that these corporate dividends will remain in net income.

Senator LA FOLLETTE. I thought you meant that they proposed to abolish the intercorporate dividend act.

Mr. BROWN. No, no; they go to the other extreme. All of it goes in as income.

Mr. CHESTEEN. On page 35 of the bill is a new provision dealing with insurance companies.

Senator LA FOLLETTE. Well, after these lower rates that we have been discussing this morning, that provision will not be necessary, will it?

Mr. CHESTEEN. The life-insurance provision?

Senator LA FOLLETTE. Yes.

Mr. CHESTEEN. Probably not.

Senator LA FOLLETTE. After all, a man who has got \$124,000 income free from tax, say, on a million dollar net income ought to be able to take care of his premiums, it seems to me. This was to meet the argument that if you took everything above \$20,000 a man might have large premiums to pay and be unable to make the payments.

Mr. CHESTEEN. That is right.

Senator LA FOLLETTE. Then it would seem to me that this subsection of section (Q) would depend finally upon the rates which were adopted on individual incomes.

Mr. CHESTEEN. I think that is correct.

Senator GUFFEY. Did you make any change back on page 31, the "depletion" in the bill? Is that any change from the existing law?

Mr. CHESTEEN. Yes. As I understand, the vote a few days ago in the Finance Committee was that the committee decided not to stop any loopholes in this bill, and that is one of the loopholes that the Nye committee found in the present law. So I assume that you are going back to the rates of depletion in the present law.



Senator GUFFEY. Well, there are a lot of loopholes in that. As an oil man I can testify to that.

Mr. CHESTEEN. Well, that is probably true. The Nye committee I think considered that the present law, which provides for 27½ percent in case of oil and gas, 15 percent in the case of metal mines, 5 percent in case of coal, and 23½ percent in the case of sulphur, provided a loophole.

Mr. BROWN. I may say the Treasury, concurring with the views of the committee, raised no objection to the reduction.

Senator LA FOLLETTE. I think I understand. The investigation of the select committee, of which Senator Couzens was chairman, brought out pretty conclusively the tremendous advantages taken of this principle.

Mr. BROWN. Recovery of more than 100 percent capital investment is certainly not desirable.

Mr. CHESTEEN. Of course, when you apply severe rates, any provision like the depletion, that exempts a substantial portion of the income, simply magnifies the inequality between such a class and that of other classes of corporations.

Senator GUFFEY. You were discussing the question of insurance on page 35 a moment ago. I got away from that.

Senator LA FOLLETTE. That was put in the bill, Senator, by the Nye committee because they proposed to take all the net income above \$20,000, and they felt that the point would be made that men who were accustomed to have very large incomes would have large commitments concerning their insurance, and therefore, as I understand it, they put this device in the bill in order to meet that criticism. Therefore, as I see it, whether this remains in the bill as we report it to the full committee will depend on what kind of a rate schedule we have.

Mr. CHESTEEN. The Nye committee also eliminated section 117 from the present law and left that out of the war bill. Section 117 provides for the computation of the amount of income from sale of capital assets that is to be included within taxable income. The Nye committee eliminated the whole section.

Under the scheme of section 117, if an individual sells property and he has held it for more than a year, but less than 2 years, only 80 percent of the income is to be taken in computing his return.

Senator LA FOLLETTE. Then, it would seem to me, Mr. Chesteen, that falls into the general category of a loophole, does it not?

Mr. CHESTEEN. I do not know whether they considered it a loophole. I think they did. I think they considered everything a loophole that allowed a taxpayer to have any form of income free from tax, or above the amount that the committee set out to leave as a maximum for tax purposes. I think that accounts for some of these innovations they have. We have very little explanation as to why they eliminated it.

Senator GUFFEY. That section 117, as now drafted, does not leave many loopholes.

Mr. CHESTEEN. No.

Senator GUFFEY. It says:

In the case of a taxpayer, other than a corporation, the whole of the gain recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income.

Mr. CHESTEEN. Yes.

Senator GUFFEY. That is a good provision.

Mr. CHESTEEN. The Nye committee struck out the provisions of the present law which require taking into account only a portion of the gain.

Senator LA FOLLETTE. All right, Mr. Chesteen, you may proceed.

Mr. CHESTEEN. There are a number of these provisions I think we can reasonably interpret as having been covered by committee action, and go back to the present law. For instance, we have loans to officers to be taxed as income; we do that at the present time, if the Bureau can establish that the loan is a distribution rather than an actual loan. This arbitrarily says that the loan is to be considered income. I think the change involves a constitutional question.

The striking of depletion, depreciation, and joint return, all you want us to include under the vote that the committee took the other day, because these were all considered as loopholes in the present law.

Senator LA FOLLETTE. Of course, this question of depletion was met by justification for consideration of that as a war policy as distinguished from a peacetime policy.

Mr. CHESTEEN. Yes.

Senator LA FOLLETTE. I think the joint return is something probably we would not want to undertake as there is a constitutional question involved.

Mr. CHESTEEN. The present depletion rates were the outgrowth of the last war. It depends upon how you view the result of the last war as to whether you think these rates should be retained for the next war.

Before 1917 we had no provision for discovery depletion. After the war, you know the history of it. We perpetuated the general effect of discovery depletion by fixing a rate of depletion for peacetime purposes that was equal to the average, or thought to be the average resulting from discovery depletion, so it now depends on how you view it. If you think the depletion allowances in the last war were too high, you should reduce present rates.

I think the second limitation in the Nye bill would prevent about 85 or 90 percent of all natural resources being allowed depletion in the event of war, because obviously those who have been allowed depletion very long have already recovered their base, so that the practical effect of the Nye provision for depletion would be to deny any depletion to a substantial portion of all natural resource industries.

Senator LA FOLLETTE. I have never been able to see any justification for the proposition of wanting to get back more capital, or let them get an exemption for more than they have put in.

Are there any other provisions you want to bring to our attention?

Mr. CHESTEEN. We have some other questions that should be brought up for your attention, but I don't know whether we should bring them up at this time.

We have the question of withholding income at the source.

Senator CONNALLY. At the source?

Mr. CHESTEEN. Yes; withholding income at the source, in case of dividends and interest paid to aliens, and also the question of taxing income from foreign sources—I mean income of foreign corporations operating in this country, or income of aliens that have sources of income in this country other than dividends or interest, but I thought we might well postpone that question until you decided the question of corporate taxes, because your decision in all such matters will depend upon what you are going to do with respect to corporate taxes.

Senator CONNALLY. Does this Nye bill make it different in the case of aliens?

Mr. CHESTEEN. Yes; you are forced to, because of the severe rates they impose in the bill.

Senator CONNALLY. You are forced to what?

Mr. CHESTEEN. The Nye committee was forced to change all of that scheme of taxation you have in the present law whenever it adopted rates for individuals and corporations.

Senator CONNALLY. Was the tax rate different on aliens than it would be on citizens, in this Nye bill?

Mr. CHESTEEN. Yes; it is different, and very severe rates.

Senator CONNALLY. We ought to have a clause somewhere in here to withhold at the source all dividends and profits that go to people who live in foreign countries, otherwise we would never get some of it, would we? Suppose a man lives in Germany, Sweden, and France, can we get all of that?

Mr. MITCHELL. Under the existing law we have had, I believe, practically ever since the 1918 act provisions that require that fixed and determinable incomes enumerated in the act is subject to withholding where such items of income are distributed to nonresident aliens, and that applies also to nonresident foreign corporations, if I may use that term; that is to say, foreign corporations which have neither a place of business nor an office within the United States.

Of course, the true situation, as you have suggested it, just simply demands we do that, in order that we may secure the tax upon income arising from United States sources and going direct to foreign nonresidents.

I think our friends across the Atlantic do the same thing with a far greater degree of severity as far as the tax rates are concerned.

Mr. CHESTEEN. To be exact, the Nye committee adopted a policy of taking 95-percent tax in case of interest and dividends paid to foreign corporations or individuals. That is in keeping with the tax on corporations.

Senator CONNALLY. At the same rate?

Mr. CHESTEEN. Well, the rate on corporations was to leave them about 3 percent of the declared value, which of course might be a rate comparable with 95 percent here.

Senator CONNALLY. We will reserve that until Thursday and take it up then.

Mr. CHESTEEN. I think it would be wise, because then whatever you do with respect to corporations will govern here; that is, you

will have to fix this rate after you have in mind the tax on the corporations.

Senator CONNALLY. Are there any other matters you have?

Mr. CHESTEEN. No; except for the questions you have postponed, the corporate-tax rates.

I might mention the March 1, 1913, situation, dividends out of March 1, 1913, accumulations in value of surplus. As you know, the present law exempts from taxes any dividends received out of pre-March 1, 1913, value of earnings. The last war act exempted that type of income.

The Nye committee struck that out of the bill and made provision for taxing dividends received during the war period, even though out of earnings prior to March 1, 1913.

Senator CONNALLY. You mean earnings on property that was held March 1, 1913?

Mr. CHESTEEN. Yes, that is right; increment in value of property or surplus in corporations. For instance, if a man had a piece of property on March 1, 1913, worth a million dollars and he only paid a hundred thousand dollars for it, if he sells it at the present time for a million dollars he is not taxable for any profit, because that was the value of March 1, 1913.

Senator CONNALLY. That was the date of the enactment of the first income-tax law?

Mr. ZUCKER. That was the effective date of the sixteenth amendment.

Mr. CHESTEEN. Yes; that was the date of the sixteenth amendment, but it was not the date of the enactment of the first income-tax law. The House, I believe, on three occasions, has tried to tax these dividends.

Senator CONNALLY. Have the courts ever passed on that?

Mr. CHESTEEN. Yes; there is precedent for saying that Congress can tax those dividends.

Senator CONNALLY. How is that?

Mr. CHESTEEN. There are Supreme Court decisions as precedent for saying Congress can tax those dividends if it elects to do so. It is a matter for Congress as to whether they want to tax them.

Senator CONNALLY. When you spoke a minute ago you were not speaking of dividends, but you were speaking of gains.

Mr. CHESTEEN. These gains may be either in the form of dividends or they may be actual gains. If I hold property which I held on March 1, 1913, and sell it my gain, of course, might be the March 1, 1913, gain. If I held stock in a corporation which had a March 1, 1913, value of property and that property is sold and distributed in the form of dividends, I would get a pre-March 1, 1913, dividend, and both would be exempt from taxes, one being in the form of dividends received through a corporation and the other in the form of receipts from the sale of my property.

Senator LA FOLLETTE. Mr. Brown, does the House cover that in their bill?

Mr. BROWN. Yes; in the House bill it is recommended that dividends paid out of profits accrued March 1, 1913, or out of increase in value March 1, 1913, be fully taxable when distributed. That is the recommendation of the Ways and Means Committee.

Senator CONNALLY. They are going to tax it.

Mr. CHESTEEN. Yes; they are.

Mr. BROWN. Yes.

Senator CONNALLY. If we can do it legally, I think we should do it.

Mr. CHESTEEN. I think it can be done legally, and that is the reason the House put it in the bill.

Senator CONNALLY. It seems to me when the constitutional amendment was adopted it subjected any property or income at any time to taxation, and there is no law higher than the Constitution.

Senator LA FOLLETTE. I suggest we leave that in the bill.

Senator CONNALLY. Is there any other matter you wish to take up at this time?

Mr. CHESTEEN. I think we might postpone anything else until Thursday.

Senator CONNALLY. Then, we will recess until 10:30 o'clock a. m. Thursday.

(Thereupon, at 11:45 a. m., the hearing was recessed until 10:30 a. m., Thursday, Apr. 9, 1936.)



## TO PREVENT PROFITEERING IN WAR

THURSDAY, APRIL 9, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Bailey, Guffey, and La Follette.

Also present: G. D. Chesteen, J. S. Zucker, and Allen T. Akin, of the Joint Committee on Internal Revenue Taxation.

Ralph W. Brown and P. J. Mitchell, of the Treasury Department.  
S. E. Rice, office of the Senate Legislative Counsel.

### STATEMENT OF RALPH W. BROWN, TREASURY DEPARTMENT

Senator CONNALLY. Are you ready to proceed, Mr. Brown?

Mr. BROWN. Yes; you asked that I ascertain the position of the Treasury Department with respect to the proposal tentatively suggested by Mr. Chesteen. I am prepared to speak as to the rates and schedules, estimates, and also as to the basis of the plan, if you wish to hear it this morning.

Senator CONNALLY. We will proceed then with the basis of the plan. Go right ahead.

Mr. BROWN. Mr. Chesteen, at a recent hearing, proposed tentatively, I understand it was only put forward as a basis of discussion, the possibility of trying to reconcile the administration proposals that are under consideration in the House.

Senator LA FOLLETTE. You are speaking now of the corporation tax?

Mr. BROWN. Yes, Senator. It was put forward as a basis of discussion, to try to reconcile the administration proposals that are under consideration in the House, with possibly the demands for revenue in wartime. The proposal was roughly that the corporation rate be increased to a flat rate, say, of 30 percent, and after taking off that 30 percent that 25 percent, say, be allowed to go tax free for purposes of war expansion, industrial operation in time of war, and that the balance be taxed at graduated rates, that is the remaining surplus be taxed at graduated rates running up to such point as the committee might determine.

You asked that I ascertain the attitude of the Treasury Department toward that suggestion. I have discussed it with my superiors and the Treasury feels that it cannot go along with that suggestion

for several reasons. The other day I pointed out the desirability of having the basis of peacetime taxation the same as that which applies in war. Of course I am not referring to applicable rates, I am referring to the basis of the tax. The reason for it, as I said, was it is highly desirable to accumulate experience in peacetime with any revenue act, in order to facilitate administration and to resolve many of the difficulties, and that becomes particularly important where you suddenly step up the rates and are compelled to face the complicated conditions imposed by war.

Now, in addition to that it is the view of the Treasury that the proposal to impose a flat rate of 30-percent corporation tax violates very sharply the principle of equal treatment of business income, whether conducted by individual or partnership enterprises, or by corporations. It also discriminates sharply between the small shareholder in a corporation and the large shareholder.

A very brief illustration, which does not take into consideration all factors but makes the point I am trying to stress: Supposing we have a corporation with \$100,000 net income; under the tentative suggestion put forward by Mr. Chesteen, 30 percent of that net income would be paid by the corporation. A small shareholder having very little other income, who, at the most, would be liable only to the normal tax of 10 percent under the committee proposal, would have paid by the corporation 30 percent, whereas his tax liability actually ought to be 10 percent. In other words, he would be taxed at three times of what, under graduated principles, and under the principle of ability to pay, he should pay.

Senator CONNALLY. That is on the assumption, though, that he has a vested interest in the returns of the corporation, no matter how high they might be?

Mr. BROWN. That is true. He has a vested interest in the remainder.

Senator CONNALLY. We are denying, though, that he has a vested interest in more than a certain proportion or certain percentage of their invested capital or their declared value on the new basis.

Mr. BROWN. Well, the new basis, of course, does not provide, I mean in principle now, I do not think it is profitable to get into the details of the House plan, because we do not know what changes will be made in them, but let us speak of the principle behind the administration proposals. That principle, as I understand it, is that, barring such provision as may be made for the taxation of earnings received from distribution the basis of taxation is the individual, in other words that earnings, whether they be by individual or partnership enterprises, or corporate enterprises, shall be taxed in the hands of the individuals, where the principle of ability to pay under the progressive rates may be applied in its most accurate sense. That is the principle underlying it, because if we are to secure any degree of equity in the treatment of business income, that seems to be about the only point where we can apply it.

Now in the past, under our income tax, the individual taxes and the corporation taxes have approached a balance. They have never actually been in balance, but for a short period, 1924 to 1932, when the maximum individual surtax was around 20 percent, and when the corporation rates ranged between 12 and 13 $\frac{3}{4}$  percent, there was a



certain amount of balance. There was still a discrimination in favor of the corporate enterprise, because of the differential between the 20 percent surtax rate and the flat 13¾ percent, which was the highest corporation rate. When you raise the individual surtax rates, as we have now, to 75 percent and you keep the corporate rate down to a point say of 15 percent, which is the maximum corporation tax today, you have a tremendous discrimination between individual and partnership business enterprises, and corporate business enterprises, and there is every incentive in the world for the large shareholders to avail themselves of the corporation rates.

Senator LA FOLLETTE. They turn it into an investment trust?

Mr. BROWN. That is correct. We know in certain cases the larger corporations have increased their holdings of securities tremendously. During the depression there has been a vast increase in the security holdings of corporations, there has been a vast increase in cash position.

And so, so far as peacetime is concerned, the administration proposals are directed to the curing of those inequalities, that is the two inequalities, the equal treatment of the various forms of business activity and equal treatment in the corporation of the various classes of shareholders.

The other main objective, of course, in the peacetime proposal is the need for revenue and for approaching more nearly to the balancing of the Budget.

Now assuming, for present purposes, that the Congress will enact legislation incorporating the principles recommended by the President, then we may assume that that will be the basis of corporate taxation in peacetime.

Assuming that plan is in effect on the outbreak of war, then the question is: Should you continue that principle or should you immediately shift over to some other principle of taxation, whether invested capital or adjusted declared value, going concern appraisal, or differential between pre-war profits and profits during the war time?

As to the basis of the Nye bill, the chief merit, as I said the other day, was that you did have this capital-stock tax and its companion excess-profits tax, and we would be accumulating experience should it be continued under that set-up. While I agree with Mr. Chesteen that the basis of adjusted-declared value cannot be said, at least in the early stages, to constitute an equal basis of taxation for all corporations, I appreciate the argument that is made that corporations have had an opportunity to make some guesses. So far three guesses have been given to them, and if they haven't guessed right, or haven't been honest about it, maybe they ought to pay the penalty.

I, personally, do not go along altogether with that proposition, because we have more at stake than merely the question of whether corporation executives have made the right decision, or whether they have acted bona fide, we have the question of the effect upon our national economy.

Now, if the capital-stock tax and the companion excess-profits tax should be continued in effect for, say, a period of 6 or 10 years, the errors made in the original declaration, and if no new declaration should be permitted, the errors made in the original declaration

would be, to a certain extent, ironed out by the adjustments that were made thereafter, and you would approach more nearly a fair basis for determining the exemption to be allowed capital before you imposed very high rates. But under the administrative proposal, if concurred in by Congress, those taxes will be removed, and with them will go the basis for the accumulation of experience in peacetime.

As to the invested-capital basis, Mr. Chesteen very clearly pointed out the difficulties there and the fact that it was not a satisfactory basis in the last war. Economists generally have not accepted invested capital as by any means a wholly fair or practical basis. Certainly to shift over to the invested-capital basis in time of war, when you do not know what the original cost was, you have got to go back to corporate records which may or may not exist, and build up this basis over a period, we will assume for 10 years. If you do compel the taxpayer to pay on the basis which can be worked out quickly, then you must anticipate that the patriotic man will pay too much, and therefore will be entitled to refunds later on, and the man who errs in his own favor will obtain, during wartime, advantages which perhaps he ought not to obtain.

So that brings me back to the basis of the administration proposals on the House side. We believe in their equity, we believe in their revenue-producing possibilities, and we recommend to the very serious consideration of this committee that that be the basis for your wartime taxation.

Senator CONNALLY. I thought that plan was somewhat similar to the one suggested by Mr. Chesteen.

Mr. BROWN. Only to this extent, Senator: After you have imposed your flat 30-percent tax, of course that 30 percent is only tentative, and allowed your 25-percent cushion for war expansion, then the suggestion is that you impose a tax on the undistributed balance at graduated rates running from whatever you like up to as high as you like. The last part of the suggestion does, of course, embody in it taxation of undistributed earnings, but the administration proposal goes beyond that.

You have had for a number of years, in fact since the beginning of the income tax, one or another provisions designed to get at the improper accumulation of corporate surpluses, and it is a matter of record that those provisions have been notably unsuccessful in accomplishing hoped-for results. There are some people who believe the mere fact they are on the books acts as some deterrent. It is hard to say whether they have not. The fact is there have been very few cases arising under section 220, and under the more recent provision, section 102. Section 351, which was imposed on the personal holding companies, I think, is an effective provision. It is limited only to personal holding companies, which are really availed of for the purpose of tax avoidance.

The administration's proposal, however, is entirely different. It embodies fundamentally equal treatment for all business income, it involves equal treatment for individuals within the same form of business organization, to wit, large and small shareholders in the various corporations, whether the corporation be large, small, or intermediate. And it does involve the fiscal principle that corporation should pay a fair tax whether distributed or not.

Senator CONNALLY. Are you speaking particularly of the corporation tax?

Mr. BROWN. Yes; entirely of the corporation tax. That does embody the fiscal principle that whether corporation earnings are undistributed or withheld, the Government shall be entitled to its fair proportion of those earnings for the support and maintenance of the Federal Government and its activities.

That principle has had the support of conservative and highly reputable advisers of Congress. The late Dr. Adams as early as 1918 went on record that whether the corporation distributed its earnings or whether they were reinvested in the business, that fiscal necessity, and I think he said logic as well, required that they should pay substantially the tax which would have been paid if they had been distributed. He expanded on that in 1919 and 1920, particularly during the period when there was so much discussion about taking off the excess-profits tax and what substitutes, if any, should be imposed.

Now, coming down to the question of the relation of that to the war problem, it does seem to me that there is one other consideration which requires some brief discussion.

Senator CONNALLY. Are you going to discuss now the applicability of that principle to the war-profits bill?

Mr. BROWN. Yes, Senator.

Senator CONNALLY. I would like to hear you.

Mr. BROWN. That is correct, Senator; yes. So far as the essential war industries or those which are directly affected by war activities are concerned, it seems to me that in wartime and under conditions such as we might anticipate in a major engagement in the future, it necessarily involves a departure in the case of those industries, certainly from the individualistic theory of business enterprise. In other words, a certain amount of regulation is going to be inevitable. A certain amount of assistance from the Government and of mutual assistance of one corporation to another in the same related group is going to be necessary, just because of the heavy demands which modern warfare makes on the industrial machine, and because of the need for speeding up and supplying the Army in the field. We haven't got time in war to worry very much about individual theories and the likes and dislikes of the individual in those war industries. Production and results are all that are required. We are not concerned with whether one man felt he should do this or another thing; we want results, and that means we are going to regulate certain industries. In fact, the other titles of the bill provide for elaborate machinery for the War Department to step in and run the whole thing if they find it is not going along according to their likes.

So it seems to me in the case of industries falling in that class, and those related industries which are affected by those primary war industries, or which supply them with certain necessary materials, that as to them any expansion must either be financed by the Government, or if the Government expects them to finance themselves, that some provision has got to be made for exempting a proportion of their earnings, such as are necessary, or for making it possible for them to go into the public markets and obtain funds for those

purposes. Possibly the public markets will be closed. We know that in the last war the New York Stock Exchange was closed for a long period of time immediately after the outbreak of the World War.

Now, it seems to me, as far as those industries which do not already have a backlog are concerned, that the committee would be warranted, while incorporating the principle of the administration bill, in making some specific provision for exemption of a portion of earnings, provided they were applied to war purposes. Very likely that could be tied up with the obtaining of certificates of necessity, approval from either the Washington authorities or their local industrial control boards. Mind you, that group of corporations is not large in number. They may be tremendous in their financial set-up and widespread organization, but you are dealing with a relatively few number of corporations.

Senator CONNALLY. Well, how far would this revolving fund that the bill carries take care of that kind of situation? That amount would be wholly inadequate, of course.

Mr. BROWN. I agree with you, Senator. It seems to me it merely establishes at this time the principle of a revolving fund. It is my personal view, of course I do not know how anyone can say definitely, that the fund would probably expand into billions of dollars before we got through.

Now if you expect industry to finance this expansion, and if you provide the necessary exemption from earnings for that purpose, or if you combine the two, it strikes me it should be tied up with the management of the war machine, and since you are dealing with a relatively few number of corporations, compared to the entire number in the country, it does not strike me as being an impossible proposition.

In addition to that, in the case of the war industries, instead of being harsher in the allowance of deductions for repairs and items of that sort, it seems to me that possibly you would have to consider some liberalization in that respect, because obviously you cannot run machinery night and day for some 365 days in the year without putting a tremendous burden on the machinery for maintenance as well as for replacements.

I think there exists today, in the deduction provisions of the law, a substantial cushion in this. How important that has been in the last 7 or 8 years was pointed out by Mr. Helvering in his recent statement before the House committee. He pointed out in two 4-year periods, I think, in the earlier one 1926 to 1929, 16.2 billions of dollars were used in those periods for depreciation, depletion, and other allowances of that nature, and in the later period, 1930 to 1933, I think it was 16.4 billions of dollars. I think it represented approximately 31 percent of statutory net income. I am speaking just roughly from recollection. So you do have, in the deductions from gross income, in determining net income, a certain amount of cushion. We haven't taken up all the slack, and I do not see an indication that we intend immediately to take up all the slack so far as it affects those provisions dealing with the determination of net taxable income.

Now as to the other corporations that are vastly greater in number, which, let us say, are not directly engaged in war production and which are only remotely connected with war production, I think

I should make it clear here that I am distinguishing between corporations that directly or indirectly are connected with the war, because we cannot draw a sharp line between direct and indirect, but when I speak of remotely I mean if they are affected by the war they are only affected as everyone is affected, the whole national economy is more or less affected; how shall we treat them? Well, some of them will derive positive benefits from the war.

You take, for example, a large shoe manufacturer. He may, either for profit reasons or for patriotic reasons, or because his plant is commandeered, turn it over entirely to war production, manufacturing boots for the Army. As the result of taking him out of the field of competition, some other fellow may go into the manufacture of shoes for the peacetime population, and he will perhaps enjoy profit which, if he had gone into the competitive field in peacetime, he would not have been able to enjoy at all. Now I do not think we have to worry very much about him, but there are others who are going to be affected, just as the individual is affected, and it seems to me that as to those corporations, many of their difficulties may be taken care of by an intelligent administration of these deductions I have referred to by the Bureau and, if the committee feels necessary, by some small provision for reserves. Personally I am opposed, in principle, to make exemptions along that line, because every one you make opens the door for tax avoidance or evasion, as well as for loss of revenue. But I do not feel you have to worry much about that beyond the point that you worry about the individual.

After all, you are requiring an individual to make tremendous sacrifices. You take a young professional man, say a young lawyer who is just getting established and he is earning his \$5,000 a year; he is unmarried; the Army comes along and puts him on the war front at \$30 a month. You do not worry about him. However, you have destroyed his budding practice. You just took him.

So it seems to me, if you set up your taxation scheme and your rates in such a manner you would avoid wrecking these corporations, if you permit them to live, if you permit them to carry on, perhaps under some difficulties, but to carry on their peacetime activities and making provision for the needs of the civilian population, that you have done your duty in wartime, just the same as you will provide the same kind of treatment for the individual. You require him to burn less coal, as we did in the last war, to go without butter, without sugar, or whatnot. In other words, I am suggesting that you ask the corporations that are taking care of the civilian population, to carry on, perhaps under difficulties, but to the best of their abilities, assuming the burdens we all must bear.

Senator BAILEY. Let me ask you a question. Assume that this bill were in effect and that a war occurred in which we were involved; what would be the effect on the stocks, the common stocks in America?

Mr. BROWN. You are now talking about the administration proposals which I am addressing my remarks to?

Senator BAILEY. I am talking about this bill right here.

Mr. BROWN. The Nye bill?

Senator BAILEY. Yes.

Mr. BROWN. Well, I am inclined to think that there might be a sharp drop in the value of common stocks, provided you did not close the stock market.

Senator BAILEY. You would have to close the stock market.

Mr. BROWN. We did that in the last war.

Senator BAILEY. That is not so important. What would happen to the banks that had these stocks as collateral?

Mr. BROWN. Well, I think that if you did not close the stock exchanges and if the banks took the position that they had to immediately liquidate securities on the artificial market which would exist on exchanges—I mean you cannot say that panic conditions represent a fair market either on the exchange or off of the exchange—

Senator BAILEY (interrupting). Why can you say that? We have no right to create legislation that would create a panic.

Mr. BROWN. You would not be creating the panic, the war would be creating the panic.

Senator BAILEY. But legislation would aggravate it. You just said it would cause a great drop in the common stocks. The common stocks are held as collateral in the bank. Now what happens to the banks under those conditions? Would the banks call on the borrower for more collateral?

Senator GUFFEY. Judge, that did not happen so much in the last war. When the stock exchange was closed the man who had common stock as collateral was protected by the fact that there was no market for the stock.

Senator BAILEY. That did not protect him.

Senator GUFFEY. It did in the North. The Federal Reserve carried their loans and the owners of the stocks were protected.

Senator BAILEY. That was a 6 months' closing law. Everything paused. The stock markets, as I recall, were closed from August to January 1. That is when the war broke out in Europe, not over here. That was due to the dumping of foreign securities here. The Europeans had investments here of about seven billions of dollars and they had to realize the cash. That does not make that stock valuable, that does not reinforce the collateral.

Senator GUFFEY. I thought you were talking about the immediate effect of it. That was our experience before. I know it was not sold.

Senator BAILEY. During a war the war-speculation stocks go up, but if you have this bill in effect it would be sure that the common stocks would go down. I am not protesting, I am just looking at the consequences.

Mr. BROWN. I think you have got perhaps to decide, Senator, whether you are going to endeavor to continue the same conditions, ignoring the fact that you have a war, that you have got to pay for it and you have to raise the money somewhere. I mean if you contemplate continuing peace time conditions in war, that is one thing. Personally I do not believe it is possible. I do not believe it will be possible, particularly under the conditions of any major war that we might get into in the near future.

Specifically answering your point about the stock market, that happens to be a field where I have had considerable experience, inasmuch as until very recently I have been one of the counsel for the New York Curb Exchange.

Senator BAILEY. The New York Curb?

Mr. BROWN. The New York Curb Exchange, and I helped organize their stock clearing corporation. I have worked in the stock clearing corporation of the New York Stock Exchange, and I cannot conceive that the stock exchange authorities would do anything else, whether

you have this bill or do not have this bill, other than close the exchanges on the breaking out of a major engagement, presupposing, of course, the conditions you assume.

The individuals who are operating that delicate machinery take into consideration all these possibilities. Whatever you might feel about the business and financial interests in New York, I know those who are operating this very delicate machinery take into consideration all these possibilities. Let us say that self-interests alone prompts them to do it, nevertheless a tremendous amount of thought by the most skillful technicians is devoted to these problems that we are talking about and with a very complete appreciation of their responsibilities.

Senator GUFFEY. How long was the Stock Exchange closed in the panic of 1907?

Mr. BROWN. I do not know, Senator. That was before my time.

Senator GUFFEY. It was closed for some weeks and months, wasn't it?

Mr. BROWN. I don't know.

Senator GUFFEY. We had no war at that time.

Senator BAILEY. That was a very brief closing period. It was brought on by an acute situation. We had two or three strikes.

Senator GUFFEY. I thought that you would recall how many days it was closed.

Senator BAILEY. That is too far back for me to say, but I do not think the stock exchange was closed 4 days in Roosevelt's time in 1907.

Mr. BROWN. In 1907?

Senator BAILEY. Yes; it was in that fight between the Northern Pacific and the Southern Pacific.

Mr. BROWN. I recall it historically, but I do not recall the duration of it.

Senator GUFFEY. It was closed longer than that. That is my recollection. I remember, as I was on the finance committee of one of the trust companies, that collateral loans were not paid then, and the commercial loans were. I do not know how long it lasted. You had to protect your collateral loans all the way through.

Mr. BROWN. I am conscious of the fact that I am presenting a thesis. I am trying, in a very general way, to discuss with you the reasons why, without going into the details of any bill, the reasons why we feel you should consider seriously using the same basis for this war bill as that proposed by the administration. Of course that is all based on the assumption that Congress will go along with those proposals. I do not know whether they will or not.

Senator BAILEY. Let us take another view of it. A prudent banker would anticipate the situation.

Mr. BROWN. Yes, sir.

Senator BAILEY. Would he be willing to take these stocks as collateral, with this bill in effect? If he should take them and if he should feel war coming on, would not he immediately begin to call his loans in?

Mr. BROWN. Well, I do not think that is the way it works. If it was an isolated situation affecting just a certain number of his borrowers, he might take that action, but here is a bill which takes in a large number.

Senator BAILEY. The banks have to keep liquid. They would anticipate this. Suppose on tomorrow, this bill being in effect, there came a situation out of which the bankers thought there would be a war, and we were in it, do you think they would not take steps to protect themselves against a drop in the stocks? Do you think they would let the stocks go way down below the value of the loan?

Mr. BROWN. No; but a banker knows a condition of that sort does not in any way reflect the true value of the intangible property in question. Also, I will say to the Senator, that there are other ways in which our Federal financial machinery works, in which you can secure the necessary liquidation. You have your Federal Reserve System, on which you have conferred additional powers. If necessary, you can confer additional powers, just the same as you contemplated it during the last depression.

Senator BAILEY. The Federal Reserve System does not put out money on inadequate collateral.

Mr. BROWN. I am not a financial theorist. I am not qualified to discuss it, but I do know that, for example, you could, if you saw fit, or if compelled to, adopt your 100-percent coverage system, which would at least take care of the worry of liquidity. If you adopt the dollar-for-dollar coverage system you have very largely disposed of the individual hoarding and the fear that you have got to be liquid in order to meet runs on your bank. With a 100-percent coverage you cannot have a run on your bank that would get anywhere.

I am not advancing that on behalf of the Treasury as a suggestion. I am just saying there is one way which a large body of economists have said is sound. I do not know whether it is or not. I know a lot of economists who have a reasonable reputation say it is.

Senator BAILEY. Don't you think we might make a provision whereby common stock would be entitled to receive a fair return?

Mr. BROWN. What is that?

Senator BAILEY. Don't you think we might so amend this bill as to make a provision for common stock to receive a fair return?

Mr. BROWN. I do not know that it needs to be done in quite that way. It is up to you to decide to what point you would want to run the rates, and the rates will determine whether there will be funds available to take care of preferred stock first and your interest payments, and after that, if you see fit, common stock.

Senator BAILEY. You must take care of that preferred stock in order that common stock would get anything.

Mr. BROWN. Oh, yes; the law imposes that duty.

Senator BAILEY. After the preferred stock is taken care of, then the common stock gets a percentage.

Mr. BROWN. From the tax point of view you do not have to take care of it.

Senator BAILEY. There shall be some profit even to the common-stock holders. That is written on the face of the bill. Therefore you must pay the preferred stock in full, because otherwise the common stock would not get as much as is provided in the bill.

Mr. BROWN. I would like to make it clear to the Senator that I am not trying to suggest the maximum point of the rates, or whether you provide a profit or do not provide a profit, I am merely talking about the basis for the application of the rates.



Senator BAILEY. It involves the base.

Mr. BROWN. You mean the administration plan involves the base?

Senator BAILEY. I do not know what the administration plan is.

Mr. BROWN. The administration plan primarily, after making certain provisions for corporations, proposes that the remaining corporate income shall be taxed in the hands of individuals at the progressive individual rates, or if they prefer to keep them, they are not trying to say you shall or shall not keep them, if you do keep them that the Government shall receive an equivalent amount of revenue which it would have obtained if they had distributed it.

Senator BAILEY. That is simply an extension of the plan that is proposed here in the new tax bill.

Senator CONNALLY. That is what he is talking about.

Senator BAILEY. He says that the Government shall pay an equivalent amount. As I understand it now, the Government shall pay 22.5 percent. I saw that in the paper this morning, that the Government shall pay 22.5 percent as the Government's share. That is not determined.

Mr. BROWN. I do not know what the latest schedules are as to the Government's share.

Senator GUFFEY. Did the Government submit a schedule? They just brought a general plan down, did they not?

Mr. BROWN. Here or on the other side?

Senator GUFFEY. In the Ways and Means Committee.

Mr. BROWN. They discussed a number of schedules.

Senator GUFFEY. They brought a plan down.

Mr. BROWN. They brought down a suggestion, and they discussed it with the subcommittee, and the subcommittee requested the Treasury to prepare schedules. They prepared dozens of schedules, a great many schedules which have been considered by the subcommittee and later by the full committee; and on the basis of those schedules and the other points in the plan, they have held hearings, and, from what I read in the newspapers, they will produce a bill in a short time.

Senator BAILEY. You propose here a 50-50 division; that is your plan?

Mr. BROWN. The Treasury is presenting to this committee for its consideration a suggestion—

Senator LA FOLLETTE. What we were discussing, Senator, was the basis, upon what basis corporation taxes would be levied in this bill in the event of war. The Nye proposal is one thing, and Mr. Chesteen suggested tentatively another; and Mr. Brown was discussing an alternative which was based upon the assumption that Congress would work out something along the lines of the administration suggestion concerning corporation taxes now pending in the House, and that if that is to become the law that the wartime taxation should not shift suddenly to some other basis upon which there would be no previous immediate peacetime experience.

Mr. BROWN. That is correct, sir.

Senator CONNALLY. The majority of the members of the committee want to be on the floor of the Senate. I am sorry we will have to cut this meeting short. We will resume tomorrow at 10:30.

(Whereupon, at the hour of 11:35 a. m., the committee recessed until tomorrow, Friday, Apr. 10, 1936, at 10:30 a. m.)



## TO PREVENT PROFITEERING IN WAR

FRIDAY, APRIL 10, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman) and Bailey.

Also present: G. D. Chesteen, J. S. Zucker, and Allen T. Akin, of the Joint Committee on Internal Revenue Taxation; Ralph W. Brown and P. J. Mitchell, of the Treasury Department; S. E. Rice, office of the Senate legislative counsel.

Senator CONNALLY. The committee will come to order. Did you conclude, Mr. Brown, on yesterday, all that you wanted to say? If you have not and have anything further you may go ahead.

Mr. BROWN. So far as outlining the basis of the tax, Senator, yes.

I do not know whether you wish me to introduce at this time the estimates on the individual income rate or not.

Senator CONNALLY. On the corporations?

Mr. BROWN. On the individual-income rate.

Senator CONNALLY. Did you not give us those yesterday?

Mr. BROWN. On yesterday you asked me if I would not speak first about the basis of the tax.

Senator CONNALLY. I think we better put them in the hearing now, then. All right, Mr. Brown.

Mr. BROWN. Mr. Chairman, at the request of the subcommittee the Treasury has had prepared an estimate of the probable yield of the individual-income taxes, normal and surtaxes, under H. R. 5529, the so-called Nye bill. And also on the two schedules submitted by the staff of the Joint Committee on Internal Revenue Taxation—

Senator CONNALLY (interposing). Those are already in the hearings.

Mr. BROWN. Yes; those schedules are.

Senator CONNALLY. Did we not put those in the hearings the other day?

Mr. BROWN. Yes; those schedules are already in the record.

At this time I will offer a memorandum which contains the estimates and explains their basis.

(The memorandum referred to is as follows:)

*Estimated revenue from war-profits tax proposals on individual incomes, based on 1928 individual incomes*

[In millions of dollars]

H. R. 5529. Rates of tax and deductions for personal exemptions and credits as under H. R. 5529 <sup>1</sup> ; earned income credit for normal tax not allowed; dividends subject to normal tax; other provisions as under Revenue Act of 1935-----	9, 783
Earned-income credit allowed and dividends exempt from normal tax-----	9, 292
Proposal no. 1. Normal rate 10 percent, surtax rates ranging from 6 percent on surtax net incomes in excess of \$1,000, to 85 percent on surtax net incomes in excess of \$30,000; personal exemptions and credits the same as in proposal no. 2; earned-income credit for normal tax not allowed; dividends subject to normal tax; other provisions as under Revenue Act of 1935-----	9, 805
Earned-income credit allowed and dividends exempt from normal tax-----	9, 123
Proposal no. 2. Normal rate 10 percent, surtax rates ranging from 6 percent on surtax net incomes in excess of \$1,000 to 80 percent on surtax net incomes in excess of \$75,000; personal exemptions, married \$1,000, single \$800, credit for dependents, \$250; earned-income credit for normal tax not allowed; dividends subject to normal tax; other provisions as under Revenue Act of 1935-----	7, 202
Earned-income credit allowed and dividends exempt from normal tax-----	6, 520

<sup>1</sup> Normal rate 6 percent, surtax rates ranging from 10 percent on surtax net incomes in excess of \$3,000 to 93 percent on surtax net incomes in excess of \$20,000; personal exemptions, married \$1,000, single \$500, credit for dependents \$100.

Mr. BROWN. I think it only requires a brief explanation.

The committee, as you will recall, left it to the Treasury to determine the year which they would take as a point of reference in making these estimates. I discussed that rather fully with the Treasury actuaries.

Senator CONNALLY. Senator Bailey, Mr. Brown is just explaining that he is putting in the record the estimates based on those two schedules that the Joint Committee on Taxation submitted to us.

Senator BAILEY. What we had the other day?

Senator CONNALLY. Yes; he is just beginning now to explain it.

Mr. BROWN. And as the result of our discussion, we decided that probably the year 1928 would most nearly represent industrial activity and the production of business profits comparable with a war year, assuming this country should be involved in a war within the next 2 or 3 years.

So these estimates are based on the revenue statistics for the year 1928.

Senator CONNALLY. 1928?

Mr. BROWN. Yes, sir. I have also asked them to make similar estimates based on a selected war year during the late war, but owing to the tremendous pressure they are under in connection with work for the Ways and Means Committee, they have not been able to do that so far.

Except for changes in rates, personal exemptions, and so forth, as indicated on the table, the provisions of the Revenue Act of 1935 with respect to the definition of income were those employed in making the estimates.

Senator BAILEY. You have all of that written out?

Mr. BROWN. I have a memorandum which I have offered for the record, Senator.

Senator BAILEY. Why not insert it in the record and we can read it, instead of taking the time to read it now, and it will save us a lot of time?

Mr. BROWN. It was inserted in the record before you came in, Senator.

I am just explaining one or two things that do not appear on the face of the memorandum.

That is all I have to say.

Senator BAILEY. They are individual rates?

Mr. BROWN. They are individual rates; yes, sir.

Senator CONNALLY. Individual incomes.

Senator BAILEY. Are you going to submit some corporate rates and estimates?

Senator CONNALLY. As soon as we determine the basis that we are going to proceed on. I suppose we can have those rates, could we not; I mean those estimates?

Mr. BROWN. Yes; the basis and the various returns of the rates.

Senator BAILEY. When you do that I wish you would pay some special attention to the common-stock interest in the corporation.

Mr. BROWN. I think that, probably, Senator, is a matter for the determination of the subcommittee.

Senator BAILEY. My views are simply stated. I am in favor of paying preferred stock dividends according to the tenure of the certificates, whatever they may be, in order that the common-stock holder may receive a fair return on his investment. That is based on the theory, which we adopted here, that there was to be some profit, and an appeal at any rate, reasonably and conservatively to the profit motive. And in order that you may do that you must pay or enable the corporation to earn the dividends on the preferred stock, for the reason that unless they do earn and pay the dividends on the preferred stock they can not pay any dividends on the common.

Mr. BROWN. That is correct. Many of them are governed by contractual obligations.

Senator BAILEY. Now that predicates an allowance of a reasonable profit—whatever that may be I do not know—on the common stock.

Senator CONNALLY. Let me ask the other experts and you, Mr. Brown, at present in computing the net income of a corporation, do you deduct interest paid out on preferred stock?

Mr. CHESTEEN. We do not.

Mr. BROWN. No.

Senator CONNALLY. You are not allowed to deduct that?

Mr. CHESTEEN. You mean dividends paid on preferred stock?

Senator CONNALLY. Yes.

Mr. CHESTEEN. We do not.

Senator CONNALLY. Is not preferred stock in effect a bond issue, and that is all it is?

Mr. CHESTEEN. It may be a substitute, but as a matter of fact it is not.

Senator BAILEY. It is a preference.

Mr. CHESTEEN. It is a preference stockholder, that is all.

Senator CONNALLY. I understand it is a preference.

Mr. CHESTEEN. He has preference on a dissolution and has preference on dividends.

Senator CONNALLY. A bondholder has preference on a dissolution. He has the first lien on the assets of the corporation, does he not, Mr. Brown?

Mr. BROWN. That is correct. But he has no interest in the equity.

Senator CONNALLY. Yes; in the equity after the debts are paid. But the preferred stock ordinarily only gets 7- or 8-percent dividend, or whatever the interest still is, and then the common-stock holders get all the balance of the income.

Mr. BROWN. That is right. And they are entitled to whatever assets remain on dissolution.

Senator BAILEY. A preferred-stock holder has a contractual right with reference to the common stock, that is all he has.

Senator CONNALLY. Senator Bailey, do you not raise an issue, though, that you cannot very well distinguish? If the corporation is permitted to earn 4 percent, we will say, or 5 percent, or whatever basis we determined, why, it is then the business of the corporation as to how under its bylaws and organization as to what it will do with that profit. We cannot very well say we are going to devise a tax scheme to do this for preferred-stock holders, or to do something else for the common-stock holders, because some other corporation might not have any preferred stock, and it might all be common stock, and you could not apply one rate for one corporation any different than you could for another. Would it be very practical, Mr. Brown?

Mr. BROWN. I do not think it would be very practical, Senator.

I think that will adjust itself if the rates permit the retention of earnings, enough to take care of the matters Senator Bailey refers to.

Senator CONNALLY. That is what I mean, if the income of the corporation is such under this bill as to allow it a reasonable profit, why, then the distribution of those profits is no concern of the Government, it seems to me.

Senator BAILEY. You will recall, Senator, that the witness here the other day—I have forgotten his name—predicated his testimony upon a 3-percent profit. And a 3-percent profit would pay only half the preferred dividends and nothing on the common.

Now, if you follow that principle through, here is what will happen, and it will happen very quickly: Common stocks will cease to be collateral in banks, and they will cease to be of value on the stock market, because you have got this act hanging over them in which their value is extinguished, and there is nothing to accumulate for them, nothing to be paid out for them, and the common stocks go down.

Now we are not writing a law here with a view to breaking the stock market, or to destroying the value of collateral. We must write the law so as to prevent anything of that sort. We do not want to bring on a collapse.

Mr. BROWN. May I suggest this, Senator, that I hold no brief for 3 percent, nor any other percent. The Treasury has felt that that was not within its province.

But the 3 percent you are speaking of might in certain circumstances take care of not only the dividend on the preferred stock,

but also dividends on the common stock, because that 3 percent is not the same 3 percent that you are talking about when you are talking about dividends. It is 3 percent on the adjusted declared value. In other words, you allow a corporation to take off 3 percent of their earnings measured by adjusted declared value before you impose the graduated heavy rates. So 3 percent of the corporation's net taxable income might be sufficient to take care of the preferred stock dividend—

Senator BAILEY (interposing). It might be.

Mr. BROWN (continuing). And provide something for the common stock.

Senator CONNALLY. And a corporation might have \$1,000,000 capital stock and only \$200,000 preferred stock.

Mr. BROWN. That is correct.

Senator CONNALLY. And in that event 3 percent on a million dollars would more than pay it.

Senator BAILEY. Yes; pay the preferred and leave a little for the common. What I am looking for is a fair allowance on the whole investment. That is the principle which we are following here.

Senator CONNALLY. Your point is we ought to allow a larger net profit?

Senator BAILEY. A larger net profit; yes.

Senator CONNALLY. A larger net profit than is proposed in the bill?

Senator BAILEY. Than the witness recently advocated; yes.

Senator CONNALLY. I do not know that Mr. Brown advocated any particular return.

Mr. BROWN. I am not advocating any return whatsoever.

Senator BAILEY. No; not you, but the gentleman who was here last week.

Senator CONNALLY. Mr. Flynn?

Mr. BROWN. Mr. Flynn; yes. He was the gentleman who organized the group which I understood worked on title I of the tax bill portion of the Nye bill of the Munitions Committee.

Senator BAILEY. I am perfectly willing to go along with the idea of providing revenue as to the war with a view to raising as much money as is needed on taxes, rather than bond issues. I know that is academic. I know that when a war breaks out the picture will change so rapidly that in all probability all this legislation will be uprooted. This is theoretical. I am willing to go on on the theory of raising revenue in that way, but the theory ought to be a reasonably sound theory. And I do not think the way to prevent war is to threaten the public with so much taxes that no man would dare to vote for war in defense of this country. I do not care to put that penalty on the American people. I am no advocate for war, but I would like to give the people of this country a fair chance to fight if they have to fight.

Mr. BROWN. Yesterday, Senator, I was devoting most of my remarks to the basis of the tax bill, and I was pointing out that the President had made certain suggestions in a tax message, which are under consideration in the House, and which alter the basis of the corporation income tax, and suggest the repeal of the capital-stock tax and its companion excess-profits tax, which form the basis, or rather the capital-stock tax did, of the Nye bill. They

use that basis of adjusted declared value as the basis for determining the percentage of exemption before you apply your heavy graduated rates. And I was emphasizing that it was of the utmost importance in the administration of any tax law, particularly one which so vitally affects our national economy, that we should accumulate experience in peacetime, and not have to overnight change over to a totally different basis in respect to which we have almost no experience.

Senator BAILEY. I think we should base what we are doing on our experience. I think this act ought to be coordinated with the act that is assumed to come down from the Ways and Means Committee.

Mr. BROWN. Then I also spoke in respect to a tentative suggestion made by Mr. Chesteen, part of which involved a flat corporation rate, say, of 30 percent. And I was asked to give the views of the Treasury. And after consulting with my superiors I presented to the committee the view that the Treasury did not feel that it could go along, because of the discrimination we felt that would result, particularly in the case of the small stockholder. Also it discriminates between business profits produced by different forms of business organizations, to wit, individuals and partnerships in relation to corporations.

Senator CONNALLY. Were you here yesterday, Senator Bailey, when Mr. Brown, as I understood him, contends that the theory underlying the House bill, and which he wants to adapt here insofar as possible—

Senator BAILEY (interposing). Of the House bill? The Nye bill?

Senator CONNALLY. No; the House bill is the general tax bill.

Senator BAILEY. You mean over here?

Senator CONNALLY. No; the general House bill now in the process of formation.

Senator BAILEY. Yes; I know about it.

Senator CONNALLY. Its theory is, in the final analysis, individuals will pay the same rate of tax on their income, whether that is an individual income in a little individual business, or whether it is dividends or profits from corporations. In other words, regardless of the source of the income, in the final analysis, every man with \$5,000, no matter where he got it, will pay relatively the same tax as every other man with \$5,000.

Is that right, Mr. Brown?

Mr. BROWN. That is correct; yes, sir.

Senator CONNALLY. That is the general theory.

Senator BAILEY. That is the analysis of the existing law?

Senator CONNALLY. No; he contends under the existing law individuals are discriminated against in favor of corporations.

Mr. BROWN. Or it may work the other way. Take two concrete examples. You may have a very small businessman, who cannot afford, under existing law, to use the corporation form with its advantages of limited liability, because the corporation rates ranging from 12.5 to 15 percent of corporation income are in excess of what he would have to pay if he conducted his business as an individual. So, although he would like to do business as a corporation and have the advantages of limited liability, he is compelled to do business as



an individual because he pays less tax that way. Then there is the reverse situation. The larger corporation, which pays, say, the maximum of 15 percent on income and fails to distribute the balance. Until it does distribute it, it goes tax free so far as the surtaxes are concerned.

Senator BAILEY. If a partnership makes tremendous profits, it suffers the penalty of a graduated tax on individuals?

Mr. BROWN. That is right.

Senator BAILEY. And if a corporation makes tremendous profits there is a limitation?

Mr. BROWN. That is right.

Senator BAILEY. At the point of 15 $\frac{3}{4}$ , I believe?

Mr. BROWN. Fifteen percent.

Senator BAILEY. Yes; 15 percent.

Mr. BROWN. It was 13 $\frac{3}{4}$ .

Senator BAILEY. That is in contemplation of the declaration of dividends which pass out to the individual and get into the higher brackets. That is the theory of the tax law?

Mr. BROWN. Undoubtedly; that motive has influenced the declaration of dividends. I do not say that is the sole motive.

Senator BAILEY. The new tax law is based on no theory whatever of taxation. It is the theory of economy. It places a penalty upon the accumulation of surpluses, and that is the theory of it, the penalization of surpluses.

Mr. BROWN. I would put it another way.

Senator BAILEY. I question whether it would even be classified as a tax bill. It is a social and economic theory.

Mr. BROWN. I do not agree, with great deference to the Senator.

The fundamental basis of this bill, as I understand it—and, of course, I have to give you what my understanding is, as I have not gotten together with all my associates in the Treasury and arrived at a common way of stating the whole thing. The thought is this: That corporation income should either be distributed to the shareholders, where it would be taxed at the graduated rates in accordance with the ability to pay, or the Government should receive from the corporation the equivalent of what it would have gotten from the shareholders. In other words, the thought is that the Government revenue should not be diminished because the individual selected the corporate form of business organization in preference to some other form of business organization.

Senator CONNALLY. In other words, the corporation can elect that if it wants to keep the surplus, then it can keep it, but it must pay the same tax as if it was distributed?

Mr. BROWN. That is correct.

Senator BAILEY. It now keeps it?

Mr. BROWN. That is correct.

Mr. CHESTEEN. What about the distribution of those earnings after they are once taxed to the corporation? Are they distributed free or are they to be subject to tax again?

Mr. BROWN. Under the House bill—and of course we are talking about something which is in a tentative state even in the House at this moment—it is contemplated that the undistributed earnings on which the corporation pays a tax shall not be tax free upon subsequent distribution.

But, of course, you must remember in that connection that while undoubtedly distributions are made out of those reserve funds—I am not speaking of reserves, but of the undistributed earnings—a large proportion of them go into capital of a nature which is not capable of being readily distributed. They go into plant and equipment.

Senator BAILEY. And employment?

Mr. BROWN. Sir?

Senator BAILEY. And employment?

Mr. BROWN. On that subject, while I do not know that it is really germane to our discussion so far as the war bill goes, we discovered, Senator, that a much smaller proportion of these so-called reserves actually were used to maintain employment, to maintain dividends, for that matter, than has been supposed, and we find the biggest use of surpluses that has been made during the depression has been in writing off losses and in making bookkeeping charges against surplus. Of course, that was in an attempt to produce the liquidity which a great many people imagined actually existed.

You want to remember that these reserves do not exist to such a great extent in the form of cash and marketable securities that could be immediately converted into cash. They existed in the form of plant, equipment, inventory and so forth.

Senator BAILEY. They were simply written down.

Mr. BROWN. We find that the biggest use made of these so-called surpluses was used for writing off losses, and readjustment of capital structure.

Senator BAILEY. That was a necessity. I do not see how you could have avoided that. If they had not had the surplus their structures would have been very badly impaired.

Mr. BROWN. In speaking of employment it is an interesting thing to note that we find that wages dropped almost at the same rate as the corporation income dropped during the depression.

Senator CONNALLY. Isn't it a rule, one of the first rules of business, that when slacking up business comes the pay roll is the first place they cut?

Mr. BROWN. Yes; but the argument is made by many who will oppose these proposals that they are used to maintain employment. And undoubtedly they were used to some extent, and by some corporations far more than others, but by and large we find that to a very limited extent, taking the experience of an average for all corporations, were the surpluses used to maintain employment.

That is a matter which of course is not susceptible of proof in the sense that two and two make four, but that is based on reliable statistics from sources.

Senator CONNALLY. Mr. Brown, I do not want to cut you short, but I am very anxious, since we won't be able to get a vote on these matters today, as there are only two of us here, to hear Mr. Chesteen in criticism—I do not mean hostile criticism—or in comment on the testimony of Mr. Brown, so that the other members, if we should have a vote on Monday, can have the copy of the hearing to read.

What do you think of that, Senator Bailey?

Senator BAILEY. You think about having a vote?

Senator CONNALLY. Yes; we are thinking of having a vote as to certain of these matters whenever we have sufficient attendance of the committee.

Senator BAILEY. I do not want to vote on this bill, I will say frankly, until I have seen what the House is going to send over to us.

Senator CONNALLY. I thought, though, we might be able to determine some of these aspects of the bill, so the draftsmen can be going ahead and getting it in shape for submission to the full committee.

Mr. BROWN. I was trying to suggest yesterday that there is some difference in the problem between wartime and peacetime.

After all, in our peacetime bill that is under consideration now on the other side, we are trying to maintain our individualistic economy, whether it is the individual doing business or the corporation. In other words, we say, "We are not interfering with your affairs. You do as you like. All we want is that you shall pay a fair proportion of the revenue to the Federal Government, whether you do business as a corporation or any other way."

But when you come to war, the needs for revenue are stepped up beyond even what they are today, and, though through necessity of speeding up war production, you have to disregard a great many principles inherent in an individualistic economy. As I said yesterday, as far as the war producers are concerned, the General Staff is going to be chiefly interested in production. They want to supply the Army in the field with all it needs. And they cannot be too much interested in the means by which it is financed.

So it seems to me insofar as war industries are concerned, and those indirectly contributing, that you have perhaps got to make a differentiation between those corporations and the corporations, the larger in number, which are taking care of the needs of the civilian population.

I just mention that because the Senator (Senator Bailey) was not here at the time I expressed that view.

Senator CONNALLY. All right, Mr. Chesteen.

#### STATEMENT OF G. D. CHESTEEN, OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Mr. CHESTEEN. Senator, we have some 10 or 15 changes in this bill that have not been passed upon. Do you want to take those up, or do you want to go on with this other subject instead?

Senator CONNALLY. You mean 10 or 15 changes from the normal?

Mr. CHESTEEN. From the peacetime bill.

Senator CONNALLY. What do you wish about that, Senator?

Senator BAILEY. You want 10 or 15 changes from the peacetime bill?

Mr. CHESTEEN. At least 10 or 15 changes.

Senator BAILEY. What is the peacetime bill?

Senator CONNALLY. He means our regular normal bill.

Mr. CHESTEEN. The normal peacetime bill, the 1934 act.

Senator CONNALLY. I think, Mr. Chesteen, rather than take those up, since we have such a small membership present this morning, that we might go on with what we have been discussing now, and

then take those up Monday when we hope to have a full attendance, because you will have to go over it again when they are present also if you do it now.

Senator BAILEY. You mean by the peacetime bill the existing revenue law?

Mr. CHESTEEN. Yes; the existing revenue law.

Senator CONNALLY. You mean 10 or 15 departures in this bill?

Mr. CHESTEEN. That is right.

Senator CONNALLY. From what are regular and existing in peacetime?

Mr. CHESTEEN. That is right.

Senator BAILEY. Yes; but in the meantime we have got a new peacetime bill coming over, and I question whether it would be worth while to submit some criticisms on the existing law until we know where we are going to on that to a very great extent, and then you can suggest your changes upon that basis.

Mr. CHESTEEN. The present proposal over in the House does not contemplate any changes in net income in the present peacetime bill. The Nye bill makes quite a number of changes in the present peacetime law.

Senator BAILEY. The Nye bill was not written with a view to revenue. I fully realize that. And I am not inclined to just take that bill and swallow it whole. When I vote for one I am going to vote for a revenue bill with no ulterior purpose, and just let the purpose be revenue. But, however that may be, I think you better wait before you make any changes unless and if you can point out there where this so-called Nye bill has changed the system of deductions and allowances under which we arrive at what we call true taxable income, and if so, I would like to see them, because that has got to be done fairly.

Mr. CHESTEEN. We contemplated that, and we are prepared to point out to you the departures from the peacetime bill.

Senator BAILEY. All right. I would be glad to have you give a memorandum on that.

Mr. CHESTEEN. Do you want us to do that at this time, or do you want us to go ahead with the other changes?

Senator BAILEY. Senator Connally suggested it might be done when we had more members present, but I think it would be better for you to put a written memorandum in the record. You see that is in the nature of an analysis of the Nye bill with respect to deductions and allowances, is it not, showing where it changes that part of the system?

Mr. CHESTEEN. In the first part of the hearings we pointed out a number of the major changes, major departures, and that is in the first part of the hearings.

Senator BAILEY. And they affect the determination of taxable income?

Mr. CHESTEEN. That is right.

Senator BAILEY. Now, I would like to have those written out *seriatim*, so I could see myself whether they were fair or not. If you have them written it will be just as well to put them in the record and let us read them.

Mr. CHESTEEN. We have not prepared a written criticism to each one of these, because we contemplated explaining them orally to the committee and let the committee get our reaction to the changes.

Senator BAILEY. Suppose you proceed, then. You do not have the memorandum? You have to dictate it into the record?

Mr. CHESTEEN. Shall I proceed with these changes, or proceed with the criticism of Mr. Brown's suggestions here to the subcommittee?

Senator BAILEY. Suppose you proceed with the criticism of Mr. Brown's suggestions. That is in line with the request of Senator Connally.

Mr. CHESTEEN. Mr. Brown's suggestion, as I understand it, contemplates a graduated—

Senator BAILEY (interposing). Before you go further, Mr. Brown over here [indicating] represents the Treasury, does he not?

Mr. CHESTEEN. Yes.

Senator BAILEY. Whom do you represent?

Mr. CHESTEEN. I am representing the staff of the joint committee.

Senator BAILEY. The what?

Mr. CHESTEEN. The staff of the Joint Committee on Internal Revenue Taxation.

Senator BAILEY. Now, that is a joint committee of the House and Senate?

Mr. CHESTEEN. That is right.

Senator BAILEY. All right.

Mr. CHESTEEN. The proposal discussed by Mr. Brown, as I understand from the report of the subcommittee of the House, contemplates a graduated tax on the undistributed earnings of corporations.

Corporations are divided into two classes for the purpose of this tax. Those below \$10,000 are taxed on a graduated scale reaching 29.5 percent.

Corporations with net incomes above \$10,000 are taxed at a graduated scale extending up to 42.5 percent.

The taxing of corporation income during a war period with this scheme of taxation, I assume, would be at much higher rates than in the peacetime bill. I think this is obvious from the fact that you are contemplating a higher surtax for individuals during a war period. The effect of a graduated tax upon the undistributed earnings is intended to encourage distribution.

Senator BAILEY. And does it not also tend to discourage expansion?

Mr. CHESTEEN. I would say if you make the rates high there would be a great urge on the part of the corporate officers to advise liberal distributions.

Senator BAILEY. Yes.

Mr. CHESTEEN. It necessarily would mean that financing and expansion must be taken care of in some other way.

Senator BAILEY. Should it stop? It would not do to borrow money.

Mr. CHESTEEN. No.

Senator BAILEY. Because you would have to earn \$3 to pay one, would you not?

Mr. CHESTEEN. That is right. Now, the alternative which the corporation would have would be to pay this very high tax on a part of its income.

Under the proposal of the House the rate is 42.5 percent. The increase of that rate in a war bill probably would be to such an extent that only a small part of the earnings would be retained by the corporation. The plan itself contemplates that when the earnings are distributed they likewise are subjected to a second tax in the hands of the individual, both normal and surtax rates.

Senator BAILEY. Let us get that clear.

Mr. CHESTEEN. Let us take the House plan——

Senator BAILEY (interposing). Now, I want to get that clear.

Here is a corporation that has earned 10 percent this year. Now, how much tax would it pay, assuming that the 10 percent was \$1,000,000?

Mr. CHESTEEN. Let us consider a maximum tax which a corporation pays on the proposal of 42.5 percent if no distribution is made.

Senator BAILEY. All right.

Mr. CHESTEEN. The plan leaves to the corporation, if it does not distribute anything, 52.5 percent of its net income.

Senator BAILEY. The corporation would retain 52.5 percent and the Government would get the 47.5 percent, is that right?

Mr. CHESTEEN. That is right. If these earnings are distributed in subsequent years to stockholders a tax rate as high as 75-percent surtax and 4-percent normal tax, making 79, would apply.

Senator BAILEY. That might be in the hands of an individual who had an income in excess of \$1,000,000, is that right?

Mr. CHESTEEN. In excess of \$5,000,000; in the hands of an individual. Now, if we assume that all of the 52.5 percent is distributed to a stockholder in the highest bracket, 42.5 percent of the income will be taken as corporate tax, and approximately 41.5 percent from the individual, making a total of approximately 84 percent on corporate earnings.

Senator BAILEY. That disregards altogether what we used to refer to as the law of diminishing returns, does it not?

Mr. CHESTEEN. I am afraid not.

Senator BAILEY. What is that?

Mr. CHESTEEN. I am afraid not.

Senator BAILEY. You are afraid it does not disregard it?

Mr. CHESTEEN. I am afraid it does.

Senator BAILEY. Go ahead.

Mr. CHESTEEN. Mr. Brown in this statement states that this principle has tended to put the corporate taxpayer and the individual taxpayer on somewhat the same basis, in that the corporation is required to pay a tax if it retains its earnings comparable with the tax which the individual would pay such as in a partnership in a similar business.

Senator BAILEY. There is nothing to prevent a partnership from being converted into a corporation, is there?

Mr. CHESTEEN. No; that is true.

The difference that I have pointed out would seem to indicate that if the corporate earnings are not distributed, if they are retained by the corporation and then ultimately distributed, that it does penalize the corporation earnings in comparison to the partnership.

Senator BAILEY. If there is a subsequent or delayed distribution there is an additional penalty?

Mr. CHESTEEN. Yes; on subsequent distributions the earnings of the corporation are taxed at the full.

Obviously, corporate earnings are subject to a tax in the year earned if they are not distributed, and subjected to a second tax at the full rates, normal and surtax, when distributed.

Senator BAILEY. You are making an impression on my mind that the law as proposed would give the partnership an advantage; is that what you are driving at?

Mr. CHESTEEN. I think that is true, unless the corporation distributes its earnings to the full extent in the year in which they are earned.

Senator BAILEY. Of course, the corporation is not going to be able to do that, and any theory that it will is not founded upon ordinary common sense. I think it is perfectly apparent to anybody that a corporation that distributes every year all it makes is bound to bust, and no power on earth could keep it going; and the same way with an individual.

Senator CONNALLY. It might do that for a while, and if it got in an unsafe condition it could quit.

Senator BAILEY. That is wholly based upon the fact that God Almighty does not run the world on an annual basis, and the theory that He does is fictitious. Man invented that theory. Corporations may live for 10, 15, 20, or 40 years at a time during good times and bad times, and the surplus of one time tides them through the debts of subsequent years. And no man can make sure of making annual profits.

Senator CONNALLY. Senator, on the other hand, take an individual, and his income cannot be seriously segregated really on the first of January, unless he is on a salary. And if a corporation wants to retain these dividends for a surplus should it not pay the tax the same as the other corporation that does distribute its dividends?

Senator BAILEY. It does pay now.

Senator CONNALLY. It does not pay in the same ratio now.

Senator BAILEY. But the corporation pays.

Senator CONNALLY. It pays, but when it distributes those profits the man who gets them pays another tax.

Senator BAILEY. That is over on the other side of the ledger. I am willing to go after the man who gets them if you wish. But the corporations do pay now on profits whether they distribute them or not.

Senator CONNALLY. So far as the corporation is concerned, but the owners of the corporation who are stockholders do not. In one case they do pay when they are distributed, and whenever they are not they do not.

Senator BAILEY. I believe your point there would be as to the dividends rather than the declaration. Go ahead.

Mr. CHESTEEN. We approached the question of corporate tax from a different view point than that which Mr. Brown approached it in his suggestion.

We did not think it is important in approaching the question of tax on corporations during a war period to give great consideration to the small stockholder, and to the possibility of dividends being subjected to a greater tax than some other form of income.

In the first place, the rate schedule submitted to you on individuals contemplates leaving enough for the individual to have sufficient to live during the war period, and pay his expenses.

In the second place the corporate tax may or may not be borne by the stockholder.

The Industrial Conference Board about 1928 secured through the Joint Committee data from several thousand corporate returns for the period beginning with 1916, and extending over a period of more than 10 years. The Board analyzed the incidence of the corporate tax and traced the tax to the consumer in increased prices.

On the basis of that study I do not think it can be fairly said that the stockholder bears the tax of the corporation. Such a portion of the tax as can be passed on to the consumer is passed on, and is not borne by the corporation and its stockholders.

Senator BAILEY. Is not the tax always passed on, either to the consumer or the producer of the raw material, or the worker, for this reason: If taxes are not passed on then they are paid out of capital, and if they are paid out of capital the corporation soon extinguishes.

Mr. CHESTEEN. That is right.

Senator CONNALLY. Is that necessarily true? Is not taxation just like any other running expense, like labor? It goes into the cost of production of the article in some cases.

Mr. CHESTEEN. I think it is generally considered a part of the cost of the product.

Senator CONNALLY. Of doing business?

Mr. CHESTEEN. The cost of doing business, and an effort is made and where it is possible the tax is passed on to the consumer, or back to the producer of the material or to the wage earner.

Senator BAILEY. And the price to the consumer is cost plus profit?

Mr. CHESTEEN. That is right.

Senator BAILEY. And, therefore, when you get the profit you take the tax out of the purchaser?

Mr. CHESTEEN. That is right.

Senator BAILEY. That is what price is?

Mr. CHESTEEN. That is right.

Senator BAILEY. Price is cost plus profit?

Mr. CHESTEEN. We had that in mind in suggesting a rate of 30 percent on corporations.

Senator CONNALLY. You mean 30 percent of the amount of their net profits?

Mr. CHESTEEN. Yes.

Senator BAILEY. In the event of war—

Mr. CHESTEEN (interposing). Yes.

Senator BAILEY (continuing). Would you be satisfied with that?

Mr. CHESTEEN. It did not occur to us that that would be imposing a very great hardship on the individual stockholder, because in a period of war we expect a certain amount of inflation.

The Nye committee, with all the safeguards to prevent inflation, I think admitted in its report that there would be inflation to some extent. Of course, if you liberalize the bill there probably will be a greater inflation.

Senator BAILEY. What do you mean by "inflation"? Let us get a definition in the record.

Senator CONNALLY. He means inflation of value and credit.



Mr. CHESTEEN. I mean inflation of prices.

Senator BAILEY. You mean increase in prices?

Mr. CHESTEEN. Yes; increase in prices.

Senator CONNALLY. Let me ask you a question right there: You speak about taking 30 percent in wartime, and that there will be inflation. There will be certainly in those industries that war stimulates?

Mr. CHESTEEN. That is right.

Senator CONNALLY. But on the other hand, there are, are there not, certain kind of industries and businesses that in time of war slump, instead of making a profit? Was not that the case during the last war? Were there not certain lines that really were worse off with the war than they were without it?

Mr. CHESTEEN. It is my recollection that very few businesses really had a slump during the war period.

It is true that conditions of war made certain lines of business more active because the civilian population and the Army bought more of certain classes of products. But I do not recall any particular line of business that suffered very greatly during the war period.

Senator CONNALLY. Boots, for instance, went up?

Mr. CHESTEEN. That is right.

Senator BAILEY. And everything else did.

Senator CONNALLY. I bought a pair that cost \$38, and I had always gotten them for \$15.

Mr. CHESTEEN. Any industry that was lagging, as I recall, got into something that was in demand during the war period, so that they really did not suffer during the period of the war.

Senator BAILEY. Notwithstanding what Mr. Flynn said, when a war comes on there is an apparent temporary prosperity, it is always paid for, and it is not a real prosperity. He said it would not get us out of the depression. Maybe it would not. Neither would the expenditure of public funds as we are now spending them get us out of the depression, but it would be a cushion for the time being, and then we paid the price later. That is what we have got to do now.

Senator CONNALLY. Is it not the same old story of the law of compensation that runs through the whole economy of the world, that we have a big spree, and then the next day we have a headache?

Senator BAILEY. And the rule of the spree is to taper off, and that is what we are trying to do. So I think we have got some logic for what we are doing in tapering off.

Mr. CHESTEEN. Assuming profits would be much larger in wartime than they are in peacetime—and I think they would—the 30 percent normal tax we consider would not impose a hardship upon the small stockholder, because his hardship is measured by what is left after distribution.

Senator CONNALLY. After you take the flat 30 percent then what do you propose in order to prevent excess profits? You said something the other day about a super tax that would catch the excessive profits.

Mr. CHESTEEN. We assume this: If we are to have any inflation during the war, as we know we will, we will have an increased demand on industry, as we had during the last war.

We contemplated that the corporation would need to have part of its profits for the normal expansion of its business during a war period, just as it would in peacetimes. And our suggestion that 25 percent of the profits to be retained as a reserve for expansion of business was based upon the theory that you did not want to interfere with normal expansion of business during the war period. And if it has been the corporate practice to retain 25 percent during the last 10 or 15 years it is reasonable to assume they will need it.

Senator BAILEY. Compare that with the excess-profits tax. Will you make that comparison?

Mr. CHESTEEN. A comparison of what?

Senator BAILEY. A comparison of excess-profits tax from 1918 to February 1919.

Mr. CHESTEEN. The only comparison we can make there—and we have no figures—is that during the war period the tax was about 50 percent of the war profits.

Senator BAILEY. The Government did get 50 percent of the profits?

Mr. CHESTEEN. The Government did get about half of the war profits.

Senator BAILEY. You mean the effect of an excess-profits tax was to bring the Government 50 percent of the profits made?

Mr. CHESTEEN. That is right.

Senator BAILEY. By the corporations in this country?

Mr. CHESTEEN. And in addition to that we know that there were reasonable distributions during the war, in many instances liberal distributions. So of course the Government secured revenue from that source.

Senator BAILEY. What they did during the war, or after, was to expand their capital structures with stock of a no-par value, and issue those stocks by the billions. That is what happened. And that was to get rid of the excessive payment of dividends. You remember that, do you not?

Whenever the Supreme Court held that stock dividends were not taxable then the corporations went at once into the stock-dividend business. That is the history of that, is it not?

Mr. CHESTEEN. Most of the stock dividends were issued after the war period.

Senator BAILEY. That was when the profits were coming in.

Mr. CHESTEEN. We assume that corporations would require a normal amount of profits to be retained for expansion of business during the war period as during peacetime. Mr. Brown's statement would indicate that the plan proposed would allow a corporation to do that.

In the plan suggested as the Treasury plan, of course, all the income retained is subjected to tax, and there would be the urge to pay out the income to avoid the corporate tax.

We suggested that you exempt from the graduated tax 25 percent of the net income, in order that the corporation might retain it for normal expansion during the war period. We think there are other reasons for retaining free from surtax 25 percent of the income during a war period.

Admitting that there is to be some increase in prices during a war period we know that inventories must be increased at the beginning of a war period, and there is an urge and an inclination on the

part of industry to carry rather heavy inventories as long as a war is being carried on.

The sudden termination of a war may be expected to be followed by deflation to the extent at least of the increase in prices that took place at the time of the declaration of war. When that happens a corporation sustains, of course, a loss in inventories as well as a loss on any other liquid assets it has on hand.

Senator BAILEY. Just as happened in the case of cotton goods and copper in the last war, and also automobiles; you remember that, do you not?

Mr. CHESTEEN. Yes; if you recall, in the last war the Revenue Act of 1918 was written after the war was over. And there was inserted in the bill a provision that if taxpayers sustained a loss in 1919, prior to January 1, 1920, by reason of a drop in inventories, the loss could be carried back against the war year of 1918. Unfortunately, the drop did not take place until 1920, and most taxpayers found they had to bear the burden of the loss in 1920, and could not carry any portion of it back against the war-profits years, and neither could they carry it forward to 1921.

Senator BAILEY. That drop began September 1, 1920, and did not it follow the abandonment of operations by the War Finance Corporation?

Mr. CHESTEEN. Yes; there were certain regulations as to copper, and hides, and many other products, including sugar, that were retained until after December 1919.

Of course, when those restrictions were removed, there followed a general demoralization of the market.

Senator BAILEY. And copper dropped from 37 cents to 4.

Mr. CHESTEEN. Yes.

Senator BAILEY. And cotton from 42 cents to 5?

Mr. CHESTEEN. Yes.

Senator BAILEY. And sugar went down to 4 or 3.5 cents?

Mr. CHESTEEN. Sugar dropped from 30 cents, I believe.

And if I remember, hides shipped in to make shoes dropped; for instance, goatskins, principally used in the manufacture of gloves and ladies' shoes, dropped from \$28 to \$36 a dozen down to \$14 a dozen. There was a general decline of inventories by reason of the removal of those restrictions by the Government and a return to peacetime conditions.

It seems to me that you must contemplate in the next war that similar conditions will follow the termination of a war.

Senator BAILEY. Let me point out to you that it will follow much more rapidly, and last much longer. There was an unusual situation following the last war.

Mr. CHESTEEN. That is right.

Senator BAILEY. Due to the fact that in 1920 and 1921 this Government began investing very heavily in Europe.

Mr. CHESTEEN. That is right.

Senator BAILEY. In reconstruction, and that revised the trend. And when that played out then came the collapse of 1929.

Mr. CHESTEEN. That is right.

Senator BAILEY. And we won't do that another time.

Senator CONNALLY. If the theory of this bill works will not that collapse after the war be less than the one before, because we will

have prevented the skyrocketing so that the fall will not be quite so great, if the theory of this bill operates?

Mr. CHESTEEN. I think we might assume that, but there will be some decline in prices.

Senator CONNALLY. There will be some recession, of course.

Mr. CHESTEEN. That is correct.

Senator CONNALLY. Because when you are going at full speed and you come to a crossing you have to slow down. That is always the case.

Mr. CHESTEEN. We think another factor has not been considered in connection with a war bill.

We know that during the last war many industries expanded during the war period, to find on the termination of the war the plant was either poorly arranged, or overexpanded in such a manner that it could not operate and make a profit after the close of the war.

For example, it is known now that many of the reorganizations that took place in the steel industry after the war, and even during the latter part of the war period, were brought about by the fact that these plants were overexpanded during the war and could not operate on a peacetime basis and survive. The result was the merger or consolidation of a great many plants.

Those mergers and rearrangements of plants, made necessary by reason of the war period, cost the corporations and the stockholders heavily in getting back to peacetime conditions.

I can recall cases where the corporation after the war found itself with no peacetime business and had to seek new fields.

Senator BAILEY. Is not that precisely in line with what Secretary Wallace has been telling us about as to the way agriculture was expanded in the wheat fields and the cotton patches? That was on account of the war. And then when the war ceased we found ourselves with, I do not know how many, millions of useless acres on land. Is not that his statement?

The same statement will run all the way through cotton mills, copper mines, similar mines, all the ores, coal, shipping, railroads, and everything else. Is not that right?

Mr. CHESTEEN. Certainly.

Senator BAILEY. Now, you propose an adjustment in this bill with a view to that?

Mr. CHESTEEN. We are not proposing an adjustment, but we think you cannot disregard those factors.

Senator CONNALLY. Those are the reasons you are advocating the retention of 25 percent?

Mr. CHESTEEN. Those are readjustments which we know are certain to follow from a war.

And if you strip a corporation of all its income, or place such a tax on a corporation as to make it desirable to pay out all of its income, you will have that situation to meet.

Senator BAILEY. You will have a busted corporation at the end of the term. And then we can have Government ownership and everything will be "hotsy-totsy."

Senator CONNALLY. That is the theory you are proceeding on in advocating the retention of 25 percent of the net profit as to the supertaxes?

Mr. CHESTEEN. That is correct.

Senator CONNALLY. So that it may accumulate a surplus to take care of the recession that follows the war; is that right?

Mr. CHESTEEN. To take care of all of these factors which I have mentioned.

The Nye bill proposes loans to certain industries engaged in the production of war materials. It is obvious that these loans will only touch a small part of industry as a whole. So industry for the most part must meet these economic changes growing out of war without any help from the Government. And if the corporation does not retain sufficient earnings to meet those situations it will be disastrous to the corporation.

Senator BAILEY. Would not that be true in peace times also?

Mr. CHESTEEN. That is probably true. Only the maladjustments are probably more and exaggerated during a war period.

Senator BAILEY. But you do not predicate anything in this world upon a uniform condition of affairs?

Mr. CHESTEEN. That is right.

Senator BAILEY. And do they not require that surplus now?

Mr. CHESTEEN. That is true. We recognize that. But we only had in mind the need during a war period.

Senator BAILEY. Let me see if I am right about this. The larger a corporation the more precarious its status; is that right? If Henry Ford begins losing money he will lose it twice as fast as he ever made it; is not that so?

Mr. CHESTEEN. That might be true.

Senator BAILEY. Take the old maxim on the market, steel is always a prince or a pauper. They make money when they make it very rapidly, and when they lose it they lose it more rapidly. And that is the same way with your automobile industry.

Senator CONNALLY. But is not the fact of their bigness something which causes their losses to be more graphic to our minds, and because they are in larger amounts, but does it necessarily follow in relation to capital or business activities that they are any larger than a small concern?

Senator BAILEY. Here is the difficulty, Senator: Big business is based on mass production and volume of sales.

Let us say Henry Ford has to sell 1,000,000 cars per year; I am not sure that is right, but just assume that. And in selling a million cars a year he makes money, but if he sells only 600,000 cars he loses money on each car he sells, because he has that overhead to maintain.

Senator CONNALLY. I admit all of that, but I do not think it necessarily follows because a concern is big it would suffer any more than a smaller concern in the same industry, or in some related industry, in proportion to its invested capital.

Senator BAILEY. Except for the principle that the small one is not based on volume and the big one is.

Senator CONNALLY. He is not based on a big volume, but he has got to have some volume or he will go out of business.

Senator BAILEY. Let me give you an illustration: A newspaper with 1,200,000 circulation will break if the cost of print paper goes to 3.5 cents, but a newspaper with 5,000 circulation will get along. There is your principle.

Mr. CHESTEEN. We think this: If you are concerned with protecting the corporation from all the price changes, inflation and readjustments during a war, then you must give consideration in your taxing rates and your method of taxation to these factors I have mentioned, and that the tax load must be measured so that it will leave corporations sufficient to meet those conditions.

If, on the other hand, you think it advisable during a war period to look to the small stockholder, disregard the economic changes that I have mentioned, and merely look and consider whether or not he is going to get a fair return on his money, then it seems to me that the suggestion which Mr. Brown makes takes care of the stockholder, and he pays the tax upon whatever he gets.

Senator BAILEY. Now, we have to go, as I want to be over to that trial, but I want to ask you a question, and you can answer it when we meet again.

When you go on the theory of distributing profits from the corporation to the stockholder do you not run the taxable income into all the possible ways of escape that the individual may have, and also into all the legal provisions made for exemptions and deductions? Do you not run a great risk there of losing income or losing revenue instead of gaining it?

Senator CONNALLY. He can defer that answer.

Mr. CHESTEEN. I think it is obvious that if you forego taxing the corporation at a flat rate and look to the stockholders that you do take a chance with the conditions of the individual stockholder.

Senator BAILEY. Just take \$100,000 distributed in this crowd here. Here are 11 persons, and each one of us has a deduction against what we get. There you run into all those deductions.

Mr. CHESTEEN. Admittedly if you look to the individual stockholder your return of tax is dependent upon the amount of income he has.

Senator BAILEY. But each man has his deductions.

Mr. CHESTEEN. The deductions allowed in his tax return.

Senator BAILEY. Assume each man was in my case. I am married and have five children. I get \$2,500, plus \$2,000; is that right?

Mr. CHESTEEN. That is right.

Senator BAILEY. That is right; I get \$4,500 exemption before any tax under the law. If every man here did, and there is around 11 here, that is about \$50,000 to start off with.

Now, if you tax it in the corporation you would get it before it ever got into this group.

Mr. CHESTEEN. On the other hand, if a taxpayer happens to be a multimillionaire you get as high as 79 percent from that individual.

Senator BAILEY. After all, you are dealing with 46 men in the United States, and you cannot pitch your tax law on 46 men. You are going to pitch it on the average in America.

However, I will be glad if you will elaborate on that.

I think we have got a lot to learn as to how much loss there is on taxes in the distribution to individuals.

Mr. ZUCKER. One thought there that should not be overlooked is that we should not assume an individual receiving dividends has no other income. Placing yourself and myself and the rest of the group as the recipient stockholders, we already have our income from fees,

salaries, and wages, which covers the exemption, and which leaves something for taxes.

Senator BAILEY. You can get your brackets for the incomes and look them over, and you will find, according to my recollection—I will not be certain, but I think I am fairly safe in saying—that only 200,000 people in the United States have taxable incomes in excess of \$10,000. You are going to deal with the low men always in taxation, because there are not many men of high incomes in this country.

Am I wrong in my figure about that?

Mr. CHESTEEN. Certainly the number of individuals—

Senator BAILEY (interposing). I think I put the figure high.

Mr. CHESTEEN (continuing). In the very high tax brackets there is a very small percent of the tax-paying public. And where there is one man in the 75 percent bracket there are many in the lower bracket.

Senator BAILEY. The amount of income derived from the higher brackets is relatively small.

It has not been long since I read this work issued by this institution down here on incomes. I went through the tables and it was astonishing to see how little revenue would be derived from taking all the money the millionaires have. And then you would not relieve this situation. I figured it up one day and you would have about \$37.50 for each man.

Mr. AIKIN. I might say, Senator, that the figure, taking the statistics for 1920, shows there were practically 210,000 people with incomes above \$10,000.

Senator BAILEY. I said 200,000. It might be a little more since 1920.

Mr. AIKIN. And that is out of 7,259,000 taxpayers.

Senator BAILEY. I said 200,000. And you say 210,000 for 1920. I think there may have been a rise since. Of course 1920 was an exceedingly prosperous year. The break in that year did not occur until the end of the year, and it began on September 1. That is right.

Senator CONNALLY. I am sorry we will have to suspend, as we have to be on the floor of the Senate.

We will have another meeting here at 10:30 on Monday morning. (Thereupon, at 12:05 p. m., the subcommittee adjourned, to meet on Monday, Apr. 13, 1936, at 10:30 a. m.)





# TO PREVENT PROFITEERING IN WAR

MONDAY, APRIL 13, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Bailey, Guffey, and La Follette.

Also present: G. D. Chesteen, J. S. Zucker, and Allen T. Akin, of the Joint Committee on Internal Revenue Taxation.

Ralph W. Brown and P. J. Mitchell, of the Treasury Department. S. E. Rice, office of Senate Legislative Counsel.

Senator CONNALLY. We will proceed.

Mr. CHESTEEN. We have prepared some data respecting the distribution of dividends to individuals which Dr. Zucker wants to present for the record.

Senator CONNALLY. Are they estimates or what has happened in the past?

(Information referred to is as follows:)

*Percentage of dividends reported by income class to total dividends reported in Statistics of Income for 10-year period 1924-33*

Income class	1924	1925	1926	1927	1928	1929	1930	1931	1932	1933
Under \$5,000.....	\$19.43	\$12.07	\$10.01	\$11.58	\$7.83	\$11.26	\$11.64	\$17.01	\$21.88	\$23.02
\$5,000 to \$10,000.....	8.98	9.27	10.84	10.12	8.75	10.57	13.65	15.59	16.16	14.90
\$10,000 to \$25,000.....	20.25	21.12	20.32	19.61	19.21	19.44	22.21	22.96	20.02	10.06
\$25,000 to \$50,000.....	17.07	17.84	16.61	15.97	15.95	15.38	15.47	13.29	13.41	13.78
\$50,000 to \$100,000.....	14.41	14.79	14.55	14.06	15.72	13.49	12.57	10.86	11.77	11.63
\$100,000 to \$150,000.....	5.59	6.51	6.75	6.50	6.96	6.48	5.67	4.72	4.28	4.12
\$150,000 to \$300,000.....	5.63	7.28	7.51	7.80	8.06	7.88	6.59	5.75	4.74	5.25
\$300,000 to \$500,000.....	2.82	3.56	4.02	6.40	4.70	4.20	3.17	2.58	2.35	2.09
\$500,000 to \$1,000,000.....	2.88	3.64	3.86	3.92	4.53	4.45	3.53	2.91	2.24	2.62
\$1,000,000 over.....	3.12	3.97	5.15	5.74	7.26	6.92	5.47	4.59	2.60	3.46

*Total dividends reported by individuals*

1924.....	\$3, 250, 913, 954	1929.....	\$4, 786, 027, 684
1925.....	3, 464, 624, 648	1930.....	4, 197, 303, 925
1926.....	4, 011, 590, 274	1931.....	3, 113, 800, 788
1927.....	4, 254, 828, 886	1932.....	1, 972, 133, 267
1928.....	4, 350, 978, 752	1933.....	1, 559, 046, 000

## STATEMENT OF J. S. ZUCKER, OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Mr. ZUCKER. This schedule constitutes a break-down of the payment of dividends for a 10-year period from 1924 to 1933, allocated in percentages to individual taxpayers in the various income groups.

We are presenting this in connection with the matter developed by Mr. Brown that, in attempting to levy a tax, a severe tax, on corporations by way of a flat tax, we would unjustly increase the tax load on individual stockholders, in the small income groups.

We are not making any adverse criticisms to the statements made by Mr. Brown, but rather, whatever is presented and put into the record is for the purpose of broadening the base for discussion, so that we may have other facts or additional data before the subcommittee makes its decisions on these matters.

Senator CONNALLY. We are glad to have them. We want all of the helpful information that we can get.

Mr. ZUCKER. The first point that I would like to develop is that it is granted that under the heavy flat tax rate approximating 30 percent that has been suggested as corporate taxes, the small stockholder would in effect have a tax load which might be called regressive; that is, instead of the tax working out along the principle of the ability to pay—those in higher-income groups paying taxes at progressive rates—in the case of the small stockholder his percentage of tax to his income might turn out to be greater than those in the upper bracket.

That is a condition that should be avoided if possible, but the severity with which it hits these small stockholders is not perhaps as alarming as might appear from the statements already made, and while we, too, wish to be solicitous of the tax load which will bear against the small earning group, I think that these considerations should be put in the record.

Senator CONNALLY. Have you some tables there that you wish to put in the record?

Mr. ZUCKER. Yes, sir; but I thought we would first explain the things that lead up to the table.

Senator CONNALLY. All right; go right along.

Mr. ZUCKER. At the time of the Senate hearings on the 1935 act Mr. Robert H. Jackson put into the record the following statement:

But it is noticeable that while those under \$5,000 received 66.55 percent of their incomes from wages and salaries and only 5 percent from dividends; those of over a million received only 2.79 of their income from wages and salaries, and 50.78 from dividends.

Taking that as a governing point, we find that we are dealing with individuals who receive but 5 percent from dividends, and even if the tax load—

Senator CONNALLY (interrupting). Those are the \$5,000 class?

Mr. ZUCKER. \$5,000 and under. I believe that Senator Bailey at the last session presented the thought that these small stockholders will be taxed very heavily under a flat corporation rate, and as I just indicated, it might work out to be a regressive rate against them. To assuage that, I am stating that the concern about these small stockholders need not be as great, in view of the fact that only a small percentage of their total net income is received from dividends. As cited here by Mr. Jackson, it is but 5 percent.

The second thought that was presented was that the corporation rate being 30 percent, an individual would in effect have to pay that rate against his allocated dividend, while the applicable individual rate which may run only to an effective rate of 10 percent.

I would like to present the idea that in the present law we have the same difficulty and we are not aggravating it in any way, by an increase in war rates on corporations if we correspondingly increase the rates on individuals. For example, a corporation today paying as high as 15 percent, if its income is in that bracket, will pay out its dividends, and the small stockholder receiving that dividend is only exempt from a 4-percent normal tax as against the 15-percent tax paid by the corporation. If we assume the existence of the 30-percent corporate tax in times of war, the individual may be subject to at least a 10-percent normal tax, so that he will save about 10 percent as against the 4 percent, and he will pay through his corporation 30 percent as against the 15 percent.

The figures are not exactly comparable or accurate; it is merely a suggestion of the fact that we are not increasing the severity of the burden against the small stockholder, and that we are not doing more to him than is done in peacetime today.

If the aim should be to correct the existing evil in the present tax law, then we have thought of a method which might ease the load, and that method is as follows: The amount which a corporation distributes after it has paid its flat tax, and assuming that you allow it a certain amount as a reserve retention to take care of plant extension or war expansion, the amount which the corporation distributes can be tagged as representing a distribution which will be taxed, or rather, I want to state it this way—the amount which the corporation does not distribute and upon which it will pay the undistributed tax, can be tagged as representing a dollar which has been taxed at a certain effective rate, and then when that dollar in a subsequent year is distributed, you can determine at what particular rate of exemption you wish to allow against that in the case of the small stockholder. That will offset a double load against the small stockholder.

That same theory has been put into the tax law. For example, in the case of installment dealers, the dollar received is determined to have within it a certain gross profit percentage and is taxable at that gross profit percentage over the years that the subsequent collections come in.

Then, again, in the case of dividend distributions out of accumulations prior to March 1913, the corporation ordinarily will put a resolution in its minute book or will actually send a letter circularizing all of the stockholders who received the dividends telling them that out of each dollar distribution they are just getting a certain percentage is taxable and the balance of it is nontaxable.

The precedent there established could be applied, if necessary.

Now turning to the schedule which we have here. It is a percentage break-down, and it does show, as Mr. Brown stated, that a rather substantial percentage of the dividends paid go to the group under \$5,000, and certainly under \$10,000.

Senator LA FOLLETTE. Am I to understand that this percentage represents the percentage of the total dividends paid, or the percentage of dividends to balance the income?

Mr. ZUCKER. This represents the percentage to the total paid by the corporations which were reported by all of these individuals.

Senator LA FOLLETTE. In other words, a man under \$5,000 on this table, or \$5,000 and under in 1933, the average percentage is 23.02?

Mr. ZUCKER. That is 23 percent of the \$1,599,000,000 as shown on the bottom there.

Senator GUFFEY. That is the group, they paid that?

Mr. ZUCKER. Yes, sir.

Senator GUFFEY. And the group from \$5,000 to \$10,000 paid 14 percent of that same amount?

Mr. ZUCKER. That is, they received 14 percent of the aggregate dividends reported by all individuals.

Senator GUFFEY. Yes.

Senator CONNALLY. Then, this is not the ratio of dividend receipts to the total income but the percentage for all of the dividends?

Mr. ZUCKER. That is right, because the amount of dividends received by individuals of \$5,000 and under, as stated by Mr. Jackson, was only 5 percent.

There are one or two thoughts, if you will allow me, that may be brought out in that connection.

First of all, that the heavy percentage in 1933 may be attributable merely to the fact that the people who had many other sources of income lost those sources of income during the depression, while they may have retained their investment stocks which yielded them dividends. If you move backward a few years on the schedule, we can see that the rates were reasonably consistent between 10 and 12 percent for the prior years, but they did jump during the depression years.

There is one other thought to emphasize, and that is while the percentage received by these small stockholders of the total dividend appears large, of course, they are a very numerous class in themselves. This represents hundreds of thousands of stockholders, and that while it looks negligible as respecting the heavy stockholders—

Senator CONNALLY (interrupting). There are only a few of them?

Mr. ZUCKER. Yes; there are only a few of them, and they are subject to high surtaxes; in other words, the yield from dividends is not distorted by virtue of the levy of a progressive rate which we now have.

Senator CONNALLY. The total dividends did decline: 1933 was the smallest of any year. In that year it was \$1,559,000,000.

Senator GUFFEY. It progressively decreased from 1929.

Mr. ZUCKER. We have also the figures of the total dividends paid by corporations. If that would be material to the discussion, we can put them in the record.

We made this additional compilation to show what percentage of dividends were intercorporate, and also what amount of dividends were paid to individuals who do not file tax returns, and in addition, the amount of dividends paid to institutions and corporations that are tax exempt, like eleemosynary institutions. As these facts are not wholly germane to a consideration of treatment for the small stockholder, we are not putting them in the record unless you want them.

Senator LA FOLLETTE. In general, they may be helpful.

Senator CONNALLY. Yes; put them in the record.

(Information referred to is as follows:)

*Analysis of all corporate profits and dividend distribution for 10-year period 1924-33, as shown by statistics of income*

[Thousands of dollars]

Corporate profits	Total for 10-year period		1924		1925		1926		1927		1928	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Compiled net profits <sup>1</sup> .....	\$57,984,061	100.00	\$6,795,152	100.00	\$9,316,383	100.00	\$9,510,439	100.00	\$8,669,046	100.00	\$12,700,843	100.00
Less Federal taxes paid.....	8,609,728	14.85	881,550	12.97	1,170,331	12.56	1,229,797	12.93	1,130,674	13.04	1,184,142	9.33
Balance available for dividends.....	49,374,333	-----	5,913,602	-----	8,146,052	-----	8,280,641	-----	7,538,372	-----	11,516,701	-----
Total cash dividends paid.....	58,692,536	101.22	4,338,822	63.85	5,189,475	55.70	5,945,292	62.51	6,423,176	74.09	7,073,723	55.69
Balance retained.....	(9,318,205)	(16.07)	1,574,780	23.18	2,956,577	31.74	2,335,349	24.56	1,115,196	12.87	4,442,978	34.98
Dividend distribution:												
Dividends paid corporations.....			915,216	21.09	1,175,481	22.65	1,506,154	25.34	1,658,076	25.82	1,916,670	27.10
Dividends paid individuals.....			3,250,914	74.93	3,464,625	66.76	4,011,590	67.47	4,254,829	66.24	4,350,979	61.51
Dividends not reported.....			172,693	3.98	549,369	10.59	427,548	7.19	510,271	7.94	806,074	11.39
Total.....			4,338,823	100.00	5,189,474	100.00	5,945,292	100.00	6,423,176	100.00	7,073,723	100.00
			1929		1930		1931		1932		1933	
			Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Compiled net profits <sup>1</sup> .....			\$11,869,507	100.00	\$4,658,709	100.00	\$ (776,603)	-----	\$ (3,829,342)	-----	\$ (930,073)	-----
Less Federal taxes paid.....			1,193,436	10.05	711,704	15.27	398,994	-----	286,034	-----	423,068	-----
Balance available for dividends.....			10,676,071	-----	3,947,005	-----	(1,175,596)	-----	(4,115,377)	-----	(1,353,141)	-----
Total cash dividends paid.....			8,355,662	70.40	8,202,241	176.06	6,151,083	-----	3,885,601	-----	3,127,459	-----
Balance retained.....			2,320,409	19.55	<sup>2</sup> (4,255,236)	(91.33)	(7,326,679)	-----	(8,000,978)	-----	(4,480,600)	-----
Dividend distribution:												
Dividends paid corporations.....			2,593,052	31.03	2,571,231	31.35	1,969,229	32.01	1,259,981	32.43	1,025,709	32.80
Dividends paid individuals.....			4,786,027	57.28	4,197,304	51.17	3,113,860	50.63	1,972,133	50.75	1,559,046	49.85
Dividends not reported.....			976,582	11.69	1,433,706	17.48	1,067,993	17.36	653,486	16.82	542,704	17.35
Total.....			8,355,661	100.00	8,202,241	100.00	6,151,082	100.00	3,885,600	100.00	3,127,459	100.00

<sup>1</sup> Statutory net income plus tax-exempt interest and dividends received on stock of domestic corporations.

<sup>2</sup> Deficit.

Schedule showing average dividends (column 1) and percent of dividends to total income (column 2), 11-year period 1924-34, of individuals in specified net-income class

Net income class	1924		1925		1926		1927		1928		1929	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Under \$5,000.....	\$94.87	3.48	\$125.51	4.01	\$132.34	4.21	\$149.19	4.95	\$111.46	3.57	\$178.93	5.27
\$5,000 to \$10,000.....	668.15	8.34	637.91	7.94	776.57	9.69	758.53	9.53	697.19	8.86	789.12	9.65
\$10,000 to \$25,000.....	3,439.25	19.59	3,090.93	17.52	3,306.35	19.08	3,310.33	19.12	3,035.59	17.87	3,428.43	19.39
\$25,000 to \$50,000.....	11,794.70	30.03	10,357.48	26.16	11,595.77	29.36	11,308.58	28.67	10,201.34	25.95	11,526.78	28.36
\$50,000 to \$100,000.....	29,636.85	37.65	24,455.30	31.53	28,864.89	36.17	27,637.61	35.17	23,571.67	30.20	26,827.31	32.92
\$100,000 to \$150,000.....	59,292.83	41.37	47,462.04	34.72	57,397.57	40.96	52,594.98	37.82	42,976.29	31.23	47,853.83	33.23
\$150,000 to \$300,000.....	97,730.49	41.47	78,294.35	33.80	92,282.43	39.49	85,740.90	36.90	66,222.87	28.73	71,954.82	29.53
\$300,000 to \$500,000.....	201,997.29	45.12	133,543.44	30.78	169,262.24	38.79	151,125.43	35.38	118,179.56	27.96	122,573.99	27.50
\$500,000 to \$1,000,000.....	349,141.76	45.83	263,939.69	34.26	330,999.69	42.54	299,962.32	38.45	200,936.90	26.39	218,585.59	27.66
\$1,000,000 and over.....	1,399,977.40	53.98	664,755.10	29.59	894,904.36	37.41	843,606.72	36.00	618,651.99	25.78	645,509.99	23.85

  

Net income class	1930		1931		1932		1933		1934	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Under \$5,000.....	\$168.66	5.31	\$201.19	6.42	\$122.55	4.78	\$106.21	4.33	\$120.06	4.91
\$5,000 to \$10,000.....	1,040.25	12.70	1,163.05	13.87	1,269.91	14.87	1,011.58	12.06	995.35	12.33
\$10,000 to \$25,000.....	4,692.21	25.09	5,190.45	26.84	4,986.26	26.88	3,928.46	21.63	4,101.94	23.13
\$25,000 to \$50,000.....	15,900.28	36.68	17,027.44	38.27	14,319.95	34.47	11,668.45	28.47	14,733.35	36.04
\$50,000 to \$100,000.....	38,679.04	44.26	43,216.00	47.28	39,346.70	47.32	30,131.20	37.45	36,508.48	45.83
\$100,000 to \$150,000.....	76,534.82	49.15	89,976.32	55.67	84,883.78	55.15	59,309.96	40.68	82,422.95	56.35
\$150,000 to \$300,000.....	133,373.99	49.83	160,137.69	56.69	157,373.12	63.05	117,830.21	47.32	160,261.69	64.90
\$300,000 to \$500,000.....	241,301.16	50.20	300,150.13	57.88	331,065.91	69.87	231,531.91	48.48	317,698.27	70.32
\$500,000 to \$1,000,000.....	466,951.73	52.96	610,081.18	64.31	630,683.09	71.21	506,074.07	58.72	654,860.46	78.20
\$1,000,000 and over.....	1,530,913.78	53.80	1,859,142.49	70.41	2,567,701.65	92.67	1,081,280.00	51.76	1,920,437.50	88.61

<sup>1</sup> Preliminary report of returns filed to Aug. 31, 1935.

Mr. ZUCKER. I think it might be well in conclusion to stress that in the last analysis, corporate endeavor does have an opportunity to shift the tax. The incidence of the corporation income tax shows that the tax can be shifted away from the point of levy to the consumer because the corporation has a business transaction in selling its goods through which it can shift the tax, while an individual paying an income tax does not have any business transaction beyond the receipt of his income, unless he is in private business as a sole trader or a partnership, to afford him a channel for shifting his tax. Therefore, the tax load from that standpoint is not exactly as the figures would indicate, because the individual receiving dividends receives them more clear from tax than he receives salaries or fees or wages.

Senator CONNALLY. Is that all you care to submit at this time?

Mr. ZUCKER. Yes, sir.

Senator CONNALLY. Has anybody any questions?

(No response.)

Senator CONNALLY. All right, Mr. Chesteen.

Mr. CHESTEEN. We have nothing further to present with respect to the plan suggested by Mr. Brown. I might say that the Nye hearings show that when the question of writing a war bill was under consideration, Mr. Mills was asked what he thought about the advisability of writing a war bill.

Senator CONNALLY. Mr. who?

Mr. CHESTEEN. Mr. Mills.

Senator CONNALLY. Ogden Mills?

Mr. CHESTEEN. Ogden Mills; who at that time was either under-secretary or Secretary of the Treasury.

Senator CONNALLY. You do not mean the Nye committee, do you?

Mr. CHESTEEN. The Nye committee; yes. Possibly, it came up prior to that time. While the McSwain bill was under preparation, but the question of writing a war bill, the idea was presented—to be exact, Senator Vandenberg, I believe, made the inquiry of Mr. Mills, and Mr. Mills replied that he thought it was not feasible to write a war bill until we had a war, but he did this at that time. Mr. Balantine, who at that time was Under Secretary or Assistant Secretary of the Treasury—

Senator CONNALLY (interrupting). Mr. Mills has not been Secretary of the Treasury for 4 years. This must have been in some old matter.

Mr. CHESTEEN. This was in 1932.

Mr. ZUCKER. It was in connection with the War Policies Commission.

Senator CONNALLY. That may be so, but the Nye committee was not in existence then.

Mr. CHESTEEN. I believe it was prior to the Nye committee's hearings, but in the early discussion of a war bill. Mr. Balantine apparently at the direction of the Secretary of the Treasury asked the income-tax unit to prepare two studies with respect to the experience of the Treasury Department in the last war.

The legal department prepared a memorandum on the legal phases of the experiences with the excess-profits tax during the last war. The administrative department of the Internal Revenue Bureau prepared a memorandum on the experiences from an administrative standpoint, with the excess-profits tax. Neither memorandum, I

believe, makes a specific recommendation, but Mr. Balantine's thought in having these memoranda prepared at the time was to have these thoughts on the experiences of the last war made a matter of record while the men in the income-tax unit had these experiences fresh in their minds and it could be reduced to writing and left as a matter of record, so that if the committee in the future decided to go through the question again of an excess-profits tax, that a record would be found of the experiences of men who participated in administering a law involving that feature during the last war. To form some basis for forming a judgment as to whether or not it should be adopted again.

We have studied those memoranda. We have not attempted to formulate any definite opinions on the advisability of an excess-profits-tax law as a workable proposition. We have merely studied them with a view that if this committee decided seriously to consider or investigate such a plan, we can go into the question and make some recommendation from our study which has been prepared.

Senator CONNALLY. Have you developed any further the idea that you suggested here the other day of this new third basis of taxation?

Mr. CHESTEEN. My thought in making the suggestion is—

Senator CONNALLY (interrupting). The Nye bill has a declared value under the 1934 act as of 1934?

Mr. CHESTEEN. That is right.

Senator CONNALLY. And the old theory was, of course, on the invested capital?

Mr. CHESTEEN. That is right.

Senator CONNALLY. Your joint committee, as I understood it the other day, suggested a new form of adopting in fact the new plan proposed in the House and superimposing a supertax to catch any extra earnings in dividends. Do you still adhere to it?

Mr. CHESTEEN. Yes. I am familiar with what, in a general way, is being worked out in the House. We suggested a plan on the assumption that something would be done in the House, and something would finally be done with respect to a peacetime bill in the Senate, but we have not attempted to analyze all of the objections which might be offered against the plan as a peacetime plan. We offered the suggestion here on the assumption that if you adopt the principle that is in the House bill as a peacetime measure, it would be advisable to continue that principle in a war bill. Our suggestions were based upon the assumption that you are going to adopt the principle as a peacetime law. Our deviations from the problem of peacetime to a war bill, we think are practical, that is, the suggestion which we made was to let a flat tax be levied upon the entire net income after leaving a reasonable reserve for expansion, to levy a surtax or an excise tax upon the amount of the net income over a reasonable reserve if not distributed. We do not see any practical objection to carrying through such a scheme.

Senator CONNALLY. Personally, I am very anxious for the committee to make sufficient progress to adopt one of these bases pretty soon, and start these draftsmen getting this bill in shape. I do not want to do it hastily or hurriedly. How do you feel about it?

Senator LA FOLLETTE. Well, in general, I think that it would be advisable for this wartime tax bill to be predicated and based on the principle of peacetime taxation. Any sudden shift of base, in



the first place, would leave the Treasury without experience in the administration of the tax. I have assumed that we would take as our predicate or our principle on the base of the tax, the bill which would eventually be worked out by the House and the Senate, with regard to the suggestion that has been made by the Treasury.

Senator CONNALLY. Do you think we can wait until that is all fixed up before we do anything here? If we do not report out a bill of some kind here, this bill will be offered on the floor, and in the general tax situation, it will complicate things.

Senator LA FOLLETTE. I realize that, and I am not suggesting our delaying any further than to be reasonably sure that the base that we adopt for the taxation of corporations will be in principle the same as that which is going to be enacted in the war. In other words, it would seem very illogical to me if this committee on one day would report out a bill with one basis of taxation for war purposes, and then follow it along a few later with a report for a very different peacetime basis.

Senator CONNALLY. I agree with you.

Senator BAILEY. I agree with you, too. I do not see how the Government could shift from one system to another. If you are in the midst of war, you may need an entirely different set-up, and every corporation in America would have to set up its books on a different basis. You would have endless confusion.

Senator GUFFEY. I am in favor of getting that base determined as soon as possible.

Senator CONNALLY. We know that it is only the question of the principle. We know now the principle of what the new bill is going to be. The details we are not greatly concerned with here, because our rates will be different from theirs, so I think if we could determine on that general principle, we might put them to work on it and put these things in shape. These hearings are very entertaining to me and very instructive, but still we want to get a bill.

Senator BAILEY. What would you think of taking such a bill as may be adopted by Congress, a peacetime bill, and treating it for wartime purposes on a percentage basis? Just lift the rates. In the event of war the rates should be lifted so much. Or, lift the rates and cut down the exemptions. That will greatly simplify your proposition. If you put the rates on a percentage basis, you would be doing the same thing. You could take a bill that is coming over from the House, and you could put a section in there, "In the event of war, these rates shall be lifted so much and the exemptions shall be cut so much." Just that one section.

Senator CONNALLY. Would that be practical from an administrative standpoint?

Mr. CHESTEEN. I don't know when we will have the next war—

Senator BAILEY (interrupting). The difference between one bill and another is largely in rates. Put in there, "In the event of war, lift the rates and cut the exemptions", and show the tables.

Mr. CHESTEEN. There are numerous innovations in the bill over there that may not be applicable to war conditions. It might be advisable to consider those.

Senator BAILEY. We start with income to begin with. All we mean to do is to lift the rates. We do not put in any new subjects of taxation. We just lift the rates. What is the objection to this,

running through it—that a fellow with an income of \$5,000, lift him so much. When you get up to the higher brackets, lift him a great deal more on the ground of ability to pay. You can lift a man with a \$100,000 income by a much larger percentage than a man with a \$5,000 income.

Senator CONNALLY. That is what we will do, in effect, after all, whether we put it in a peace bill or a separate bill.

Senator BAILEY. It will come down to a matter of percentage. Why can we not fix the percentage? You can do that in the bill that is coming over.

Senator CONNALLY. Are you prepared now to vote on the base? Adopt it as the basis for our work?

Senator LA FOLLETTE. I am assuming that this Congress is going to act on the recommendations of the President, with such changes as the Congress may see fit to make in those suggestions, and personally I would be willing right now for the proposition that this committee should accept that basis of tax for war purposes, and then proceed to make any adjustments or changes which we think are necessary.

Senator CONNALLY. Make that motion then if you care to.

Senator LA FOLLETTE. Yes; I will make the motion that we adopt in principle the base of the tax for corporations in this war taxation bill, that has been recommended by the administration and now under consideration in the House.

Senator BAILEY. We adopt in principle the base of the bill?

Senator LA FOLLETTE. The bases of taxation for war purposes, for instance, as distinguished from the present corporation base.

Senator BAILEY. We should conform the war bill to the peacetime act? I think that is all right.

Senator CONNALLY. Those in favor say "aye."

The vote is unanimous. That, of course, does not involve the question of rates. I suppose all of us have the view that we have got to have that supertax in there somewhere to catch these inordinate war profits. Can you work that out?

Mr. CHESTEEN. You probably will want to change those rates which are adopted in the peacetime bill; but no one knows what will be done by the House.

Senator CONNALLY. We can proceed here in regard to war rates, regardless of what the peacetime rate is, couldn't we?

Mr. CHESTEEN. I should think you would like to know the peacetime rate before you finally pass on the war rate.

Senator BAILEY. You have a difficulty with respect to the new legislation. The bill is in the House. That bill is not passed.

Senator CONNALLY. But it will be.

Mr. CHESTEEN. The rate is dependent upon the amount of net income retained.

Senator BAILEY. You do not tax the corporation on its net income under that bill.

Mr. CHESTEEN. Yes; but the rate of tax is graduated according to the amount retained.

Senator BAILEY. It is an entirely different principle.

Mr. CHESTEEN. There are many changes suggested in the subcommittee report of the Ways and Means Committee, which, if finally

adopted, you will probably want to pass upon as to whether or not these changes are applicable to a war period.

Senator BAILEY. Is it not your understanding that the bill in the House is based on taxing the individual recipient of the dividend rather than the corporation?

Mr. CHESTEEN. Well, all the information I have is the report. Of course that only deals with suggested rates on the undistributed net income. I do not know what the theory of it is; I cannot say.

Senator BAILEY. I may be wrong about it, but I thought everybody understood that the new plan planned to tax, so far as the corporation is concerned, that portion of the profits that are undistributed, with a view to driving them out of the treasury of the corporation into the hands of the individual and getting the income there. Is that not what you understand?

Mr. BROWN. That is not exactly correct. I will put it in this way, that the theory is that corporation profits should be taxed in the hands of the shareholders at graduated rates, or in the alternative, if it is the decision of the corporate managements to retain the whole or a part of corporation profits in the treasury, that the amount of profits retained shall be taxed at rates which will produce for the United States Treasury an equivalent amount of revenue. That is the fundamental basis.

Senator BAILEY. You get it either way?

Mr. BROWN. You get it either way. We say that the United States ought not to be deprived of its revenues because the board of directors decide in one case that they will keep a hundred percent, or in another case that they will keep 10 percent, or whatever they keep. We say, "Make your decision and keep what you like, but we do not feel that that decision ought to deprive us of a fair tax representing a fair proportion of those earnings."

Senator CONNALLY. In other words, whether they distribute it or whether they do not, they should bear the same rate of taxation to the Government?

Mr. BROWN. As near as that is possible; yes.

Senator CONNALLY. That is the theory, as I understand it, of the bill.

Senator BAILEY. We do now tax the earnings of the corporation.

Senator CONNALLY. You do not necessarily tax them at the same ratio as you tax individuals, and if you get away from that——

Mr. BROWN (interrupting). Far from it.

Senator BAILEY. It depends altogether on what bracket he is in. I have noticed here that you have presented dividends as reported by income classes. I have not made an analysis, but I am rather amazed at it. It appears that the people who get large incomes had a very low ratio of dividends.

Senator CONNALLY. That is because there are so few of them.

Senator LA FOLLETTE. That is the ratio of their income to dividends. That is the ratio of the total dividends paid, which they received.

Senator CONNALLY. In other words, that last figure on the bottom of the page, \$1,550,000,000, is the total amount of dividends, and those percentages are the percentages that that class of taxpayers bore to the total amount. There are so many more \$5,000 people.

Senator BAILEY. It is not the ratio of dividend to income, but the ratio of income to the total dividends declared. I would like to know how it compares with earnings. I am rather amazed at it. It is just about half. I would like to know what the earnings are. I would like to see how this compares with actual earnings of the corporation.

Senator CONNALLY. I don't know whether we have that figure or not. Of course, this only represents dividends that were distributed.

Senator BAILEY. The earnings will give you the difference and show you how much was retained.

Senator LA FOLLETTE. It only shows the dividends reported by individuals. It does not represent the total payment of dividends.

Senator BAILEY. I just want to see what is reported here.

Mr. ZUCKER. Would you like to see this statement? [Handing statement to Senator Bailey.]

Senator BAILEY. Here [indicating] is your statutory net income. This is 1933 here. The statutory net income was \$2,985,000,000 in 1933. The dividends reported by individuals was \$1,559,000,000—a difference of about \$1,400,000,000.

Senator LA FOLLETTE. What would the total dividends amount to for that year?

Mr. ZUCKER. The total dividends paid in that year were \$3,127,-459,000.

Senator BAILEY. They paid more than they earned?

Mr. ZUCKER. Yes, sir. The difference is covered in dividends received by individuals who do not file returns; also by the amounts received by tax-exempt corporations, and also through the payment of intercorporate dividends which under the 1932 act were not reported for tax purposes.

Senator BAILEY. Take 1928 for an example. The total dividends reported by individuals was \$4,350,000,000. In 1928, from the report that I have before me, the statutory net income of the corporations was \$10,617,741,000. That is something better than 6 billions that was not reflected in taxes collected from individuals. Is that right?

Mr. ZUCKER. Except that there may be some proportion of it reflected, since the entire amount distributed in this year was in excess of 7 billion, according to the record.

Senator BAILEY. But here is the point. The dividends reported by individuals are reported in the income-tax returns for the purposes of taxation, isn't it?

Mr. ZUCKER. Yes, sir.

Senator BAILEY. It is only \$4,350,000,000, but in that same year the statutory net income of the corporations was \$10,617,000,000. There is a very great disparity there that astonishes me.

Mr. ZUCKER. \$2,000,000,000 was paid to corporations that were subsidiaries, and they were not subject to any tax in 1928.

Senator BAILEY. That is a corporate report, and this is a report of individuals. If you had your corporate report before you, that fell in those days in the 12½-percent tax, is that right?

Mr. ZUCKER. Twelve percent.

Senator BAILEY. Twelve and three-quarters, I believe it was.

Mr. CHESTEEN. We might take up the question, if you wish, of the individual rates.

Senator CONNALLY. You mean of individuals?

Mr. CHESTEEN. Yes.

Senator CONNALLY. You had some rates here the other day.

Mr. CHESTEEN. We submitted schedules.

Senator BAILEY. We will have a full analysis of these figures when the peacetime bill, as we call it, comes over.

Senator CONNALLY. Go ahead, Mr. Chesteen.

Mr. CHESTEEN. We presented two schedules at prior meetings. One, I believe, reached a maximum tax of 94 percent, and the other, the last schedule we presented, reached an effective rate of around 87 percent, I believe, and a maximum tax rate of 90 percent, 80-percent surtax above \$75,000 income and a 10-percent normal tax. That rate was discussed with you last week.

Senator CONNALLY. Have you changed your mind?

Senator LA FOLLETTE. In your table, Mr. Brown, do you designate that as proposal no. 2 or proposal no. 3, that Mr. Chesteen just mentioned?

Mr. BROWN. Proposal no. 1 runs up to 85 percent.

Senator LA FOLLETTE. That is the Nye bill as it stands?

Mr. BROWN. No, sir; H. R. 5529.

Senator LA FOLLETTE. That is the Nye bill as it stands.

Mr. BROWN. Oh, yes. We changed the arrangement for the record. We thought that ought to appear as the Nye bill instead of proposal no. 1. No. 1 is the first joint-committee proposal. No. 2 is the second joint-committee proposal, and we designated the Nye bill H. R. 5529.

Senator LA FOLLETTE. Which were you discussing? Proposal no. 2, normal tax, normal rate of 10 percent, surtax ranging from 6 percent—this need not go in the record.

(Discussion off the record.)

Senator CONNALLY. Senator La Follette suggests instead of starting at \$75,000 we start at \$50,000.

Senator LA FOLLETTE. That will produce more revenue, would it not?

Mr. BROWN. Yes; but neither will produce as much as the Nye bill.

Senator CONNALLY. If the Nye bill works.

Mr. BROWN. I am just speaking of the mathematics of it.

Senator LA FOLLETTE. Would it be very much trouble, Mr. Brown, to give us an estimate of the normal rate of 10 percent and surtax rates ranging from 6 percent on surtax net income in excess of \$1,000, to 80 percent on surtax net incomes in excess of \$50,000? Personal exemptions, married \$1,800 and single \$800, and credit for dependents of \$250, and earned-income credit for normal tax. I would just like to see how much that would yield.

Mr. BROWN. The only change you are making is that you are going to level off at \$50,000?

Senator LA FOLLETTE. Instead of 75.

Mr. BROWN. Yes; we shall be very glad to get it for you. I discovered that it means much more work than I had any idea of, but we shall be very glad to get it.

Senator CONNALLY. That is on the basis of these tentative rates that they suggested the other day. You would have to change them, of course, when you level off at 50.

Mr. CHESTEEN. You have to change all the rates, if you are going to level off at \$50,000.

Mr. AKIN. I can show you on this chart how the curve would look if you did level off at \$50,000. The purple line here [indicating] is your second proposal, and the orange line [indicating] is the first proposal. This [indicating] is your \$50,000 line here, so that your proposal would come up in between these two lines and start leveling here [indicating].

Senator CONNALLY. Which is the Nye line?

Mr. AKIN. This brown line is the Nye line. The orange line is the first proposal. The second proposal, the British peacetime rates, and the present 1935 law. And I might call your attention to this small scale here showing the curve plotted from \$1,000 to \$25,000. This is \$25,000 here.

Showing that the first proposal followed the British peacetime rates up to about \$4,500. The second proposal was under the Nye rates up to \$2,500, and was higher up to \$7,500, approximated them at \$8,000, and then was a great deal less from then on to \$25,000.

The British rates crossed the Nye rates, and are above the Nye rates, over \$7,500, and then considerably under; of course, the 1935 rates are decidedly under all the proposals.

Mr. BROWN. Which schedule of rates would the Senator like to have us use? Schedule no. 1 or schedule no. 2. So far as individual rates are concerned, we can level them at any point, but up to \$50,000, we would want to know which schedule you prefer to use.

Senator LA FOLLETTE. You mean what the maximum would be?

Mr. BROWN. No; I mean the rates intervening, from the point where you start until the point where you level off, if you want to use one of the schedules that have already been submitted.

(Discussion off the record.)

Senator BAILEY. What is the leveling-off conception? I do not understand that expression. What is the leveling-off place?

Mr. BROWN. We would carry the rates up to a certain point and then the same rate would apply.

Senator BAILEY. A flat rate?

Mr. BROWN. Yes. Senator La Follette suggested that the Treasury get up some estimates based on a levelling off at \$50,000 of net taxable income.

Senator BAILEY. And the same percentage applied to all the others?

Senator CONNALLY. To all above \$50,000.

Senator LA FOLLETTE. Maximum rates would apply above \$50,000. In the Nye bill, Senator, they level off at \$20,000. In one schedule of rates we had just tentatively—

Senator BAILEY (interrupting). And the same percentage for \$20,000.

Senator LA FOLLETTE. That is what the Nye bill does. There is one suggestion we had under consideration, to level off at \$30,000, and another one levelled off at \$50,000, and the difference between those two, based on the 1928 returns, the estimate would indicate a difference in revenue of about \$2,600,000,000. What I was just, for the information of the committee, asking was to ascertain what the comparative revenue estimates would be if you levelled off at \$50,000 instead of \$75,000 or \$30,000, or \$20,000, as provided in the Nye or

these other proposals. Just for the information of the committee.

Mr. CHESTEEN. In those two proposals, the normal tax is the same in each case, but in the no. 1 the maximum surtax was 85, and in the no. 2 the maximum surtax was 80.

Mr. BROWN. The no. 1 was considerably heavier in the lower brackets too, wasn't it? It was based on the British rates more or less?

Mr. CHESTEEN. There was a slight change all the way down in the various brackets.

Mr. BROWN. We tried to present two schedules to you which were more or less consistent. I suppose Senator La Follette's would be in between, and it might possibly require some adjustment of rates below the leveling-off point.

Senator CONNALLY. According to this table, a man with \$50,000 would pay, under proposal no. 2, \$22,930 out of his \$50,000.

Senator BAILEY. That is 44 percent.

Senator CONNALLY. Yes.

Senator BAILEY. What would a man with \$100,000 pay? Forty-four percent?

Senator CONNALLY. He would pay on that other \$50,000, 80 percent, which would be \$40,000 more. He pays 65.11 percent on \$100,000. If he leveled off at \$50,000, he would pay more. With \$100,000, even leveling that at \$75,000, he would pay 65 percent in tax. That is a pretty good amount.

Senator BAILEY. The percentage tends to increase, but I do not get the leveling off yet.

Senator CONNALLY. The leveling off is when it gets to \$50,000; then all above \$50,000 would pay the 80 percent.

Mr. BROWN. Eighty-percent surtax and 10-percent normal, which would be 90.

Senator CONNALLY. Ninety percent of everything in excess of \$50,000?

Senator LA FOLLETTE. What I was considering was to take the rates in proposal no. 2 here, which is the middle one, and instead of leveling off at 75, level off at 50, and make whatever adjustments you have to in the rates to take care of that change.

Mr. CHESTEEN. In other words, make the curve as uniform as you can up to \$50,000?

Senator LA FOLLETTE. Yes.

Mr. CHESTEEN. That means going all the way back and distributing the load greater in the lower brackets than we have in the no. 2 proposal.

Senator CONNALLY. I cannot quite reconcile myself to the view that after \$50,000 that that all be the same rate. You are discriminating in a sense against the man with the \$60,000 or \$70,000 income and the man with \$1,000,000, because on that million-dollar income, after he pays the \$50,000, he pays no higher ratio than the man with \$60,000.

Senator BAILEY. Take the \$1,000,000 income. The tax is 87.21 on the million.

Mr. CHASTEEN. Is that on the no. 2 proposal you have before you?

Senator BAILEY. Yes; 87.21 is not on the cases above a million dollars, but it is on the whole income of a million dollars.

Mr. CHESTEEN. That is right.

Senator BAILEY. That is not the present system at all. But let me go at that. My State is going to adopt an amendment this year to authorize the taxation increase up to 10 percent. It now has authority to tax up to 6 percent, but 87 and 10 is 97. Do you mean to say that you would take, between the State of North Carolina and the Federal Government, 97 percent of a man's income if he had a million dollars?

Mr. CHESTEEN. I have not checked up the State of California, but I am informed by persons that know the State law that the rate is as high as 15 percent in the State of California, with no deduction for Federal income tax. Whether you want to consider that in adopting this, I don't know.

Senator BAILEY. Look at this. This would leave a man with an income of \$30,000 out of \$1,000,000.

Senator CONNALLY. No; it would not.

Senator BAILEY. I am adding 10 percent for my State. 87 percent for the Federal Government, 10 percent for North Carolina, makes 97 percent, and that leaves him 3 percent. It is really less than 3 percent, because you have 87.21, but call it 3 percent. Then he has an income of \$30,000 out of a million. That is what you cut him down to. What would be the effect of that?

Mr. CHESTEEN. You will leave more than the Nye bill does. The Nye bill only left approximately \$19,000 out of the first \$1,000,000.

Senator BAILEY. What would be the effect of it? I am not saying that any man is entitled to an income of a million dollars a year. We can say that that is economically unsound and probably morally unsound. But you can drop down to \$200,000, and the tax is 77½ percent, and North Carolina adds 10 percent, making 87½ percent, which gives him \$26,000. What is the economic effect of that?

Mr. BROWN. I don't know that any man can say what will be. Of course, speaking for the Treasury, I do not hold any brief for any schedule of rates.

Senator BAILEY. I will tell you what the effect will be. There won't be any such incomes to tax. They won't stand them. They will get rid of the income.

Mr. BROWN. At what point it will become effective, at what point the rate will become effective as a deterrent to individual and corporate activity, that is a matter of judgment, based on a man's experience.

Senator BAILEY. He will be prompted to get rid of his estate rather than to give it to the Government. He will give it to his kinspeople or give it to charity.

Mr. BROWN. As I understood it, one theory of the Nye bill is that you have to pay for the war as you go along, and the reason they were arguing for such high rates was that they wanted to make them so high that the tax couldn't be passed on and thus inflate prices. I believe they have referred in some of their hearings to a study made by the Federal Trade Commission which indicated that the war cost us a great deal more in terms of dollars because of inflation that took place; in other words, we paid so many more counters to run the war than we would have if prices had not gone up. I won't say they went up in proportion, but they certainly went up during the last war.



Now, as I understand it, they are trying to prevent inflation, to pay the cost of the war while it is being fought and to avoid ill effects after the war. I don't know whether that is sound or not; I could not say. I don't know enough about the general reasons for human action, or economics, to be able to form an opinion.

Senator BAILEY. Well, the principle of the capitalistic system is the inducement of profits. Take away the inducement of profits and you have destroyed that system. You may not have made any change whatever in your Constitution, but you have destroyed the system.

Mr. BROWN. I understood that the full committee had made the decision that we were not to destroy the profit motive.

Senator BAILEY. This would not only destroy the profit motive, but it will destroy the capitalistic system. It may be a good thing to do that, I am not arguing that, but we ought to know whether we are doing it.

Senator LA FOLLETTE. As I understood, the full committee desired us or took action that we should try to get the maximum amount of revenue, commensurate with the conduct of war. How to carry that out in actual specific rates and proposals is just a matter of judgment.

Senator BAILEY. I just foresee a very great distribution of estates in prospect of war. We have no prospect now. But they would see this bill coming down, and they would very promptly distribute their estates. They would wish to have their incomes go to their children or their brothers or their sisters.

Senator LA FOLLETTE. What I desire to do was just to get for the information of the committee, the difference in the estimated revenue yields so that insofar as that factor was to be taken into consideration, we would have really a fourth alternative proposal to consider.

Mr. ZUCKER. Without appearing to be an advocate for the rates or in any way condoning them, but merely in connection with what you stated, I believe it might be material to consider the number of individuals that may be in the million-dollar class, which of itself will not be so large.

Senator BAILEY. Only 46. I understand.

Mr. ZUCKER. Against those, that severe rate will apply.

Senator BAILEY. All I am arguing about it is that you would cease to get money from them. You would not get it on that basis at all. The effect of high taxation on a corporation is to increase the volume of newspaper advertising. It is very simple. That is what made the newspapers in the United States rich; it was the excess-profits tax. A man came to the end of the year with enormous profits. He said, "The Government is going to get these profits. Rather than have the Government, I will pay them out in advertising." You saw every big newspaper in America practically double its advertising right after the excess-profits tax came in. Men find ways to divert their money from taxation, out of which they argue they get nothing, into something they argue they get something. That will be the effect of it.

Mr. BROWN. I think I should say, Senator, that in connection with allowances for advertising, as I pointed out at the very beginning of these hearings, the Bureau approaches the administration of a war-

time bill today under different conditions from what it did in 1917 or 1918, and I am quite confident that the Bureau will be far more critical of a jump-up in advertising expense today than it was then, when we had little experience with the income taxes and were under the necessity of building up a personnel, and were faced with an everchanging personnel. We did not keep people in the Bureau for more than 5 or 6 months. They would get a little experience and they would go out into private practice.

Today we have a rather competent personnel and a rather critical personnel when it comes to examining obvious devices of that sort to beat the income tax.

Senator BAILEY. You would have to show affirmatively in court and before a jury that the money was appropriated for the advertising purposes with intent to invade the tax liability or to reduce the liability. A man has a right to advertise.

Mr. BROWN. If a man spent a half million dollars this year and jumped his appropriation for advertising up to a million dollars another year, he would have to show a very good reason to justify it—

Senator BAILEY. He could do that.

Mr. BROWN. or he would only be allowed a half million.

Senator BAILEY. That is what has happened after the 1918 act. I was a witness to it, and my recollection is perfectly fresh about it. I saw newspapers that had been worth \$50,000 sell for \$500,000. Newspapers that had been worth \$100,000 sell for \$1,000,000. The singular thing is that those papers have kept up their volume since. We find a great deal of advertising now. The American public learned to advertise under the influences of the 1918 act. But I was astonished to see how many newspaper owners were made rich.

Senator CONNALLY. Do we want to try to take any vote on these rates now?

Senator BAILEY. I am not prepared to vote on the rates.

Senator LA FOLLETTE. No. I would like to give it further consideration.

Senator CONNALLY. Are there any other matters? You had several other matters you said the other day that you wanted to submit.

Mr. CHESTEEN. We have some 15 items in the bill which represents a departure from the peacetime laws.

Senator CONNALLY. We instructed you the other day to strike out everything from the bill which undertook to modify the peacetime taxation and make this purely a war bill.

Mr. CHESTEEN. As I understood, that decision applied to those innovations in the bill which attempted to restrict deductions and plug loopholes. I did not interpret it as applying to any other questions involved in the bill, such as penalties, interest, the question of amortization, and many other items in the bill that are not intended to be loophole factors at all.

Senator BAILEY. What provision have you in the bill for a corporation to expand its business under the excuse to aid in the war, and when the war is over there is no need for those facilities? Have you a proper provision for that?

Mr. CHESTEEN. What is that?

Senator CONNALLY. Amortization and depreciation.

Mr. CHESTEEN. In the economic sections of the bill, there is provided a revolving fund of \$500,000,000 for the purpose of making loans to industry.

Senator BAILEY. Take a simple example. Suppose there is a knitting mill in North Carolina. The Government wants a lot of socks for a million soldiers, and it is a big order. The mill buys a lot of machinery for that. It has to be done quickly. Then the war is over and there is no need for that machinery. The demand it was supplying was abnormal and it comes back to normal. Is there any provision in the bill for recovery as against the loss for not using that machinery any more?

Mr. CHESTEEN. There is a provision in the bill for loaning a corporation that engaged in producing articles for use by the soldiers, by the Army, an amount to purchase machinery and equipment or construct buildings. The security anticipated is a mortgage on the war facilities purchased with the money, and it is contemplated that after the war some settlement of that loan will be made with the individual or corporation.

Senator BAILEY. All right; let us go a step further.

Senator CONNALLY. Still it is a loan and it is supposed to be paid back. What Senator Bailey has in mind, as I understand it, is with relation to that income, or the provisions in the bill which would enable them to write off a lot of that loss and take it out as a deduction.

Mr. CHESTEEN. There is nothing in the income tax.

Senator BAILEY. He is not going to be allowed to make enough money in the war to pay for the capital invested, but the capital invested at the end of the war is worthless. Is there anything in there to make him, and if there is not, he won't do it.

Mr. CHESTEEN. There is nothing in title I for the purpose of writing off against income.

Senator BAILEY. I think you ought to have something. Let me give you another instance. Do you remember that the War Finance Corporation called upon the farmers of the United States to expand their acres, to work night and day, and produce all of the wheat and all of the cotton and all of the corn and all of the hogs they could? Then suddenly in the month of May 1920 the War Finance Corporation, after the crops were planted, withdrew its assistance, withdrew its loans, and began to wind up, and that fall the farmers were left with an immense surplus on their hands, and that surplus is one of the difficulties we are dealing with to this day. Is there any provision there to reimburse the farmer who produces a hundred acres of wheat, and the Government induces him to produce 200 acres of wheat?

Senator CONNALLY. Let me ask you this. In the tax part of title I, what are the provisions for any losses?

Mr. CHESTEEN. None. The only provision in the tax bill is the allowance for depreciation on depreciable property, and if the property is discarded, of course, there is the provision for losses, just as there is in peacetimes. But there is no provision in title I with the exception of the provisions that are in the ordinary peacetime law with respect to losses. So, if a manufacturer during the war period acquires machinery and equipment, unless he should discard it during the war period, there would be no provision for deducting the loss.

Senator BAILEY. Do you know what we did with the excess trucks we had at the end of the war? We bought them and distributed them. We made the automobile people rich. I won't say it is wrong

that we protected them. I think you will find that something like a billion dollars was used up that way. We induced them to produce the trucks. The same way with automobiles. We had induced the manufacturers to make them, and the war came to an end and there was no demand for them. The same way with copper. We induced the production of an immense amount of copper. It took 5 years to get rid of it. It had the banks in New York shaky, because they had loaned so much money on copper. The Guaranty Trust Co. carried a copper account for a long time and gradually worked it out. Those are difficulties we are dealing with. If we are going to write a war bill, we have to write one in connection with the circumstances.

Mr. ZUCKER. The Nye committee has more or less thought that matter out to a conclusion.

Senator BAILEY. What is their conclusion?

Mr. ZUCKER. What they contemplate is that the revolving fund will be utilized, and that since the assets purchased from the fund obtained will be the only security, at the end of the war the Government will take over these assets, and they contemplate as to plant and equipment, I am quoting [reading]:

As to the plant and equipment which the Government has thus acquired, the choice will be between Government operation and sale for little if any better than salvage prices.

In other words, their conclusion is that they must foster the making of war material, and they will utilize this revolving fund to finance these various corporations, and at the termination of the war, if the corporation cannot pay back the loan, the Government will resort to foreclosure or other procedure and take over these assets. It is expected that they will not have their wartime value, but will have merely salvage value. That would be an additional war cost.

Senator BAILEY. But the Government takes the loss on the excess materials and the excess equipment. Is that the Nye bill's conclusion?

Mr. ZUCKER. That is the Nye conclusion.

Senator LA FOLLETTE. It is half a dozen of one and six of another. If you let them write it off, the Government loses from the revenue point of view, while they are writing it off.

Mr. ZUCKER. During the last war, they wrote off in excess of 425 millions amortization.

Senator BAILEY. I should think you would have a provision in the war tax bill just to the general effect that upon the expansion of any institution or anybody in response to demand by the Government, sufficient provision will be made, and that will be made from the farmer up, or the farmer down, because we did call on the farmer during the war just as much as we did on the munitions manufacturers.

Mr. CHESTEEN. You are probably thinking of an inflation during the war, which the Nye committee hoped to prevent.

Senator BAILEY. No; it is not inflation. What happens in a war is very simple. We consume material at a terrific rate. We now have a consumption of cotton in the world of our cotton of about 14 million bales of American cotton. If a war came along, we would consume 20 million bales. Cotton is the basis of your gunpowder.

**Senator CONNALLY.** It seems to me we have to have both of these angles, because in the one case a concern might not need to borrow from the Government for facilities, and yet it would expand and have a tremendous loss after the war, so I think you have to have not only this revolving fund, but you have to have some provision in here to allow corporations and individuals, for that matter, that where there is established a direct war loss, to take deduction for it.

**Senator LA FOLLETTE.** Of course, we have very liberal provisions in the peacetime, as far as that is concerned. Has the Treasury ever made any studies as to whether or not the amount that they deduct for amortization and replacement is actually used for that purpose? Is it not a fact, or is it—I do not know whether it is or not—but I am under the impression that a great deal of these deductions are availed of, and then later the money which they have set up for this purpose is eventually transferred to the capital account or some other place.

**Mr. BROWN.** There is no provision in the peacetime law for amortization, but provision is made for deductions for depreciation, depletion, and wear and tear, which all come under depreciation.

There has been some slack, which the Bureau as it has gained experience is beginning to tighten up on. In other words, they are going into each industry, and I should say that within a very short time the Bureau will be in a position, on the basis of its experience, and its audit of thousands of returns, to estimate for each industry approximately what the proper allowance for depreciation in that industry is.

**Senator CONNALLY.** That is where the graft has been heretofore. They would take a straight depreciation, and it was more than the actual depreciation frequently, and as you suggest, they would take credit on the books for that depreciation and, maybe in later years, either pass it to capital account or pay it out in dividends.

**Senator LA FOLLETTE.** I have been told, for instance, that there are industries that have gotten machinery that is 10 or 15 years old, and that they have taken depreciation for them long since and never replaced that machinery.

**Senator CONNALLY.** I do not doubt it.

**Mr. CHESTEEN.** It may be of some interest to you to consider this question. In deducting depreciation, while the corporation as a business matter seeks to deduct it, actual wear and tear of the property during the taxable year, to do that of course you must resort to somebody's judgment, and it is a very difficult matter for anybody to say how much plant has actually depreciated in wear and tear during a taxable year. The result was that the depreciation rates prior to 1916 were not uniform, not even in the same industry or even in the same plant over a period of years. If the taxpayer had a prosperous period, he probably would set up healthy deductions. If they had a lean one, he would probably, in most instances, show a smaller amount of deductions.

When the Treasury Department came to administer the war-revenue laws, it was faced with the problem of determining depreciation for invested capital as well as current deductions. The Department adopted almost uniformly the straight-line theory of depreciation, that is, the asset was estimated to have a certain useful life based either upon the experiences of the taxpayer or similar taxpayers in

that industry. From that experience, a rate was determined for the property at a certain theoretical life, say, 10 years. On the basis of that estimated life, depreciation was taken of 10 percent every year until the asset was exhausted. Frequently theoretical life did not coincide with actual life, with the result that a taxpayer recouped his cost long before the expiration of actual life.

Senator BAILEY. That is your depreciation with respect to machinery, but I was thinking about what you could probably classify as obsolescence. It gets out of any need for it by reason of the cessation of the war. It is not depreciation; it is obsolescence, but really it is not obsolescence in the technical sense. In the technical sense, it is machinery ceasing to be available because better machinery has been invented.

Mr. CHESTEEN. Let me answer Senator La Follette first, and then I will come to your question. Of course, with the necessity for audit of all of the war years, the necessity for valuation of all 1913 property and the necessity for valuing all property paid into a corporation, it imposed upon the Internal Revenue Bureau an almost impossible task in the way of making accurate determinations either for depreciation or for valuation purposes. The result was that for a number of years the administration permitted excessive depreciation deductions in some cases, so that corporations found themselves with assets estimated to have a 10-year life that stayed in the plant and would be good for several years. And either through the deduction of an excessive rate or through the replacement of the property by charges to repairs which went to expense account.

Beginning with about 1934, the matter of the Bureau practice was discussed in connection with the 1934 Revenue Act, as you recall, and a proposal was submitted by a subcommittee of the House Ways and Means Committee to reduce the allowances by 25 percent. While that was under consideration by the Ways and Means Committee, the Secretary of the Treasury indicated that the Treasury Department thought that it could work the problem out in an administrative way. I think since that time an effort has been made to reduce, as a whole, the rates of depreciation and to fix a rate in keeping with the history of the corporation and its own experience or the experience of similar corporations.

Senator LA FOLLETTE. What Senator Bailey has in mind is—as I understand it—this: Suppose the Government wants a new plant built for shoes or for anything else, what is the policy of the Government going to be when that war need is gone and the people who built the plant have it on their hands? For example, what did the Government do with regard to a plant, for instance, like the Old Hickory plant down in Nashville? That was built, was it not, by the Du Ponts for war purposes? I know, for instance, in my own town, there is a building standing there called the Four Lakes Ordnance Co., or something of that kind, that was built during the war for the purpose of making something. I have forgotten now just what it was, but something in connection with ordnance. It is still standing there. I am sure the Government must have taken care of those people. I understood they made substantial profits out of the war.

Senator CONNALLY. The shipbuilding was a good example of that. A lot of those fellows just went bankrupt. The Government did make payment to some of some money to pay them back. Shipyards

were not worth a dollar after the war was over. We had some in my State and they went bankrupt and never did get anything out of it.

Senator BAILEY. I would suggest that we write a section for licensing partnerships, individuals, and corporations upon receiving orders from the Government, and provide that they should pay these taxes, and then provide further at the end of the war or at any time after 2 years after the end of the war, they could adjust the matter with the Government on the basis in which they would receive a certain percentage of profit. Make the percentage small, but then you have to guarantee them something.

Senator CONNALLY. What would happen, most probably, would be this: Under these industrial sections, if the Government figured they did not have any hope of making any profit, the Government would have to take over their plants and run them.

Senator BAILEY. I think the same thing with the farmer. I do not think we ought to induce the farmer to expand his crops to buy a lot of mules and horses and plows, and then have no further use for them. We had a fearful panic in 1921. It was very short, but it was dreadful while it lasted. It was very bad in my section of the country. They were figuring on the basis of 42 cents for cotton, for instance. You have to make some provision for that sort of thing.

Senator CONNALLY. We will go on tomorrow at 10:30.

(Whereupon, at 12:15 p. m., a recess was taken until Tuesday, Apr. 14, 1936, at 10:30 a. m.)





# TO PREVENT PROFITEERING IN WAR

TUESDAY, APRIL 14, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senator Connally (chairman).

Also present: G. D. Chesteen, J. S. Zucker, and Allen T. Akin, of the Joint Committee on Internal Revenue Taxation; Ralph W. Brown and P. J. Mitchell, of the Treasury Department; S. E. Rice, office of Senate Legislative Counsel.

Senator CONNALLY. I am ready to proceed, gentlemen.

Mr. BROWN. Mr. Chairman, yesterday the subcommittee, on the suggestion of Senator La Follette, asked the Treasury to obtain an estimate of the probable yield on a schedule of rates applicable to individual incomes, which would level off in effect at \$50,000; in other words, when you reach the \$50,000 the maximum rates would then apply to all above that figure.

We made some slight rearrangement of the brackets below that, because of the suggestion which had been made that it ought to be a symmetrical curve as shown by the graph up to that point.

In making those few minor changes I consulted with the staff of the joint committee.

I offer for the record at this point the proposed schedule.

(The schedule referred to is as follows:)

*Schedule of surtax rates under which it is required to submit an estimate for the use of the subcommittee of the Senate Finance Committee*

Surtax net income:	Rate of surtax, percent
\$1,000 to \$2,000-----	6
\$2,000 to \$3,000-----	9
\$3,000 to \$4,000-----	12
\$4,000 to \$6,000-----	15
\$6,000 to \$8,000-----	18
\$8,000 to \$10,000-----	21
\$10,000 to \$14,000-----	25
\$14,000 to \$18,000-----	30
\$18,000 to \$24,000-----	40
\$24,000 to \$30,000-----	50
\$30,000 to \$40,000-----	60
\$40,000 to \$50,000-----	70
In excess of \$50,000-----	80

NOTE.—As in the prior estimates, the personal exemption, and credit for dependents are as follows: Single persons, \$800; married persons, \$1,000; credit for dependents, \$250. Rate of normal tax, 10 percent.

Senator CONNALLY. You are using the \$1,000 and \$2,000 rates?

Mr. BROWN. We used the same personal exemptions that were suggested by the committee, that is, \$1,600 for married and \$800 for the individual, and \$250 credit for dependents.

It is estimated that the total revenue under the individual income-tax proposal which I have just referred to would amount to \$7,866,000,000 if the earned income credits and dividends are not allowed as credit against net income subject to the normal tax.

Senator CONNALLY. You mean you would get that much revenue out of individual incomes?

Mr. BROWN. That is correct. And \$7,184,000,000 if these credits are allowed. As in the case of the estimates for the proposal furnished on April 9, 1936, the 1928 level of individual incomes was used. That represents approximately an increase of \$600,000,000 over the lower of the two schedules submitted by the joint committee.

Senator CONNALLY. In other words, leveling off at 50 would give us \$600,000,000 more?

Mr. BROWN. That is approximately correct.

Senator CONNALLY. That is quite an item.

Mr. CHESTEEN. The Finance Committee took the view that the war bill should not interfere with the profit motive.

Senator CONNALLY. We did not go that far, but we said it should not destroy the profit motive. Of course, anything that takes any of it interferes with it in a measure.

Mr. CHESTERTON. One of the factors for the profit motive is the schedule, and of course it is a question as to what degree it should go in a war bill to more or less hamper the profit motive. We have not assumed, in working out these schedules we prepared, to pass upon that question because we assumed it is a policy question which the committee itself could pass on; but we prepared schedules more or less at the suggestion of the subcommittee to conform to the British rates in the lower brackets and to carry out a maximum rate in the higher brackets indicated by subcommittee members.

We have not conducted a study of what effect these rates might have on the profit motive, if we go anything like 90 or 95 percent maximum.

Of course if you want an expression we would have to take some time to think over that last question. We know that Great Britain in the last war had rates around 80 percent, and of course when you go above 80 percent, I should want to survey the result of war rates in the past before I would want to express an opinion on very high rates.

Mr. BROWN. We ourselves went above 80 percent.

Mr. CHESTEEN. You mean on individuals.

Mr. BROWN. Oh, you are talking about individuals?

Mr. CHESTEEN. Yes.

Senator CONNALLY. These rates you have presented can go in the record, if you have no objection.

Mr. CHESTEEN. I would like to have you put them in the record.

Senator CONNALLY. They may be inserted in the record at this time.

(The matter referred to is as follows:)

## THIRD PROPOSAL

## Normal tax 10-percent surtax

Surtax net income	Rate	Bracket	Total
On first \$1,000.....	0	0	0
\$1,000 to \$2,000.....	6	60	60
\$2,000 to \$3,000.....	9	90	150
\$3,000 to \$4,000.....	12	120	270
\$4,000 to \$6,000.....	15	300	570
\$6,000 to \$8,000.....	18	360	930
\$8,000 to \$10,000.....	21	420	1,350
\$10,000 to \$14,000.....	25	1,000	2,350
\$14,000 to \$18,000.....	30	1,200	3,550
\$18,000 to \$24,000.....	40	2,400	5,950
\$24,000 to \$30,000.....	50	3,000	8,950
\$30,000 to \$40,000.....	60	6,000	14,950
\$40,000 to \$50,000.....	70	7,000	21,950
Over \$50,000.....	80		
Personal exemption:			
Married person.....			\$1,600
Single person.....			800
Each dependent.....			280

## Married persons, no dependents

	Tax	Percent of net income		Tax	Percent of net income
\$1,000.....	0		\$14,000.....	\$3,190	22.78
\$1,500.....	0		\$16,000.....	3,910	24.43
\$2,000.....	\$40	0.2	\$18,000.....	4,710	26.16
\$2,500.....	90	3.6	\$20,000.....	5,530	27.65
\$3,000.....	164	5.4	\$25,000.....	8,050	32.20
\$3,500.....	244	6.9	\$30,000.....	10,990	36.63
\$4,000.....	336	8.4	\$40,000.....	17,830	44.57
\$4,500.....	431	9.57	\$50,000.....	25,670	51.34
\$5,000.....	538	10.76	\$60,000.....	34,510	57.51
\$6,000.....	770	12.83	\$70,000.....	43,510	62.15
\$7,000.....	1,020	14.57	\$80,000.....	52,510	65.63
\$8,000.....	1,282	16.02	\$100,000.....	70,510	70.51
\$9,000.....	1,564	17.06	\$200,000.....	160,510	80.25
\$10,000.....	1,854	18.54	\$500,000.....	430,510	86.10
\$12,000.....	2,490	20.75	\$1,000,000.....	880,510	88.05

Senator CONNALLY. Do you have any further comment to make on that, Mr. Chesteen?

Mr. CHESTEEN. No, sir; I just wanted to know whether between now and Monday you want us to study the various suggestions as to rates, and express any views.

Senator CONNALLY. Yes, I think so; because we are evidently going to have a division of opinion as to how high some of these rates should go, and we should be prepared to intelligently act on it.

Mr. CHESTEEN. I regard that as one of the most important questions in the bill.

Senator CONNALLY. Yes; if we are going to adopt a peacetime basis, rate is about all that is left.

Mr. CHESTEEN. That is correct. I am satisfied the Nye committee devoted a lot of thought to the rate schedule, and that committee adopted a rate schedule which the committee believed would accomplish the purposes sought by the Nye committee in a tax bill.

The committee wanted to prevent as much as it possibly could inflations during the war period, and the tax bill with those rates is designed to aid the economic sections in preventing the taxpaying public retaining a large part of the war profits, so I think here you are dealing with one of the most important questions we have. I do not know that our study would be worth anything to you, but if you want us to give some thought to it, we shall be glad to do that.

Senator CONNALLY. Yes; we will be glad to have you do that. We think it would be of assistance, and that is what we have got you here for. We are just the judges on the bench, and want the lawyers to argue and exhaust the subject matter; then we will pass on it.

You all agree you would make progress if we suspend now and let you work over these things and get them in shape?

Mr. BROWN. Yes, sir.

Senator CONNALLY. Suppose we recess and call you when you are ready? You would rather have the rest of this week?

Mr. BROWN. I should think we would need at least the rest of the week to set up the program.

Senator CONNALLY. In the meantime between now and Monday could you fix tentatively at least all of these proposals, so that we could next week vote on them and get them in shape?

I would like to get some of these questions behind us next week, so that the drafting people could go ahead to get this bill in shape.

If you think you could put the time in between now and Monday more profitably on this work, we will call you when you are ready. Thank you very much.

Consequently we will now recess subject to call.

(Thereupon, at 11:45 a. m., the hearing was recessed subject to the call of the chairman.)

## TO PREVENT PROFITEERING IN WAR

FRIDAY, APRIL 24, 1936

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

The subcommittee met, pursuant to call, at 2 p. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Bailey, Guffey, and La Follette.

Also present: G. D. Chesteen and others of the Joint Committee on Internal Revenue Taxation. Ralph W. Brown and Raymond H. Joy, of the Treasury Department.

Senator CONNALLY. Are you ready to proceed?

Mr. BROWN, would you like to go ahead from where you were at the last session? We agreed that we would take a recess and allow the Treasury and the staff in the joint committee to get ready. Is that what you had in mind?

Mr. BROWN. That is true.

Senator CONNALLY. Are you now prepared to go ahead?

Mr. BROWN. Yes.

Senator CONNALLY. Let us direct your attention to this fact. We have gotten to the point where we are considering general provisions of this bill and they are to be considered in connection with the general tax bill which the committee is now considering.

Mr. BROWN. With respect to that question, you have already had before you schedules dealing with the individual-income taxes. The committee has made no final decision on the individual rate schedules. Mr. Chesteen, as I understand it, was requested at the last hearing to prepare and to submit some comments on the individual schedules. The corporation-rate schedule does tie into that problem, because there should be some correlation between the individual rates and the corporation rates. That is a matter of policy. My own thought with respect to the corporation rates is that they should bear a relationship to the individual rates. First, I suggest that we hear from Mr. Chesteen.

Mr. CHESTEEN. We have no further comments to make, Senator. We have nothing further to offer because the bill covers the schedule very well.

Senator CONNALLY. Until Senator La Follette comes I do not know of any suggestions to make. Go ahead, Mr. Brown.

Mr. BROWN. I suppose, Senator, that we should take up the corporation-rate schedule.

Senator CONNALLY. I think it would probably be more appropriate to act on the individual rates first as interrelated to the rates for

the corporations. I will be very frank to say that with this new bill we are in a very complex situation.

Senator GUFFEY. I agree with you on that, Senator.

Senator CONNALLY. Then, I think we will defer for the moment, Mr. Chesteen, or you, Mr. Brown, and you can present the tables on rates.

Mr. BROWN. Since they originate with Mr. Chesteen, I think it might be more appropriate for him to take that matter up.

Mr. CHESTEEN. Very well.

Senator CONNALLY. Under that table, if a man had \$50,000 of income, would pay a tax of \$9,500?

Mr. BROWN. That is right, but the total tax would be 90 percent; 90 percent would be taken in tax and leave the taxpayer 10 percent.

Senator CONNALLY. And if he had a hundred thousand dollars—I move that we adopt that. Based on the individual-income tax, first on the theory that the corporation rates can be passed on later.

Senator BAILEY. That is including the individual rates?

Senator CONNALLY. No. That is the individual rate. That is on page 199.

Senator LA FOLLETTE. I think what Senator Connally had in mind was that there ought to be some kind of correlation between the corporation rates and the individual rates.

Senator CONNALLY. In other words, there ought to be no discrimination between corporation and individual rates. We should adjust the individual rates with the corporation rates.

Senator LA FOLLETTE. In other words, we ought to adjust the corporation rates with the individual rates.

Senator CONNALLY. That is it exactly. Does any member want to discuss this further?

(A motion to adopt was put and carried.)

Senator CONNALLY. Then we adopt the rates on page 191 and we can go right ahead. Mr. Brown, go right ahead.

Mr. BROWN. I should like to say at the outset that we are faced with a considerable problem in the drafting of the bill. The Nye bill was drafted on one basis; that is, it had a theory for the taxation of corporations which, as I said before, was based on the capital stock tax. If we do away with that basis of taxation in peacetime, it will become necessary to decide whether to carry along that basis for wartime or to substitute some other basis. I invited the attention of the committee to the basis which has been under consideration in the House, and your subcommittee at one time decided to go ahead on that basis. So, facing the practical problem, I have been thinking along these lines, that we might take the 1934 act, so far as applicable in relation to the taxation of individual incomes, and add such provisions as might be necessary to deal with the corporation and war problems.

Senator CONNALLY. Would it be practical to adopt a supertax on the basis of the 1934 act, with the modifications of the corporate tax in this bill and superimpose that without going into a great mass in these two bills?

Mr. BROWN. Well, that was the basis of my suggestion. My thought was that we ought not to attempt to have this committee go over the ground which the full committee will cover in its considera-

tion of the main tax bill. We could take the House bill, which is now having some advance consideration by the Senate Finance Committee, and engraft upon it such provisions as might be necessary to take care of the special problems which may be created by war. The Treasury and the staff of the joint committee have been giving some consideration to these problems during the recent recess. The Treasury is prepared to discuss these problems with the committee, especially the subjects of amortization and inventory losses. However, before doing so, it was my thought that the committee might first wish to clear away some minor problems of an administrative nature. A decision by the committee on a number of these minor problems would enable the office of the Legislative Counsel to make substantial headway in the drafting of a large part of the new title I which I understand the subcommittee contemplates offering as a substitute for the title now contained in the bill.

Section 22 (b) (3) of the Nye bill, which will be found on page 23 of H. R. 5529, as referred to your subcommittee, reads:

*Bequests and Devises.*—The value of property acquired by bequest, devise, or inheritance (but the income from such property shall be included in gross income);

Senator CONNALLY. These are exclusions?

Mr. BROWN. The provision I have referred to relates to exclusions from gross income. It will be noted that gifts have been omitted from the title, as well as from the body of the subsection. It was our thought that this omission was inadvertent. In this connection I may add that this provision in the Revenue Act of 1934, and the corresponding provisions of prior revenue acts, excludes from gross income gifts, bequests, and devises. Gifts have been considered as not constituting income ever since the enactment of the first income tax. The effect of omitting any reference to gifts in subsection 22 (b) (3) is to include them in gross income. As I have said, I believe that the omission was inadvertent. If it was intentional, a constitutional question is raised whether gifts may be so treated.

Senator CONNALLY. They are taxable now? Why was it necessary to exclude them?

Mr. BROWN. I am not sure that the committee voted on that question. That is why I raise it now.

Senator CONNALLY. We discussed it, and we came to a conclusion that if a man paid a higher rate in peacetime than in wartime—

Senator BAILEY (interposing), I will vote on that.

Senator CONNALLY. That the rate on bequests be the same in peacetime as in wartime.

Mr. CHESTEEN. But as far as income tax payable is concerned, that is not income.

Senator CONNALLY. That is correct. But we insert in here the gift.

Mr. CHESTEEN. Yes.

Mr. BROWN. The next problem comes under section 55 of the Nye bill.

Senator CONNALLY. Page what?

Mr. BROWN. That is page 58. This section deals with the question of the publicity of returns.

Senator LA FOLLETTE. I can state my idea on that. I do not think you will ever have a satisfactory income-tax system unless you make

income-tax returns public records. At the same time, I think devices that are offered as a substitute for the publicity, where there is secrecy, gives practically all of the disadvantages, and you have none of the benefits that flow from it, which I personally frankly believe outweigh the disadvantages. In other words, this kind of a "pink-slip" device does not accomplish anything, and at the same time it has all of the same things that can be said against making the return a public record. Any of those things can be said against this substitute device. Of course, my position is that I would like to see the income-tax returns made public records.

Senator BAILEY. Then you mean they should be promulgated as public records? Is that what you are bidding for?

Senator LA FOLLETTE. No. If a man is told to make out a return, you have not achieved what I think is accomplished by making the return a public record and open to inspection, and yet you have aroused all of the animosity on the part of the people who do not believe there should be a public record of a return.

Senator BAILEY. I am one of those people.

Senator LA FOLLETTE. I know you are. But all that I am saying is that, so far as this particular provision is concerned, it seems to me it is neither fish nor fowl.

Senator BAILEY. If you will excuse me, I do not see how the publicity of returns helps the Government.

Senator CONNALLY. Is it the same as the present law of 1934?

Mr. BROWN. No. Last year you repealed the "pink-slip" provision by Public, No. 40. I do not happen to have that here. Public, No. 40 does not provide for any publicity. It is entirely a matter for the decision of the committee.

Senator CONNALLY. Suppose we adopt the same policy as in peacetime.

Senator GUFFEY. This makes the return a public record.

Mr. BROWN. The committee may be interested in the provision in the Nye bill. It provides [reading]:

Immediately upon the effective date of this title, the President shall make public, upon such terms and conditions as he may see fit, the returns of all taxpayers for the year prior to such effective date, notwithstanding and in addition to any other terms or provisions of law relating to such publicity.

Senator CONNALLY. The "effective date of this title" would be in time of war?

Mr. BROWN. Yes.

Senator CONNALLY. I move that we carry forward the existing law.

Senator LA FOLLETTE. I am perfectly willing to do that, because I am perfectly willing to not delay this bill. That is something that I do not see any special force or any reason why I should delay or encumber this bill by a fight which I may make on another occasion.

(The motion was put and carried.)

Senator BAILEY. That means subsection (c)?

Senator CONNALLY. It means to carry forward the existing law as it is.

Senator LA FOLLETTE. It is the existing law at this time.

Senator BAILEY. Any law which may be in existence at this time. I agree with Senator La Follette on that.

Mr. BROWN. The same provisions which are now contained in the House bill.



Senator CONNALLY. Do you want to make any other motion?

Senator BAILEY. No. I agree with the motion as made.

Senator CONNALLY. All right. It is adopted.

Mr. BROWN. The next problem raised is in section 56, in relation to payment of the tax. Section 56 (a) is the same as the existing law. The Nye bill, however, omits sections (b) and (c) of the 1934 act. Subsection (b) of the 1934 act allows the taxpayer to pay in installments.

Senator CONNALLY. Quarterly?

Mr. BROWN. Quarterly; yes, sir. Subsection (c) of the existing law allows the Commissioner to extend the time of payment for a period not to exceed 6 months.

Senator LA FOLLETTE (interposing). I move that it be retained.

Senator CONNALLY. The motion that this section be modified to make it the existing law.

(Motion put and carried.)

Mr. BROWN. Does the committee wish to consider the provision providing for payment on a quarterly basis? It has been omitted in the Nye bill.

Senator CONNALLY. What do you say about that?

Senator LA FOLLETTE. Just so there won't be any confusion, I move that we retain the provision as to quarterly payments.

Senator CONNALLY. As to the quarterly payments, all in favor of that say "aye."

(Motion put and carried.)

Mr. BROWN. On the question of voluntary advance payments, that in effect gives the taxpayer a credit. That, of course, is a question of policy.

Senator LA FOLLETTE. I suppose it is offered to induce the early filing of returns, on the assumption that you are to get the money. It is to get the money pouring in as early as possible.

Senator CONNALLY. What is the disposition of the committee on that?

Senator BAILEY. I think it is a very good idea.

Senator CONNALLY. Is the motion to retain this clause?

Senator LA FOLLETTE. I would like to get Mr. Brown's point of view as to what you think of the administrative problem that this presents?

Mr. BROWN. I think, Senator La Follette, that it would create a grave administrative problem, one that would be hard to administer, and the rate seems to be rather high. I think it is particularly high from the point of view of the Nye bill, because this interest might be sufficient to allow a wealthy taxpayer to double the amount that he would be allowed to retain.

Senator CONNALLY. I personally think that this ought to go out.

Senator BAILEY. The Government wants to get the cash.

Senator CONNALLY. The Government gets the cash at the present time. In time of war we would probably get it at a higher rate than now.

Senator BAILEY. But you have to weigh over against the administrative problem, and if the Treasury feels that it will make a terrific burden on the staff, it might outweigh any advantages that might come from retaining it.

Mr. BROWN. The Treasury thinks it will impose a heavy burden.

Senator BAILEY. Do you notice the limitation there, that no amount can exceed \$10,000? The whole idea is to give the Government \$10,000.

Mr. BROWN. That is the limitation in any taxable year.

Senator CONNALLY. What is the disposition of the committee?

Senator BAILEY. What is your motion?

Senator CONNALLY. There is no motion pending.

Senator BAILEY. I move that it stand.

Senator LA FOLLETTE. I do not want to let it stand, so far as I am personally concerned.

Mr. BROWN. I will state that quite a number of amendments were made last year, limiting the rate of interest to 6 percent instead of 12 percent. I do not know whether that might affect your decision or not.

Senator BAILEY. One percent per month by way of interest seems rather high.

Mr. BROWN. Of course, the interest on Government paper might change in wartime.

Senator LA FOLLETTE. I move that the section be retained with the 6 percent per annum rate.

Senator BAILEY. One-half of 1 percent per month.

Senator LA FOLLETTE. Yes.

(The motion was put and carried.)

Senator LA FOLLETTE. Are there any other exclusions which you think should be made?

Mr. BROWN. There may be some changes in draftsmanship.

Senator LA FOLLETTE. So far as I am concerned, they can carry out their own ideas in draftsmanship.

Mr. BROWN. The jeopardy advance payment plan is designed to secure the Government, and is the same as the Revenue Act of 1934. What you have referred to here is just a reference.

Senator CONNALLY. I move that it be retained.

Mr. CHESTEEN. May I point this out? We have penalties, interest, quarterly payments, and other things, and that is all provided for in the Nye bill. Those things that I have mentioned deviate from the present law. The committee imposed severe penalties, because where taxpayers had violated the law the committee thought there should be a very heavy penalty. The question is, do you want to leave the present law as it is for those penalties? The question which you discussed a few minutes ago, discount on advance, is similar to a provision in the act of 1917. It is my recollection that in 1918 Secretary McAdoo advised Congress to omit this provision from the 1918 act. It was alleged that wealthy individuals and corporations were making advance payments so as to save a substantial amount. I think that the present law is adequate to bring the money into the Treasury. It is also my recollection that when we had advance payments the difficulty experienced was out of proportion to the benefit.

Senator CONNALLY. I move to reconsider that clause.

Senator BAILEY. I am perfectly willing to go along with you on that.

(The motion was put and carried.)

Mr. BROWN. It was not my idea to go through this act section by section. So far as the voluntary advance payment is concerned, I admit that it is a difficult problem administratively.

Senator CONNALLY. Is it of sufficient importance to take it out?

Mr. BROWN. My personal opinion is that it is. I think I agree with Mr. Chesteen.

Senator CONNALLY. I move that we strike that.

(Motion put and carried.)

Mr. BROWN. The next question arises under section 63. That question is wholly a question of policy and, speaking for the Treasury, I have nothing to say in respect to it. It is a complete innovation. We have never had anything like it, so far as I know.

Senator LA FOLLETTE. I am perfectly willing to let that go out with the rest of it to push this bill along.

Mr. BROWN. It came up at one of the other meetings, April 3, when Senator Connally said, "I would be in favor of striking that out."

Senator BAILEY. I move that it go out.

Senator LA FOLLETTE. All in favor of that motion say "aye."

(The motion was put and carried.)

Senator BAILEY. Why did you put section 64 in there, page 63?

Mr. BROWN. Mr. Chesteen spoke on that the other day. The Treasury is a little in doubt as to what the purpose of that provision is.

Senator BAILEY. Did you see in the news of today's paper that the people of England insured themselves against the increase of rates?

Mr. BROWN. No; I did not.

Senator BAILEY. Well, Lloyd's insured them against the increase of income tax and they made a killing, and so I do not know why men ought not to be insured—but I do not know what the object is.

Senator LA FOLLETTE. Is there anything in the Nye bill about this thing?

Mr. CHESTEEN. No, sir.

Senator BAILEY. I move that this should go out.

Senator LA FOLLETTE. I do not know what the object of it is myself.

Senator BAILEY. It would be a prudent thing for him to insure.

It shall hereafter be unlawful for any person, or any agent of the United States, to agree or contract, directly or indirectly, pay or assume or bear the burden of any tax payable by any taxpayer under the provisions of this act. Any such contract or agreement shall be null and void and shall not be in force or given effect by any court.

Senator LA FOLLETTE. I suggest that go out.

(Motion put and carried.)

Mr. BROWN. The next is section 65. This section prohibits under any circumstances suits to restrain the assessments or collection of any tax.

The apparent purpose of the section is to reenforce section 3224 of the Revised Statutes, which reads as follows:

No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.

Under the latter provision there have been exceptional encountered cases where there was thought to exist no complete and adequate remedy at law, or where the rights or business of the taxpayer would be destroyed. In such cases the equity powers of the courts were invoked and collection of the tax was stayed.

Until the rise of extensive litigation in connection with the processing taxes, Revised Statute 3224 was considered sufficient for practical purposes to prevent interference with the assessment and col-

lection of taxes. Under the processing taxes, many of the district courts granted injunctions and finally the Supreme Court granted a temporary injunction, despite the provisions of Revised Statute 3224. In the circumstances, and despite the diversity of opinion as to the meaning of those cases, it is believed to be futile to try to impose greater limitations than those provided in Revised Statute 3224, which, it is recommended, should not be disturbed for the purposes of this legislation.

Senator LA FOLLETTE. In other words, you think if the present law does not prevent it, no further law should be enacted?

Mr. BROWN. Yes, sir.

(Motion to eliminate the section was put and carried.)

Mr. BROWN. The next problem arises in section 131, on page—well, that has been omitted in the Nye bill. It is section 131 of the Revenue Act of 1934. This raises a question in respect to credits for foreign taxes paid, and the question I raise is whether, as under existing law, we should allow a credit for those taxes.

Senator LA FOLLETTE. It is not in this law?

Mr. BROWN. It is not in the bill; it is stricken out in the Nye bill.

Senator CONNALLY. If they take it from the income, the Government gets more taxes. I move that we provide for that. The motion is that we retain the present law, and that will be an insertion in the law.

Mr. BROWN. Yes, sir.

Senator CONNALLY. In other words, in the Nye bill they could not take it one way or the other.

Mr. BROWN. That is correct.

Senator CONNALLY. All right.

(The motion was put and carried.)

Senator CONNALLY. What is the next point?

Mr. CHESTEEN. Mr. Chairman, we discussed the other day the question of percentage deflation, and there was left for decision whether or not you would adopt the rates fixed in the Nye bill or return to the present rates of percentage, or adopt some other third method.

Mr. CONNALLY. Depletion is depletion and is not consummation.

Mr. CHESTEEN. Of course, the present law is on a percentage basis. Therefore a taxpayer may recover a greater amount than the original cost. My personal opinion is that the question of depletion in a war bill is as important as the question of depletion in a peacetime bill. You will recall that the Ways and Means Committee in 1930 held hearings on depletion of mines. The whole subject was gone into thoroughly, and as a result of those hearings Congress adopted percentage rates. It is my view that if the rates should be changed for wartime they should be changed for peacetime, and if they should be changed for peacetime they should be changed for wartime. The Treasury may have a different view, but I can see no reason at this time why you should take that matter up when the subject has already been gone into thoroughly.

Senator CONNALLY. Have you any other remarks to make?

Mr. BROWN. I think, if I may be permitted, I should like to present a view in respect to this subject which might be applied to peacetime taxation as well as to war.

Subsections 3 and 4 of section 114 (b) of the Nye bill provide that, in lieu of adjusted costs, the basis of the depletion allowance in the case of oil-and-gas wells, and coal, metal, and sulphur mines, shall be at given percentages of the gross income of the taxpayer from such properties, but not to exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. The percentages of 9 percent of gross income for oil-and-gas wells, 2½ percent for coal mines, 5 percent for metal mines, and 7½ percent for sulphur mines, may in fact exceed to some extent depletion computed on the adjusted cost or other basis, although in some cases, such as a fee purchase of proven property, it may well not be as much as cost depletion. It might well be provided in these instances also, as an addition to each of subdivisions 3 and 4 as they now stand, that [reading]:

In no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

The Nye bill reduces the allowances in existing law.

Senator CONNALLY. How do those rates compare with the present rates?

Mr. CHESTEEN. Approximately one-third, but that is not all that is in the Nye bill. The bill states this: That if the taxpayer has already recovered his base, no depletion is allowable.

Mr. BROWN. There is the other side of the picture that I was going to take up. But we are dealing in a large number of cases with taxpayers who have recovered their cost on March 1, 1913, value and have continued to get this deduction. The net result is that they are given an indirect subsidy to that extent.

Senator BAILEY. As I understand the situation, if you charge up so much of the value, you have used a certain amount of capital and it has gone forth. That is not income. It never was income. A man is entitled to an income to pay taxes only on the income and not anything upon his capital.

Mr. BROWN. It may be that he bought the property—

Senator BAILEY. It may have cost him 5 cents.

Mr. BROWN. As Mr. Chesteen says, if you adopt that philosophy that may be so, but I believe if a man pays a hundred thousand dollars for a property and if we permit him to recover that \$100,000, it is a question whether we should permit him deductions in excess of \$100,000, because in such a case you are not only giving him his original capital, but something else.

Mr. CHESTEEN. We have gone over all of this ground several years ago, in which the question was threshed out. We found that there were several economic reasons why they should deduct depletion. These rates are in the present law as the result of studies made in the Treasury Department and by the joint committee. Whether or not you think these rates are too high is a question for you to determine, but it seems to me this bill is not the place to begin revision.

Mr. BROWN. If you have correctly estimated the entire ore body, you can recover the exact amount or approximately that amount by allowing a percentage for depletion over the entire area. In such a case the percentage depletion would recover your capital. There are, of course, inaccuracies in an estimate of that kind, because you do not know how much ore is in the ground.

Senator CONNALLY. Here is a manufacturing plant. You allow those people depletions to maintain their obsolescent machinery and all of that.

Senator LA FOLLETTE. We have been too lenient with them. I can take you out to plants where they have depleted their machinery and they are still operating their machinery.

Senator CONNALLY. If they had an actual depletion, so that it worked physically just as good as when it started, that would be one thing. Most of these properties have experts, and we do not know how far those men are going to go, or how long this property will last.

Senator LA FOLLETTE. But by the time they have got back their part of it, why should they have any part of it left?

Mr. CHESTEEN. If you have an oil well, that is your capital.

Senator CONNALLY. I suggested that a few minutes ago. If you go along with a manufacturing concern, the physical property is worth dollar for dollar.

Senator BAILEY. My difficulty is that the income, first of all, is in the nature of the net results—

Senator LA FOLLETTE (interposing). I am not talking about the provisions of this bill. I am talking about the provisions of the existing law.

Senator CONNALLY. The proposition here is whether we shall keep the provisions of the existing law in this bill.

Mr. BROWN. The Nye bill says that no amount recovered shall exceed 100 percent. As I say, I am not trying to delay the passage of this bill by raising any controversial matters. The committee did give a good deal of consideration to the problem and the Treasury staff did present some views similar to those I have presented here.

Senator CONNALLY. Senator La Follette has to go.

Mr. CHESTEEN. I assume that if we adopt the present law as to the basis of the tax and later the present law should be changed, that this bill should be changed and brought up to date so that in the future we should have a rule for depletion the same in peace as in war. If we adopt another rule for peacetime, it would be a very easy matter for you to change it in wartime by amendment. I am assuming that you are trying to adopt a rule as impartial in wartime as in peacetime. The industries came in during the last war and contended that the Congress should adopt a far more favorable policy for wartime, and I am assuming that you should not adopt a less favorable provision in wartime than in peacetime.

Senator BAILEY. Suppose I own 10,000 acres of land, and then I am only allowed 9 percent of my own profits. Do you think for one minute I would let any man cut it? So I think that this section is wrong.

Mr. CHESTEEN. I do not know whether you would adopt any other policy in wartime than in time of peace.

Mr. BROWN. I am trying to present my views, but I do not want to substitute my views for those of the committee.

Senator CONNALLY. Go right ahead.

Mr. BROWN. There are one or two other problems which I believe are noncontroversial problems. The next provision, Senator, is sec-

tion 166. That appears on page 136. The Nye people have written a special provision here which departs very much from existing law.

Senator CONNALLY. Why should that be treated any differently in time of war than in time of peace?

Mr. BROWN. I did not suggest that. I suggest we retain the existing provision of law.

Senator CONNALLY. What are your views as to that?

Mr. CHESTEEN. I agree with Mr. Brown.

(The motion was put and carried to retain the existing law.)

Mr. BROWN. The next section is section 145, which deals with penalties. That is on page 124. The Committee on Military Affairs made two changes in this subdivision. Lines 12 to 17, page 124, having to do with persons attempting to evade or defeat any tax imposed by this title, and so forth, are stricken out. Lines 17 to 23 are added by the Committee on Military Affairs, the important change being that the penalty which may be imposed is increased from \$10,000 to \$100,000.

Senator CONNALLY. Was this bill referred to the Committee on Military Affairs as to the industrial sections?

Mr. BROWN. This bill was first referred to the Munitions Committee, which struck out all but the enacting clause and substituted a new bill, and then the bill was referred to the Committee on Military Affairs.

Senator CONNALLY. Only as to its industrial sections?

Mr. BROWN. They did not confine their amendment to the industrial titles. As I say, lines 17 to 23 are added by the Committee on Military Affairs, the important change being that the penalty which may be imposed is increased from \$10,000 to \$100,000. Now, the question there is as to the amount of the penalty.

Senator CONNALLY. What is the present law?

Mr. CHESTEEN. \$10,000.

Mr. BROWN. I would like to introduce Mr. Joy of the general counsel's office, who is, I think, better qualified to speak on this matter.

Senator CONNALLY. All right.

Mr. RAYMOND L. JOY. The existing law provides in section 145 of the 1934 act—section 145 (a) covers misdemeanors and provides substantially as stated in paragraph 145 (a) of the Nye bill, and provides for a penalty of not to exceed \$10,000 or imprisonment of not to exceed 1 year, or both, together with the cost of prosecution.

(b) of section 145 of the 1934 act covers penalties for the willful refusal or failure to collect, account for, or pay over taxes, and for willful attempts in any manner to evade or defeat any tax imposed, and provides a penalty of not more than \$10,000 or imprisonment for not more than 5 years, or both.

Senator CONNALLY. Which are substantially as they are in the old law?

Mr. JOY. Except that the fine is increased in both instances to this \$100,000.

Senator CONNALLY. This was done by the Committee on Military Affairs?

Mr. JOY. Yes. That is correct.

Senator BAILEY. That is in the discretion of the judge.

Senator CONNALLY. Yes. It shall be not more than \$100,000.

Mr. JOY. It would seem desirable that the punishment imposed for a particular offense should bear some relation to the seriousness of the offense. While we in the penal division of the general counsel's office may regard tax evasion as a very serious crime, it is a fact that the public generally does not regard it as such, with reference to other crimes which are inserted in this bill. There are many quite flagrant cases referred to the courts where, under the existing law, the fines may be very light. I recall one particular case where the taxpayer involved was a bootlegger, who was an evader of a very large amount of taxes; he was found guilty and fined \$5. In other instances where the offense for which the taxpayer may be indicted is a felony and the felony provision of section 145 is invoked, there is a tendency to let the taxpayer, especially if he is a reputable citizen in the community, plead guilty to the misdemeanor and not have to stand trial.

Senator CONNALLY. What do you suggest?

Mr. JOY. It is my own idea that the insertion of so large an amount, so large a fine as \$100,000 would have a tendency to create a public antagonism against tax prosecutions.

Senator BAILEY. It is in the discretion of the court.

Mr. JOY. The present fine of \$10,000 is much more than the court will ordinarily impose.

Senator BAILEY. But it is in the discretion of the judge.

Senator CONNALLY. Yes. Your suggestion is that the present law should be retained?

Mr. JOY. That would be my recommendation—that the present law should stand.

Senator CONNALLY. Senator Bailey, the Military Affairs Committee amendment is that the fine shall be not more than \$100,000.

Senator BAILEY. Yes. I do not object to that \$100,000. That is all right. The judge can settle that.

Senator CONNALLY (reading):

Shall be fined not more than \$100,000—

Fine and imprisonment. There is no discretion there.

Mr. JOY. That is new. That is not in the existing law.

Senator CONNALLY. They strike out that three times. That has been stricken from the bill.

Senator BAILEY. The failure to collect the tax at the source; what does that refer to?

Mr. JOY. In some cases persons prosecuted under (b) would not be the taxpayer, would not be the man who evaded the tax, but the man who made out the return. I call your attention to the effect of that later part, "and shall be liable to a penalty of three times the amount of such tax withheld or evaded." That is mandatory on the court, and the rate of taxes in this class would make that very large.

Senator BAILEY. That is all right. Where a man willfully undertakes to defraud the Government of taxes, he ought to be made to pay a great many thousand dollars.

Senator CONNALLY. The Military Affairs Committee has stricken that out and left it to the court. Suppose we vote on this now? Do you want to adopt that?

Senator BAILEY. I am perfectly willing to restore it.



**Mr. CHESTEEN.** Under (a) these may be misdemeanors. Last year the subcommittee of the House undertook a study of this question, and one of the questions was the question of penalties. It is my recollection that the position of the Commissioner of Internal Revenue was that the penalties were very severe. The subcommittee did not undertake revision, because other questions prevented completion of their study. In view of that background I would hesitate to say that penalties of this kind should be increased.

**Senator CONNALLY.** I think we should defer a vote on this until Monday.

**Mr. Joy.** I should say that there is reasonable probability that there may be some proposed amendments to this. This is only a part of the existing law with reference to these penalties. Section 1114 of the 1926 act covers not only the three subparagraphs of section 145, but also provides for the punishment of persons who aid or assist taxpayers in the evasion of tax payments.

**Senator BAILEY.** Of course, you should do that, because there are persons who do that.

**Mr. Joy.** In that provision the amount of fines is retained at \$10,000, without the provision for three times the amount evaded, because in many cases the person will not owe any amount at all. In most instances, of course, the person does owe the amount.

**Senator CONNALLY.** Is there anything further on this section?

**Senator BAILEY.** You have got your definition of the word "person" there. I believe that should contain some phrase to include an attorney at law or accountant or other person of that character.

**Senator CONNALLY.** Perhaps you should look into that, both of you.

**Mr. Brown.** That covers the provisions of the 1934 act. There is under consideration, at the present time, a proposed amendment of existing law with respect to the requirement for an oath, so that, with respect to individual returns, the taxpayer, if he declares that he makes it subject to the penalties of perjury, will not have to swear to it at all, and that is in accordance with the existing law in the State of Massachusetts, and somewhat along the lines of a bill introduced by Senator Walsh; and the Treasury, I believe, has suggested some amendment to his bill.

**Senator BAILEY.** If he did not know much about it and he just signed it, and then the man who made it up ought to be indicted, and the man who signed it, no matter how much he didn't understand it, ought to be. Then he could explain to the court how he signed it, not understanding it, when it was intended for him.

**Mr. Brown.** This proposal was to do away with the requirement of the oath on the income-tax returns, and will require them, under the penalties of perjury, to sign their names; so that, in order to prosecute successfully for perjury, you will not have to prove that they actually swore to them.

**Senator BAILEY.** Couldn't you put it this way—that if the completed return was not done in accordance with the form required, then the person signing it did it with intent to defraud? We have a very notable case along that line.

**Mr. Brown.** The present provision of the Criminal Code, with respect to notaries is not very strict, and there is nothing we can do

to a notary for putting his or her seal on a document in swearing a person.

Senator BAILEY. I make up my return, and he takes it to some other person—

Senator CONNALLY (interposing). This is off the record.

(Discussion occurred off the record.)

Senator CONNALLY. If it is desirable, we will defer voting on this until Monday. What other matter have you to bring up?

Mr. BROWN. Section 272, which is on page 164 of the bill. The only question I raise now is whether the Commissioner should be required in all cases to collect the additional tax on notice of the deficiency. That brings up the general problem of whether taxpayers, when they are advised of an additional tax, shall have a right, as they have today, to petition the Board of Tax Appeals without the filing of any bond or other security pending the decision of the Board of Tax Appeals.

It is my personal view that the taxpayer, if he should have any additional assessment, should pay it and sue to get it back. Certainly we should not do, as we do today, permit an appeal to the Board of Tax Appeals without posting any bond whatsoever. We find that in a great many cases, after the decision of the Board of Tax Appeals, that the taxpayer is unable to pay.

Senator BAILEY. Then your suggestion is that we require a bond?

Mr. BROWN. My suggestion is that in wartime we might consider the desirability of the taxpayer paying the tax and asserting his right to get it back.

Senator BAILEY. That is a case where the taxpayer pays \$1,000 and the Commissioner of Internal Revenue finds that he owes \$2,000?

Mr. BROWN. That is the case exactly, and I suggest that he pay the additional \$1,000.

Senator CONNALLY. Doesn't the Bureau also, unless you raise assessments, make it large enough to cover any possibility, and makes it a hardship on the taxpayer if he has to pay in cash the assessments the Commissioner should levy and then go to court to get it back?

Mr. BROWN. I think that practice in the Bureau is to some extent influenced by the fact that he does not have to pay at once, and he does not have to file a bond. In other words, it does not make very much difference what we claim.

Senator CONNALLY. That is true under the present law, but in wartime it might work a hardship on him.

Mr. BROWN. Yes. It would have a sobering effect on the Bureau officials.

Senator BAILEY. What I wish to present is the arbitrary method of assessment of a man who cannot pay and then arbitrarily preventing him from putting his defense up in the district court in his prosecution by the Government.

Mr. BROWN. Today you can pay the tax and then sue in the district court to recover, or in the Court of Claims, or you can file a petition with the Board of Tax Appeals and stay the proceedings.

Of course, today the taxpayer, if he chooses to go before the district court—if he thinks that is a more favorable forum—he can pay his tax and bring his suit there or in the Court of Claims. But the great majority prefer to delay payment of the tax.

Senator BAILEY. He must appeal to the circuit court? Is that the present procedure?

Mr. BROWN. He can do that.

Senator BAILEY. I would not like to cut a man off of his right to sue just on the ground that he is too poor to give a bond; and whenever you give him this assessment you diminish his right to give a bond.

Mr. BROWN. Then your suggestion is that some provision should be made there.

Senator BAILEY. No. I think that language is too short, inasmuch as you do not say how the assessment should be made. My recollection is that it is a lien against the taxpayer; and when you file your lien, to make it legal against third parties, you must make a record of it in the county in which the property is.

Mr. BROWN. Yes. I do not quite understand your suggestion. If the suggestion is that upon the deficiency notice there is a prima-facie case—

Senator BAILEY (interposing). That is the rule now. You go into a court, and the moment the assessment is shown to the court, the burden shifts to the taxpayer to show that the assessment is not correct.

Mr. BROWN. Yes; but that is a different matter.

Senator BAILEY. If he has no property and can give a bond, that is one thing; but if he has neither property nor capacity to give a bond, he should have a right to prosecute his claim.

Mr. BROWN. In the last war, Senator, the taxpayer was required to pay this additional tax, but he could file a claim in abatement and in that way stay collections? The result was that a large number of claims were stayed in that way.

Senator BAILEY. That is the reason I made that statement. I handled a large number of claims. We had a very fine judge down in our district, and he was a very nice and a very just man. That is the reason I make my suggestion. I am talking about the fellow who cannot give a bond.

Senator CONNALLY. Under the present law, if there is a deficiency notice and he does not go to the collector, do you go out there and levy on his property? You do not bring any suit?

Mr. BROWN. It is not necessary. You can do so.

Senator CONNALLY. If you brought a suit could you set up defenses in that suit?

Mr. BROWN. Yes, sir.

Senator CONNALLY. How would it do to provide that the taxpayer, in event of a deficiency, may file a petition with the Board of Tax Appeals upon the filing of a bond? Make that a condition to his doing so?

Mr. BROWN. That would be satisfactory to the Bureau. I do not know whether that would be satisfactory to Senator Bailey.

Senator CONNALLY. If he has property the chances are that he can make a bond. If he has not any property it does not make any difference one way or the other. What do you think, Senator Bailey?

Senator BAILEY. Let him go into court and make it a condition precedent.

Senator CONNALLY. That he either give bond or make sufficient proof of his inability to do so?

Senator BAILEY. Yes; and file it individually.

Senator CONNALLY. Let the court determine of his inability to give a bond? I think he ought to have a hearing. I do not think that this Government ought to authoritatively say "he owes that money", and we go out and take his property away from him. The man that is able to give a bond ought to give a bond, or make a showing to the court that he is unable to do so. If he cannot give a bond and convinces the court of his inability to give a bond, he has not any recourse. Is that unreasonable?

Mr. BROWN. I do not think that is wholly unreasonable.

Senator CONNALLY. Does that take away his right?

Senator BAILEY. No. I have heard of cases where the Treasury Department has thrown men into bankruptcy and destroyed them, and they could not put up the bond and the only thing they could do was to take refuge in bankruptcy, and while we had several of these cases and tried them in the district court, the district court said there was no liability whatever, but those people ruined him and there was no liability.

Mr. BROWN. But the other side of the picture is where the United States has been deprived of its just revenue and no security was required.

Senator CONNALLY. Or where the property was dissipated.

Mr. BROWN. Yes, sir.

Senator BAILEY. I am looking at both sides. We can never pursue the policy of ruining a man just because he is broke.

Mr. BROWN. I meant no criticism at all, but in these illustrations we must not lose sight of the fact that the Government in the majority of cases is in the right and is actually losing a large amount of revenue.

Speaking of Senator Connally's suggestion, I think we could probably go along with that view very readily, except that I should point out that you may, in a great many cases, have two trials. You may have a trial on how much he is worth and another on the merits.

Senator CONNALLY. That comes up in court many times.

Mr. BROWN. It is your thought to have the Board of Tax Appeals decide?

Senator CONNALLY. Yes. Make it his business to file his petition with the Board of Tax Appeals that he could not give a bond, and in that event that he may file a petition with the Board of Tax Appeals.

Mr. BROWN. He does not come personally before the Board?

Senator CONNALLY. He would.

Mr. BROWN. In effect he would have to take the pauper's oath?

Senator CONNALLY. Yes. That is right.

Mr. CHESTEEN. My thought is, we have a peacetime method of collecting taxes. There are just two factors that differ in wartime. One is the need of the Government in time of war for revenue. On the other hand, you have a taxpayer whose individual welfare should be considered. You are providing in this bill very high rates of taxation. I have no doubt that the Commissioner is going to have a very hard time in collecting the taxes; he is going to create hardship in getting the money. Are you going out and collect a tax as high as 90 percent, when the taxpayer has probably been thrown into bankruptcy? I think that is the problem before you, whether with these

high rates you are going to take the tax first and let the taxpayer try to get it back afterward.

But I approach it from another viewpoint, that the taxpayer is going to make an honest return, and while there is an urgent need for revenue, that is so in peacetimes. If the present policy of appeals to the Board of Tax Appeals is advisable for peacetime, then I should say the same policy should apply in time of war.

Senator BAILEY. Your suggestion is that we let it stay like it is at the present time?

Mr. CHESTEEN. Yes.

Senator BAILEY. I am agreeable to that.

Mr. CHESTEEN. I am not commenting on the present situation at all. It may be that the present situation is not the best at the present time.

Mr. BROWN. The view which I have been trying to present may perhaps be made a little clearer by reference to our experience. Our tax laws are technical and at times the administration of them has been technical. This situation is oftentimes justified by the Tax Administration on the ground that the taxpayer is prone to take advantage of technicalities. It is difficult to say which came first. While I have a high regard for the honesty of the average taxpayer, nevertheless it is often the case that the relation of the Government with the taxpayer is viewed as something of a sporting event. While there is no desire to be harsh, still for purposes of wartime taxation I feel that every effort must be made to protect the revenue. If you run the rates up to a very high point and fail to provide for a bond pending appeal, the temptation of the taxpayer in filing his return to err in his own favor will be very great.

Senator CONNALLY. On the other hand, the higher the rate the harder is the collection of those rates. My thought is that the higher the rate and the greater the hardship on the taxpayer, ought to restrain the Government in the collection of it. In peace-time you treat him better. You give him a chance, but when the rate is so high you make him discouraged.

Mr. BROWN. Theoretically, I see much to be said for providing some relief where a man proves he cannot supply a bond, or in the case of very poor taxpayers.

Senator BAILEY. I want to get this straight. Suppose that the Commissioner files a petition and sends out an assessor to collect. That is an assessment?

Mr. BROWN. He cannot do that. He has to send a notice of that deficiency and let the taxpayer appeal to the Tax Board except in the case of jeopardy assessments.

Senator BAILEY. Then we should change the law so that the Commissioner could send down to the taxpayer. Then you have a right to lay your hands on the property.

Mr. BROWN. I appreciate that I am suggesting changes in existing law, but several of these items appeared to be so vitally associated with the collection of revenue as to justify me in bringing them to your attention. If it is desired to follow the rule of making no change in the present law, then, of course, our problem is much simplified.

Senator BAILEY. I had rather do that.

Senator CONNALLY. So we will pass on it on Monday. We will pass section 272 until Monday.

Mr. BROWN. Sections 292, 294, and 295. The question raised there is as to the rate of interest to be allowed on deficiencies.

Senator CONNALLY. What is it under existing law?

Mr. BROWN. Under existing law the rate is 6 percent.

Senator CONNALLY. You want to make it 1 percent a month?

Mr. BROWN. No.

Senator CONNALLY. The Army did that.

Mr. BROWN. Yes. Under the War Revenue Acts of 1917 and 1918 the rate was 6 percent.

Senator CONNALLY. I move to put it back to 6. What do you say?

Senator BAILEY. All right.

Mr. BROWN. Section 322 (b) (3)—that is on page 186—the interest on credit or refunds is at 6 percent. The Nye bill provides for 3 percent. It is a question of policy.

Mr. CHESTEEN. I think we had a change a few years ago. It was unsatisfactory to the public, and the Congress changed it to 6.

Senator CONNALLY. On the theory that it was 6 percent and that is what it should be?

Mr. CHESTEEN. That is right.

Senator CONNALLY. Of course, the Government can borrow money at less rate of interest than that.

Mr. BROWN. I am content to have it remain at 6.

Senator BAILEY. What do you say?

Mr. BROWN. We are paying 6 percent.

Senator BAILEY. I should say it would be equal to the rate he would be entitled to. Let us put it at 4 percent.

Senator CONNALLY. Do you think we will run into any difficulty?

Mr. CHESTEEN. We had some difficulties before and Congress, as you know, changed it back to 6.

Senator BAILEY. What Congress was that?

Mr. CHESTEEN. I think 1934. The change was first made in 1934, and back to 6 percent in 1935.

Mr. BROWN. I have no other questions. I do not know whether the committee wishes to decide this question in respect to the use of the House bill.

(After discussion off the record, at 5:15 p. m., the subcommittee adjourned to meet at 2 p. m. on Tuesday, Apr. 28, 1936.)

## TO PREVENT PROFITEERING IN WAR

TUESDAY, APRIL 28, 1936

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

The subcommittee met, pursuant to call, at 2 p. m., in the District Committee room in the Capitol Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Bailey, and La Follette.

Also present: G. D. Chesteen, Ralph W. Brown, and J. S. Zucker.

Senator CONNALLY. The committee will come to order. The matters that we wanted to examine today were largely the suggestion that we take out of the pending tax bill the new plan and put it in this bill and then relate the corporation rate as nearly as possible to the individual income taxes. Are you prepared to discuss that, Mr. Brown?

Mr. BROWN. Well, only in a very general way. It was my thought that the committee would want to consider the problem of the relationship of the corporate rates to the individual rates, adopting, perhaps, in principle, the same interrelation that we have in the pending peace-bill clause.

Senator CONNALLY. Yes; we do. What we need is a rate on corporations that will bear a proper relationship to the increased income-tax rates. That is right, is it not, Senator?

Senator LA FOLLETTE. Yes, sir.

Mr. BROWN. At the present time where you run up the individual rates to a very high point—in the existing law, the surtax rates run now to 75 percent plus 4 percent normal tax, or a total of 79 percent—and provide a maximum corporation rate of only 15 percent, you have a situation which invites trouble.

To use as an illustration of physics, you have got a potential there causing an incentive to retain earnings in the corporation, because immediately they get out of the corporation and are distributed in the various income-tax classes, they become subject to the graduated surtax rates.

Senator CONNALLY. Let me ask you this: Suppose we vote this afternoon and say the schedules carry the same relative rates on corporations as these rates which we have already gotten from individual income, could you do that?

Mr. BROWN. I could not, Senator, because I am not qualified.

Senator CONNALLY. I mean could the Joint Committee on Taxation do that? That is what we want done. If that can be done, there

is no occasion for us to be talking about it 2 or 3 days. Just go on and do it, if it is practical to be done.

**Mr. BROWN.** I think it is practical all right to accept that general thesis, but whether you want to do it without some preliminary discussion on the subject I do not know. On behalf of the Treasury, of course, I am looking to the committee to indicate the policy, because whatever schedule of rates may be determined by the committee the Treasury will be glad to estimate the probable yield and probable effect. It will also be glad to convert the rate schedule into the necessary percentage schedule which has been set up as an alternative method in the peacetime bill.

**Senator LA FOLLETTE.** It is important in another way. When this new tax plan for corporations was devised, as I understand it, an effort was made to fix the rate on retention of undistributed profits at such a scale, or such a schedule that so far as the Treasury was concerned it would get the same amount, or practically the same amount of revenue, regardless of whether the corporation elected to retain or whether it elected to distribute.

**Mr. BROWN.** That is my understanding.

**Senator LA FOLLETTE.** That is my understanding of it. All right. Now, cannot that same thing be done so far as these rates that we have arrived at for individual incomes in this war-tax program are concerned?

**Mr. BROWN.** I should think so, Senator. It may take a little time to work it out.

**Senator LA FOLLETTE.** I understand it will take some time. In other words, the higher your individual income-tax rates are the more incentive there is for taxpayers in the upper brackets to use their influence in the policy of corporations to retain profits, because if they are distributed they are going to pay a higher tax than they will pay at the present corporate rates.

**Mr. BROWN.** That is correct.

**Senator LA FOLLETTE.** That is my understanding. The theory of the new bill is you are going to plug up what might almost be called a loophole, or at least a device for lowering the taxes by fixing a tax on corporations which will result in their paying approximately the same amount of revenue to the Treasury, whether they are retained or whether they are distributed. Now, if it is possible to do that with the existing individual income-tax schedules, I cannot see why there is any insurmountable problem presented so far as the schedules that have been tentatively agreed to by this subcommittee for individual rates are concerned, and if there are any obstacles I would like to have somebody speak up and say what they are.

**Mr. BROWN.** Is it the thought of the committee that you would have three rate schedules as much along the plan of the pending bill as possible? As you recall, there are two main rate schedules, one applicable to corporations, with net incomes of \$10,000 or under, and then there is a schedule applicable to corporations with incomes in excess of that figure. And in order to make a proper adjustment between the first and the second schedule, so that an increase of \$1



in income will not result in a disproportionate increase in tax, they provided a third schedule for bridging that gap.

Senator LA FOLLETTE. Theoretically it seems to me perfectly sound, but as a practical matter it complicates the appearance of this pending tax bill a tremendous amount.

Mr. BROWN. I think it is largely a matter of appearance.

Senator LA FOLLETTE. I think it is, too.

Senator CONNALLY. Could not you devise one plan and get rid of the three?

Mr. BROWN. I should think so, unless it is the opinion of the committee that some special provision should be made for corporations in the lower income-tax groups.

Senator CONNALLY. What is your view, Senator La Follette, on that?

Senator LA FOLLETTE. Well, as I say, I think perhaps in theory it sounds perfectly all right, but it seems to me that they have complicated the pending bill a good deal in order to serve that theoretical end, and I am doubtful whether the benefits that are going to flow from that are going to be worth the complication that they have indulged in.

Senator CONNALLY. I would very much prefer one flat plan if we could get it to apply to all corporations. This is a war bill; it is not a permanent piece of legislation.

Mr. RICE. Senator, in that connection, it might take a little longer to work that out. It would be a deviation from this bill which you already have.

Senator CONNALLY. It would take longer to work that out?

Mr. RICE. That is my thought. How about that, Mr. Brown?

Mr. BROWN. From the point of view of the Treasury actuaries one schedule is easier for them to work on than three schedules, and of course you will appreciate that the actuarial work is a larger burden than would appear to a person like myself who has not had much experience with actuarial work. In other words, it is a considerable job to work it out, but that is purely a matter of delay for a few days, that is all.

If the committee will indicate the general character of the rate schedule that it has in mind then we can very easily do the rest, and we will get to work at once on it.

Senator CONNALLY. Mr. Chesteen, can you advise anything?

Mr. CHESTEEN. We have given some thought to the question since yesterday afternoon when I talked to you and have prepared a rough draft of two possible schedules. We did this merely to supplement what the Treasury had to say with relation to the schedule today. I have assumed all the while that the Treasury would have something on rates to submit to you, and what we were preparing would merely throw some light on the rates and schedules.

We approach this subject from this viewpoint, that it is desirable to just have one schedule in the war-time bill instead of two schedules and four computations, as we have in the present bill, and these

schedules and rates that we have prepared are based on only one schedule for all corporations, whether small or large.

(Mr. Chesten submitted the following rates and schedules:)

### II. R. 5520, CORPORATION TAX

#### PROPOSAL NO. 1

If there is no undistributed income, there shall be no tax on the adjusted net income.

If the undistributed net income is 10 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 5 percent.

If the undistributed net income is 15 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 10 percent.

If the undistributed net income is 20 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 20 percent.

If the undistributed net income is 25 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 30 percent.

If the undistributed net income is 30 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 40 percent.

If the undistributed net income is 35 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 50 percent.

If the undistributed net income is 40 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 60 percent.

#### PROPOSAL NO. 2

If there is no undistributed net income, there shall be no tax on the adjusted net income.

If the undistributed net income is 5 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 30 percent.

If the undistributed net income is 10 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 37.5 percent.

If the undistributed net income is 15 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 47.5 percent.

If the undistributed net income is 20 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 60 percent.

If the undistributed net income is 25 percent of the adjusted net income, the rate of tax on the adjusted net income shall be 75 percent.

### II. R. 5520—Schedule showing effect of the several rates of tax on adjusted net income of \$100,000

Undistributed amount retained	Amount of tax	Amount distributed	Total adjusted net income	Undistributed amount retained	Amount of tax	Amount distributed	Total adjusted net income
Proposal no. 1:				Proposal no. 2:			
\$10,000.....	\$5,000	\$85,000	\$100,000	\$5,000.....	\$30,000	\$65,000	\$100,000
\$15,000.....	10,000	75,000	100,000	\$10,000.....	37,500	52,500	100,000
\$20,000.....	20,000	60,000	100,000	\$15,000.....	47,500	37,500	100,000
\$25,000.....	30,000	45,000	100,000	\$20,000.....	60,000	20,000	100,000
\$30,000.....	40,000	30,000	100,000	\$25,000.....	75,000	None	100,000
\$35,000.....	50,000	15,000	100,000				
\$40,000.....	60,000	None	100,000				

**II. R. 5529, SCHEDULE OF CORPORATION RATES BASED UPON UNDISTRIBUTED NET INCOME**

**PROPOSAL NO. 1**

If the undistributed net income is a percentage of the adjusted net income as shown in column 1, then the rate of tax on the adjusted net income shall be the percentage of the adjusted net income as shown in column 2.

Column 1	Column 2	Column 1	Column 2
<i>Percent</i>	<i>Percent</i>	<i>Percent</i>	<i>Percent</i>
0	0.0	21	22.0
1	.5	22	24.0
2	1.0	23	26.0
3	1.5	24	28.0
4	2.0	25	30.0
5	2.5	26	32.0
6	3.0	27	34.0
7	3.5	28	36.0
8	4.0	29	38.0
9	4.5	30	40.0
10	5.0	31	42.0
11	6.0	32	44.0
12	7.0	33	46.0
13	8.0	34	48.0
14	9.0	35	50.0
15	10.0	36	52.0
16	12.0	37	54.0
17	14.0	38	56.0
18	16.0	39	58.0
19	18.0	40	60.0
20	20.0		

**II. R. 5529, SCHEDULE OF CORPORATION RATES BASED UPON UNDISTRIBUTED NET INCOME**

**PROPOSAL NO. 2**

If the undistributed net income is a percentage of the adjusted net income as shown in column 1, then the rate of tax on the adjusted net income shall be the percentage of the adjusted net income as shown in column 2.

Column 1	Column 2	Column 1	Column 2
<i>Percent</i>	<i>Percent</i>	<i>Percent</i>	<i>Percent</i>
0	0.0	13	43.5
1	6.0	14	45.5
2	12.0	15	47.5
3	18.0	16	50.0
4	24.0	17	52.5
5	30.0	18	55.0
6	31.5	19	57.5
7	33.0	20	60.0
8	34.5	21	63.0
9	36.0	22	66.0
10	37.5	23	69.0
11	39.5	24	72.0
12	41.5	25	75.0

Mr. CHESTEEN. Now we had thought of the possibility of giving some relief to smaller corporations. We had thought of one plan, that you might do that by a small exemption, that you might grant them \$1,000 or \$2,000 deduction, as we did once in the individual-income-tax laws, if you want to grant any special consideration to corporations below \$10,000.

The present bill has one schedule for corporations of \$10,000 or less. It occurred to us that if you want to grant any special relief to those corporations you can do it by one deduction of whatever amount you thought was necessary.

Mr. ZUCKER will explain these schedules as far as we have gone about the study of the plan, and tell you what we have done to relate these rates to the rates that you adopted on individuals. There are two plans. You notice that plan no. 1 runs up to 60 percent and plan no. 2 runs up to 75 percent.

Senator CONNALLY. Do you feel that these bear a fair relationship to the individual returns?

Mr. ZUCKER. We started with the report of the subcommittee of the Ways and Means Committee, in which, under schedules 1 and 2, there are listed minimum and maximum rates from which ultimately the actuarial tables were computed that appear in the proposed bill, H. R. 12395. Under our proposal 1, which is shown in this exhibit, the maximum rate which we used was 60 percent. That 60 percent is comparable to the 42.5 percent in schedule 2 shown in the Ways and Means Subcommittee report, and the increase is reasonably comparable to the difference in the maximum surtax rates under the existing bill, which is 75 percent, and the 80 percent surtax plus the 10 percent normal tax under the proposed war-profits tax bill. The effect of our set-up of rates is shown on page 2 of this exhibit, under proposal 1.

Senator CONNALLY. Column 1?

Mr. ZUCKER. The schedules reflect applicable rates based on percentages retained, but not for all brackets, because that would require some actuarial computations to get at the effective rate applicable to the odd amounts.

Now it was readily realized, as soon as we constructed this, that there is one wide divergence between an attempt to parallel the war profits corporation rate to the individual surtax rates as against the peace-time rates, because the maximum is reached in the ordinary surtax rates at \$1,000,000, while for the purpose of the war-profits bill it has been voted that the maximum start at \$50,000.

To convey the effect of a persuasive tax, encouraging distributions by corporations, we had to adjust the rates further, so that corporations will not retain their income but will distribute it to stockholders whose income may be subject to surtaxes at the \$50,000 level and over, and that is the reason for proposal no. 2.

Proposal no. 2 is very tentative. It is merely a suggestion. We did not work out all the computations in order to scientifically establish that this is truly and fully comparable. That will have to be done by weighted averages. We decided upon a maximum rate of 75 percent to take care of and to parallel the individual surtax rate on the war-profits bill at 80 percent, beginning at income of \$50,000 and over, and also the 10 percent normal tax.

Another reason why we took the figure we did here is because from what has been presented over at the House, and also before the Senate Finance Committee, the reserves which it has been found corporations maintain in peacetimes, that is, the amounts which they use for plant extension and for general working capital operations, have approximated about 30 percent per annum over the past 10-year period. We thought in wartimes, if we say a corporation can be permitted, as may be seen under proposal 2, to retain 25 percent of its income, that will constitute a sufficient cushion to maintain itself through the various Government revolving funds for plant extension and war facilities. If corporations see fit not to keep 25 percent, which they could do under this plan, if they keep less and distribute more the rates will be less. Of course, we then get the excess from the individuals through the surtax brackets.

The computations which are shown on page 3 are merely the series of intermediary percentages between these basic ones.

Senator CONNALLY. That is on page 3 or 4?

Mr. ZUCKER. Well, whatever way you happen to have them, Senator. It is plan no. 1 and plan no. 2. They are both there.

Senator CONNALLY. Proposal no. 1?

Mr. ZUCKER. Proposal no. 1 and proposal no. 2 convey the same idea, except that they apply to the respective rates as contained in proposal 1 and proposal 2. It just gives you, partly worked out, the application of the effective rate to these various proportions that are retained. These are all worked out on the retained income, the amount which a corporation decides to keep. A corresponding schedule can be worked out from the standpoint of divided credit, but it will give the same result. The adjusted-net income consists of the amount retained, the amount distributed, and the tax. The method here is exactly the method followed in the proposed corporation tax now pending.

Senator CONNALLY. Let me ask you a question here about the difference in proposal no. 1. You say in the first bracket there [reading]:

If the undistributed net income is 10 percent of the adjusted net income the rate of tax on the adjusted net income should be 5 percent.

Now, down here in no. 2 you say the same thing, but you say [reading]:

If it is 5 percent of the adjusted net income the rate of tax on the adjusted net income shall be 30 percent.

Why is there that wide divergence between the two?

Mr. ZUCKER. The difference between these two was necessary because under proposal no. 2 we attempted to give due recognition to the fact that under the rate which the subcommittee has decided for individuals, the maximum rate will apply at \$50,000, and so we had to step up these rates so that corporations will not find it expedient in war times to retain the profits rather than distribute them.

Senator CONNALLY. I see.

Mr. ZUCKER. Under proposal no. 1, there is an attempt merely to parallel the rates. In the one case it is 80 percent surtax and 10 percent normal, which is the war-profits bill, and in the other case it is 75 percent surtax and 4 percent normal, or 79 percent. That is

why there is not so much discrepancy there, because we merely take the maximum rates. In proposal no. 2 we try to take in the other qualifying factors, the points at which the maximum rates begin.

Then another reason for that, Senator Connally, is that if you will notice, we had to adjust the rates that if it were plotted on a curve—or, for example, assuming, as these examples show, an adjusted net income of \$100,000, under proposal no. 2 if a corporation decides to retain and not distribute \$5,000 it will have to give the Government \$7,500. If it decides to keep another \$5,000, to do so it will have to give the Government \$10,000 in taxes. Thirdly, if it decides to keep another \$5,000 it will have to give the Government \$12,500, and lastly, if it decides to keep another \$5,000 up to the \$25,000, it will have to give the Government \$15,000, and thus the incentive to retain is lessened.

We took that to be the plan of the administration in the proposed bill, and these efforts of ours are merely an attempt to carry out those same objectives. You may recall we had suggested for your consideration an entirely different set-up to this, which is in the record, that is a flat tax against all corporations, then a retention of an amount which we may call necessary reserves, and then finally a tax running possibly as high as 75 percent on the remainder. Mr. Brown, in his statements concerning it, however, suggested that we adhere to the principles in the pending corporation tax bill, so we strived here merely to adjust a typical rate schedule to the idea which was expressed in the administration program.

Senator CONNALLY. Do you think proposal no. 2 would fairly reflect, as to corporations, the same relative rate as carried in the income-tax schedules which we have adopted?

Mr. ZUCKER. I think there is where we need the aid of the Treasury statisticians. For example, Mr. McLeod knows now that the weighted rate against individuals on surtaxes is about 32½ percent. If the Treasury actuaries were given the revised or the present rates as you have voted them to find what the effective or average surtax rate is, then we could use that as a ratio. This was our guess as close as we could make it. The way the comparison has to be done is to get a weighted average of the number of taxpayers in each bracket and the rate applicable to each bracket, and thus obtain an average rate against all taxpayers. Mr. McLeod has done that for the administration bill and probably has the data available from which to make computations for this. Mr. Brown would know better than I would.

Senator CONNALLY. Mr. Brown, how long would it take?

Mr. BROWN. I spoke to Mr. Oliphant yesterday afternoon. He said just as soon as we had an indication of the probable range of these rates that we would get to work on them.

Senator LA FOLLETTE. What I would like to have the Treasury do is to do the same job on these corporation rates that it did on the corporation rate for the pending bill. I am not saying that they wrote the rate.

Mr. BROWN. No.

Senator LA FOLLETTE. But they did advise, I assume, in the Ways and Means Committee, as to what corporate rates were necessary in order to balance this situation insofar as the corporations' undistributed profits were concerned.

Mr. BROWN. That is correct.

Senator LA FOLLETTE. We have adopted certain schedules for wartime individual rates. What I would like the Treasury to do is to take the suggestion, if it has got any amendments or criticisms of it to give it to us and to let us know what they believe or what they would advise this committee, assuming that it wants to strike a balance between the individual rates and the corporate rate, as to what schedule would be necessary or appropriate for that purpose.

Mr. BROWN. The only reason I did not do it, Senator, is because I understood at the last meeting it was contemplated you would refer the bill to the full committee to take care of that phase of it.

Senator LA FOLLETTE. No.

Senator CONNALLY. We have since decided we would do it ourselves, because the committee could then change it if it was not satisfactory.

Mr. CHESTEEN. We thought this would merely provide the basis for study.

Mr. ZUCKER. We have eliminated for purposes of a wartime act the necessity for two sets of schedules, if it meets with the approval of the subcommittee.

Senator LA FOLLETTE. I personally think it is very desirable.

Senator CONNALLY. That is correct.

Mr. ZUCKER. These incomes under \$10,000 will not be treated differently. The effective rate will not be so much, because they will have less income to be taxed. However, if you wish to give small earning corporations some exemption, that can be done, and we can give them a lighter tax load.

Mr. BROWN. My thought was there would be no necessity of doing that in wartime since the war producers could be taken care of either by the revolving fund or by some proper allowance for amortization, whereas the corporations serving the needs of the civilian population would be treated the same as everyone else. They will have to make whatever sacrifices the war called for.

Senator CONNALLY. Let me ask you this: With this kind of a plan, this present plan, and with these kind of rates, would that catch the corporation with a very large rate of income as compared to its capital?

Senator LA FOLLETTE. It has no relation to its capital.

Senator CONNALLY. I know it does not. I am asking what will happen in practice. Suppose here is a war corporation that makes a lot of money, of course it would have a large income. Would these high rates catch it or would they pay no higher rate than another corporation that did not make so much?

Mr. ZUCKER. The rate that they would pay would be no different for the small corporation than it would be for the large corporation. It is all based on the amount they would retain, or the amount that they would distribute. Assume a corporation had made \$100,000,000 during the war in one of the war years, if they decided to retain \$25,000,000 of that \$100,000,000 they would have to give the Government \$75,000,000.

Senator CONNALLY. Suppose they paid it out to the individuals?

Mr. ZUCKER. Suppose they paid it out in dividends?

Senator CONNALLY. Yes.

Mr. ZUCKER. We would get a high surtax from individuals. Senator CONNALLY. Because we would increase their rates we would get it practically all?

Mr. ZUCKER. Yes; but not quite all.

Senator CONNALLY. I have always had a doubt in my own mind as to whether or not we ought to adopt this kind of a system or adopt a flat system with graduated war-profits tax, in other words, excess profits tax to catch these fellows that make a large return on their capital.

Mr. CHESTEEN. That can only be done, you know, by adopting some kind of invested capital scheme. It is inherent in this scheme, or any other income-tax scheme, that you do not give any consideration to the rate of return on capital, simply tax it all at a flat rate.

Mr. ZUCKER. This has a better war effect. That is what we are driving at, because the corporation that will make enormous profits during the war, assuming its capital is large, will have to pay a larger amount on this basis. The Government will take 75 percent and will get more dollars, will get a chance to recapture the war profit without giving such corporations a percentage return on their invested capital.

Senator CONNALLY. That is right.

Mr. ZUCKER. There is one more observation and that probably will be something which Mr. Brown will consider in connection with the suggestion by Senator La Follette, and that is while what we have here is a series of graduated rates, something should be devised to affect the corporations for which the proposed peace-time bill has special rates, certain banking institutions, insurance companies, foreign corporations, and the like. They have been treated at either a 15 percent rate or 22.5 percent rate. We have made no recommendation as yet on that.

Senator LA FOLLETTE. Let us hear from the Treasury on that.

Mr. BROWN. Well, as to the foreign corporations, one of the reasons for the changes suggested in existing law is because of the administrative difficulties in collecting the taxes that now exist, and it was felt that the basic principle ought to be withholding at the source, that we should get the money as it went out and not allow it to go out and then hope we will get it back again.

I think that the set-up of the administration bill in the treatment of nonresident aliens and foreign corporations is one of the most constructive things that has been worked out so far, and I suggest the incorporation of those principles in this war-time bill.

Senator LA FOLLETTE. I agree with that. Perhaps you might have to make the rates a little different. I mean, that is a subject you will have to give consideration to. I think that that is what we really had in mind when we picked up this corporation section of the present bill, that we will also include those. At least that is what I understand.

Mr. BROWN. Well, that is based very largely on taxation at the source, and the rate applicable to income of foreign corporations has been fixed at 22.5 percent, that is those that have a permanent establishment in this country, and the tax is levied on the proportion of income attributable to capital employed in this country.

Now, as to the fixed and determinable periodical income paid from various sources in this country, in the case of foreign corporations, the administration bill provides a tax of 15 percent.



In the case of such income going to nonresident aliens, the tax is 10 percent.

In the case of domestic banks and insurance companies the committee in the House felt that it was not desirable to have the tax schedules I and II apply, inasmuch as it was felt that banks ought to be encouraged to some extent to build up their capital and surplus, and so they are taxed at a flat rate of 15 percent.

As to domestic insurance companies, again, it was felt they ought not be taxed at the graduated rates, and the rate applicable to them is the same as to the banks, 15 percent.

Then there is the case of corporations which have an impaired capital. In the case of those corporations the income, which does not exceed the amount necessary to restore their impaired capital position, is taxed at the rate of 22.5 percent, and the balance is taxed the same as the income of other corporations.

Now, in the case of corporations that by contract are required to put in a sinking fund, or to accumulate earnings to take care of specific situations, and which are prevented from paying any dividends out of their current net earnings, in the case of those corporations a flat tax of 22.5 percent applies.

There is also another provision in the House bill. In the case of a corporation which pays out dividends in excess of adjusted net income, they are allowed a credit carry-over into the next year, and if there still remains a balance they can carry it over into the second year following the taxable year. That takes care of corporations which pay out dividends out of accumulated surpluses. That is an encouragement to them, to distribute accumulated surpluses.

Returning to the question of taxation of banks and insurance companies, that is domestic banks and insurance companies, it would seem to me that the same general principles apply in peacetime as in wartime; on the other hand, it may very well be that the rates applicable should be materially increased. They should not be increased, it seems to me, beyond the point which would imperil their proper management and safety. I am not prepared to suggest what the rate should be, but I shall be glad to look into the matter and to report as soon as I can.

In the case of foreign corporations and nonresident aliens, it seems to me that is very much of a matter of policy for the committee. I do not suppose we want to drive business out of the country. On the other hand, not quite the same conditions will prevail in wartime. I do not suppose, in the case of a major war, with embargoes and blockades, and all the other restrictions on international trade, that markets of this country will be quite so attractive, from an investment standpoint, as they are in peacetime. It may be that our security and commodity exchanges will be closed for periods during the war. That in itself will divert capital from this country, particularly capital that is employed in trading on exchanges.

There is, of course, always a large amount of international capital that drifts from one country to the other, and it would be rather hard to anticipate just what conditions would apply and how it would react in the case of a major war in which we might be engaged. It seems to me that if we place the rate high enough to insure a fair return, considering the burdens that are being carried by our own

citizens and residents, that we probably would have arrived at a reasonable basis for taxation.

As to foreign corporations, or business enterprises having a permanent establishment in this country and carrying on business here essentially as resident corporations or businesses, it seems to me, to the extent of the capital employed in this country and the returns on such capital, they should be treated substantially as our own citizens. That is, the effective rates paid by them should roughly parallel the treatment of domestic corporations and citizens.

That is all I have to say in that respect.

Senator BAILEY. Have you given some thought to the various classes of corporations?

Mr. CHESTEEN. We have given some thought to the various classes of corporations and treated them differently from the ordinary case. So far we are not prepared to make any suggestion about any particular class of corporations. We must realize this, that banks may be in a different position than other corporations. You may not want to treat banks in the same manner as you want to treat certain other classes of corporations, such as corporations with a deficit. You may want to disregard that, however, and treat them in wartime the same as any other class of corporations.

I think these various classes that have been treated differently in the bill will require some special consideration, as to the circumstances which prompted the Ways and Means Committee to classify a particular class differently from the ordinary corporation, because when you come to a war period you are going to adopt a severe schedule of rates. The reasons for excepting any corporation from the schedule of rates ought to be some fact or circumstance that would justify it in time of war, and not some particular condition that might justify its exception at the present time.

Senator BAILEY. Well, you will agree with me we should not predicate legislation on a system of going into war the first effect of which would be to impair the value of the policy holders, or the policies held by insurance companies throughout the country? We are not trying to put penalties upon insurance, what we are trying to do is to take the profit out of war.

Senator CONNALLY. That is our primary purpose.

Senator BAILEY. Well, I think another thing is it is to notify the American people just what war will mean to them. I think this bill has some peace value in it.

Senator LA FOLLETTE. Mr. Brown, I think we have discussed this corporate matter about as far as we can go today, and if the Treasury and joint committee experts will work together or separately and then get together and confer about this, and try to get these rates in with relation to the individual rates that have been agreed to, that we have accomplished about all we can today on this particular phase of it. Now it would seem to me the question of these individual corporations is something you can give further consideration to. When we meet in relation to corporate rates we can discuss the corporations that are given a separate or special treatment in the present pending bill.

Mr. BROWN. It is my thought, Senator, along that line, it would be quite possible for us to go ahead with a substantial part of the draft-

ing of the bill, without a final decision as to the rate, provided the general framework of the bill is as you have indicated today, don't you think so?

Mr. CHESTEEN. Yes.

Senator LA FOLLETTE. If necessary I will make the motion.

Senator CONNALLY. Make a motion.

Senator LA FOLLETTE. I move then that the experts, both the Treasury experts and the joint committee experts, be requested to proceed with the drafting of the bill, using the pending bill as the base, and that they then submit to us such suggestions as they are able to work out with relation to the rates on corporations, having in mind the individual rates that have previously been adopted by the committee.

Senator BAILEY. Would not you want to add there that where the bill in the Finance Committee makes exceptions with respect to corporations of various types, that similar exceptions be made in this bill?

Senator LA FOLLETTE. I would have included that in the motion, excepting that Mr. Chesteen suggested that perhaps we want to give further consideration to that, and that the experts might want to give further consideration to those corporations that are given special treatment in the bill, not that I do not think you probably will have to give them special treatment, but you might want to consider whether you would use the peace-time rate or perhaps a proportionately higher rate.

Senator CONNALLY. Instead of 15 percent making it 20 percent or 22.5 percent?

Senator LA FOLLETTE. Something like that, to bring it in general line with what the other taxpayers are carrying.

Senator BAILEY. Of course this will be a tentative bill that is to be printed?

Senator LA FOLLETTE. It is not to be printed. I just thought they were to begin work on it.

Senator BAILEY. I thought you were going to have it printed.

Senator CONNALLY. When they finish the draft we will have it printed.

Mr. CHESTEEN. Relating these corporate rates with the individual rates, that study can be carried forward and computations made. That has no relation to this other question of what you would do with these various corporations.

Senator BAILEY. It seems to me it would be helpful if you would give consideration to what you suggest would be a comparable burden for those who have the special flat rate consideration in peace time under the pending bill, in view of the fact that there are those who get a special flat-rate consideration, as to what their rate ought to be to bring them somewhat into balance with the rate on other corporations for war purposes.

Now we had some other questions, Mr. Chairman.

Senator CONNALLY. Let us put that to a vote. I understand the question. Don't you, Senator Bailey?

Senator BAILEY. We are just going to authorize them to proceed on the basis of the pending bill, to make a draft.

Senator CONNALLY. A draft of corporate rates that will have the proper relationship to individual rates which we have already adopted.

Mr. CHESTEEN. And with the view to having only one schedule.

Senator CONNALLY. One schedule. So many as are in favor of that will say "aye." Opposed, "no." Unanimously carried.

Senator LA FOLLETTE. Now we have the question of the percentage of depletion left open, and the question of amortization for war-plant expansion.

Senator CONNALLY. Well, I move that the depletion be kept like it is in peacetime.

Senator BAILEY. Mr. Chairman, my judgement about depletion is that we could state a principle of calculating depletion that would be good for this bill and all other bills. Depletion is a reality which can be defined, and I think we ought to define it in some revenue law and let it stay there for all time. Now I may not be right, but I feel sure I know what depletion is. It is not a matter of law, it is a matter of fact. I think if you stick to the fact you keep yourself out of the wilderness. If you try to draw an artificial thing called depletion you haven't gotten out of it.

Senator CONNALLY. Senator Bailey, I do not think you can reduce it to a mathematical nicety. I think it is largely a matter of speculation, for instance in a mine, as to whether you know how long your mine is going to last. You have no way of knowing it.

Senator BAILEY. You would have to relate that to the investment. Nobody knows how much oil is in the well, but we do know how much money is in the well.

Senator CONNALLY. Well, I thought for the purpose of this bill it would be better to go on with the depletion in the light of experience and practice under the peacetime, rather than devise a whole new system. If you have got a new system that works, that is all right, but I do not want to spend a month's time to figure out a new one, if you put it in here.

Senator BAILEY. What is depletion in standing timber?

Senator CONNALLY. I do not know.

Senator BAILEY. It is the difference in the value of the estate before and after the taking.

Senator CONNALLY. Of course, that is the legal definition. What definition the Treasury uses in estimating that kind of depletion I do not know.

Senator BAILEY. It is the same way with the mine.

Senator CONNALLY. The rate of depletion is one thing with one industry and it is another percentage with another industry. Is that true?

Mr. CHESTEEN. All except nonmetals and timber are treated on a percentage basis.

Senator CONNALLY. All except non-metals and timber?

Mr. CHESTEEN. Yes.

Mr. BROWN. Those percentages of Mr. Chesteen were based on discovery values. The question is whether, for the purpose of war revenue, you want to retain them.

Mr. CHESTEEN. If you are treating natural resources on a certain basis in peacetime there is a greater urge to continue that same policy

in the war than it is to make it more severe. To make it more severe you are just going contrary to all economic laws.

Mr. BROWN. Do you suggest any new provision in respect to oil?

Senator BAILEY. Is not depletion the same thing in war as it is in peace? Depletion is depletion.

Mr. BROWN. I will concede there may be some greater necessity to speed up production in time of war than there is in time of peace. Personally I feel the rate of production is about all we can stand in natural resources at the moment.

Senator BAILEY. It is the same thing in timber. You can deplete more rapidly in 1 year than you can in another. You can cut timber more rapidly. After all, depletion is the amount of timber taken.

Mr. BROWN. It seems to me, Senator, after a taxpayer has recovered his cost, or his March 1, 1913, value, that any additional allowance for depletion beyond that point is in effect granting him a subsidy.

Senator CONNALLY. Let me ask you, Mr. Brown: Suppose here is a mine, or oil well or coal mine, suppose one concern had owned it in 1913, and somebody else comes along and buys it at a greatly enhanced value over 1913, would you hold him down to the 1913 value, allowing no depletion on his added capital?

Mr. BROWN. Well, I would want to be very careful to see that there was not an unwarranted step-up in value, because a lot of revenue goes out the window in that way.

Senator CONNALLY. I am assuming that is in good faith. Here is an old, rickety farm here that would sell at \$10 an acre, and somebody comes along and discovers a gold mine on it, or an oil well, and then he sells it for \$1,000,000. The man that buys it for \$1,000,000 ought to have some depletion.

Senator BAILEY. Depletion ought to be on the basis of investment, otherwise he would just recover capital assets.

Mr. CHESTEEN. My comments the other day on this subject were not directed to the merits of percentage depletion, but to the relationship of percentage depletion in a wartime as compared to peacetime. Certainly all the factors should be in favor of at least treating depletions as liberally in wartime as you would in peacetime, because of the fact that these are the first materials needed in carrying on a war. I pointed out at that time the fact that the peacetime rates of depletion were adopted as a result of exhaustive investigations and special hearings by the Ways and Means Committee. Based in part upon those hearings, the Finance Committee finally adopted the present rates of depletion for mines, sulphur and coal. It may be that those rates are too high. It may be that it is not advisable to allow corporations to return more than their capital.

Certainly those questions, in order to be gone into, would require more time than this committee could take now. You would want to go into all that background and see whether or not those rates could be revised downward, and just how far they should be revised for peacetime. Having done that then you might have some basis for saying that war rates should be different from what we have under consideration here.

Senator LA FOLLETTE. Whatever the arguments may be for or against them in peacetime, although personally I think the rates are

out of line, but waving all that aside I do not see how you can justify in wartime the proposition of letting a man go out and make enormous war profits, set up a depletion after he has recovered his investment at the 1913 value, set up the depletion against those war profits. You are giving him a consideration that nobody ought to have.

Mr. CHESTEEN. Well, you are doing that in peacetime.

Senator LA FOLLETTE. Sure, you are doing that in peacetime, but when you have set up all these rates and you ask everybody to come in and make sacrifices on the basis of war, it seems to me that the least thing you can do is to say, when a man has depleted and gotten his 1913 values back, or his cost back, that he shall not use that as a device for escaping his share of the increased burden of war taxation.

Mr. BROWN. It also affects the rate which is applied to him, because that is taken out in the determination of adjusted net income. It may bring him down to a lower rate schedule.

Mr. CHESTEEN. You are stepping up his tax burden out of proportion to the average corporation, as compared to peacetime, if you do not allow the depletion.

Senator LA FOLLETTE. I say if he uses the device once he shall not keep on using it over and over again until he pays no taxes at all in wartime.

Mr. CHESTEEN. That is a different question.

Senator LA FOLLETTE. I think that is the same question. That is the question I am talking about.

Senator CONNALLY. Mr. Chesteen is not defending the rate, but he says he thinks it ought to be less burdensome in wartime than it is in peacetime.

Senator BAILEY. Let me put this question to you: Suppose I have a thousand acres of standing timber and I find myself solvent under this war-tax bill which allows a very small profit. Then I am notified that if I cut that timber rapidly, just as rapidly as the country's needs may require, and all of it is cut during the war, and my income is cut likewise, do you think I would use my timber or hold it until after the war is over?

Mr. CHESTEEN. I think you would withhold cutting the timber until after the war, if we put a severe tax on timber.

Senator BAILEY. I ran a brick plant during the World War, and I know what the depletion was down there.

Senator LA FOLLETTE. Do you think, Senator, after you have actually depleted the cost on your clay deposits, for instance, that you ought to be permitted during the war to go on and deplete again, again, and again, with the result that you do not pay any tax at all?

Senator BAILEY. I will stick to that, that once the depletion allowance has been fully accounted for everything else that is recovered, timber, clay, or oil wells, is a profit.

Senator CONNALLY. Can you draw a provision to do that, allowing the percentages of depletion up to the time he got his capital back?

Mr. CHESTEEN. I would say that a large percent have already recovered their capital, either capital or the March 1, 1913, value. As I recall, the March 1, 1913, values on mines were based for the most part on an estimate of operation until not later than 1946.

Senator LA FOLLETTE. That is a very simple thing to do. All you have to do is to leave the percentage depletion as it stands in the existing law, and just add the same provision that is added in the Nye bill, that in no case shall it be over or above the March 1, 1913, value.

Mr. CHESTEEN. That brings up another question. As has been brought out here in these special hearings, one of the reasons that prompted the Congress to adopt percentage rates, and that is especially true for the mines and certain coal companies, the 1913 values were very uneven. Some mines had a pretty high value and other mines had low values.

Senator LA FOLLETTE. Well, they have got the alternative, haven't they, under the existing law?

Mr. CHESTEEN. If you fix a return on capital as the basis of future depletion the larger 1913 value, of course, would get the return on a larger value, and the one which had a low value in 1913 would get much less return.

Senator LA FOLLETTE. He has the right to take the cost prior to 1913, hasn't he?

Mr. CHESTEEN. But the cost prior to 1913, in many instances, is another problem. You go back now and attempt to determine the value of the stock and you have about the same problem that you had in 1913. In many of those corporations we did not know what the cost was; we just took the 1913 value, because the acquisition was prior to March 1913, and we knew the value would be higher than attempting to determine the cost.

Senator LA FOLLETTE. Take corporation 16 in this schedule; how did you find out that their depletion on cost of March 1, 1913, value was \$3,204,608.27?

Mr. CHESTEEN. They probably had the cost. The March 1, 1913, value then was higher there. That is what they used.

Senator LA FOLLETTE. Sure. If you acquired the mine in 1890, the corporation probably paid a very small amount for it.

Senator BAILEY. Don't you apply the principle of income-tax calculation on individuals with respect to depreciation, just as the Senator was suggesting about depletion? That is to say, if I own a brick building and I take an allowance of 3 percent annually for depreciation, and I take it for 30 years, or 33 years, I have then taken all the depreciation that can be taken on that building, but the building stands, and I sell it, and then I pay the tax on the whole proceeds of the sale; isn't that right? Isn't that the law?

Mr. CHESTEEN. They tax the profit.

Senator BAILEY. You follow me, Senator?

Senator LA FOLLETTE. Yes, sir.

Senator BAILEY. There are a great many cases like that in this country.

Mr. CHESTEEN. But there is no comparison between a building and a mine.

Senator CONNALLY. I will vote with you, Senator La Follette.

Senator BAILEY. I realize you gentlemen have had a long experience here in working out some sort of practical theory of depletion in terms of law rather than fact.

Senator LA FOLLETTE. The point, however, Senator, is, as far as these companies getting a percentage of depletion is concerned, they

haven't really stuck to the facts, as you say. What they have stuck to is a mathematical formula which, as Mr. Chesteen says, they have worked out after a long struggle. Do not forget that it was not worked out on any scientific, disinterested basis. You had just as much pressure as can be exerted on Congress by these companies that get the advantage of this situation. I am not criticizing, but I think that is quite an accurate statement of the situation as Mr. Chesteen depicts it. I always had the impression that some ideal situation would be worked out, but it was not, it was worked out on the basis of a compromise that we made, as always happens when there is conflict of opinion and interest, but it does seem to me, as I said before, that for the purpose of war taxation, whatever may be the policy in peace times, if you come along and say that a man, just because he happens to be in the mining, or the oil business, that he cannot go on and take his depletion against his war profits, when you are asking everybody else to come forward and carry a very heavy tax load, I say that is not justified.

Senator BAILEY. In your oil business you have to allow for the investment in wildcat wells, and in dry wells.

Senator CONNALLY. You would not in this case.

Senator BAILEY. Is not that the rule?

Senator CONNALLY. That is not depletion; that is an expense in doing business, I suppose. You take a deduction on that.

Senator LA FOLLETTE. You take a deduction on that. That is one of the things they justify it on. They say there are so many of these aspirations that do not produce anything, but of course if the same company makes those investments they have the right to deduct the expense.

Senator CONNALLY. While they have the right to deduct it, they are out that much money. If they had not taken that hazard they would have that much money to distribute.

Here is one difficulty that I see with the point that Mr. Chesteen points out, that is in the case of these natural resources, that we allow them a lesser protection in time of war than in time of peace, instead of stimulating them.

Another point is that if you do not give them any depletion when they have gotten their capital back, you have got one company that cannot take depletion and you have got another company that can take depletion, and you are giving a favoritism, of course, very strongly, to the firm that can take depletion.

Senator LA FOLLETTE. Senator, if they still can take depletion, under the suggestion we are talking about, it means they haven't recovered their 1913 value, or their cost.

Senator CONNALLY. That is true.

Mr. BROWN. May I suggest, if you keep the percentage of rates in existing law but limit the recovery to 100 percent of the March 1, 1913, value, the high rate of the existing law would stimulate the bringing in of new oil wells, new mines, and so forth.

Senator CONNALLY. You are talking about 1913 value or cost. Does that mean cost prior to 1913 or does that mean cost since 1913, that the property be acquired since then?

Mr. BROWN. In the case of property acquired subsequent to March 1, 1913, the cost is what applies. For property acquired prior to



March 1, 1913, you take the value as of March 1, 1913, or cost, whichever is greater.

Senator CONNALLY. How would it suit you to adopt the present rate, if you do in peacetime, and when you get the capital back you stop?

Mr. CHESTEEN. Let me show you an illustration to see how often that applies. A mine was purchased in 1912 for about \$2,000,000. The 1913 value of the mine, as fixed by the Bureau, is \$219,000,000.

Another very rich mine was acquired prior to 1913—I do not recall the cost, but it was a substantial amount; a court fixed the value just prior to 1913 at \$90,000,000 in a suit not involving taxes. The 1913 value of that mine was fixed at \$48,000,000 for tax purposes, or practically one-half of the value prior to 1913.

Now, in those two cases, if you were to limit each to return on basis, one would be getting \$219,000,000, whereas the cost in 1913 was only \$2,000,000.

The other company that is getting a \$48,000,000 return, the court found the value prior to 1913 was \$90,000,000 in a suit not involving taxes.

Mr. BROWN. Were the same issues at stake?

Mr. CHESTEEN. That suit involved the value of the mine, so I think you cannot reconcile the uneven treatment that you are going to give the natural resources if you resort to return on capital based on those values established by the income-tax unit for 1913, and it was one of the factors that was taken into consideration by the Ways and Finances Committee in adopting percentage depletion, that they would treat all natural resources on the same basis.

Senator CONNALLY. This present tax bill does not touch that at all?

Mr. BROWN. It is believed at the present time that the Bureau is losing in this item alone about \$40,000,000 a year. In wartime, if the profits are greater and you apply the same percentages, naturally that figure would be stepped up very materially. As I pointed out before, it would make some difference in the rate schedules applicable to these corporations.

Senator BAILEY. Why cannot we leave these gentlemen to make a suggestion to us?

Senator CONNALLY. They are making it right now.

Senator BAILEY. I mean, make them in this draft.

Senator LA FOLLETTE. They are to make a study of this.

Senator BAILEY. I want you to use the obsolescence. In wartime you will have a great deal of left-over machinery; you will have a great deal of left-over ships, buildings, and all sorts of things.

Mr. BROWN. We are prepared to discuss that.

Mr. CHESTEEN. I am not inclined to disagree with Senator La Follette in his thought that when they recover the capital they should not get any more. My only point is, to follow up that thought is justice to natural resources, whether you should not look more thoroughly into the whole question before you make that decision?

Senator CONNALLY. We haven't got much time to do that.

Mr. CHESTEEN. I realize that. There is a lot of weight in your thought; but I think you should consider all the factors that enter

into consideration. It might be that all of the present system should be changed, but I think there are factors that we haven't the time to go into here, that I believe Senator La Follette himself would want to think over before he made final decision on his thought here, which I think has a lot of merit. It is really something that requires more than just a short discussion.

Senator BAILEY. Of course, in depletion you add interest.

Senator CONNALLY. No; the interest is supposed to have been profit taken out during the year.

Senator BAILEY. Supposing it had not any, he would be entitled to interest. Supposing he had been losing interest all of the time; don't you add the interest when you go to calculate his depletion?

Mr. CHESTEEN. No; after determining the gross income you deduct a certain percentage of the gross income.

Senator BAILEY. Then you take depletion without allowing for the cost?

Mr. ZUCKER. Except insofar as depletion allowance itself comprehends a return based on the original capital; this covers interest.

Mr. ZUCKER. Senator, if I might add, perhaps this whole question could be more or less compromised, as you suggested other matters are. Why not adopt the rate in granting the depletion allowance as indicated in the Nye bill, which would just add more severity in granting the depletion allowance without a complete upheaval of the basis? As a compromise between the two bases it might be well to allow all corporations to deduct depletion, but to take it at the rates indicated rather than the peacetime rates which we have here.

Senator CONNALLY. What are the peacetime rates?

Mr. BROWN. They are 27½ percent on gross income of oil and gas wells, 5 percent on coal mines, 15 percent for metal mines, and 23 percent for sulphur mines.

Senator CONNALLY. How would it be to take half the rate?

Senator LA FOLLETTE. These are one third.

Mr. ZUCKER. Considering that they already have an advantage on the recovery basis, I think if we allowed them one third, that would still be giving more or less of a subsidy, to the group of natural-resource industries as against ordinary corporations. It may not be amiss to treat them drastically with respect to depletion allowances in wartimes.

Senator LA FOLLETTE. But not put any ceiling on it?

Mr. ZUCKER. But not exclude them from taking any depletion in wartime, because, as Mr. Chesteen has stated, a large proportion of these corporations have already taken as much depletion as they would be entitled to if the La Follette suggestion was incorporated into the war-profits bill.

Senator CONNALLY. I am willing to take the Nye plan.

Senator BAILEY. I do not think it is fair. You really tax a man's capital.

Senator CONNALLY. We just reduce his rates. We do not stop him from taking some depletion.

Senator BAILEY. If depletion was capital invested, say the purchase price plus 6 percent, then we begin to tax him on 50 percent of his capital invested here.

Mr. ZUCKER. That is not capital invested, it is capital discovered.

Senator BAILEY. Well, you would find on the present value it is capital.

Senator CONNALLY. If he has not taken it all, he would have capital invested.

Mr. ZUCKER. It is capital invested; it is capital for which no contribution has been made other than the risk in speculation.

Senator BAILEY. You are separating the corporations into two groups, one in which the depletion has been fully accounted for and another in which it has not.

Mr. ZUCKER. No, sir; I do not understand that that is what you mean.

Senator BAILEY. It is a simple proposition. If I invested \$100,000 in standing timber and you allowed me only one half, that would be \$50,000, and you tax me on the other half, you tax me on my capital, you do not tax me on my income.

Senator CONNALLY. He means one-half of the allowance for depletion.

Mr. ZUCKER. The deductions are based on the percentage of income earned during the year.

Senator BAILEY. You allow so much for depreciation, so much percent of his income.

Senator CONNALLY. You have got \$100,000 worth of timber, you take \$10,000 profit on that, they allow you a certain percentage on that \$10,000 as depletion.

Mr. ZUCKER. That is why it is possible, under the present scheme, to recover more than the capital invested.

Senator CONNALLY. Theoretically it is based on an estimate as to the life of the mine or the timber or whatever it may be.

Mr. ZUCKER. It is based on the principle that the exploitation of the natural resources should continue, and that the Government merely takes a proportion of the profits of the exploitation, irrespective of the amount of investment.

Senator BAILEY. It is an allowance for depletion over and against income, is it not?

Mr. ZUCKER. Yes, sir.

Senator BAILEY. What is the Nye rate?

Mr. CHESTEEN. These percentages, as you recall, anticipate giving the industries the general effect of discovery depletion March 1, 1913.

Senator BAILEY. What?

Mr. CHESTEEN. These rates were intended to give the industry as a whole the approximate benefit that it got under the law prevailing prior to the time of the adoption of the percentage. If you recall, the laws prior to the adoption of the percentage, provided for discovery value, in case of discovery of natural resources, that you valued the capital within 30 days of the discovery, and where the discovery was made prior to March 1, 1913, you took the March 1, 1913 value. Now those valuations contemplated a certain period. From that time on you would not get anything, so the percentage depletion did continue the benefit of valuations as long as the property was operated. As Senator La Follette pointed out, the benefit of the discovery value was carried out as long as the mine or the oil well produced a product.

Senator BAILEY. But that is not percentage of value, that is percentage of income.

Mr. CHESTEEN. Percentage of income.

Senator BAILEY. Then you would never arrive at the value.

Mr. CHESTEEN. You might get your value back. The chances are you would get more than your value.

Mr. BROWN. You would get your cost back in any event.

Senator CONNALLY. That is, if you make your cost you would get it back.

Mr. BROWN. All of our recent cases provide in any event depletion on cost should be allowed.

Mr. ZUCKER. I think the changed rates as offered in the Nye bill can be found from what has been put in the record by Mr. Parker before the subcommittee. If you wish me to, I will repeat them now. The Nye bill proposes 9 percent in lieu of 27 $\frac{1}{2}$  percent.

Senator BAILEY. That is 9 percent of the net income.

Mr. ZUCKER. On the gross income.

Senator BAILEY. That is deducted for depletion, that is deducted from the net income. That is a calculation to find the net.

Mr. ZUCKER. Yes.

Senator BAILEY. That takes 9 percent.

Mr. ZUCKER. In lieu of 27 $\frac{1}{2}$  percent.

Senator BAILEY. That is with respect to oil. Would it be different in respect to different institutions?

Senator CONNALLY. In peacetime it is 27.5 percent.

Mr. ZUCKER. Metal mines, 7 $\frac{1}{2}$  percent in lieu of 15 percent.

Senator BAILEY. Suppose we compromise, instead of having 30 percent make it 50 percent?

Mr. ZUCKER. Some of these are 50 percent. We haven't been able to ascertain how they arrived at these rates.

Senator CONNALLY. Fifty percent is agreeable to me.

Senator BAILEY. I will make the motion that we compromise this thing by making it 50 percent.

Senator CONNALLY. Is there any discussion? All in favor say "aye." Opposed, "no." It is carried. It is 50 percent in the peacetime law. You understand that now, do you?

Mr. BROWN. Yes.

Senator CONNALLY. Now what else have you got? Is "amortization" next?

Mr. BROWN. H. R. 5529, as referred to the Senate Finance Committee, makes no provision, either in connection with the revenue title of the bill or otherwise, for amortization of the cost of wartime construction which may be necessary to expand peacetime facilities. The Munitions committee recommends (Report No. 944, pt. 2, p. 34) that no amortization be allowed in connection with the revenue, but instead that governmental loans be authorized for such construction as may be found necessary for the prosecution of the war and which cannot otherwise be financed. However, the committee observes that if no allowance is made for the amortization of such new construction, there may be anticipated considerable insistence that such construction be paid for by outright governmental subsidy.

While the committee has recommended the financing of such wartime construction by direct governmental loans, it apparently recognizes that such method will result in a very large loss to the Government at the conclusion of the war, through the compromise of some

war loans and the defaulting of others, and that under either the loan or subsidy plan it may be anticipated that the Government at the termination of the war will find itself in possession of "extensive plants and equipment, the usefulness and value of which as a whole will be conjectural." (Rept. No. 944, pt. 2, p. 31). The report concludes the subject of "Amortization" with the statement:

As to the plant and equipment which the Government has acquired, the choice will be between Government operation and sale for little, if any, better than salvage prices.

The Munitions Committee states at various places in Report No. 577 that one of the primary objectives of the bill is to eliminate and prevent inflation due to war borrowing by the Government. The proposal to provide for war construction by direct governmental loans would necessarily require the immediate outlay by the Government of vast sums of money which the tax structure would not then have provided and which would be immediately obtainable only by bond issues, much of which would, of course, be absorbed by the industries whose plants were to be expanded. This method not only would tend to create inflation due to Government borrowing, which the committee desires to avoid, but would also tend to restrict private capital available for such industrial expansion. If industries are given no assurance that the cost of wartime construction may be recovered through amortization, it is not unlikely that the industries will be loath to risk their private capital for such construction, due to the uncertainty of its peacetime value and the probable duration of the war, with the result that substantially all such construction would be left to Government financing.

While exact figures are not available, it may be roughly estimated that the loss in revenue sustained by the Government through amortization under the 1918 and 1921 Revenue Acts was about 60 percent of the total amount of amortization claimed by taxpayers. However, the total amount of amortization claimed was substantially less than the total cost of wartime construction.

Exhibit no. 1405 of Report No. 944 (pt. 2), which is a summary of amortization allowances of \$500,000 or over as allowed by appraisal section up to April 30, 1925, shows a total of the amount finally claimed as \$635,934,923.16 and the total amount finally allowed as \$425,921,945.92, or roughly 65 percent. The column in this exhibit under the heading "Amount finally allowed" does not represent the amount finally allowed by the Bureau in the disposition of these cases but in the amount recommended by the Appraisal Section of the Bureau. The total amount actually allowed on final disposition of these cases was probably somewhat lower, due to redeterminations resulting from Solicitor's rulings, and so forth. No figures are available with respect to the amount allowed on claims under \$500,000 but it is the opinion of those in the Bureau who were connected with this work that the percentages of allowance was lower, probably not more than 55 percent. It is estimated that claims under \$500,000 amounted to approximately two-thirds of those in excess of \$500,000, or about \$400,000,000, making roughly \$1,000,000,000 of amortization claimed by taxpayers, against which the Government allowed approximately \$600,000,000, or 60 percent. If the amount of amortization finally claimed by taxpayers represented in fact only approximately 75 percent of the total cost of wartime construction, the

allowance of \$600,000,000 through amortization would represent a loss to the Government of only approximately 48 percent of the total cost. The observations of the special committee as to the outcome of financing wartime construction by governmental loans cannot be reduced to comparative figures but the dreary picture presented as to the situation of the Government at the conclusion of the war, coupled with past experience in connection with the disposition of surplus property by the Government, seems to indicate a much greater loss by this method than would be sustained through the procedure of amortization in connection with the revenue.

Large and costly installations designed wholly for the production of war materials and which will be practically useless after the war may well be financed directly through the medium of governmental loans and subsidies from a revolving fund created for that purpose. The measure of profit to be realized from the production of such materials will no doubt receive special consideration in connection with the contract covering the construction loan and, of course, the subject of the amortization of the cost of such construction projects could be completely covered by the loan contract. There will remain, however, a vast amount of industrial expansion in connection with the production of articles and commodities necessary in wartime for both the civilian population and the military and naval forces. The aggregate cost of construction to meet this sort of expansion will be very large and it would appear desirable that it be financed so far as possible by private capital rather than through Government loans, which would necessitate increased Government borrowing. As an inducement to the employment of private capital for such construction, it is believed that some provision should be made for the amortization of the capital investment in connection with the taxation. Even if the margin of profit to be allowed manufacturers and producers of essential commodities is restricted to the minimum during wartime, it is not unlikely that such manufacturers and producers would be willing to employ their capital and credit to meet the cost of wartime expansion if they could have some assurance in advance that they would be entitled to recover the cost of such construction through amortization in connection with their taxes. With the experience gained by the Bureau of Internal Revenue in connection with the subject of amortization under the 1918 and 1921 acts there seems to be little ground for fear that the general subject cannot be handled more efficiently than was the case following the last war. That experience likewise will enable the drafting of legislation and regulations which will more strictly control the allowance of amortization. Much of the difficulties arising in connection with amortization under the 1918 and 1921 acts resulted from the broad provisions of the acts, which provided for amortization of construction for the production of articles "contributing to the prosecution of the war." This wording was perhaps too broad and enabled taxpayers to claim amortization in connection with the production of articles and commodities quite remote from the actual needs of the Nation for a successful prosecution of the war.

It is assumed, as a matter of course, that in the event of war in the future there will be a governmental board or commission which will exercise strict control over all industrial construction.

Undoubtedly no manufacturer will be able to construct any plant or obtain materials and supplies for such construction without first having his project approved by such board of control. Such a board apparently would be independent of the agency which would be created by the President under title III of H. R. 5529, "War Resources Control", and the War Finance Control Commission provided for by title V of the bill, the jurisdiction of such agency or commission might be extended to cover the function above-mentioned.

As an inducement to the employment of private capital for war-time construction, it is suggested that the decision of such War Industrial Control Board to permit the construction of particular projects because the article or commodity to be produced was "essential to the prosecution of the war" might well be conclusive of the question whether such project should be entitled to amortization in connection with taxation. Such a plan would enable the manufacturer to know in advance and before he expends his capital whether he will be entitled in principle, to amortize the cost of construction of the project. The amount of such amortization ultimately to be allowed would be left for determination by the Bureau of Internal Revenue. To have reasonable assurance that the revenue would be properly protected against the possibility of too liberal an attitude on the part of such board to recognize articles as "essential to the prosecution of the war," it is believed provision should be made whereby the Treasury Department would be represented on such board.

I will refer to that again in connection with the concrete suggestion which we have drafted for the consideration of the committee.

To carry out the foregoing plan it is suggested that the amortization provision contained in section 234 (a) (8) of the Revenue Act of 1921 be redrafted so as to restrict its scope in the light of the experience of the Bureau of Internal Revenue in the administration of the amortization provisions of the 1918 and 1921 acts and to meet as far as possible the objections of the Munitions Committee to the inclusion of such provision in a war-revenue bill.

I might say at this point that but for the concrete examples referred to by the Munitions Committee of the criticisms made by the Munitions Committee and the Bureau of Internal Revenue, I think we might have thought a provision for a reasonable allowance for amortization would be about all that was actually required, but in view of that criticism, and in order to assure that there would be some check, we have, at the risk of complicating the actual provision, attempted to meet some of those concrete criticisms.

Such a redraft—and this relates to section 234 (a) (8) of the 1921 act—should accomplish the following, among other, objectives:

(a) Allow amortization only as to construction actually begun after the declaration of war to provide for the production of articles or commodities essential to the prosecution of the war.

(b) Deny amortization of the cost of construction of projects either begun or contracted for prior to the declaration of war and designed to meet peacetime needs.

(c) Deny amortization of the cost of facilities in existence prior to the declaration of war but which were thereafter transferred to new owners, where no amortization would be allowable in the absence of such transfer.

The allowance of amortization only as to construction projects approved by the board or agency designated by the President would go far toward the accomplishment of these objectives. The statutory authority of such board might well confine its approval of construction projects to such as will result in the production of articles "essential to the prosecution of the war", with a view to the restriction of the allowance of amortization to projects for the production of articles, commodities, or facilities closely related to the military purposes, and to deny it in the case of projects for the production of things having only a remote relation to such purposes.

Senator CONNALLY. When you say "contracts", of course you mean construction either of buildings or facilities or plants or any instrumentalities?

Mr. BROWN. That is correct; yes.

Senator BAILEY. Farms or finance corporations during the World War—you would have to go into the whole field, would you not?

Mr. BROWN. I suppose this suggestion which we have made might cover that problem. The theory that we are going on is any kind of production, especially production which calls for labor or materials, that under the conditions of such a war as we may anticipate you will not be able to get either materials or labor for such construction without authority from war industries control of some sort. Generally speaking, the President will be vested with very broad powers and he will delegate those powers, and in the other title of the bill some provision has been made for a certain kind of control. Our thought is that when the taxpayer goes to the War Department, or some other control agency, to obtain authority to build, that this right to amortization should be discussed at that time and a decision made before he puts up his money.

Senator BAILEY. You have this provision, that in the event of war any industry, or anyone else, who is called upon to do anything to prosecute the war, should get a license first from some proper authority?

Mr. BROWN. That is right.

Senator BAILEY. When he gets a license from the Government, and if he puts up his own capital he is entitled to get a certain return of capital.

Senator LA FOLLETTE. He has a right to write off what he invested for war purposes.

Senator BAILEY. If he has got a contract he is to be allowed a reasonable amortization, but in any event he is to be allowed the equal of his losses at the end of the war on account of his investment—not his operations but his investments.

Mr. BROWN. I am not sure but what you have not mentioned a number of subjects which we have not studied.

Senator BAILEY. I was just giving you the main object, without going into details. That is the principle you have in mind?

Mr. BROWN. Yes. The chief thought I was presenting is this: That he would have to get authority for new construction. Let us leave the farmers out for a moment. When he got that authority the question as to his right to amortization would be then discussed and if it was decided he should be entitled to it, the decision would then be made. It would not be a contract, but, having secured the right to build these facilities he would be entitled in principle to



amortization, the amount thereof to be determined later by the Bureau, applying the rule of reasonable amortization.

Senator BAILEY. With a view to account for any losses in the capital investment due to the termination of the war? The war may last 3 months or it may last 3 years. The process of amortization, if it would last 2 or 3 months would be very rapid, and if it were 2 or 3 years it would be slow. In the matter of contract he should be just repaid by the principle of amortization being applied while the thing was going on, and then a lump sum at the end of the term. Is not that what you would have to do?

Mr. BROWN. There are two things that would happen. First, he has got to get his authority to construct, and at that time a determination will be made by this Board as to whether the construction is essential to the prosecution of the war.

Now we are changing the situation from the last war. In the last war it was "contributing to the prosecution of the war." We are limiting it now to "essential to the prosecution of the war", because we found in the last war period a great many features contributed, in more or less degree, to the prosecution of the war. What is essential to the prosecution of the war may be a narrower concept. What is essential for the military and naval forces may even be applied to the civilian population, if they are in such a situation that they are being starved or in danger of annihilation.

Senator CONNALLY. What you are doing is determining in advance of the war to let the man take a chance on amortization?

Mr. BROWN. That is right.

Senator CONNALLY. He is going to build the plant, he says it is necessary for the war, he will build it, and if there is any loss by reason of this construction he will take it in the form of amortization.

Mr. BROWN. That is correct.

Senator CONNALLY. He has got to take a chance. He does not know whether he will get amortization or not. After the war is over he has to fight it out, he has to determine what to do with it. We have had shipbuilding companies making claims 10 years after the war.

Mr. BROWN. It is also contemplated, of course, that this Board might authorize construction which it did not consider to be essential, provided the materials and men were available. In such case there would be no allowance for amortization.

Senator CONNALLY. Have you got a suggestion drafted there?

Mr. BROWN. Yes, we have, Senator.

Senator CONNALLY. Do you have the percentages, and all that sort of thing?

Mr. BROWN. No; it is not on the percentage basis. It will be a reasonable allowance, depending upon circumstances.

Senator CONNALLY. Do you take it all in 1 year or do you take it over a period of years?

Mr. BROWN. It would depend somewhat on when the facility was constructed and how long the war lasted.

Senator CONNALLY. Suppose the war lasted 1 year, and there would not be enough for amortization, would you carry him over?

Mr. BROWN. If the construction were, say, toward the end of the war and the allowance for amortization would not be sufficient to

induce him to do it, he would probably insist that he be taken care of in some other way, so we would make a contract, what we call contractual amortization. That would be an allowance of the price fixed.

Senator CONNALLY. Suppose a man just went ahead, suppose he got permission to build his plant and the war stopped suddenly, would you carry on the amortization into the second year?

Mr. BROWN. There will be no carry-over into the subsequent years.

Senator CONNALLY. Go ahead with your plan.

Mr. BROWN. This is only a tentative suggestion:

*Amortization.* In the case of buildings, machinery, equipment, or other facilities, contracted for and constructed, erected, installed, or acquired on or after the effective date of this Act, for the production of articles essential to the prosecution of the war, and in the case of vessels contracted for and constructed or acquired on or after such date for the transportation of articles or men essential to the prosecution of the war, there shall be allowed, for any taxable year ending after the effective date of this Act, a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer (not in excess of the adjusted basis under section 113), but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income; *Provided*, That amortization shall not be allowed under this paragraph unless the construction, erection, installation, or acquisition of the facility or vessel shall have been authorized by the President, through such agency as he shall designate, and determined by such agency to be for the production of articles essential to the prosecution of the war, or, in the case of vessels, for the transportation of articles or men essential to the prosecution of the war; *Provided further*, That in the case of vessels, buildings, machinery, equipment, or other facilities contracted for, or constructed, erected, or installed prior to the effective date of this Act, but acquired by the taxpayer subsequent to such date, whether by purchase, exchange, gift, transfer, or in any other manner, no amortization shall be allowed under this section; *Provided further*, That after this Act shall cease to be effective the Commissioner may reexamine the returns made under this Act, and if he then finds that the deduction originally allowed was incorrect, the tax for the year or years affected shall be redetermined. The amount of the deduction to be finally allowed under this paragraph shall be measured by the conditions prevailing during a period of not more than three years after the date upon which this Act shall cease to be effective. The amount of any deficiency in tax determined to be due may be assessed and collected at any time, subject to the provisions of section 272, without regard to the provisions of section 275. The amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 322.

I might say, in connection with that last proviso, it is generally the thought that there shall be no limitation on the time when the Commissioner may reexamine and redetermine the amount of the deduction taken, but we have taken a 3-year period following the determination of the war, and I might say in parentheses, that that was approximately the period taken after the last war, to use as a base for determining peacetime use, peacetime value or use. We did not feel that there should be any limitation of the time for that determination, but that perhaps, in the interest of speeding up the redetermination, and facilitating the administration there ought to be a definite period taken. We would prefer, of course, a longer period, but that would delay the final adjustment. That, roughly speaking, is the plan.

Senator CONNALLY. That is your proposed draft?

Mr. BROWN. Yes.

Senator BAILEY. Suppose we ask them to go over it?

Senator CONNALLY. You would want a little time on that. This is the only major question that remains for us to determine, is it now?

Senator LA FOLLETTE. So far as I know.

Mr. CHESTEEN. I do not know whether you are going to consider the question of inventories or not. We had a provision of that kind in the 1918 act.

Mr. BROWN. We have provided for that, too. I do not know whether you want to take it up this afternoon or not.

Mr. CHESTEEN. I might say, on this subject, that we have in mind a plan that is somewhat different from this plan.

Senator CONNALLY. On amortization?

Mr. CHESTEEN. Yes. It will take some 35 or 40 minutes to discuss the plan.

Mr. BROWN. It might be helpful if we could hear Mr. Chesteen's plan.

Senator LA FOLLETTE. Yes; go ahead.

Senator CONNALLY. Yes.

Mr. CHESTEEN. We approach this subject by first giving some consideration to the experiences of the last war. I realize that there has been considerable criticism of the amortization plan in the 1918 act. I think it is fair to say a substantial portion of the criticisms that are well taken may be ascribed to three causes: Attempts on the part of the Bureau to administer the general provision without having first made proper preparation in the drafting of regulations and rules to govern the determination of amortization. The regulations were hurriedly drawn, and as a result many of them were the subject of litigation, and a great many criticisms resulted.

The second cause of criticisms was failure on the part of the Bureau to coordinate the legal department with the Administrative Department in determining amortization.

The third cause for criticisms was the fact that some of the language was more or less ambiguous and gave rise to liberal interpretations that resulted in probable loss of revenue. On the whole, however, I am convinced there was little loss of revenue from amortization.

Senator CONNALLY. You say you are persuaded there was little loss of revenue from amortization?

Mr. CHESTEEN. Yes. The figures given by Mr. Brown a few minutes ago, as you know, show about \$600,000,000 amortization, and when you figure the rate of tax, about 50 percent, that section cost the Government about \$300,000,000 in revenue.

I have examined just recently a tabulation of contracts of the Ordnance Department of the war, and I find that out of about a billion dollars in contracts \$667,000,000, approximately, was paid for war materials, and approximately \$400,000,000 was paid for amortization of equipment. The total war contracts were something like \$12,000,000,000 for war material. So that if we consider those figures, \$600,000,000 does not look like a very large figure for allowances to taxpayers for war facilities. We know that Great Britain, a country which had a revenue law similar to ours, allowed amortization on a much broader scale than was allowed in the Revenue Act of 1918.

Had we followed a similar principle we would have had allowances several times what was allowed under the provision in the 1918 act.

Our suggestion is that you take the 1918 act, where the experience and litigation shows the act is defective, that if it is possible to cure those defects in the law and rewrite the section so as to make restrictions that were not in the 1918 act.

I might summarize some of the experiences of the Bureau in connection with the most controversial words in the 1918 act. The 1918 act provided for amortization in case of buildings and machinery, equipment, and other facilities. That is the language suggested by Mr. Brown in his proposal.

One of the phrases that came up for interpretation was what "other facilities" included. The Bureau ruled that "other facilities" referred to property of a like kind, as buildings and machinery, that is property that was subject to depreciation, subject to wear and tear, subject to obsolescence, and under that interpretation land was excluded from amortization.

In a short while a claim was filed involving the question of whether "other facilities" included the exploration work, and expenditures for the development of mines. The Bureau held that a mine shaft was not included within the meaning of "other facilities."

That question went to the Federal court in the *Corona Coal & Coke case*, and the court held that "other facilities" included a mine shaft.

You can see if that principle had been applied in the beginning, we would have had cases where mine shafts had been sunk during the war that would have been subject to amortization.

That decision came rather late and, so far as I know, there were no other claims filed, other than those existing at that time.

Subsequent to that decision and as the result of that decision, one of the larger oil companies laid claim to amortization on the costs of drilling wells, both productive wells and dry wells. The Bureau of Internal Revenue allowed amortization on those costs. You can see if we would apply that principle to the oil industry we would have thousands of claims by oil drillers, by oil corporations who sunk wells during the period of the war. Fortunately, no other company laid claim to amortization on the cost of drilling wells.

Senator BAILEY. Would not that be aided now by your licensing and contracts?

Mr. CHESTEEN. I personally feel that that decision is unsound, but the Bureau of Internal Revenue did not appeal the decision; it stood as a decision and was followed by the Bureau in the *Oil case*.

We suggest that the word "facility" be limited, so as to clarify the language and exclude oil wells and mines. I do not think Congress ever intended that such construction be placed on the language.

The next language in the statute for interpretation was on "cost of property erected, installed, or acquired on and after April 6, 1917."

Now leaving for the moment the date, the question arose as to the construction of these words "erected, installed, or acquired."

The Bureau in the beginning took the position that the intention of Congress was to allow amortization on property, physical title to which had been taken on and after April 6, 1917.

Under that construction vessels that had been constructed for a long time prior to the war, without any thought of prosecution in

the war were allowed. Many other types of construction that was prolonged over a substantial period came under the interpretation which the Bureau had placed upon that language.

The Bureau of Internal Revenue, after having followed that interpretation for quite a while, raised the question as an affirmative issue before the Board of Tax Appeals, in what is known as the *Jenks Spinning case*, and there the attorney for the Government contended that this language, "constructed, erected, installed, or acquired on and after April 6", should be interpreted so as to place the purpose for which the construction was made at the time of the contract, and argued that since the contract had been entered into prior to April 6 the purpose was not to prosecute the war, and therefore those costs that were contracted for, the commitments made prior to April 6, should be excluded from the request. The Board disagreed with that contention, and held that costs, title to which was taken after the declaration of war, should be included as a part of the amortization.

We think that you might well consider whether or not you want to exclude anything, as Mr. Brown has pointed out in his draft, that commitment was made or contracted for prior to the declaration of war. That would exclude anything that the taxpayer intended for peacetime use.

Now, the next phrase that we think you might consider, although it was subject to some litigation, is "for the production of articles contributing to the prosecution of the war."

The question arose as to what "production" meant. The Bureau took the position that "production of an article" meant mechanical or chemical change of the product as it passed through the taxpayer's plant. As the result of that interpretation, any taxpayer that performed a service was not permitted amortization on facilities. Finally a number of borderline cases pressed for interpretation. One of the first was a taxayer who had acquired facilities for freezing meat, and the question arose as to whether the freezing of meat was the production of an article. The case was tried before the Board of Tax Appeals and the taxpayer submitted proof that frozen meat is a different article from fresh meat—that there was a chemical change.

Senator LA FOLLETTE. He was producing frozen meat?

Mr. CHESTEEN. Yes; he was producing an article when he froze meat, because it had a different texture from fresh meat, and the Board agreed with that contention and allowed it. The next type of borderline case was a case of a taxpayer that had sacked grain; this he maintained contributed to the prosecution of the war. That case was not litigated, but the case started with the view that sacking grain was not producing an article, since the sacking was a mere incident to transportation, and it did not change the form or the texture of the product, and the taxpayer was not entitled to amortization. The company, however, was finally allowed amortization.

Among other borderline cases was the inspection of cloth. It was the practice in the woolen industry to send their product to an inspector before delivering it to the Army or to the customer. This inspector was an expert on inspecting cloth. He inspected the cloth and rejected any imperfect bolts or pieces of shrunken cloth. The Bureau of Internal Revenue held there was no chemical or physical change in the cloth and that the taxpayer was only performing a

service; that he was not producing an article. Those cases were all settled in that way. They were rejected. None of them appealed.

Those cases illustrate the fact that you have borderline cases, where the question of the production of the article hinges merely on whether or not you have changed the form, either made a chemical change or a physical change in the product.

Senator BAILEY. What is the objection to the licensing and contracting system?

Mr. CHESTEEN. I am merely pointing out that here you have certain language which was tested at least by some litigation. Insofar as we know that language would not give any trouble if you should put it back into another wartime act.

Senator LA FOLLETTE. As I understand it, you have used that language?

Mr. BROWN. We have used some of that language, Senator.

Mr. CHESTEEN. The next phrase, and the phrase that really caused most of the trouble, is the words "contributing to the prosecution of the war."

Mr. BROWN has suggested that you insert the word "directly."

Mr. BROWN. "Essential."

Mr. CHESTEEN. "Essential to the prosecution of the war." The language in the 1918 act merely said "contributing to the prosecution of the war." When the Bureau first entered upon the administration of the law it limited the claims to war contracts and subcontracts. In a very short time taxpayers other than those having contracts came in and asked for amortization. These contended that contracts for delivery of a product to some manufacturing concern that had war contracts satisfied the statutes and subcontracts and went into other fields. Resort was first had to the Food Control Act and War Finance Act, and other priority lists as to what articles were essential in the prosecution of the war.

I think the list of allowances covered pretty well a great many articles, not only of food but materials that were supplied to sub-contractors and contractors, and many manufacturing concerns that were engaged in producing articles for the civilian population.

The question of whether an article was a necessity or a luxury came up. For example, chocolate. Some manufacturers of chocolate had small contracts either with the Red Cross or other organizations. These manufacturers contended that chocolate contributed to the prosecution of the war. They contended that it was a food and was so considered by the chemists.

Such claims, rejected at first, were later allowed.

Senator BAILEY. Why not get together on that section?

Mr. CHESTEEN. Cigarettes was another type of case at first denied on grounds of being a luxury, but later allowed. Fertilizer was held to be an article that contributed to the prosecution of the war. The fertilizer factories produced an article which was sold to the farmers.

Senator CONNALLY. You can narrow the language so as to exclude the hypothetical cases.

Mr. CHESTEEN. By 1924 and 1925 the interpretation of the phrase "contributing to the prosecution of the war" had reached a stage where almost anything came within the interpretation.

Since 1924 the Board of Tax Appeals had a number of cases in which the Board indicated very clearly it never would have gone as far as the Bureau did in allowing claims for amortization.

We have had one or two cases before the courts. I know the circuit court of appeals has pointed out that the taxpayer's product must have some war connection. He must show that the facilities acquired are for the production of an article that has some war connection.

So I think it is fair to assume that the broad construction which the Bureau put on the words "contributing to the prosecution of the war" is beyond the intendment of the statute, and beyond what the courts would have gone.

While we haven't any decisions by the Supreme Court on this phrase, I think it is fair to assume that those decisions that we have by the Board and by the lower courts tend, since 1925, to restrict the application of the section.

Senator CONNALLY. But the language is, as quoted by Mr. Brown, "necessary for the prosecution of the war."

Mr. BROWN. "Essential."

Senator CONNALLY. "Essential" is narrower than "contributing," because "contributing" might be directly contributing, indirectly contributing, remotely contributing, yet it would be contributing.

Mr. CHESTEEN. I doubt if that would cure the trouble. As pointed out, trouble was experienced in distinguishing between a luxury and a necessity.

Senator CONNALLY. A what?

Mr. CHESTEEN. A luxury. For instance, candy was a luxury, but the manufacturer of candy was not entitled to amortization.

Senator BAILEY. Where would a man land with that sort of contention if he went before the Commission?

Mr. CHESTEEN. Cigarettes were a luxury, yet manufacturers were allowed amortization.

Senator CONNALLY. What is the use of appearing before the Board and getting a license to advance a lot of those claims?

Mr. CHESTEEN. If the Administration is placed in two departments, you will have plenty of trouble. You will probably have greater allowances than you will if you place it in one department.

We think that you will have less trouble with a provision that has been construed, even though broadly, and will accomplish greater equity, it will be administered with less trouble and with less cost, than you will if you attempt to blaze the way, and write a new section, and impose upon the Bureau the necessity for starting out and establishing new precedents by having litigation all over again.

We can see some clear way to a reasonable administration under language that has been interpreted, and even though it may be broader than you would like to have. I question whether that particular word "essential" accomplishes anything at all. If it narrows down to what is essential to the prosecution of the war I do not see that you have done anything with the statute.

Senator CONNALLY. He does not use "contributed" in this draft.

Mr. CHESTEEN. "Essential to the prosecution of the war", is what you have.

Mr. BROWN. Yes; we thought that was considerably narrower than "contribute."

Mr. CHESTEEN. As I see it, those manufacturers who supply the war manufacturer, might reasonably be allowed amortization, and that is what the courts indicated by the Briggs Manufacturing, and other cases.

The taxpayer must show his product has some war connection. He cannot come in and have a claim in a broad way. I will give you a typical case that indicates extreme liberality to all requests at that time.

A manufacturer in a midwestern town offered a product called ensilage knives, used for the cutting of corn and other feed stuffs.

He filed a claim for amortization, and the claim was rejected. When it came before me, I thought it was very much of a joke, but he produced an article contributing in the prosecution of the war. Not until after I discussed it with him did I get the basis of his claim. He contended this, that he produced an article which was used by midwestern farmers to cut corn, that the corn was used to feed dairy cattle and beef cattle, some of which may have gone to the Chicago marts, there was slaughtered, and some of the meat possibly undoubtedly would go to France, because the packers had large contracts with the Federal Government. I denied that claim because I thought this was a joke. Strange to say the Committee on Appeals and Review, a separate organization at that time in the Bureau of Internal Revenue, allowed that case.

Mr. BROWN. It would never be allowed again.

Mr. CHESTEEN. The court decisions subsequent to that time clearly pointed out, and the Bureau, beginning with 1925, narrowed their interpretation of the statute until these court decisions have given some basis for saying that just anybody can come in and claim amortization on the ground that he produces something which indirectly had some bearing upon winning the war. I think the language there "contributing in the prosecution of the war" is what ordinarily would not be so dangerous if we were to insert it into an act as it is, but I think we might be able to make it dangerous.

Senator LA FOLLETTE. I am in favor of restricting it.

Senator CONNALLY. Of course, a lot of that can be obviated by the Board, by defining what is essential.

Mr. BROWN. We have that in mind Senator. There might, of course, be articles that we would not anticipate today as being essential to the prosecution of the war.

We felt that one of the most important things that every businessman has in mind when he invests his money in any kind of activity, is certainty. We feel that if he went before this Board—and I assume he would have to go before it anyway, because I anticipate in the next war there will be vastly greater regulation than there has ever been before—so I say, if he goes before the Board he will know in advance, when he is investing his private funds, whether or not he is going to be entitled to the amortization or not. If he is turned down, then he makes his investment with full knowledge that he is not going to be given this special allowance.

Mr. CHESTEEN. As I say, we want the manufacturers of the country to get into top speed production as soon as possible after the war. If we impose regulation by the War Department to regulate



the allowance demands daily in construction, it will slow up the industry that is contemplating the purchase of war facilities. It occurred to us it is better to leave all of that to the tax provision.

The taxpayer notes: Here is a provision that will give the relief in the event he required something for producing an article. He could look at this statute and the record before he would get some idea as to what he could purchase.

Senator LA FOLLETTE. I would hate to have him look at some of the records of the banks.

Mr. CHESTEEN. We realize it is hard to reword this section, and to make any great changes in it is going to take time. To work on any plan would take time. Otherwise what you would do would just be full of loopholes and full of inequalities. It would be worth very little.

We thought that the section that had been administered had been tested by the courts and was a pretty fair basis for taking a chance on a hurried provision.

Senator CONNALLY. It is too broad a basis, according to my point of view. We haven't had an opportunity to study Mr. Brown's proposal.

Mr. CHESTEEN. I wonder if you think it throws any light on the fact that Great Britain allowed amortization on a much broader basis in the World War? I think it is fair to assume that if we had had a provision equivalent to the British law we would have allowed several times what we allowed during the past war.

Senator CONNALLY. That may be, but the British law might not even be right.

Mr. CHESTEEN. Strange to say there was no criticism, as far as I know, in the territory, empire, or war industry, not more than it was entitled to, and their laws are administered with less criticism than we find in this country.

Senator CONNALLY. I think in the industries which you mentioned there, they simply took a chance on making a lot of money in a line of industry that became, directly or indirectly, connected with the prosecution of war. They ought to take their chances, gambling they will win the war, and if they lose, all right.

Mr. CHESTEEN. I agree with you. You ought not to go any further than the essential industries that supply the war manufacturers. Probably you would want to stop at that point. Now, the problem is to write in the law language that will stop probably the producers who supply the war materials. I do not think you can do that much better than you can by trying to take this statute and see if you can narrow it. I do not know that you can. I think that the courts' decisions do point to the fact that it would limit amortization to those cases where the manufacturer should show some war connection, and that certainly is a much narrower field than the Bureau conceived of in about 1924, when they allowed all these claims.

Senator CONNALLY. You said "narrow the language." We do not need to depend on the court. We can just change the language to make it narrow.

Mr. CHESTEEN. The difficulty is in changing the language to get something. If you say "contributing directly to the prosecution of the war"; then you have language that may cut out a great many claims.

Senator CONNALLY. There is always a borderline, no matter where you stop, where you have got to differentiate. No matter how far you go, there is always somebody just beyond it.

Mr. CHESTEEN. I always felt that "contributing to the prosecution of the war", as the court pointed out in the *Burkes case*, that you must see some war connection.

Senator LA FOLLETTE. You just pointed out that somebody who was manufacturing some knives for ensilage cutters in Wisconsin got his claim amortized.

Mr. CHESTEEN. That shows the extreme to which the Bureau went in the subject before the litigation in the Board of Tax Appeals.

Senator CONNALLY. Do you suppose you gentlemen, the joint committee and the Treasury, could not collaborate on this and work out something on it for us? Can you agree on something?

Mr. CHESTEEN. My frank opinion is that you have a great deal of danger and a great deal of risk if you try to do what Mr. Brown contemplates there, especially in the length of time that we have to prepare a bill.

Senator LA FOLLETTE. As I understand it, your chief criticism is that the representative of the Treasury, sitting on this Board, would be influenced by the War Department to designate as essential to the conduct of the war industries something that ought not to be included. Is that what you are afraid of?

Mr. CHESTEEN. I am afraid of two things. I am afraid that the War Department functioning over there will delay the installation of equipment in the first place, and prevent manufacturers from getting under way without a great deal of red tape, and postpone it.

In the second place, I believe it will result in probably a broader application of the section, and probably a great many people coming in that otherwise would not come in, and that you would have both the determination and reliance on one department of the Government.

Senator CONNALLY. Could you not have the Bureau of Internal Revenue determine what was essential for the war?

Mr. BROWN. That was not contemplated.

Senator CONNALLY. I know. Mr. Chesteen said it ought to be under one bureau.

Senator LA FOLLETTE. Mr. Chesteen, is it proposed to make one general provision? Suppose the Bureau sat in with the Board in advance and helped to decide whether an industry was essential or not? If it was so, if it was determined in advance, we would have to amortize it?

Mr. BROWN. We provided that this authority should be exercised through the President, because we did not feel that sitting here today we could anticipate what might be the most effective agency for carrying this out, so we vested the power in the President. He can delegate it as he sees fit, depending on the circumstances he has to face at the time.

We feel also, while we do not claim that this is perfection, or anything of that sort, it is the best thing that we have been able to think of in the time available.

We must remember that we are the most highly industrialized Nation in the world, and that we are more industrialized today by a

lot than we were in the late war. It seems to me that to a very large extent existing industrial facilities are going to take care of many of our war needs, and it also will depend on what kind of a war we are in, to a great extent.

Senator Bailey spoke of agricultural products. In the last war we had allies, and our allies had an inadequate supply of agricultural commodities. Much of our expansion of those commodities was due to the necessity of providing them with necessary food products. If we were in a war by ourselves against a great naval power like Japan, for example, I doubt very much whether there would be any need for a great expansion of agricultural commodities. There might be, but it would not seem so. On the other hand, if we had a great many allies and were involved in a European war, we again might have to come to the fore and supply them with their food products.

Senator LA FOLLETTE. Putting it in another way, if I understand you, your idea is that our present productive capacity is ample to take care of any immediate needs for the conduct of the war, and if the war was of such a nature that it became evident we needed a great expansion of plant capacity for the conduct of the war, that there would be time enough for such an agency as the President might designate to pass upon these questions, that there could be some determination of which were then to have amortization and which were not?

Mr. BROWN. That is right.

Mr. ZUCKER. However, the allowance of amortization is not predicated on that, but is narrowed down to granting some form of additional deduction for industry that will have to convert its plant, or construct entirely new facilities adapted directly for war purposes. It is not a question of whether an industry is operating today at a percentage greater than prior and therefore can meet industrial needs, but it is largely a question of conversion.

Senator LA FOLLETTE. I understand that.

Mr. ZUCKER. That only presses the need for amortization, that is conversion or construction of new facilities.

Senator LA FOLLETTE. Yes; but the war was declared on April 6, 1917, and we did not have a hiatus there in which there were not plants getting ready to turn out shells and powder, and whatever other things they needed, pending the passage of a revenue act, getting amortization on those that were going to convert.

Senator CONNALLY. We cannot act on this this afternoon.

Mr. BROWN. There are two things left over. There is the question of whether the taxpayer who has had a deficiency notice, who, as a condition of his right to prosecute his appeal, would either have to pay the deficiency or put up security for it. Since the last meeting of the committee, I have taken that up with the Bureau officials, and they are very greatly concerned at the possibility of losing a large amount of revenue, not only during the continuance of the war, but altogether, if we have to have a preliminary determination as to each and every taxpayer's ability to put up a bond or other security.

Senator CONNALLY. We have been laboring on the peacetime measure. Why decide this now?

Senator LA FOLLETTE. We have been laboring under a very great disadvantage.

Senator CONNALLY. Have you got anything like that in this new bill?

Mr. BROWN. No.

Senator CONNALLY. I do not see any reason for changing the whole basis in wartime.

Mr. BROWN. Of course, we did not have anything of the sort in the last war. The general rule was the taxpayer was supposed to pay.

Senator CONNALLY. Gentlemen, we thank you very much. We will recess until 10:30 o'clock tomorrow morning.

(Whereupon, at the hour of 5:05 p. m., a recess was taken until 10:30 o'clock the next day, Apr. 29, 1936.)

## TO PREVENT PROFITEERING IN WAR

WEDNESDAY, APRIL 29, 1936

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

The subcommittee met, pursuant to adjournment, at 10:30 a. m., in room 310, Senate Office Building, Senator Tom Connally presiding.

Present: Senators Connally (chairman), Bailey, and Guffey.

Also present: G. D. Chesteen and others of the Joint Committee on Internal Revenue Taxation; Ralph W. Brown, Raymond L. Joy, and others of the Treasury Department.

Senator CONNALLY. We will resume where we discontinued at the previous hearing, if you can recall that.

Mr. BROWN. I was talking about the payment of deficiencies.

Senator CONNALLY. And whether it would require bond or payment?

Mr. BROWN. Bond or payment. Under existing law, the taxpayer has 90 days after receiving the deficiency notice in which to take an appeal, and if he does take an appeal, that stays the collection until after the judgment of the Board of Tax Appeals becomes final. I have taken the position that, for the purposes of wartime taxation, the taxpayer ought to pay the additional tax; and if he feels he has paid too much, sue to get it back. I feel that if we do not do that, there will be a great deal of incentive for corporations to err in their own favor. I will put it this way: That the patriotic corporation will probably pay too much and the fellow who takes his own interest to heart first will probably underpay, and it may result in competitive advantages to the latter corporation which it really ought not to have.

Senator CONNALLY. What page is that, do you remember now, 170?

Mr. BROWN. It is 272, in the Nye bill.

Senator CONNALLY. You mean section 272?

Mr. BROWN. Section 272; yes, sir.

Senator CONNALLY. That is page 164.

Mr. BROWN. Now, the Nye bill, Senator Connally, does give the Commissioner the right to assess immediately and to collect. Our criticism of that provision is that it ought to be all one way or it ought to be all the other. There ought not to be the added administrative burden of having him make up his mind in which cases he is going to apply that rule. Our thought was that it ought to be mandatory on the Commissioner to assess and that collection ought to be had immediately. Senator Bailey presented what is probably

the exception rather than the rule, the case of a taxpayer which may be embarrassed either to pay or to provide a bond. We have given a good deal of thought to that proposition, and in the time available I do not see any way of working out a satisfactory solution to that problem.

Senator CONNALLY. As it stands in the bill, he has got to pay; he has got to pay and then sue?

Mr. BROWN. As I read the language, Senator, it is discretionary with the Commissioner, and it was our thought that that places a very heavy administrative burden on the Commissioner and also puts him in the unenviable position of making that decision. He will have a great many administrative problems in wartime, and it strikes me that it is not unreasonable to ask the taxpayer to pay. Of course, if he is bankrupt and cannot pay and is willing to go through bankruptcy proceedings, that creates a different situation. Mere hardship alone I do not think ought to be a material consideration where there will be unavoidably a great many hardships to everyone.

However, it is recognized that that is a question of policy. I do feel, though, that if you retain the provisions of existing law whereby an appeal to the Board of Tax Appeals will stay assessments and collection, except in case of jeopardy assessments, there will be a lot of revenue lost to the Government which we can ill afford to lose. In the last war we provided for payment. However, claims in abatement which were allowed at that time in effect allowed the taxpayer to avoid payment until a subsequent determination of his liability.

I should point out, however, that even in the case of a claim of abatement under the wartime revenue act the Commissioner could require the posting of a bond in a penal amount double the sum of the claim.

Senator CONNALLY. You were not here the other day, Senator Guffey, when we had this up. When the Commissioner examines a return and finds that there is an additional tax, an additional assessment is made. The question now is whether to make him pay that immediately or allow him to give a bond and appeal to the Board of Tax Appeals, or, under the present law, to appeal to the Board of Tax Appeals without giving any bond. That is right, is it not?

Mr. BROWN. That is correct, sir.

Senator CONNALLY. And he must file a notice to the Board of Tax Appeals, and he has 90 days after receiving the notice in which to decide whether to appeal or not, in which to pay or appeal.

Senator GUFFEY. I am in favor of requiring him to pay. There is a necessity, and if you are going to have a war you are going to need the money.

Senator CONNALLY. Of course, if it is finally adjudicated it is improper, he gets the money back, or a refund.

Mr. BROWN. That is correct.

Senator GUFFEY. Did you do that in the last war?

Mr. BROWN. In the last war the general rule was he was required to pay, but at the time he could file a claim in abatement the general effect was that he did not pay. But in order to have his claim in abatement effective he could be required to post a bond. Of course, that did protect the ultimate tax liability in cases where that was done.

Senator GUFFEY. There was a billion and a half returned too.

Senator CONNALLY. You mean refunds?

Senator GUFFEY. In refunds.

Senator CONNALLY. That was long after the war.

Senator GUFFEY. But it was done in war years. It was returned.

Mr. BROWN. Yes; it was returned. As I say, the man who is highly patriotic errs against himself. The man who takes a more technical, self-interest point of view probably errs against the Government. That gives him a certain competitive advantage, naturally, in the war period. My thought is that they should all be on the same footing and have to pay or at least secure the additional tax liability.

Senator CONNALLY. We heard you, Mr. Chesteen, the other day on this, did we not?

Mr. CHESTEEN. Yes, sir; I merely pointed out for the record that you have in war times—

Senator CONNALLY. Was that all, Mr. Brown?

Mr. BROWN. That is all on that point.

Senator CONNALLY. I mean on that point.

Mr. CHESTEEN. You have a greater urge in war times for the collection of revenue on the one hand. On the other hand, you have a more severe rate or schedule of tax.

Senator CONNALLY. That is right.

Mr. CHESTEEN. And therefore if you collect the tax first, greater hardships will undoubtedly result than in peacetimes. In peacetimes we have seen fit to allow taxpayers to appeal to the Board before collection of tax. It seems to me it is a matter of weighing the hardships that you are going to cause the general public in paying severe rates of tax against the urgent need for a few dollars in revenue that might be obtained by the other method.

Senator CONNALLY. Could you work out, Mr. Brown, a plan to require a bond?

Mr. BROWN. Yes; I think we can work out a plan for filing a bond; yes, sir.

Senator CONNALLY. I want the Government to be secured, and yet at the same time to make the taxpayer pay the highest possible amount that the Commissioner might figure he owes might work a hardship on him.

Mr. BROWN. Of course, the Nye committee had in mind cash in hand, since cash in hand meant reduced Government borrowings during the war period.

Senator GUFFEY. Of course, the last war the rates were not so high, and when these people got the billion and a half back they were then rejoicing in it. But you either ought to make them pay or have a bond, in my judgment, Senator.

Mr. CHESTEEN. I think you will find that a great portion, that is at least a majority of the additional assessments, were paid during the administration of the 1918 act. It is true that a substantial number filed claims in abatement, but I think a far greater percent of taxpayers paid the tax and relied upon the good faith of the Government to make a refund on the merits.

Senator GUFFEY. Remember this now; this is what happened: They paid the tax, and those who filed in their own right an appeal on the tax, later Mr. Mellon, Secretary of the Treasury, passed an

act, according to my recollection, allowing everybody to appeal from the assessments levied, although they did not take advantage of it at the time they paid their tax, and that was what caused the great refund, due to that bill that Mr. Mellon passed. I think I am right on that, if you check it up. Only about 25 percent of the people that had a right to bring it up later filed the objection at the time.

Senator CONNALLY. Of course, the probabilities are that a great many of them would pay, because there would be no sense in litigating it and piling up additional costs and attorney's fees, but there might be some cases in which there was a substantial reduction.

Mr. BROWN. Of course, you have already provided that the Commissioner under certain circumstances has a right to extend the time of payment.

Mr. CHESTNEN. I think I pointed out on this question before—I haven't the statistics before me, but it is a matter of record—that of the additional assessments proposed under 90 day letters, a substantial portion of that is erased by the Board or by settlements in the Bureau by stipulation.

Senator CONNALLY. Before they get to the final adjudication.

Mr. CHESTNEN. So that indicates a great many of proposed assessments are erroneous, or at least they cannot be sustained before the Board.

Senator GERRY. I offer a motion that it be redrafted to require the taxpayer to file a bond with his return.

Senator CONNALLY. File a bond if he appeals, you mean?

Senator GERRY. File a bond if he appeals.

Senator CONNALLY. All in favor of that, say "aye."

[Ayes.]

Senator CONNALLY. The motion prevails.

Mr. CHESTNEN. Mr. Chairman, may I submit for the record at this point a rough draft of the suggestions we made yesterday with respect to amortization?

Senator CONNALLY. All right.

Mr. CHESTNEN. All this draft does is to try to stop obvious loopholes disclosed by the experience of the 1918 Revenue Act and to make certain changes as a result of court decisions which would open other loopholes for excessive allowances. I think it is fair to say that the plan as a whole, if it had been in effect during the 1918 act, would have probably reduced the allowances by at least a third of the amount allowed, because many of these revisions are substantial revisions in the law, and all of them are practically restricting the experience and the interpretations that was put on the 1918 act. It is not necessary for me to take up—

Senator CONNALLY. How long is it? Can you read it?

Mr. CHESTNEN. Yes, I can read it; it is not very long. It is only two pages.

Senator CONNALLY. Suppose you give Mr. Brown an extra copy.

Mr. CHESTNEN (reading):

(S) AMORTIZATION.—(1) PROVISION FOR ALLOWANCE: *in the case of buildings, machinery, equipment, or facilities of a similar character contracted for and constructed, erected, installed, or acquired on or after the effect date of this title and prior to the date on which Congress shall declare the emergency created by such war to be at an end (except property acquired by the taxpayer in a non-taxable exchange permitted under section 112) for the produc-*



tion of articles contributing to the prosecution of the war and in the case of vessels constructed for and constructed or acquired on or after such date for the transportation of articles, or men contributing to the prosecution of war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer. At any time within three years from the date on which Congress shall declare the emergency created by such war at an end the Commission shall reexamine the returns and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the tax for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of the tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 822.

(2) TENTATIVE ALLOWANCE. —

That is a provision for a tentative allowance during the period of the war and after the war make a final determination.

For the purpose of returns made during the effective date of this title, the preliminary estimate of the amount of such amortization for any year shall not exceed 15 percent of the cost of such part of the facilities or vessels as have been borne by the taxpayer: *Provided*, That when the aggregate allowances equal to 60 percent of the cost of the facilities or vessels no further allowances shall be made.

(3) SPREAD OF AMORTIZATION: The amortization allowance shall be apportioned (a) in cases where the property was employed in the production of articles contributing to the prosecution of the war —

Senator CONNALLY. Do you use the word "contributing" there?

Mr. CHESTEEN. "Contributing to the prosecution of the war."

Senator CONNALLY. Instead of "essential"?

Mr. CHESTEEN. Yes, sir. [Continuing reading:]

over the respective accounting periods of use or employment of such property by the taxpayer on the basis of the net income (computed without the benefit of the deduction for amortization) of the taxpayer. (b) In cases where the property was not completed in time for use in the production of articles contributing to the prosecution of the war, on the basis of the expenditures made on account of which amortization is allowed.

4. SCOPE OF ALLOWANCE: The allowance under this subsection shall be inclusive of all depreciation during the amortization on property subject to amortization.

That is according to the decision in *U. S. Cartridge case*, which held that the Bureau allowances for amortization were not inclusive of depreciation on the property but merely allowed a deduction for the excess cost due to the inflation of the war. If that decision, which we must recognize as law, had been applied to all the war years, almost every taxpayer would have been entitled to substantial allowances for depreciation on property on which amortization was claimed and on which no depreciation was allowed.

It is that factor, among others, which leads me to believe that our aggregate allowances during the war were very conservative, because we certainly denied depreciation on all property which the Supreme Court said they were entitled to depreciation on on a post-war basis.

As I pointed out yesterday, the word "facility" was construed by the Bureau not to include land or mine development or oil development. The Federal court construed it to include mine development, and the Bureau followed that construction and applied it to the development of oil rights.

I changed the language so that I believe it will exclude any such interpretation or include all that great body of claims that might be allowed.

I made a change here. The language of the law in the 1918 act said "erected, installed, or acquired on or after April 6, 1917." As I pointed out yesterday, large amounts of construction were contracted for back as far as 1915 that were not actually expended until after April 6, 1917, and formed the basis of the amortization allowance, in substantial amounts. I changed that to provide that there must be a contract as well as a construction after the declaration of war, which would cut out any anticipation of war by starting construction beforehand that may have had no relation to the war.

Also, I tried to eliminate here property acquired during the war period in the so-called tax free exchange under the reorganization provisions should not form the basis for amortization. That section caused a very great loophole that I doubt can be plugged in any manner.

So, as a whole, this draft is intended to get rid of all the controversial items that have been up except the words "contributing to the prosecution of war." As I stated yesterday, I felt that in the light of the late court decisions and Board decisions, that "contributing to the prosecution of the war" has some sensible meaning in the revenue act, and I think those decisions indicate that the article must have some war connection and I do not believe claims having such a remote connection with the war as were allowed prior to 1925 by the Bureau are within the intent of the statute.

Senator COXSALLY. In what respects does that differ from your draft yesterday, Mr. Brown?

Mr. BROWN. There are two primary points of divergence.

Senator COXSALLY. Yesterday Mr. Brown submitted a tentative draft on amortization.

Mr. BROWN. Those points are; Mr. Chesteen uses the language "contributing to the prosecution of the war", and our suggestion contained the language "essential to the prosecution of the war." We felt that that was a narrowing, statutory narrowing, of the language, which might possibly eliminate to some degree the taking in of a lot of these facilities and items which Mr. Chesteen referred to yesterday. I personally believe the Bureau would be disinclined to go as far as it did in the last war without any change in the statutory language. On the other hand, it seems to me that if we could adopt a phrase which was somewhat narrower, that would be advantageous.

The other point of divergence is in respect to our proposal that the determination of the question whether the taxpayer would be entitled to any amortization would rest with an agency appointed by the President. In other words, a taxpayer about to invest his funds in war plant or equipment would be required to obtain a license from this war agency, and at the same time he could take up with the agency whether it was considered essential to the prosecution of the war. If the agency determined that it was, why then he would know right then before he invested any of his funds that he was going to obtain a reasonable allowance for amortization. That latter determination—that is, the measure of the amortization—would be determined by the Bureau through the application of the rule of what is reasonable in the circumstances then existing.

The reason that we felt that that might be a possible solution was that we felt that most certainly in the next war corporations and industry will be subject to a much greater degree of regulation than in the past war. The nature of a modern warfare is such that it seemed almost inevitable that corporations and individuals would not be able to enter into new construction and expansion of facilities without some kind of authority from the war authorities. As I said yesterday, materials and labor will not be available in a very large number of instances without some release from the war authorities, and that being the case, we felt that the decision on the right to amortization, based on whether or not the war authorities considered it essential, should be determined at that time; and that would have the additional advantage, as I said, of assuring the taxpayer before he invests his money that he is going to get an allowance for reasonable amortization.

Now those are the two points of divergence and the two plans. We hold no special brief for our own plan. In the time available I gathered together some of our ablest and most experienced men in the Bureau to work out this. I do not believe that they would claim for it perfection or anything like that, but it is one way which we think it might safely be handled at this time.

Senator CONNALLY. Let me explain to Senator Guffey what we did yesterday. Yesterday we took up this amortization, and the Treasury proposed a plan whereby a man who wanted to expand his plant for the manufacture of articles—we used the word “essential”——

Mr. BROWN. “Essential” is correct.

Senator CONNALLY. “Essential to the prosecution of the war”——should apply to some board set up by the President for a license, and that was what Mr. Brown meant, that he would know that when he got his license, if he did have a license, they could amortize it and thereafter he would proceed to expand his plant, and so forth and so on.

So the two points of difference, really, in the two plans, the outstanding ones, are the narrowing of the language from “contributing to the war” as used by Mr. Chesteen, and “essential to the prosecution of the war.” And on the Government license Mr. Chesteen made the point that it would be rather impractical to have two agencies dealing with the matter, one to get the license from and pass on the essential character of the industry, and then the Bureau of Internal Revenue in setting the tax.

Now you can go ahead, Mr. Chesteen.

Mr. CHESTEEN. I gave some consideration to both of these suggestions of Mr. Brown in drafting my suggestions.

As to the first, as to whether it is desirable to use the word “essential” or stay with the language that has been used in the 1918 act, is a matter, of course, for you to decide. I looked up the word “essential”, and I came to the conclusion that it was about as difficult to determine whether a manufacturer produced an article that was essential to the prosecution of the war as it was to determine whether he contributed to the prosecution of the war. Further, a construction might be placed upon the word that would restrict the application of the section to a too narrow base.

Senator CONNALLY. Would not the board, when granting the license, more or less pass on that question?

Mr. CHESTEEN. I am coming to the other point. So, as between the two, it seemed to me that it was better to stay with language that had been interpreted at least in some measure by the Board and by the Federal courts, and for that reason I stayed with the language of the 1918 act.

As to the other point, it has been my experience and my observation that where you place the responsibility for the administration of any law in the hands of more than one department it inevitably follows that there will be lack of proper coordination in administration. Now, if that be a tax law, that lack of coordination is likely to result in a very uneven application of the law and a very inconsistent administration of the law. No better example of that exists in our past than the history of the income-tax law itself, where its administration and interpretation is under the direction of two departments instead of one.

We looked at it from this viewpoint: It is bad enough to have two departments to administer a tax law. It would be worse to have three departments trying to administer the same law.

Senator CONNALLY. Is it true that two departments are administering it? I do not take that view.

Senator GUFFEY. What are the two departments?

Mr. CHESTEEN. The Department of Justice and the Treasury Department.

Senator CONNALLY. I am talking about this present proposition, though. This board set up by the President would not have anything to do with determining the tax. All it would have to do would be to say whether this particular industry is one to be expanded or it is desirable to develop, on the theory that it is an essential war industry. After that board does that, why, the tax becomes purely a matter within the Bureau of Internal Revenue, doesn't it?

Mr. CHESTEEN. That is true. It performs one of the most essential administrative functions in determining whether amortization is allowable.

Senator CONNALLY. I know, but after it has determined that it is going to be allowed, then it is a matter for the Internal Revenue Bureau to arrive at what ought to be allowed.

Mr. CHESTEEN. That is true; but, as I see it, you may have the War Department taking a very liberal attitude and you may have the Bureau of Internal Revenue taking the opposite attitude in the construction of the law.

It seemed to me that all experience indicates that the more you concentrate all of the administration of a law in the hands of one department the more likely you are to have coordination and consistency of administration.

Senator CONNALLY. I grant you that is true.

Mr. CHESTEEN. I do not know whether this plan is a dangerous plan. It might be a feasible plan. I don't know. It is something new.

Senator CONNALLY. Your generalization there about centralizing the whole matter in one bureau is a good one. But still this is a

problem that has two aspects. If we are going to enter a war at all, why we want to win it. Now that is a military and a naval problem, as to what is necessary to be done to carry on the war successfully.

After this board determined that this is an industry that ought to be stimulated and that it performs that function, then the tax under that becomes a matter for the Bureau of Internal Revenue. I do not see very well how you can vest in a bureau, for instance, the question of determining what is an essential war industry. It would be just as foreign to the duties of the bureau to determine what is an essential war industry as it would to the board to determine what is a proper tax.

MR. CHESTEEN. From my viewpoint I did not adopt that language, because, as I conceived it, this is a tax provision, and it would be better that it all be in a taxing law and the determination be made in the final returns rather than have the determination made in the War Department when the first question of producing an article comes up.

Senator CONNALLY. Suppose a company did not get a license at all and went ahead and expanded on its own hook. He then could not get an amortization later on? Is that your draft, Mr. Brown?

MR. BROWN. There would be none; no, sir. My plan is based on the theory that in order to get the right to obtain materials and labor for this plant expansion under the conditions of the next war it would be necessary in any event for the taxpayer to go to some agency to secure that right.

Senator CONNALLY. Would there be danger there, however, of the board, in the exercise of its powers, showing favoritism in only giving a few concerns the right to expand in the manufacture of these articles and exclude others arbitrarily?

MR. BROWN. Of course, I am indulging in speculation, but it is my thought that such a bill, probably made up of such representatives as the President might feel were necessary, would make that determination on whether they considered this production or expansion or facility sufficiently essential—we are proposing—to the prosecution of the war, and having done so it would seem to me that they have determined at that time the right of the taxpayer to receive a reasonable allowance for amortization.

Senator CONNALLY. That though really is in harmony with the industrial sections of this bill after all, which give to the President vast powers as to the control of all sorts of industries that may be engaged in war, even to the extent of commandeering them and taking them over. Isn't that true?

MR. BROWN. That is correct.

Then there was another point, that we felt under the high tax rates contemplated in this bill possibly a taxpayer might need some inducement to put up his own money, and before he actually made that decision he would want to know to some extent how he was going to come out, and that that would possibly encourage him to use his funds, which he might not otherwise do.

If I may add, there were two other minor points of divergence. Mr. Chesteen provided for a tentative allowance in wartime and also made provision for the rate of the allowance. We had contem-

plated that would be handled by rules and regulations. I do not know that there would be any serious objection to putting it in the statute, except that it is not quite so flexible.

One other thing, in connection with the original determination as to the right to deduct amortization, that that would be a final decision and would not be subject to court review. As to the amount of amortization, the amount awarded by the Bureau for reasonable amortization, that would, however, be subject to review by the courts.

Senator GUFFEY. Mr. Chairman, I move we adopt the amendment as suggested by Mr. Brown.

Senator CONNALLY. That is that we use the language "essential"?

Senator GUFFEY. Yes.

Senator CONNALLY. In preference to—

Senator GUFFEY. "Contributing."

Senator CONNALLY. And the Board getting the consent?

Senator GUFFEY. Yes.

Senator CONNALLY. War Industries Board. I think we should really merge these two. I think the clauses of Mr. Chesteen on the two points you just mentioned a moment ago might well be incorporated in the draft.

Mr. BROWN. We would be glad to work that out with Mr. Chesteen.

Senator CONNALLY. If you could incorporate the "essential" and the Board part and then spreading it over the period and the tentative allowances, I think those are valuable points. The tentative allowances, especially, because if the taxpayer gets the tentative allowance he has some assurance that he is going to get amortization, even more than he got when he got his certificate. He would be more encouraged to go ahead and develop his facilities than he would otherwise. Don't you think so?

Senator GUFFEY. I agree with you.

Mr. BROWN. We left it out, Mr. Chairman, because the tentative amount will be something which the corporation will have to take into consideration in the decision as to the amount of distribution they should make under the new plan for the taxation of corporations. However, if the committee feels that it is desirable to put that in, we make no point of it.

Mr. CHESTEEN. Mr. Chairman, I have not examined a copy of Mr. Brown's suggestion, but I did not hear anywhere the suggestion I put in the draft about excluding reorganizations. Do you have that?

Senator CONNALLY. Did you comment on that, Mr. Brown?

Mr. BROWN. I did not comment, Senator.

Mr. CHESTEEN. I am not so sure of my position with respect to reorganization since I have not had time to think over the extent of the loophole. I think it is all right.

Senator CONNALLY. What do you think of that?

Mr. CHESTEEN. If the Treasury arrived at the same conclusion, we might be safe.

Mr. BROWN. We have arrived at substantially the same conclusion, and our draft does cover that. It was a subject of discussion with the group that worked on this provision of the bill.

Senator CONNALLY. Suppose you incorporate that in there?

Mr. CHESTEEN. That is undoubtedly a substantial loophole in the event of war.

Senator CONNALLY. If it is agreeable.

Senator GUFFEY. Yes.

Senator CONNALLY. So, if Mr. Brown and his group and Mr. Chesteen and his group can merge and get together and make a draft on amortization, it is the action of the committee.

Mr. CHESTEEN. There is another provision that I have that I am not sure that we are in agreement on. I excluded in the draft commitments made prior to the declaration of war, in the view that they are peacetime projects.

Mr. BROWN. We have that, Senator.

Mr. CHESTEEN. At the end of the period I likewise excluded anything that had not been constructed or acquired at the termination of the war. I realize there would be some hardship under that policy.

Senator CONNALLY. You mean a facility that had not been constructed and completed?

Mr. CHESTEEN. Yes. Possibly a project is 10 percent completed and the taxpayer is required, of course, to go ahead with the entire project. It may be a substantial sum. He would not get any amortization on the remaining portion, even though his commitment during the war, and really the loss that he is going to sustain as the result of that construction, did grow out of the war. I do not know whether you want to take care of that. It might be a little difficulty to draft the provision.

Senator CONNALLY. That is pretty harsh.

Mr. CHESTEEN. I think it is a very harsh rule, but I was faced with this proposition, trying to get something before you, and I could not, in the length of time I had, work that out satisfactorily; but I think it might work a very great hardship in some cases.

Now, the 1918 act permitted the taxpayer to amortize the construction where the loss, even though the expenditure extended beyond the period of the war, where the loss to the taxpayer, if he had abandoned the project at the end of the war, would be greater than it would if he had gone on with the contract. Under those circumstances the taxpayer was allowed to include all these costs beyond the period of the war and have the estimate on loss on the entire construction after it was completed, because we said that was a less loss than he would have been entitled to had he stopped construction at the date of the close of the war and then paid off all his liabilities for breach of contract in going through with the project.

It seemed to me that is a pretty sound policy, and that was carried through. It is not in the act, but it is carried through as an administrative interpretation. We may have trouble in working it out in a short time.

Mr. BROWN. May I ask Mr. Joy to speak of that, because of his wide experience on the provisions of the last war?

Senator CONNALLY. Mr. Joy, we will be glad to hear you.

Mr. JOY. I believe it would hardly be feasible to exclude altogether contracts begun before the war terminated and not completed. Under the plan the board authorizing the construction would have determined that the product of that construction was essential to the prosecution of the war, and therefore the taxpayer would be entitled in principle to amortize that construction. If the war terminates suddenly before his plant is completed, it would not

change the fact that he had begun it under that authorization and understanding. So we left out altogether everything in our draft with respect to such contracts, merely providing that a reasonable allowance for amortization should be made.

Senator CONNALLY. Who is going to determine that?

Mr. JOY. The Bureau of Internal Revenue.

Senator CONNALLY. To determine what is reasonable?

Mr. JOY. The taxpayer could either scrap his plant on the termination of war, take salvage value on what he had expended, or if he wanted to complete the plant for peacetime use the Bureau, taking into account the relative expenditures, would make a reasonable allowance for the amortization of his cost prior to the termination of the war.

Senator CONNALLY. In all these amortization allowances, though, the word "reasonable" would be a matter for determination by the Bureau.

Mr. JOY. Yes.

Senator CONNALLY. Or, of course, by the courts if it got into court?

Mr. JOY. Yes; that would be subject to litigation.

Senator CONNALLY. So it is a very flexible term. It would depend largely upon the particular industry and all that sort of business as to what was reasonable under all the circumstances.

Mr. JOY. It would seem likely that in the case of a major war that had continued for some few years and the termination of that war was very uncertain, producers might be quite reluctant to enter into any further construction if under the provisions of the act they were not entitled to any amortization at all in the event the construction was not completed before the war ended.

Senator GUFFEY. Who appointed a committee since the last war to adjust these differences? I remember there was a committee in Pittsburgh who adjusted these uncompleted buildings, uncompleted plants, and where part of the material had been purchased.

Mr. JOY. That was handled through the engineering department of the Bureau.

Senator GUFFEY. It was done that way, but they sent that local committee out there to advise with them.

Mr. CHESTEEN. Do you refer to the situation of war contracts?

Senator GUFFEY. Yes.

Senator CONNALLY. That was not under the Bureau.

Mr. CHESTEEN. That was settled by the War Department. I am not sure who had charge of that work. I know there was someone appointed specifically for that job.

Senator GUFFEY. They had a general committee appointed and a particular local industry committee. That did not have anything to do with the amortization or depreciation of the uncompleted plant that was under contract?

Mr. CHESTEEN. Yes. Under the Dent Act the War Department was authorized not only to make settlement for the taxpayer for the cancellation of the contracts so far as the profit it concerned, so far as the undelivered portion is concerned, but they were authorized to reimburse the taxpayer for the facilities which he would have amortized in his price had he carried through the contract. Several millions of dollars were allowed as contractual amortization



by the War Department in the settlement of those contracts, and pursuant to the Dent Act we reduced the cost of the facilities on which amortization was allowed by the amount allowed by the War Department.

Senator CONNALLY. When it comes to these contracts that you are speaking of that were made toward the end of the war, if a proprietor has in fact made a binding contract legally, he is practically in the same position as if the plant were completed, because he has either got to go on and fill it or he has to cancel it on terms provided in the contract which takes care of the contractor or the man that is constructing it substantially in the same measure as he would if he had gone on and finished it.

It seems to me if it has been determined that he is engaged in an essential industry and started his plant and the war suddenly ended, he ought to be entitled to amortization just as any other contractor who might have completed his project, although he might have produced not a single war munition. What do you think of that?

Senator GUFFEY. I think that is fair.

Mr. BROWN. We agree to that, Senator, and under our suggested plan the determination would already have been made as to his right to obtain amortization.

Now, it is true, as Mr. Chesteen pointed out, that there might be some adjustments before we come to our determination of the amount of amortization, due to what he called and what was called contractual amortization. That is outside the administration of the income tax.

Senator CONNALLY. Suppose he had a clause in his contract with the man that was building for him that he could cancel it on certain terms. Of course, all those factors would go into determination by the Bureau as to what was reasonable amortization.

Mr. BROWN. It would be one of the circumstances.

Senator CONNALLY. On the other hand, if he had a different kind of a contract where he had to go ahead and complete it or else pay the contract price, irrespective of whether he needed those facilities, that would be still another factor that the Board would have to determine, or consider at least, in arriving at a fair measure of amortization. Is that correct?

Mr. BROWN. That is correct, sir.

Senator GUFFEY. I will cover that in a motion.

Senator CONNALLY. Senator Guffey makes the motion that we have you gentlemen get together and merge these two plans, as indicated awhile ago, with the provision that there be an allowance in the cases that you have just mentioned. So all in favor of the motion will say "Aye." (Ayes.) The motion is carried.

Mr. BROWN. Now, there are two other problems which are raised under war conditions, and I would like to have Mr. Joy mention them if it is the wish of the committee.

Senator CONNALLY. In connection with this particular matter, amortization?

Mr. BROWN. No. They bear on related problems.

Mr. JOY. The first provision that we suggest should be inserted in the pending bill is with respect to carry-over contracts, whereby, if a taxpayer is continuing the operation of Government contracts

after the war, realizing profits at the same rate that he realized during the war period, we have a provision here that the profits realized from that contract shall be taxed at the rates provided in this bill, in proportion to his income from other sources, however, the income from other sources to be taxed at the rate provided in the revenue law coming into effect when this act terminates.

Senator CONNALLY. What do you mean by "carry-over contracts"? Do you mean, for instance—

Mr. JOY. War contracts.

Senator CONNALLY. Blankets for the Army, say? You mean after the war is over he continues to go ahead and fill his contract?

Mr. JOY. Yes. Well, any war contract that he was working on when the war terminated and realizing profits on that basis.

Senator CONNALLY. You mean the Government, contracts with the Government, or with anybody else?

Mr. JOY. We have it in here limited to Government contracts.

Senator CONNALLY. I think that is the only practical way to have it.

Mr. JOY. We have a draft of a proposed section here that we think would take care of that, if you care to have me read it. We would suggest that there be inserted on page 20 of the bill, following line 18, a new section as follows:

SEC. 14. Carry-over contracts: For each taxable year beginning after the date upon which this Act otherwise ceases to be effective, or portion of taxable year beginning after such date, there shall be levied, collected, and paid upon the net income of every taxpayer deriving in such year a net income of more than \$10,000 from any Government contract or contracts made during the effective period of this Act, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in this Act as the net income attributable to such Government contract or contracts bears to the entire net income.

(2) Such a portion of a tax computed at the rates specified in the income tax act which is otherwise effective after the date upon which this Act otherwise ceases to be effective, as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary: *Provided*, That nothing herein shall be construed to extend the three-year period provided in section 23 (b) (2).

That language has been, part of it at least, taken from section 301 of the war profits and excess-profits tax title of the 1918 act. A similar provision was made in the 1918 act for taxing such carry-over contracts or profits, and we have adhered rather closely to the same provisions in this suggestion here.

Senator CONNALLY. What do you think of that, Mr. Chesteen?

Mr. CHESTEEN. Mr. Chairman, we considered this question. In the light of the experience in the last war and after study of the question, we decided it would be inadvisable to put anything in the bill on this question. In the first place, we know that if a war is not terminated close to the end of the taxable year practically all the contracts will be immediately canceled. The few contracts that were continued after the end of 1918 in the last war were those where the Government found it advantageous for the most part to

have the taxpayer complete the contract, either because the Government probably needed the product or thought it was more economical than it was to cancel the contract and pay the damages.

Now, looking at it from that standpoint, we concluded that in all events there would be a small amount of war income after the termination of the war.

Secondly, from the taxpayer's standpoint he may be worse off by having to continue on Government contracts than if his contracts had been canceled. I recall cases in the last war where taxpayers were allowed to continue under Government contracts and they were worse off by reason of it, for this reason—

Senator CONNALLY. In that case they would not have to pay this additional tax, would they?

Mr. CHESTEEN. For this reason: They could not get back into their peacetime business until they finished these contracts. By that time their competitors had taken a lot of their business and they found it very hard to get back their trade. I remember one or two companies that have been more or less on the rocks for a number of years after 1919 on that account. It is true that you might have a few cases where there would be a substantial amount of income during the year following the war, but the economic disadvantages that may result to the taxpayer in the aftermath of the war may not be of any net advantage to him, even if you do not tax the income at the war rates.

For another reason we discarded it, because it would be more or less a problem of administration. Under the scheme of this tax bill that is now in the House we thought that if you continued that through the period after the war you would have to have substantial rates in order to force distribution, so the taxpayer would pay a substantial tax probably in peacetime even under peacetime rates.

Senator GUFFEY. When does this tax bill terminate—soon after the war?

Mr. CHESTEEN. I believe this says when the emergency should be declared at an end.

Senator GUFFEY. Congress must declare one?

Mr. CHESTEEN. Yes, sir.

Senator GUFFEY. That answers my question.

Senator CONNALLY. Mr. Joy, you say you had a good deal of experience in the Bureau adjusting the war taxes?

Mr. Joy. Not in connection with this particular section that I am talking about.

Senator CONNALLY. Let me ask you. If, in the cases mentioned by Mr. Chesteen, they did not make high profits, they would not pay the tax, would they?

Mr. Joy. No. You mean during the war?

Senator CONNALLY. No; after the war.

Senator GUFFEY. After the war.

Senator CONNALLY. If they went on producing after the war. Unless the Bureau could show that he was making a high rate of return on these war profits, he would not have to pay?

Mr. Joy. No; it would not turn on whether the profit was large or not, but if he realized income from a Government contract after the termination of the war that income would be taxed at the wartime

rates. The rest of his income would be taxed at the rates provided in the bill which would take effect after this one terminates.

Mr. CHESTEEN. May I point out, Mr. Chairman, this fact: It seemed to us that that was a matter for the Congress after the war was over to decide whether they were going to tax a hangover on Government contracts. If it is any substantial amount or worth while, that could be determined in peacetime.

Senator CONNALLY. On the other hand, you are carrying over into peacetime the losses and amortizing.

Mr. JOY. The next provision I have to discuss is loss on inventory.

Senator CONNALLY. That is projected over into the peacetime period. Now if it is going to give him these amortizations and so on, why would it not be good to include his profits?

Mr. CHESTEEN. Surely. I know you were providing for this, that if a contractor did not complete a project during the period of the war he could take an economic loss determined by amortization on costs incurred after the war back into the war period, so as to get the deduction against his war income.

Mr. BROWN. The next point to be taken up, Senator, is the question of inventory losses, which does involve a carry-over of losses into the post-war period.

Senator CONNALLY. Suppose you present that too and we will consider them both together.

Mr. JOY. The loss on inventory provisions contained in section 214 (a) (12) of the Revenue Act of 1918 were based upon the anticipation of a drop in the basic price of commodities upon the return to peacetime conditions. The provisions extended only to the years 1918 and 1919. As subsequent events revealed, the sharp decline in price levels did not take place until 1920. It appears to have been the general experience of the past that such price declines have followed the advent of peace, and it is highly probable that history in this respect will repeat itself. It is therefore believed that the loss on inventory provisions should be inserted properly in a wartime tax measure.

The provision that we have here is similar to the provision contained in the 1918 act, modified in some respects, and it is as follows: It is suggested that there be inserted on page 35 of this bill following line 24 a new subsection (R), as follows:

(R) LOSS IN INVENTORY: (1) At the time of filing return for the last taxable year under this Act a taxpayer may (notwithstanding any other provision of law), file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed, then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 6 per centum per annum from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income.

(2) If no such claim is filed—

That is at the time of filing his return for the last taxable year under this act—

but it is shown to the satisfaction of the Commissioner that during the period of one year after the date upon which the last return under this Act is due the taxpayer has sustained a loss of the character above described, then the amount of such loss shall be deducted from the net income for the last taxable year under this Act, and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 322.

Section 322 relates to the filing of claims for refund.

That would provide that the taxpayer in filing his last return under this act could file a claim for refund based upon this deflation in the value of his inventory, or if he did not file his claim with that return and he could show to the Commissioner in the year following that deflation had occurred, then this permits him to take that loss against his tax for the last year under this act.

Senator CONNALLY. Take it against his profit?

Mr. JOY. Yes.

Senator CONNALLY. Deductions, not against the tax?

Mr. JOY. Yes.

Senator CONNALLY. But against his net income?

Mr. JOY. The gross income for the last taxable year under this act.

Mr. CHESTEEN. Mr. Chairman, we took the same position with respect to this matter. Undoubtedly considerable inflation will take place under this bill at the time of war, and there will be some deflation of inventories following the war. This act will go out of existence and cease to be in effect at the declaration by Congress that the emergency ceases to exist.

We took this view, that to allow a loss that will take place after the war in the peacetime period can better be measured by a Congress that enacts a law following the war, in the belief that they will know whether that is an emergency or there is sufficient deflation to warrant any relief to the taxpayer in the last 2 or 3 years of the war.

But from our viewpoint, we thought that, since that was an economic change that was going to take place after the war and at a time when Congress would have under consideration a peacetime bill, we thought it could be better measured by Congress at that time than now.

We point this out, too: Congress attempted to measure the period of deflation of inventories in 1919, as you remember. The act was passed on February 26, 1919, and contained a provision in the law to that effect. Of course, we know what happened. The drop came in 1920, and the taxpayers got very little benefit under this provision.

Senator CONNALLY. Congress could do that under this bill if we provided that they did not get substantial deflation and the shrinkage came later. As matter of fact, Congress could do it. But as I get this, Congress could do it after the war if it occurred by reason of the war, and therefore it is proper to treat it in a war-time taxation measure because it is an incident of the war. But for the war, there would not have been the shrinkage; would not have been the stimulation.

Mr. CHESTEEN. I think you would have to consider this fact, that there might be a period of 2 years.

Senator CONNALLY. If there were, then the peacetime Congress, as you suggest, could then pass another act or amend the existing law; but it seems to me that, since it is a necessary incident of the war, it is properly includable in this bill.

Senator GURFEY. I agree with you. Mr. Chairman, I offer a motion that both of the amendments suggested by Mr. Joy be included in this bill.

Senator CONNALLY. As many as favor it say "aye." [Ayes.] All right; those two provisions are in.

What else have we? Aren't we getting down toward the end of this bill?

Mr. BROWN. There is the question of penalties that was laid over, Senator.

Senator CONNALLY. I hate to determine that myself, with nobody else here. Is that the only thing you think of—the penalties?

Mr. BROWN. I think that was the only thing.

Mr. RICE. How about debt-ridden corporations?

Mr. BROWN. Oh, there are one or two problems that arose in connection with the administration bill which we are using as a basis for our treatment of the corporations. The administration bill provides for a tax of 15 percent on that portion of the income of a corporation with impaired capital structure, which is applied toward the restoration of its capital position, and the balance is taxed under the rate schedules which are applicable, depending upon the amount of income that is retained by the corporation.

Senator CONNALLY. What is the objection to just carrying forward those same provisions?

Mr. BROWN. Well, I should point out that the administration bill in certain situations draws a line, which is March 3, 1936. In other words, it takes care of the situation of corporations in that connection as of the date of the President's message to Congress, but it does not make any provision for the future situation.

Senator CONNALLY. Why couldn't we adopt, instead of March 3, 1936, the declaration of war, if the corporation is in that condition at the time of declaration of war?

Mr. BROWN. Well, that would be practical. It is a question of policy if you wanted to do that. I assume that if we went along a long number of years before getting into war, under the provisions of the peacetime bill that situation would have worked itself out through the new methods of financing and adjustments which corporations would have to make.

Senator CONNALLY. What we are discussing now, Senator Bailey, is the suggestion as to whether or not we shall carry forward in this wartime bill the provisions in the new tax bill providing for debt-ridden corporations to pay a tax of 22.5 percent.

Senator BAILEY. Yes; I see.

Senator CONNALLY. Do you care to say anything on that, Mr. Chesteen?

Mr. CHESTEEN. We have no comments to make on that section, Senator.

Senator CONNALLY. All right.

Senator BAILEY. I make a motion to include that.

Senator CONNALLY. The motion is that it be carried forward in this bill as the beginning of the war instead of March 3.

Senator BAILEY. Provided it is in the next tax bill.

Senator CONNALLY. As many as favor the motion say "aye."  
[Ayes.] All right.

Now, what else? We are about to get through with this bill.

Mr. BROWN. Then there is the question of corporations with debts, for which special provision is made in H. R. 12395.

Senator CONNALLY. That is the new tax bill.

Mr. BROWN. Yes; in section 16 of that bill. The problem to which I referred just now arises in that connection. The House bill in section 16 draws a line on March 3, 1936, the date of the President's message.

Senator CONNALLY. In that clause we have just voted on, of course, you would have to relate that increased rate, would you not, along with the other rates?

Mr. BROWN. Yes. That provides, you see, for a flat rate of tax.

Senator CONNALLY. You would have to increase that flat rate in ratio to the increased rates that you are figuring out now for the corporation?

Mr. BROWN. We are doing that; yes, sir.

Senator CONNALLY. All right; go ahead.

Senator BAILEY. What do you do with section 64 on page 63?

Mr. BROWN. Of which bill, Senator?

Senator BAILEY. That is of H. R. 5529, the wartime bill.

Mr. BROWN. You have already made the decision with respect to that, to eliminate it.

Senator BAILEY. All right; that is what I want. That is stricken out.

Senator CONNALLY. That is out, is it not?

Mr. BROWN. That is out; yes, sir.

Senator CONNALLY. Now, what other matters, gentlemen?

Mr. BROWN. Then you wish, in respect to the problem raised by section 16 of H. R. 12395, to adopt the effective date of the war?

Senator CONNALLY. The declaration of the emergency. Don't you think so?

Mr. BROWN. It is purely a question of policy.

Senator CONNALLY. How could you determine it?

Mr. BROWN. Well, as I say, if we have a long period of peace before this title takes effect, it is very likely that there will be material readjustment of the method of handling debts.

Senator CONNALLY. If that is true, there would be none of them that would be applicable. If it is effective as of the date of the declaration of war, no corporation that was not at that time in these debt difficulties would have the right to claim this lower rate. Isn't that true?

Mr. BROWN. That is right; yes.

Senator CONNALLY. I think that is a matter that would work itself out.

Senator BAILEY. Have you made any provision in your bill for scientific instruments, inventions, and that sort of thing? Do you have those under the same rule of taxation that you have general commerce?

Mr. BROWN. We are not suggesting any different treatment than would apply in peace times, so far as that is concerned. I suppose if some new scientific instrument had to be produced for essential

war purposes, some special allowances might be made by way of amortization or something of that sort to encourage investment of private capital for the production of such scientific instruments.

Senator BAILEY. Those scientific instruments already in use.

Senator CONNALLY. They are not treated any differently than any other problems. But in the case of scientific instruments necessary for war, the Navy Department could very easily make special contracts for their production or make loans under the revolving fund, under that section of this bill.

Mr. BROWN. That is correct. You have three factors contributing to that situation. You have the revolving fund from which direct subsidies or loans may be made. You have contractual amortization to which Mr. Chesteen referred; that is, a provision being made for recovery of part of the cost of the installation in fixing the price. Then you have, third, this provision for amortization which applies against income tax. Those three provisions will be in the law if this plan is adopted, to take care of war production of whatever may be essential to its prosecution.

Senator BAILEY. That is to be retained in the final draft of the act?

Senator CONNALLY. Oh, yes. All three of those features are in the bill now and voted on.

Senator BAILEY. I should think when you go to calculate the profits on a scientific instrument you would undertake to make a fair allowance for the experimental period in making the instrument. The instrument may be a very inexpensive thing, but in order to produce it and to perfect it a great deal of money may have been expended. It should be valued for the purposes of amortization, not on the basis of its present cost, but on the basis of the expenditures to bring it about.

Mr. BROWN. Well, I would say that that was to some extent taken care of by title III of this bill, which I am not especially familiar with. Those are the provisions that were written in the Nye bill and reviewed by the Military Affairs Committee. That is a little outside the scope of our tax studies.

Senator BAILEY. Before you leave this, Mr. Chairman, I would like to have some provision made of that sort. I think it is a perfectly fair thing.

Senator CONNALLY. That seems to be covered in the section of this bill over which we have no jurisdiction, in the industrial sections. That is title II, page 202. Wasn't it true in the last war that the Government, in effect, did take over—not actually but through favorable contract and manufacturing agreements—all of that kind of things that were necessary for the War and the Navy Departments? I mean radio, submarine finders, and the like. I know that there was a branch of the War Department or the Navy that had the encouragement and handling of all of that new kind of equipment. I know there was a man here from my State that thought he had an apparatus for locating submarines by trigonometry and by triangulation an having listeners down in the water with microphones, as it were, at one end of the boat, and they would get a sound wave through the water over there, and they would get one over here, and they would triangulate it and figure it out and locate the submarine. I know that there was some branch of the War or Navy



Department that was handling those things, and if they found something they wanted, why they either made a contract with him to take it over and buy it or they made a war contract with him to manufacture the article.

Mr. BROWN. I am familiar with the apparatus the Senator refers to, since I was for a short time assigned for instruction with the submarine service during the war, but I am not familiar with the tax arrangements that were made. I do not know whether there are any of these gentlemen here who can speak on that or not.

Senator BAILEY. I think we ought to have a clause in the bill providing for that. You certainly want to encourage the inventive factor.

Senator CONNALLY. Would not amortization, in a sense, take care of that, provisions for amortization? And the Senator spoke of the expense of preparing the invention and experimenting with it. Would not those be necessary elements of deduction in the estimation of the tax derived from the invention?

Mr. CHESTEEN. There is provision in the law for depreciation and the cost of patents, just the same as the acquisition of any other depreciable property.

Senator CONNALLY. That is what I meant.

Mr. CHESTEEN. It is amortized over the life of the patent. So the taxpayer has adequate protection for the return of his cost tax-free.

Senator BAILEY. What do you mean by the "return of his cost", for the return of the patent or for the return of the cost that looks back to the period of experimentation?

Mr. CHESTEEN. Well, if he does not get it in one way he gets it in another. If it is not set up as a part of the cost of the patent, it is a part of the expense of the operation of the year in which the expenditure is made. That is a matter of bookkeeping, how much of those costs are really part of the cost of the patent and how much is experimental expense. You take very large corporations in the country that operate by using patents and you will find that they have a large experimental department. The cost runs into large figures.

Senator CONNALLY. They deduct that.

Mr. CHESTEEN. Some of that cost may be set up as the cost of patents, and a substantial portion of it is undoubtedly found to be experimental expense and did not result in any capital item, such as a patent they could use. Therefore, it is charged off in the year expended.

Senator BAILEY. We were upon yesterday discussing the period of amortization.

Senator CONNALLY. We adopted that this morning.

Senator BAILEY. It would not be difficult to add to that a special clause that amortization of scientific instruments be made on aircraft, explosives, and gases, as they are all a part of the war plan now. Shotguns do not have anything to do with war, you know. I believe that something should be allowed for the period of experimentation and preliminary steps when you came to calculate your amortization.

The whole idea in my mind is just this: If we ever have a war it is going to be fought by means of inventive genius rather than by men and animals. That is the way they are fighting in Ethiopia

right now, you know. They are not shooting much. They are just flying over those people and dropping chemicals on them. We are going to have that to deal with if we have a war. We ought to encourage brains over here to produce things of that sort, whatever they may be; we cannot imagine. But if you say to begin with, a man who does that shall receive no reward except 3 or 4 or 5 percent, he is going to apply his energies to something else. I want to fix it so he will have an inducement. I am not at all trying to write a bill that will prevent us from being prepared for war.

**Senator CONNALLY.** The economic sections in the revolving fund— isn't that exactly what they are designed for? The Government comes in and says, "Here, we will furnish you the money if you don't want to take the risk. We will finance you and develop this." That is taken care of in the bill.

**Mr. BROWN.** It might very well be taken care of by contractual amortization. If I understand Mr. Chesteen, and my own understanding is that, the provisions in existing law and which we are continuing in this act will make adequate provision, but beyond that there is contractual amortization as well as loans or subsidies under the other titles of the act. I think, Senator Bailey, that the situation is adequately covered in the provisions which you now have.

**Senator BAILEY.** I can write the amendment to express my thought.

**Mr. CHESTEEN.** Mr. Chairman, may I inquire whether you have settled the question of the taxing of foreign income on holdings, on dividends and interest and rent? All of that is in this pending bill in the House, and while we have no comments to submit, it occurred to us that that is a subject that you want to consider before disposing of the bill.

**Mr. BROWN.** I had understood on that, and, in my conversation with Mr. McLeod last evening, had tentatively asked him to consider rates applicable to those classes of taxpayers which would be comparable with the treatment accorded to such taxpayers, relatively speaking, under the Administration bill.

**Senator CONNALLY.** It had been my thought that we were going to carry forward those classes of the Administration bill, and that is consistent with the new rates.

**Mr. BROWN.** Yes. In other words, the new rates applicable would bear the same relationship to the corporation and individual rates in this bill as the treatment accorded to them in the peacetime bill bears to the other peacetime rates. I also asked them if they would not give special consideration to problems which were outside the tax structure, inasmuch as banks and insurance companies may possibly find it necessary to retain a larger portion of their earnings than other classes of taxpayers. In other words, I suggested that they consider this problem from the point of view of banking problems and the problems of insurance companies and any other related matters which seem to them pertinent, and they said that they would bear in mind those considerations.

**Senator CONNALLY.** In order to settle the matter, I make the motion that we carry forward into this bill the comparable provisions of the pending House bill with relation to collecting that sort of income on foreign corporations and nonresident aliens with rates

adjusted to proper ratio with the individual income-tax rates, and the corporation tax rates which we heretofore indicated. As many as favor that say "Aye." (Ayes.) Carried.

Senator BAILEY. What was your principle of amortization adopted this morning?

Senator CONNALLY. We have merged the two plans, one suggested by Mr. Chesteen, one by Mr. Brown. I expect one of them better explain it briefly.

Mr. BROWN. We have adopted features of both.

Senator CONNALLY. I say we have merged the two, some features of both, providing that when the war ends they should be allowed a reasonable amortization, and "reasonable" is one that the Commissioner would have to determine under all the circumstances of the particular case, taking into view the industry and the likelihood of its going on in peacetime, and we give them a 3-year period.

Mr. CHESTEEN. Yes.

Senator CONNALLY. We make a tentative allowance first, and then the taxpayer files his return for the last year of the war. We make a tentative allowance and then they work it out over a 3-year period and reexamine the returns of the taxpayer for that particular period with a view to adjusting and standardizing his allowance. Is that right, Mr. Chesteen?

Mr. CHESTEEN. Yes, sir; the same as treated in the 1918 act. We gave them a 3-year period in which to determine the usefulness of the property which taxpayers wanted to retain for peacetime purposes, and on the basis of the actual use of the property during that period the Bureau measured the excess cost.

Senator BAILEY. I do not believe I can write what I have in mind as "amortization." I will have to write it under another clause, if you want to reserve that until it comes before the committee.

Senator CONNALLY. All right; we will reserve that until we meet here further on, or when we report the matter, that is, at the meeting of the full committee.

Any other matters, gentlemen?

Mr. BROWN. There is the question of penalties that I mentioned a few minutes ago.

Senator CONNALLY. Penalties for nonpayment of tax?

Mr. BROWN. Yes, sir.

Senator BAILEY. Why not adopt the new revenue bill, whatever penalties there are?

Senator CONNALLY. Were you including more severe penalties in this wartime act than in the pending House bill?

Mr. BROWN. No, Senator. The Nye bill does raise the penalties from \$10,000 to \$100,000, and they also provide for a penalty for an additional tax.

Senator CONNALLY. Three times the tax?

Mr. BROWN. Yes; in certain situations. We pointed out that that was meaningless to some extent, because the provision applies to some persons who are not under any tax liabilities; so it would not do any good to multiply the tax liability by 3 in such cases.

Senator CONNALLY. What is your view to carrying forward simply the provisions of peacetime law on that?

Mr. BROWN. We suggest that; yes.

Senator CONNALLY. Do you make a motion to that effect?

Senator BAILEY. Yes.

Senator CONNALLY. The motion is that the committee adopt the peacetime-penalty provisions. All in favor say "Aye." (Ayes.) It is unanimously carried.

Now, is that all?

(Discussion off the record.)

Senator CONNALLY. Very well; we will hear from you Friday. With the permission of you gentlemen, the two staffs here, each of you may be called upon at any time to help work out any provisions that there is any haze or uncertainty about.

Mr. BROWN. We will be glad to have our people come up here; or glad to have them come down to us, whichever is more convenient.

Senator CONNALLY. We are all very much obliged to you, gentlemen. I want to take this occasion to say that, so far as the Treasury experts and the Joint Committee on Taxation's staffs are concerned, I feel they are very capable and efficient and loyal and able, and I congratulate the Government on having that kind of people in its service.

Senator BAILEY. Yes; that is right.

Senator CONNALLY. And we are very appreciative and grateful to you and hope you will continue to help us now to get this bill finally drafted and put back on the desks of the full committee. I will include the legislative counsel among the others as being efficient and able and capable and loyal in their services. It has been a long and tedious and complex and intricate task that we have had, and but for the assistance of counsel that you gentlemen have given us, we would not have gotten very far.

Mr. CHESTEEN. I want to say that Mr. Brown and I have worked independently on this, and we have tried to stimulate ideas that would provoke discussions by doing that. At times our ideas have coincided, and again we have had different views.

Senator CONNALLY. I think that has been helpful, if you do not always agree, because it gives us the double picture and we can decide what we want to do.

Mr. BROWN. Our relations with Mr. Chesteen and Mr. Parker have always been most cordial, and I certainly appreciate their cooperation and assistance.

Senator CONNALLY. If at any time you want me or any of us we will respond. If there is any doubt about what we want done we will be glad to come down and sit with you. Thank you all, gentlemen.

(Whereupon, at 12:15 p. m., the subcommittee adjourned, to meet at the call of the chairman.)